KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

Compelling Testimony From Non-U.S. Witnesses in Securities Law and White Collar Criminal Cases

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IN THIS ISSUE

The increasing globalization of hedge fund and private equity firms raises new questions of relevance to senior personnel who are charged with securities law violations and other claims of malfeasance. In addition, criminal prosecutions against individuals involved in alternative investment have been increasing steadily in recent years.

Imagine that you are a portfolio manager in the Greenwich or New York office of a hedge fund firm, with offices in various financial centers around the world. Imagine further that you are charged with some act of fraud in regards to your management of your particular fund. Although key witnesses are located in London and Geneva, they are willing to travel to the United States to testify for the prosecution. You, in turn, discover employees who would testify that you were correct in your activities, but they are unwilling to leave London or Geneva and unwilling voluntarily to produce documents that would corroborate their testimony.

Will you be able to secure evidence that could clear you when it is located outside the reach of U.S. courts?

The defense of white-collar crime increasingly involves the need to obtain evidence from witnesses located abroad. Without careful planning, exculpatory evidence may remain out of the reach of a defendant for whom such evidence is the only thing standing between him and a prison sentence.

Best Cases

Courts do not have the authority to compel foreign nationals to travel to the United States to testify. Thus, the most desirable scenario is where the foreign witness is willing to travel to the United States voluntarily. In that case, the only potential obstacle is obtaining a visa for entry into the country. Notably, the Fifth and Sixth Amendments require that the government act in good faith and not refuse to issue a visa in order to deny a defendant access to a material witness.

Nonetheless, it is advisable both to consult with immigration counsel and to make sure that the prosecutor communicates his consent to entry to the Department of State. The defense lawyer should also maintain regular contact with the witness to ensure that she remains willing to travel at trial time. An eleventh-hour change of heart will leave no time to take alternative measures to preserve the witness's testimony.

In the less-common situation where the witness is a U.S. national, courts do have the ability to issue subpoenas for U.S. testimony or documents. Under 28 U.S.C. § 1783, if a court finds it "necessary in the interest of justice," it may require a citizen or resident to return, as long as personal jurisdiction over that witness otherwise exists, an inquiry that primarily considers the witness's contacts with the United States.

Rule 15

However, in the above hypothetical, the non-U.S. witnesses are unwilling to travel to the United States to testify for the defense. In such cases, they may be able to testify in a deposition taken in the United Kingdom pursuant to Fed. R. Crim. P. 15. Rule 15 allows a party to depose an unavailable potential witness to preserve his testimony for trial, but only when exceptional circumstances exist.

When conducting a deposition abroad, counsel must ensure that the deposition complies with the Federal Rules of Evidence, is otherwise "taken and filed in the same manner as a deposition in a civil action," and includes cross-examination that mirrors what would be allowed at trial.

This typically requires a showing that:

1) the potential witness is unavailable to testify at trial; and
2) the witness's testimony is material, which is often a difficult standard to meet.

The grant of a Rule 15 motion is only the first step, however, as the defense lawyer must conduct the deposition in compliance with the foreign nation's laws. It is therefore critical to research those laws thoroughly and, ideally, to consult with an attorney practicing in the foreign jurisdiction. In countries that allow the taking of voluntary depositions by stipulation of the parties, the deposition can usually proceed in a fairly straightforward manner. In those that do not, it may be necessary to request assistance from the foreign court, as discussed further below. The defense lawyer should avoid this necessity if possible by asking the witness to travel to a country that allows voluntary depositions.

When conducting a deposition abroad, counsel must ensure that the deposition complies with the Federal Rules of Evidence, is otherwise "taken and filed in the same manner as a deposition in a civil action," and includes cross-examination that mirrors what would be allowed at trial. To be sure, depending on the country, this may be difficult, although perhaps in recognition of the difficulty of navigating foreign justice systems, courts have not always interpreted Rule 15 rigidly.

Compulsion of Evidence: MLATS and Letters Rogatory

But what if the foreign laws allow depositions, but the witness is unwilling to sit for one?

At that point, counsel must face the daunting process of seeking to compel evidence abroad. Although at first blush one might think that the many Mutual Legal Assistance Treaties (MLATs) that are in force may provide relief, those treaties apply to the government only, and most specifically exclude the creation of rights for criminal defendants. Although nothing prevents the defense lawyer from asking the prosecutor to use an MLAT on the defendant's behalf, that tack is highly unlikely to succeed.

Nevertheless, some have suggested that a bad-faith refusal by the Department of Justice (DOJ) to file an MLAT request could violate the compulsory process clause of the Sixth Amendment or the due process clause of the Fifth Amendment. Although the Supreme Court held long ago that the right to compulsory process does not extend to foreign witnesses who are beyond the power of our courts — see *Mancusi v. Stubbs*, 408 U.S. 204, 212-13 (1972) — the Court specifically relied on the lack of an existing procedure to compel evidence abroad for use in our courts. MLATs did not exist when *Mancusi* was decided in 1972, and its holding may be outdated. Arguably, the government now has the means to "compel" the attendance of foreign witnesses.

Thus, in a clear-cut case, the time may be ripe for a defendant to lodge an objection to a refusal by the DOJ to issue an MLAT. Such a case should involve clear, exculpatory evidence that is unobtainable by any other means. The reality, of course, is that most defendants will be left with the cumbersome letters rogatory process. A letter rogatory is a formal request for judicial action sent by a domestic court to a foreign court through diplomatic channels, and it typically must pass through numerous agencies and ministries. The process is extremely slow — it can take a year or more for a foreign court to receive and act on a letter rogatory, and there are no means of tracking its progress through the system. Even worse, a foreign court acts on a letter rogatory only as a matter of comity, with no relief available for a flat denial.

The defense lawyer should consult with the Department of State and local counsel at the foreign site in preparing a letter rogatory to ensure that all the requirements of the particular foreign jurisdiction are met. The defense lawyer should also keep in mind that depositions authorized in connection with a letter rogatory will be taken in accordance with the foreign jurisdiction's laws, which may prevent counsel from questioning the witness directly and may not provide for a verbatim transcript. That unfortunate circumstance could limit the evidence's admissibility at trial.

Conclusion

Mindful of these obstacles, our hypothetical portfolio manager hopes his London and Geneva witnesses are amenable to his overtures lest he spend months or years bogged down in the letters rogatory process. His lawyers must act quickly to identify any potential foreign witnesses and arrange to preserve their testimony and other evidence early in the preparation for trial. It remains to be seen whether the Supreme Court will ever order the government to file an MLAT request, but as the business, financial and law enforcement worlds increasingly transcend national borders, courts will inevitably face the issue someday soon.

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SEC Proposes Changes to Improve Access to Foreign Broker-Dealers

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The pace of internationalization of securities markets has been significant since the adoption of Rule 15a-6 in 1989. The industry has advocated the liberalization of Rule 15a-6 to expand cross-border access for market investors.

The Securities and Exchange Commission ("SEC") recently proposed amendments to Rule 15a-6 under the Securities Exchange Act of 1934 (the "Exchange Act"). Rule 15a-6 provides limited exemptions from registration and regulation as a broker-dealer to non-U.S. broker-dealers which engage in limited activities in the United States. The proposed amendments to Rule 15a-6 would expand the range of U.S. investors that non-U.S. broker-dealers may contact for the purpose of providing research reports and soliciting securities transactions. The proposed changes should increase access by U.S. investors to securities of non-U.S. issuers.

Current Rule

Rule 15a-6 permits an unregistered non-U.S. broker-dealer to engage in certain activities without being "chaperoned" by a registered broker-dealer, such as:

- Effecting "unsolicited" securities transactions for U.S. persons (however, the SEC has interpreted "solicitation" very broadly, thereby limiting its usefulness);
- Effecting and soliciting transactions for such as multilateral development banks and their affiliates, non-U.S. persons temporarily present in the United States, and U.S. citizens permanently located outside the United States; and
- Providing research reports to certain major institutional investors ($100 million in total assets).

Internationalization of Securities Markets

The pace of internationalization of securities markets has been significant since the adoption of Rule 15a-6 in 1989. The industry has advocated the liberalization of Rule 15a-6 to expand cross-border access for market investors. The SEC proposal addresses a number of specific areas under Rule 15a-6, including: (1) persons who can be contacted by a non-U.S. broker-dealer; (2) dissemination of quotes by non-U.S. broker-dealers; (3) distribution of research by non-U.S. broker-dealers; (4) execution of trades by non-U.S. broker-dealers; (5) counterparties and specific customers; and (6) providing information to U.S. customers regarding non-U.S. option exchanges.

Expansion of Qualified Investors

The proposed rule would expand the range of U.S. investors with which a non-U.S. broker-dealer could interact to include "qualified investors" as defined under Section 3(a)(54) of the Exchange Act. The proposal would allow additional investors to interact with non-U.S. broker-dealers by lowering the threshold for participation from major institutional investors to qualified investors with at least $25 million in investments. The SEC believes that the lower threshold reflects recognition of investors with the skills necessary to independently assess a non-U.S. broker-dealer's integrity and competence to access markets.

Unsolicited Trades on Quotation Systems

The SEC has previously determined that it would not consider a solicitation to have occurred for purposes of Rule 15a-6 if there were a U.S. distribution of non-U.S. broker-dealers' quotations by third-party systems, such as those operated by non-U.S. marketplaces or private vendors, that primarily distribute these quotations outside of the United States.

The SEC acknowledges in the proposal that third-party quotation systems have become increasingly global in scope such that there is no longer a meaningful distinction between systems that distribute quotations primarily in or outside the United States. Under the revised rule, the SEC would no longer require that a non-U.S. broker-dealer's (or third-party's) quotation system primarily distributes quotations outside of the United States to avoid being deemed a U.S. solicitation, in the absence of other contacts with a U.S. person.

Provision of Research Reports

The SEC proposes allowing non-U.S. broker-dealers to distribute research reports to, and effect transactions in the securities discussed in such reports with, "qualified investors," rather than restricting distribution of these reports to institutional investors with $100 million or more in assets.

Solicitation Transactions by Non-U.S. Broker Dealers

The proposed rules are intended to reduce the obligations of U.S. broker-dealers, under the chaperoning rules, in transactions between non-U.S. broker-dealers and qualified investors. The proposed amendments require that the non-U.S. broker-dealer be regulated by a foreign securities authority for conducting securities-related activities. Additionally, as a requirement of and in conjunction with each of the proposed amendments, non-U.S. broker-dealers will be required to disclose to U.S. investors that they are not subject to regulation by the SEC, U.S. bankruptcy law or any U.S. self-regulatory organization ("SRO").

Proposed Exemption (A)(1) — Non-U.S. Broker-Dealers Conducting "Foreign Business"

Proposed Exemption (A)(1) would allow non-U.S. broker-dealers to engage in full-service brokerage services to U.S. qualified investors if they are primarily engaged in a "foreign business." Foreign business would be defined to mean a business with U.S. qualified investors and foreign resident clients where at least 85% of the aggregate value of transactions effected during a two-year period is derived from non-U.S. securities.

If available, Exemption (A)(1) would allow non-U.S. broker-dealers to place in custody funds and securities of U.S. investors subject to the either of following requirements:

- A U.S. broker-dealer would be required to maintain the books and records for transactions with U.S. qualified investors, but could do so in accordance with the regulations of the foreign securities authority regulating the non-U.S. broker-dealer; or

- The U.S. broker-dealer with the non-U.S. broker-dealer could maintain the books and records relating to transactions subject to Exemption (A)(1) if the U.S. broker-dealer determines that it has access to such books and records from the non-U.S. broker-dealer upon request of the SEC.

Under Exemption (A)(1) the U.S. broker dealer would not be required to effect all aspects of the transaction. Therefore, with respect to transactions effected under Exemption (A)(1), the intermediating U.S. broker-dealer would no longer have to comply with federal securities laws and SRO rules applicable to a U.S. broker-dealer effecting a transaction in securities, unless it were otherwise involved in effecting the transaction. It is unclear how a U.S. broker-dealer would determine that records could be obtained from a non-U.S. broker-dealer, and would be able to maintain records with such non-U.S. broker-dealer. Additionally, non-U.S. broker-dealers may be reluctant to expose themselves to SEC scrutiny based on the maintenance of its records.

Proposed Exemption (A)(2) — U.S. Broker-Dealers as Intermediaries

Proposed Exemption (A)(2) would be available to non-U.S. broker-dealers that solicit transactions with U.S. qualified investors that have accounts, and place in custody their funds and securities, with U.S. registered broker-dealers. Under this exemption, the U.S. broker-dealer would be required to maintain the books and records relating to any transactions and to receive, deliver and safeguard funds and securities on behalf of clients in such transactions.

The primary benefit to a non-U.S. broker-dealer of Proposed Exemption (A)(1) would be the ability to place in custody funds and securities of a U.S. investor. Proposed Exemption (A)(2) would require the participation of a U.S. broker-dealer in a transaction as the custodian of funds and securities.

Sales Activities

Both proposed Exemptions (A)(1) and (A)(2) would eliminate the requirement in current Rule 15a-6(a)(3) that foreign associated persons be accompanied by an associated person of a U.S. registered broker-dealer during in-person visits with U.S. investors. The proposed rule also would eliminate the current requirement that an associated person of a U.S. registered broker-dealer participate in communications between foreign associated persons and U.S. investors, whether oral or electronic.

Qualification Standards

Non-U.S. broker-dealers intending to rely on proposed Rule 15a-6(a)(3) would need to meet certain qualification requirements. Under the proposed rule (as under the current rule), the non-U.S. broker-dealer would be required to provide to the SEC, upon request or pursuant to agreement between the SEC and any non-U.S. securities authority, information or documents related to the non-U.S. broker-dealer's activities in inducing or attempting to induce securities transactions by qualified investors.

> *Under the proposal, a non-U.S. broker-dealer would be permitted to effect transactions involving options on non-U.S. securities on the non-U.S. options exchange of which it is a member for a qualified investor, if the non-U.S. broker-dealer did not solicit the investor.*

The proposed rule also would require the non-U.S. broker-dealer to determine that its associated persons who effect transactions with qualified investors are not subject to a statutory disqualification under Section 3(a)(39) of the Exchange Act. This would be a change from the current rule which requires the U.S. registered broker-dealer intermediating the transaction to make this determination. The SEC believes shifting the responsibility for making the statutory disqualification determination would be appropriate because the non-U.S. broker-dealer is in possession of the relevant information regarding its foreign associated persons.

Foreign Resident Client and Foreign Options Exchanges

The SEC's proposal would allow non-U.S. broker-dealers to solicit and effect transactions involving "foreign resident clients." A "foreign resident client" would be defined as: (1) an entity not organized in the United States or engaged in a trade or business under United States tax laws; (2) a natural person who is not a United States resident under United States tax laws; or (3) an entity not organized in the United States and at least 85% owned by an entity or person that meets either of the first two definitions of a foreign resident client.

Familiarization with Non-U.S. Options Exchanges

Under the proposal, a non-U.S. broker-dealer would be permitted to effect transactions involving options on non-U.S. securities on the non-U.S. options exchange of which it is a member for a qualified investor, if the non-U.S. broker-dealer did not solicit the investor. The proposal would also permit certain activities by a non-U.S. options exchange representative or foreign office, which would include providing qualified investors with a disclosure document that describes the non-U.S. options exchange and, upon request by the investor, providing a list of participants that can take orders for that exchange.

Impact on Non-U.S. Broker-Dealers and U.S. Investors

The proposed amendments are expected to give a broader spectrum of U.S. investors an opportunity to acquire non-U.S. securities and information regarding non-U.S. securities markets. Non-U.S. broker-dealers should incur lower transaction costs and streamline the process to access U.S. markets. U.S. broker-dealers should also be able to provide a broader range of services and products to their clients.

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INVESTMENT FUNDS *New York Breakfast Series*

Wednesday, September 17, 2008

Recent Trends in Criminal Prosecutions and Regulatory Enforcement of Hedge Funds and Private Equity Funds – How to Stay One Step Ahead!

Hedge fund managers and private equity fund general partners are increasingly concerned about their potential exposure to enforcement actions by the Securities and Exchange Commission ("SEC") and criminal prosecutions. In a period of intense market dislocation and growing numbers of unhappy investors, regulators and prosecutors are taking notice of the alternative asset classes like never before.

With the recent creation of a new 25-person hedge fund task force within the SEC's Division of Enforcement dedicated to scrutinizing hedge funds and how they operate, a spate of enforcement actions and SEC investigations of hedge funds and their managers have been initiated. A string of aggressive and high-profile criminal prosecutions, culminating in the recent criminal charges brought against two former Bear Stearns hedge fund managers in New York, has followed as well. Private equity funds, although less prevalent in media reports and public debate, have similar cause for concern as many of these developments could equally apply to them in analogous circumstances.

Kaye Scholer's Eric H. Sussman and Daniel R. Alonso, former federal securities fraud prosecutors, will focus on several key issues that hedge fund and private equity professionals should bear in mind to avoid becoming an enforcement target for securities regulators and federal prosecutors.

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8:00 am	**Registration and Breakfast**
8:30 am	**Session**
9:10 am	**Q&A**
9:20 am	**Session Ends**

To receive a copy of the presentation materials, please send an email to: ncole@kayescholer.com.

German Private Equity Funds – Key Tax Issues

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Despite the many opportunities for investment, structuring and launching German private equity funds remains burdensome. For years, the volume of investments made in Germany has been significantly higher than the volume of investments managed in Germany.

Private equity has been booming in Germany in recent years as it has elsewhere in Europe. German private equity funds are focusing on many industry segments, such as mechanical engineering, information technology and the chemical industry. Over the decades, most of the target companies have been located in Bavaria and Baden-Württemberg. Bavaria's life science cluster is centred in Martinsried, and in the 1980s, most of the major U.S. hardware and software manufacturers settled in or around Munich. The Baden-Württemberg region has the highest concentration of high-technology companies in Europe.

Despite the many opportunities for investment, structuring and launching German private equity funds remains burdensome. For years, the volume of investments made in Germany has been significantly higher than the volume of investments managed in Germany. The reason lies in a unstable tax environment that does not provide international investors with the required amount of certainty that German private equity vehicles will be treated as a mere asset management that is without the scope of the trade tax. This trade tax can be avoided even in case of a trade or business if no Permanent Establishment is maintained in Germany.

The main fund vehicles currently offered primarily to German private equity investors is the GmbH & Co. KG. A limited partnership (*Kommanditgesellschaft* ("KG")) is a business partnership established by one or more limited partners (*Kommanditisten*) and a general partner (*Komplementär*). The GmbH & Co. KG, which conveniently combines the flexibility of a partnership with the limited liability of a corporation, allows partnership interests to be transferred without notarization and requires no minimum capital.

The main rules governing the KG are laid down in Sec. 161 *et seq.* of the German Commercial Code (*Handelsgesetzbuch*). The limited partners are generally excluded from the management of the limited partnership and they are prevented from representing the limited partnership: deviation is possible and often used in order to allow the sponsors to get access to their carry participation and thereby avoid the domestic partnership to be treated as a trade or business only by virtue of having only corporations as general partners, Sec. 15 para 3 ITA. On the other hand, the limited partners' liability is limited to their partnership contribution. This structure qualifies the limited partnership as a generally transparent investment vehicle.

The GmbH & Co. KG is, in general, tax-transparent except with regard to trade tax and VAT. No trade tax will be levied if it is neither a business partnership (*i.e.*, not a commercial trade or business but only an asset-holding partnership) nor a deemed business partnership as mentioned above for tax purposes.

Business and Non-Business Partnerships

In a decree dated December 16, 2003, the Federal Ministry of Finance (*Bundesministerium der Finanzen*) listed criteria for differentiating between business and non-business private equity partnerships. A private equity fund holding shares or interests in a portfolio company will normally be treated as non-business, if the following conditions are met:

- there is no debt financing of the investments at the partnership level;
- the partnership does not grant guarantees or securities for obligations of the portfolio companies;
- the partnership does not maintain its own substantial organization;
- the partnership does not use any market experience and abstains from active management activities in the portfolio companies;
- the sales proceeds are not reinvested; and
- the partnership does not offer any participation to the public or render services to third parties.

The decree indicates that a partnership might be treated as a business if the above criteria are not met; however, the "overall picture," taking all facts and circumstances into account, is decisive.

For early-stage and other venture capital investments, the newly-introduced Venture Capital Participation Company (*Wagniskapitalbeteiligungsgesellschaft*) provides for a non-business qualification. This qualification, however, is only granted where certain restrictions are met (*e.g.*, a minimum fund capital of 1 million, a minimum fund investment of 25,000, a maximum share in the portfolio company of 90%, *etc.*).

The charaterization as a business partnership is important for trade tax purposes but also for the taxability of capital gains on the individual's partner level. Capital gains within a trade or business are subject to income tax whereas capital gains from the sale or exchange of stocks are not; if the participation is lower than 1%. Theses rules will change with effect to shares acquired from 2009 on.

Basis of Taxation

Investors in the partnership are liable for income tax when income is received by the partnership, as the income is directly attributed to the partner for tax purposes. If, therefore, proceeds are reinvested (or otherwise not distributed), the investors are still liable for taxes on the profits and gains without having received them.

If a withholding tax has been deducted from dividend income received by the GmbH & Co. KG from German corporations, the GmbH & Co. KG, that maintains a trade or business in Germany, will receive an appropriate tax credit for its German investors, which is passed on, *pro rata*, to these investors. The position for non-residents is the same as for residents if the GmbH & Co. KG is qualified as a business partnership, because in this case the partners are treated as having a fractional permanent establishment through the partnership in Germany. On income arising from a permanent establishment, either individual income tax or corporate income tax, as applicable, is levied from non-resident investors. Foreign investors are not able to credit withholding taxes if they are invested in a KG that maintains a mere asset management.

Upon the disposal of an interest in a non-business partnership (*vermögensverwaltende Personengesellschaft*), the partner will be treated as if he had held the assets of the partnership directly (look-through perspective).

The winding-up profits on the liquidation of the GmbH & Co. KG, even if it maintains a trade or business, are not subject to a trade tax as long as profits are distributed to individuals. Income tax applies to each partner. Each private individual partner may be entitled to a reduced income tax rate, determined as if only 1/5 of the capital gains from the sale were realized in that year if he is not taxed in the highest tax bracket. Corporate partners are subject to trade tax in case of a liquidation of a KG that maintains a trade or business and a domestic PE.

> *The tax authorities are now beginning to question whether the general rule of a VAT exemption of a partnership's balance sheet profits should also apply to private equity partnerships.*

In contrast to the GmbH, the GmbH & Co. KG structure in general allows investors to offset losses against profits at the investor level. A loss is attributed on a *pro rata* basis to each partner and can principally be offset against his income from other sources for corporate income tax and, if the GmbH & Co. KG is transparent for trade tax, at the level of the investor.

A foreign individual who is a partner of a business partnership will usually pay the tax at the same rate on income from the partnership as a German resident partner (with the exception of church tax and tax benefits granted to married couples filing a joint tax return).

However, a different treatment would be applicable for foreign investors who are partners in a non-business partnership. As such, these foreign investors are subject to tax in Germany only in case of German sourced income. In addition, depending on whether the country of residence of the foreign investor and Germany have entered into a double-taxation treaty, the right to tax may be with the country of residence of the foreign investor.

Income Tax

A partnership fund does not constitute a taxable entity. The partners will be taxed on their shares of income.

Domestic corporate partners will be able to claim the participation exemption on dividend income as well as capital gains on stock as well as the participation exemption for trade tax purposes (under different and additional requirements if they or the KG maintains a trade or business). Foreign corporate partners will be able to claim the zero-withholding tax rate on dividend income according to the EU Parent-Subsidiary Directive and/or where treaty protection provides that the German anti-treaty shopping rules are respected.

Domestic individual partners will be able to claim a 50% participation exemption on dividends and capital gains on stock (of participation of at least 1%) as well as the participation exemption for trade tax purposes (under different conditions if they or the KG maintains a trade or business) should they maintain a trade or business. Foreign individual partners will be able to claim a reduced withholding tax rate under the applicable double-tax treaty on the gross dividend.

VAT

A current investment of a private equity fund will need further support from the fund's management entity. Certain supervisory and consulting functions might therefore be implemented at the level of the fund entity. This may raise VAT questions.

Under a decree dated May 31, 2007, services will be subject to VAT if they are rendered in Germany for remuneration. Whereas the location of the rendered service may not be subject to structuring, the remuneration could be structured. No VAT-taxable remuneration would be assumed if either a shareholder or a partner renders services vis-à-vis its subsidiary or partnership and if the services are rendered in connection with the position as a shareholder or partner. as a contribution in kind. To the contrary, a generally VAT-taxable remuneration would be assumed if a shareholder or partner renders services and receives fees as though it were a third party.

A non-taxable remuneration by virtue of a contribution basically requires that the payment be interpreted as part of the partnership's income distribution. There are several small distinctions which determine such characterisation and its VAT consequences.

Payments made during the first "poor" years of a fund's life cycle need even more consideration. Withdrawals from the partners' capital reserve accounts have to be reported in the partnership's profit-and-loss statement, and might increase the so-called balance sheet profits. The tax authorities are now beginning to question whether the general rule of a VAT exemption of a partnership's balance sheet profits should also apply to private equity partnerships.

The same distinction will be made with regard to the income distribution if the fund itself renders services vis-à-vis its subsidiary or partnership.

Conclusion

Germany offers a limited partnership structure to private equity sponsors in the form of the GmbH & Co. KG as well as other partnership forms. The essential qualification as a non-business partnership can only be secured by a careful structuring of the GP/LP contractual relationship as well as of the underlying investments; it is only necessary in case of a domestic partnership or domestic investors because otherwise neither Trade Tax could be triggered nor the German capital gains tax may apply. The newly-introduced Venture Capital Participation Company (*Wagniskapitalbeteiligungsgesellschaft)* guarantees a non-business qualification for early-stage and other venture capital funds, but carries so many restrictions that probably few German VCs will chose this vehicle.

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Should Sovereign Wealth Funds be Regulated?
(*Part 2*)

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There have also been indications that the U.S. Congress will consider adopting specific federal legislation to regulate SWFs if the IMF does not shortly produce a global voluntary code of conduct to govern them.

Despite calls from individual European countries such as France and Germany for the introduction of stringent EU regulations to govern the operation of sovereign wealth funds ("SWFs") in the EU (effectively entrenching both a review procedure along principles similar to that in the U.S. along with the reintroduction of the ability of individual EU member state governments to retain "golden shares" in certain instances involving the proposed acquisition of strategic assets), the official response of the EU Commission has been fairly timid.

The EU Commission has clearly rejected any radical protectionist EU response to SWF's in favor of the adoption of a voluntary code of conduct for SWF's operating in the EU, with the fairly weak threat of the adoption of a more stringent approach in the event that the code is not voluntarily embraced by SWFs. The code to be developed will be further based on the following primary principles, being (i) a commitment to an open investment environment both in the EU and elsewhere, (ii) support of multilateral work in organizations such as the IMF and OECD, (iii) use of existing instruments at EU and member state level, (iv) respect for EC Treaty obligations and international commitments, (v) proportionality and transparency and (vi) good corporate governance of SWFs.

The U.S. Regulatory Response

In the United States, the passing of the Foreign Investment and National Security Act ("FINSA") in 2007, which amends the Exon-Florio Amendment to the Defense Production Act of 1950 (and which was passed largely following the aftermath of the failed Dubai Ports World deal) and the related amendment to Executive Order 11858 concerning foreign investment review by the Committee on Foreign Investment in the United States ("CFIUS"), provides increasing restrictions through the expansion of the concept of "national security" to include infrastructure-related assets and more rigorous review by CFIUS on investment by foreign governments applicable to SWF's. The U.S. Treasury Department also recently published proposed regulations implementing FINSA. The proposed regulations also directly address issues surrounding investment by SWF's in U.S. companies. The new proposed regulations for example:

(i) explicitly provide that "control" for the purposes of FINSA may be exercised through minority ownership interest, including minority interests constituting less than 10% of the voting securities of a U.S. company, unless such interest can be considered solely a passive investment. This clarification is in direct response to the recent acquisitions by SWFs of less than 10% minority stakes in U.S. investment banks designed to take advantage of the "safe harbor" exemption available under the regulations for a foreign investment of 10% or less of the voting securities of a U.S. company, and thus avoid a lengthy CFIUS review; and

(ii) require CFIUS to conduct a formal 45-day review of any proposed foreign investment by an entity controlled by a foreign government, unless both the Treasury Secretary and the head of the lead reviewing agency conclude after review that any such transaction will not threaten U.S. national security.

There have also been indications that the U.S. Congress will consider adopting specific federal legislation to regulate SWFs if the IMF does not shortly produce a global voluntary code of conduct to govern them. Regulation is also being considered at the state rather than federal level. A proposed piece of legislation known as the "Responsible Private Equity Investment Act" was, for example, introduced for discussion in the state assembly of California that would prevent large state pension plans such as the California Public Employees' Retirement System ("CALPERS") and the California State Teachers' Retirement System ("CALSTRS") from investing in private-equity firms owned in whole or in part by an SWF, or in any private investment

The IMF International Working Group on Sovereign Wealth Funds (consisting of representatives from 25 IMF member countries as well as observers from each of the OECD, World Bank and Saudi Arabia) has announced that it has reached a preliminary agreement on a set of twenty-four voluntary principles known as the "Generally Accepted Principles and Practices For Sovereign Wealth Funds" or "GAPP."

funds managed by such private-equity firms, where the SWF is funded by governments which are not party to international treaties concerning the protection of international human rights or have been found to be in continual violation of human rights. Given the current size of the investments of such pension funds in blue chip private equity management firms such as Blackstone, Carlyle, Apollo and their related private investment funds as well as the significant proportion comprised by these investments in the top performing investments of the entire investment portfolio of each of CALPERS and CALSTRS, it would seem that any such regulation as proposed would be completely impractical and indeed the proposed legislation has been withdrawn (although its proponents contend that such withdrawal constitutes a delay rather than an outright abandonment of such legislation). This represents a clear example of how in the absence of a coherent regulatory policy unmanaged and uniformed public alarm concerning SWFs can lead to an ill conceived and fragmented national regulatory response. The U.S. Securities and Exchange Commission has also expressed concern that SWFs potentially run a significant risk of insider trading given their access to "material non-public information" by virtue of their government links and further that regulation of such entities would be difficult given that any investigation of an SWF would require the co-operation of a foreign government which at the same time owned and operated an SWF under investigation thereby creating an inherent conflict of interest situation. Another idea mooted to ensure that SWFs adhere to any established regulatory guidelines would be to make their current U.S. federal tax exemption under section 892 of the U.S. Internal Revenue Code contingent on such adherence. It is clear that the increase in regulatory scrutiny over the past six months has cooled SWF sentiment for investment in the U.S. as evidenced by the marked drop in direct investment by SW's in U.S. companies when compared with the beginning of the year.

Despite the strong political rhetoric in the U.S. (at both the state and federal level) as well as in the EU on this issue, the effects of the sub-prime crisis means that the economies of most EU countries as well as that of the U.S. cannot afford to adopt stringent protectionist regulation.

The way forward: Adoption of an international code of conduct

The initial reaction of certain SWFs to proposals for regulation has been to reject the idea of any formal regulation and further characterize such proposals as a disguised form of financial protectionism on the basis that they (i) operate on strictly commercial terms akin to large private investment funds and are thus motivated exclusively by long-term growth and a higher return on invested capital rather than geopolitical concerns as is evident, it is argued, from the fact that the majority of the SWF investments made to date have been small non-voting equity stakes with no corporate governance rights in non-sensitive industry sectors, and (ii) do not constitute a systemic risk in that they are, unlike private investment funds, long-term and not speculative investors (generally having unleveraged positions), meaning that their investment activities are likely to have a stabilizing rather than a disruptive effect on international financial markets over the long term.

This general statement as a summary rationale for the absence of any regulation is, however, inherently flawed. First, many of the SWFs exist and operate in politically autocratic states in which it is difficult to accept that they would operate immune from potential political interference without the imposition of some form of international mandatory rules. Second, the lack of transparency and accountability which are inherent features of many SWFs are likely to produce and perpetuate inherent market instability given that (i) mere rumors or speculation will, absent clear information concerning their investment policies and given the significance of the size of their investments, exist in international financial markets, and (ii) there is a more significant risk given the absence of external regulatory and internal oversight of SWFs of destabilizing "rogue trader" incidents.

Despite the heated nature of the current debate it is clear that some form of compromise will need to be reached, given the economic imperative of both sides to do so. SWFs require access to the well-developed and liquid financial markets of certain Recipient Countries in order to ensure that their large capital surpluses remain invested in a diversified portfolio of higher yield investments, whilst many Recipient Countries remain in desperate need of such foreign investment either to shore up the balance sheets of ailing financial institutions or to fund large current account deficits. It is the nature of such regulatory compromise that now remains the challenge.

Attempts have been made by a few individual countries to reach a unilateral agreement at the international level. The U.S., Abu Dhabi and Singapore have agreed on a broad set of principles to govern the conduct of SWFs, including: (i) commercial rather than a geopolitical criteria for investment decisions, (ii) greater information disclosure by SWFs, (iii) strong corporate governance and operational risk management systems, (iv) fair competition with the private sector, and (v) compliance with applicable regulatory and disclosure requirements of the host country. The parties also agreed on four policy principles governing countries receiving foreign investment from SWFs ("Recipient Countries"): (i) non-protectionist barriers to foreign direct investment, (ii) clear and predictable inward investment frameworks, (iii) non-discrimination amongst investors and (iv) proportionality of regulatory inward response in the case of genuine national security concerns raised by transactions involving SWFs.

Given the global nature of this issue, and the participation of national governments rather than purely private participants, regulation (and indeed sanction in the case of non-compliance) would however be most effectively coordinated at the international multilateral level through international financial institutions such as the G7, the IMF and the OECD rather than at national (and in the case of the U.S., state) level. Indeed most of the current efforts to crystallize a set of principles to govern the conduct of SWFs as well as Recipient Countries, either at the national or international level, have stressed that such measures are merely precursors to the development and adoption of a comprehensive and detailed framework of principles to be developed by each of the IMF and the OECD.

The OECD has published its report dealing with best practices for Recipient Countries, which provides a more detailed focus on the inward investment policies of Recipient Countries based on four broad principles: (i) non-discrimination between similarly situated investors, (ii) transparency and predictability of regulatory objectives and policies, (iii) regulatory proportionality, and (iv) accountability of regulatory authorities.

The IMF International Working Group on Sovereign Wealth Funds, a body constituted by the IMF in order to facilitate the development of a best practice code of conduct to govern SWFs (and consisting of representatives from 25 IMF member countries as well as observers from each of the OECD, World Bank and Saudi Arabia), has announced that it has reached a preliminary agreement on a set of twenty-four voluntary principles known as the "Generally Accepted Principles and Practices For Sovereign Wealth Funds" or "GAPP," designed to address the key issues of concern for Recipient Countries in relation to the activities of SWFs such as institutional structure, risk management, transparency, accountability and political neutrality in investment management.

Compromise, in the context of the above, therefore requires Recipient Countries to resist financial protectionism by embracing the best practice guidelines recently proposed by the OECD and SWFs in turn to accept a form of voluntary regulation in accordance with GAPP.

The voluntary and substantively vague nature of GAPP however represents the greatest danger to the effectiveness of the proposed regulatory compromise. In order to stress the non-binding nature of the principles, SWFs have rejected the use of terminology such as a "code of practice" or "rules of conduct" to describe GAPP as well as any suggestion from the IMF that it be charged with monitoring ongoing SWF compliance with GAPP. Furthermore, GAPP seemingly will not require SWFs to disclose their size, details of their portfolio holdings or voting records in respect of investments, thereby doing little to address the key concern of transparency.

Given the voluntary and substantively vague nature of GAPP, certain SWFs (most likely those emanating from countries constituting emerging geopolitical rivals to many Recipient Countries), are likely to do little in the short-to-medium term to fully embrace the proposed guidelines on a purely voluntary basis (even in its current mild form), with the inevitable consequence being a backlash by some Recipient Countries (and in the case of the U.S., potentially some individual states) in the form of a range of fragmented individual and protectionist regulatory measures in clear violation of the OECD principles, which could disrupt the efficiency of global capital flows and thereby further severely damage global economic growth.

The most effective policy response from a regulatory perspective in implementing any such compromise would be, however, to adopt a mandatory international code of regulatory conduct to govern SWF's premised on the basis of the broad policy principles proposed by each of the OECD and the IMF and policed by international bodies such as the G7, OECD and the IMF. This policy response does not presume that the mere act of labeling such a code as "mandatory" or "binding" will in itself provide sufficient leverage to ensure compliance without enforcement, however, it is clearly more attractive than the current proposal which is destined to render the code a "toothless tiger" from the outset thereby increasing the prospect of the negative outcome described above. Consequently, the proposed alternative (assuming that the binding nature of the code does not result in a further compromise on the substance of the provisions) is more likely to achieve the ultimate goal of the regulatory compromise, being the maintenance of global capital flow efficiency while at the same time addressing the legitimate political and economic systemic issues which are inherent in the global investment activities of SWFs.

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NEWS ALERT Cash Solicitation Rule Does Not Apply to Investment Funds

The staff of the Securities and Exchange Commission (the "SEC") issued a no-action letter on July 15, 2008, clarifying that Rule 206(4)-3 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), known as the "cash solicitation rule," does not apply to a registered investment adviser's cash payment to a person solely to compensate that person for soliciting investors or prospective investors for an investment pool managed by the adviser.

Section 206(4) of the Advisers Act makes it unlawful for any investment adviser to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative, and authorizes the SEC by rules and regulations to define and prescribe means reasonably designed to prevent such acts, practices and courses of business. Rule 206(4)-3 under the Advisers Act makes it unlawful for any investment adviser required to be registered under the Advisers Act to pay a cash fee, directly or indirectly, to a solicitor "with respect to solicitation activities" unless the payments are made in compliance with conditions set forth therein. The SEC intended for Rule 206(4)-3 to address the conflicts of interest inherent in certain cash solicitation arrangements.

While a literal reading of Rule 206(4)-3 could view it as applying to cash payments made by advisers to others to compensate them for soliciting investors for investment pools managed by the advisers, the staff believes that the SEC did not intend for the Rule to apply to those payments. First, the SEC releases proposing and adopting Rule 206(4)-3 did not contain any statements suggesting that the Rule would apply to cash payments by advisers to others solely to compensate them for soliciting investors for investment pools managed by the advisers. Second, the Rule is designed to apply to solicitations and referrals in which the solicited or referred persons may ultimately enter into investment advisory contracts with the investment adviser, yet investors in investment pools (as such) do not typically enter into investment advisory contracts with the investment advisers of the pools. Third, the Rule's use of the terms "client" and "prospective client," rather than "investor" or "prospective investor," also suggests that the Rule was intended to apply to solicitations and referrals in which the solicited or referred persons may ultimately enter into investment advisory contracts with the adviser.

Furthermore, the *Goldstein* decision supports a narrow interpretation of the Rule. In *Goldstein*, the court stated that, for purposes of Section 206 of the Advisers Act, investors in a pooled investment vehicle are not "clients" of the investment adviser of the pool. Similarly, the SEC staff believes that references to "client" and "prospective client" in Rule 206(4)-3 should not be interpreted to include investors or prospective investors in investment pools.

Whether a registered investment adviser's cash payment to a person is being made solely to compensate that person for soliciting or referring investors or prospective investors to invest in investment pools managed by the adviser will depend upon all of the facts and circumstances of the particular case. In the SEC staff's view, the most pertinent factors generally will include the nature of the arrangement between the soliciting/referring person and the adviser, the nature of the relationship between the adviser and the solicited/referred person, and the purpose of the adviser's cash payment to such person.

For example, the Rule would not appear to apply to an adviser's cash payment to a referring/soliciting person, where the adviser manages or seeks to manage only investment pools and is not seeking to enter into investment advisory relationships with other persons, and the payment compensates the referring person solely for referring persons to invest in the pools managed by the adviser. However, the Rule would seem to apply if the adviser manages or seeks to manage investment pools and individual accounts, and is seeking to enter into investment advisory relationships with other persons, and its cash payments compensate the referring person for referring investors as prospective advisory clients.

If Rule 206(4)-3 does not apply to an investment adviser, it follows that the referring person would not be required by the Rule to provide the investor or the prospective investor with either the written agreement specified in Rule 206(4)(a)(1)(iii) under the Advisers Act or the investment adviser's written disclosure statement specified in Rule 204-3 under the Advisers Act. Importantly, even if Rule 206(4)-3 does not apply to a particular situation, the soliciting/referring person may generally be required by Section 206 of the Advisers Act to disclose to the investor or prospective investor material facts relating to conflicts of interests. Depending upon the circumstances, a soliciting/referring person may be "advising others ... as to the advisability of investing in ... securities" within the meaning of Section 202(a)(11) of the Advisers Act, and thus may be an investment adviser subject to Section 206 of the Advisers Act.

The SEC did not address whether a person's receipt of cash compensation from an investment adviser of an investment pool for soliciting or referring investors or prospective investors to invest in the pool would result in the person being considered a "broker" under Section 3(a)(4) of the Securities Exchange Act of 1934, as amended.

The SEC no-action letter is available online at: http://www.sec.gov/divisions/investment/noaction/2008/mayerbrown071508-206.htm

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