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INVESTMENT FUNDS NEWSLETTER

The Proposed European Directive on Alternative Investment Fund Managers

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What Does the Directive Cover?

The draft directive (the "Directive") will apply to alternative investment fund managers ("AIFMs") established in a European Union ("EU") member state who have alternative investment funds ("AIFs") under management with a value of more than €100 million, unless the AIFs concerned have no leverage and there is a lock-in period of five years or more, where the threshold is raised to €500 million.

AIFs are any funds that are not regulated under the Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive, whether domiciled inside or outside the EU. This wide definition means that not only hedge funds and private equity funds are covered, but also real estate funds, commodity funds and infrastructure funds. Private equity funds (particularly start-ups and venture capital funds) may find the higher threshold useful in excluding them from regulation, though it will be of less value to buyout funds.

Credit institutions (*i.e.*, banks) are excluded from the scope of the Directive, provided that the management services are provided through a separate division and not through a subsidiary. Also excluded, it would appear (because they are not AIFMs as defined), are distributor/placement firms that provide marketing services to AIFs.

Those AIFMs in the EU managing AIFs below the €100 million (or €500 million) threshold will remain subject to their home state regulation and supervision, which will vary from state to state. However, Member States must provide a mechanism for such AIFMs to opt-in to regulation under the Directive.

The Directive is a "framework directive," which means that it sets out general principles only. Consequently, many details are unclear at this stage, such as what happens when the assets under management fluctuate above and below the threshold. If the Directive comes into force, we can expect the detail to take the form of a further directive, as in the case of the Markets in Financial Instruments Directive ("MiFID").

What Does the Directive Require of AIFMs

AIFMs within the scope of the Directive are required to be authorized by the Member State in which they are established. Applications for authorization must include details of all those who have a 10% or greater interest in the AIFM, a business plan, and the characteristics of the AIFs that will be managed. Completed applications must be processed within two months, which will require a significant acceleration of the process for some regulators. The FSA, for instance, which already requires AIFMs in the U.K. to be authorized, currently has six months to determine such applications.

AIFMs are also subject to conduct of business requirements, which in broad terms requires them to behave honestly and fairly, and to act in the best interests of the AIF and its investors. No investor can be given preferential treatment, unless this is disclosed in the AIF rules or instruments of incorporation. Side letters and other similar arrangements therefore require disclosure, though it is not clear whether this means giving full details of the arrangements, rather than a general statement of the existence of such arrangements and the areas that they cover, which is sufficient under current guidance from the Alternative Investment

Management Association ("AIMA"). In addition, AIFMs will be required to comply with conflicts of interest, risk management, liquidity management and investment in securitisation obligations.

Finally, for each AIF that it manages, an AIFM is required to ensure that an independent valuation firm is appointed, along with a depositary. The depositary must be an EU credit institution.

Are There Capital Requirements?

The Directive sets a minimum capital requirement for AIFMs of €125,000. Where the AIFs managed by the AIFM exceed €250 million, there will be an extra capital requirement of 0.02% of the excess over 250 million. As many U.K. private equity firms are currently required to operate with much lower capital, this provision could have a large impact.

How Does the Directive Treat Marketing of AIFs?

An AIFM covered by the Directive may market AIFs to professional investors in its home Member State, and also to retail investors if the Member State permits. In addition, it may market the AIFs to professional investors in all other Member States. This marketing "passport" will be very welcome to those AIFMs who currently struggle with a multitude of local marketing requirements in the EU. However, the initial use of the "passport" is restricted, applying only in respect of AIFs domiciled in the EU.

AIFMs marketing non-EU AIFs in the EU will therefore remain subject to local marketing requirements, until the "third country" provisions of the Directive come into force, three years after the main provisions. The Commission, perhaps optimistically, believes that the main provisions could be in force by 2011, so an EU-based AIFM marketing Cayman funds will need to wait until 2014 to take advantage of the passport — assuming that it can meet the additional marketing conditions that apply (see below).

What Impact Will the Directive Have on Non-EU AIFMs and AIFs?

A significant one. EU-based AIFMs will be able to take advantage of the marketing "passport" for non-EU based AIFs three years after the rest of the Directive comes into force. However, this can occur only if the country in which the AIF is domiciled has entered into an agreement with the Member State in which the marketing is to occur, under which tax information on individuals is to be shared in compliance with Article 26 of the OECD Model Tax Convention (an "Article 26 tax agreement"). This may severely restrict the availability of the "passport": for instance, the Cayman Islands, home to over 9,000 hedge funds, currently has such arrangements only with certain Scandinavian members of the EU.

Member States may authorize non-EU AIFMs provided that certain conditions are met, including the AIFM providing information about itself and the AIFs it manages, the European Commission deeming that the country in which the AIFM is established has equivalent prudential and on-going supervision requirements to those of the EU, and there being an Article 26 tax agreement in place between the country in which the AIFM is established and the Member State concerned. However, it will be very difficult for any non-EU AIFM to satisfy these conditions. For instance, U.S. hedge fund managers would not meet them, as they are not currently subject to capital requirements.

It would appear that if non-EU AIFMs are not authorised under the Directive, they will not be able to market AIFs (whether located in or outside the EU) anywhere in the EU, even though they can currently do so under the rules of individual Member States. The only recourse in that circumstance (other than to ignore the EU market altogether) would be for the non-EU AIFM to establish an EU-based subsidiary and for that entity to apply for authorization under the Directive in the normal way. However, that solution would not in itself solve all the problems: affiliates of U.S.-based AIFMs may find the requirement for the AIF to have an independent valuation firm particularly troublesome, given that this is not standard practice in the U.S. hedge fund industry.

How have the proposals been received?

Poorly. The British Venture Capital Association described the Directive as "irrational," pointing out that it had not been consulted on the proposals event though the UK is home to more than half of the European private equity industry. In AIMA's view, the Directive contains "many ill-considered provisions which are impracticable and may prove unworkable." Almost the only point on which all parties agree is the Commission's comment that the Directive will be "the object of intense political discussion and negotiation" in the coming months. AIFMs both in and outside the EU will anxiously await the outcome.

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Implications for Private Equity Funds with Portfolio Company Pension Liability

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In September 2007, the Appeals Board of the Pension Benefit Guaranty Corporation ("PBGC") held a private equity fund liable for the pension underfunding of one of the fund's bankrupt portfolio companies. Since that decision was issued, and given the important and possibly severe economic implications for private equity funds, funds must remain focused on this issue and follow on-going developments in this area.

Background

Under the Employee Retirement Income Security Act of 1974 ("ERISA"), when a pension plan sponsor terminates a plan, members of the sponsor's "controlled group" are jointly and severally liable for the corresponding unfunded liabilities, even though the members may have had no relationship to the pension plan. Entities are part of the same controlled group if they are (1) engaged in a "trade or business" and (2) under "common control." Generally, a parent-subsidiary group is under common control where the parent owns at least 80% of the stock of the subsidiary, based upon either voting power or value, or, in the case of a partnership, at least 80% of the capital or profits interest.

Accordingly, if a private equity fund engages in a trade or business and owns at least an 80% interest in a portfolio company, it may be liable for certain pension and benefits liabilities of the portfolio company. The controlled group liabilities would generally not extend further up the ownership chain to the fund's partners, unless any partner acquired an 80% or greater capital or profits interest in the fund. However, under partnership law, the general partner of the fund would be ultimately responsible for any liabilities incurred by the fund, including the pension liabilities described herein.

Until the PBGC's decision, many practitioners had taken the position that private equity funds were not "trades or businesses" and, therefore, were shielded from the pension liabilities of their portfolio companies. The decision, however, reveals that the PBGC disagrees.

Until the PBGC's decision, many practitioners had taken the position that private equity funds were not "trades or businesses" and, therefore, were shielded from the pension liabilities of their portfolio companies.

Decision

The private equity fund ("Fund") involved in the decision was a Delaware limited partnership. The Fund owned a 96% interest in a Delaware corporation, which had sponsored a pension plan that was terminated when the corporation filed for bankruptcy. The PBGC asserted that the Fund, as a member of the corporation's controlled group, was liable for the corporation's more than $3,000,000 in unfunded pension liabilities arising from the plan's termination.

The Fund disputed any liability, arguing that it could not be in the corporation's controlled group because the Fund was not engaged in a trade or business. The Fund argued that it was merely a "passive investment vehicle that has no employees, no involvement in the day-to-day operations of its investments and no income other than passive investment income."

The PBGC rejected the Fund's argument and held the Fund liable for its portfolio company's termination liability. The PBGC distinguished its decision from cases where individuals with passive investment activities were found not to have been conducting a trade or business. The PBGC explained that the

Fund, unlike the taxpayers in those cases, was actively involved in its investments as evidenced by the general partners' investment and management services and compensation for such services. The Fund was formed as a business entity "to select, acquire, dispose of, and manage investments ... through its agent," unlike individual taxpayers who invest their own money for their own gain.

Implications

Aside from the obvious effect that private equity funds (and members of their controlled group) may be liable for the pension plan termination liability of their portfolio companies, the decision has implications for numerous other situations in which liability can be imposed on funds. If the PBGC's interpretation of engaging in "trade or business" is followed by arbitrators and/or courts, a private equity fund that owns 80% of its portfolio company may be liable for the withdrawal liability incurred by a portfolio company when it withdraws from a multi-employer pension plan. Also, portfolio companies may be barred from terminating underfunded pension plans unless all members of the controlled group are in bankruptcy or liquidation. Further, the fund may be liable for certain COBRA payments, PBGC premiums and excise taxes for failing to meet minimum funding standards.

Credit agreements may also be impacted by the decision. Credit agreements often contain clauses that prohibit the underfunding of any pension plans in the debtor's controlled group, as well as require certain financial covenants to be maintained. An underfunded pension plan sponsored by a portfolio company could cause a different portfolio company owned by the fund, or the fund itself, to be in violation of its ERISA or financial covenants.

Since the issuance of the PBGC decision, we have been awaiting further interpretative guidance. To date, however, there has been no guidance — one way or the other — from federal courts on whether they will apply the PBGC's position. However, because the structure of the Fund in the PBGC decision is similar to that of many private equity funds, it is reasonable to expect that the PBGC will pursue other funds going forward. Given the potentially large liabilities, prudent private equity funds should use careful planning before acquiring portfolio companies and in determining the ownership levels of such companies.

Recommendations

One way to avoid the issue, or minimize its impact, is to perform thorough due diligence on target companies and their ERISA-controlled groups. Due diligence should enable private equity funds to determine whether a target's pension plan is underfunded and whether there exists potential multi-employer pension plan withdrawal liability. If so, the private equity fund may consider reflecting these potential liabilities in the purchase price. Due diligence should also be used to determine whether the target is a member of a "controlled group" with plan sponsors whose plans are or may become underfunded. The due diligence should be continued after the deal closes, because plan underfunding fluctuates with, among other things, changes in the equity markets, debt markets, and plan sponsor's workforce.

Another possible way to avoid liability is to structure the acquisition such that, even if the private equity fund is engaged in a trade or business, the fund is not under "common control" with the target. This can be achieved in several ways. For example, the fund may keep its ownership level, by vote and value, to less than the 80% threshold. Alternately, the private equity firm might split the interest in the target among two or more of its funds, if possible, or employ an alternative investment vehicle, either of which can dilute the fund's interest in the target to under 80%. Even in the event of such a bifurcation, there remains a risk that the PBGC could posit that the investment is, in effect, maintained by a single entity, in which event the PBGC decision could be applied.

Importantly, since this area of law continues to evolve, funds should remain updated on developments, both administrative and judicial. While these potential control group liabilities have been largely ignored in the past, the risk of having liabilities assessed against a fund or among portfolio companies has substantially increased based upon the PBGC's position and the current lack of judicial authority to the contrary.

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Credit Default Swaps — In Regulatory Flux

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The SEC has been a harbinger of changes to come in credit default swap regulation. One of the first steps has been the establishment of clearinghouses as central counterparties for certain credit default swaps, which the SEC has facilitated through exemptive orders and an interim final rule.

The credit default swap, once an esoteric financial instrument, has by now become a familiar villain in the credit crisis. Politically, it is a prime and present target for regulation. Regulators seem to have concluded that the credit default swap, by increasing the systematic risk faced by banks around the world, played a causal role in spreading and multiplying the crisis. In addition, some regulators have become concerned that the credit default swap is hampering economic recovery. As credit default swap contracts generally pay protection buyers only at default on the underlying obligation, some bondholders have purportedly withheld their consent to restructurings, preferring the higher payment provided by their credit default swap contracts when the debtor entered bankruptcy to the reduced amounts proffered in the proposed restructuring.[1] As a result, the era of the unregulated credit default swap is drawing to a close.

The Commercial Role of Credit Default Swaps

The first credit default swaps were invented by the derivatives team at JPMorgan Chase & Co. in the mid-1990s. Initially, they were a way of reinvigorating the bank's declining derivatives business.[2] Yet, because they could also be used to shift the risk of default on JPMorgan's loans to third parties, credit default swaps had the added potential to reduce the amount of regulatory capital the bank was required to hold, freeing that capital for other uses.

In short order, credit default swaps were a hugely successful derivatives innovation. Today, the notional value of the credit default swap market is estimated to be in excess of $45 trillion,[3] while the entire over-the-counter derivatives market of which they are a part is estimated at approximately $600 trillion. This amounts to roughly ten times the world's gross domestic product, $60.7 trillion, as estimated by the International Monetary Fund.[4]

Still, the notional value of credit default swaps and other over-the-counter derivatives may be misleadingly large. Sellers of credit default swaps often bought protection in turn, hedging their exposure, and adding large dollar amounts to the total notional value of the entire credit default swap market at each step in the chain. For example, the notional value of all credit default swaps tied to the Lehman Brothers bankruptcy was approximately $365 billion. Upon settlement, approximately $7.3 billion in cashflows, or a net 2% exposure, was actually exchanged between the protection buyers and sellers.[5]

Similar net-percentage exposures throughout the credit default swap market, although they would greatly reduce the $45 trillion estimate, would still amount to quite a large market: approximately $1 trillion in net exposure related to credit default swaps worldwide. It is also worth noting that 2% of the entire over-the-counter derivatives market would mean approximately $12 trillion in worldwide exposure, nearly the same as the entire gross domestic product of the United States, $14.3 trillion. Any changes in regulation of the credit default swap market, or indeed in regula-

1 White, George. "How will CDS dealers react to regulation?" *Dealscape*, May 14,2009.
2 Tett, Gillian. "The Dream Machine: Invention of Credit Derivatives." *Financial Times*, March 24, 2006.
3 Schmitt, Rick. "Prophet and Loss." *Stanford Magazine*, March/April 2009.
4 International Monetary Fund. *World Economic Outlook Database*, April 2009.
5 van Duyn, Aline and Nicole Bullock. "Lehman CDS pay-outs higher than expected." *Financial Times*, October 10, 2008.

tion of the larger derivatives market of which it is but a part, will have significant consequences for the financial industry.

Historical and Current Regulation of Credit Default Swaps

Historically, the regulatory scheme for credit default swaps has been piecemeal, not commensurate with the significance of the market and subject to little, if any, public disclosure of the trades taking place. For this reason, markets in credit default swaps and other over-the-counter derivatives have been referred to as "dark markets,"[6] or more commonly, as the "shadow banking system."[7]

However, this is the very reason most often cited for the rapid mushrooming of credit default swaps. Such contracts were exempted from many regulations that apply to other financial instruments. In 1993, the Commodity Futures Trading Commission ("CFTC") exempted from regulation certain over-the-counter derivatives traded between two parties, such as the credit default swap, under the rationale that sophisticated investors who engaged in such trades could best police their own interests. In addition, the Commodity Futures Modernization Act of 2000 ensured that credit default swaps would not generally be considered futures contracts, which would be traded through a central clearinghouse and subject to additional regulation.[8]

The Securities and Exchange Commission ("SEC") has also maintained that it has little power to regulate credit default swaps. This was primarily because the Gramm-Leach-Bliley Act amended the Securities Act of 1933, Section 2A, to exclude security-based swap agreements from the definition of "security" and the Securities Exchange Act of 1934, Section 3A, to exclude any swap agreements from the definition of "security," seeming largely to remove credit default swaps from the ambit of the SEC. In 2006, the then-Chairman of the SEC stated in a Congressional hearing that "neither the SEC nor any regulator has authority over the CDS market" and that SEC enforcement powers were limited to antifraud provisions.[9] Together, these Congressional, CFTC and SEC-related actions and omissions left the credit default swaps market essentially immune to regulatory authority.

In recent months, the SEC has changed its course somewhat, filing charges against a former hedge fund manager for insider trading related to credit default swaps and promising further enforcement to come. The change in direction seems informed by a reinterpretation of the Gramm-Leach-Bliley Act, which suggests security-based swap agreements, when traded through a central clearinghouse, are not in fact exempt from regulation by the SEC.

Current Intentions Regarding Regulation

The SEC has been a harbinger of changes to come in credit default swap regulation. One of the first steps has been the establishment of clearinghouses as central counterparties for certain credit default swaps, which the SEC has facilitated through exemptive orders and an interim final rule.[10]

On May 13, 2009, the U.S. Department of the Treasury, SEC and CFTC also issued a statement requesting Congress to amend the Commodity Exchange Act[11] and securities laws, as well as "any other relevant laws."[12] The stated goals of this plan include promoting transparency and efficiency in the credit default swap market, and reducing fraud, market manipulation, exploitation of unsophisticated parties and accumulation of systemic risk.

The statement went on to detail specific steps which the Treasury, SEC and CFTC felt needed to be taken. They asked Congress to require clearinghouses to enforce significant margin requirements on over-the-counter derivatives dealers. To prevent parties from creating customized over-the-counter derivatives solely to escape the regulated clearinghouses, they suggested Congress enact a presumption that, once a regulated clearinghouse has accepted a certain type of over-the-counter derivative for clearing, all derivatives of that type would be considered standardized contracts that must be cleared.

The SEC and CFTC would also be more clearly empowered, through a "robust and appropriate regime of prudential supervision and regulation," to enforce a sys-

6 Cho. David and Zachary A. Goldfarb. "U.S. Pushes Ahead With Derivatives Regulation." *The Washington Post*, May 14, 2009.

7 Tett, Gillian and Paul J. Davies. "Out of the shadows: How banking's secret system broke down." *Financial Times*, December 16, 2007.

8 Labaton, Stephen and Jackie Calmes. "Obama Proposes a First Overhaul of Finance Rules." *The New York Times*, May 14, 2009.

9 Rappaport, Liz. "As SEC Steps Up Vigilance, It's Policing Some New Beats." *The Wall Street Journal*, May 7, 2009.

10 Securities and Exchange Commission. Release Nos. 33-8999; 34-59246; 39-2549. Jan. 14, 2009. "Temporary Exemptions for Eligible Credit Default Swaps to Facilitate Operation of Central Counterparties to Clear and Settle Credit Default Swaps."

11 7 U.S.C. § 1, *et seq.*

12 Letter from Timothy F. Geithner, Secretary of the Treasury, to Senator Henry Reid. May 13, 2009.

tem of recordkeeping and reporting for credit default swaps. This system would capture all over-the-counter derivatives dealers, including those trading in customized over-the counter derivatives that need not be cleared, and "all other firms whose activities in those markets create large exposures to counterparties." The aggregated data collected in this manner would then be provided to the public.

The Obama administration on May 14, 2009, echoed the statements from the Treasury, SEC and CFTC, and also made a point of requesting that Congress tighten the regulation on derivatives as quickly as possible and calling for the repeal of much of the Commodity Futures Modernization Act of 2000.

The Treasury, SEC and CFTC also stated that regulators should cooperate with non-United States jurisdictions to promote more standard derivatives regulation internationally, and prevent the migration of trades out of the United States. The worry is that too-stringent rules in the United States would simply send the over-the-counter derivatives market elsewhere.

Responding to some of the issues and questions outlined above, on June 16, 2009, the Obama administration distributed a more detailed White Paper providing clarity and specificity on its proposal to regulate over-the-counter derivatives.[13] The administration plans to ask Congress to take legislative action as soon as possible to give the SEC and CFTC greatly enhanced control of over-the-counter derivatives trades.[14]

The White Paper fleshes out what promises to be a significant change in the way derivatives are regulated in the United States. First, margin requirements and regulatory capital requirements exceeding those currently required of banks would be instituted for trades in over-the-counter derivatives. Second, both the SEC and CFTC would be empowered to require recordkeeping and reporting from parties trading in over-the-counter derivatives, including collecting data on customized derivative trades that would not be cleared through a centralized counterparty. Third, in certain instances the CFTC would be allowed to place limits on positions taken in over-the-counter derivatives.

The regulatory regime outside the United States is developing independently and rapidly. Some members of the European Parliament are adamant that the EU should continue updating its regulations to protect EU financial markets from the future spread of financial crises from the United States. Recently, the European Parliament approved legislation, to take effect in 2011, that requires banks in the European Union to maintain a 5% position in any structured assets they sell to investors. In addition, EU banks will not be permitted to buy any structured assets from banks, including those in the United States or in other non-EU jurisdictions, whose originating lenders or investment bank sponsors do not also adhere to the 5% retention requirement minimum.[15] It remains to be seen how changes in other jurisdictions will affect the decisions to be made in the evolving United States regulations, and vice versa.

In addition to the potential for multiple schemes of regulation in different jurisdictions, it is likely that increased transparency will decrease the profitability of credit default swaps and other over-the-counter derivatives, a not insubstantial concern given the size of the market. Disclosure may have a similar profit-dampening effect as the introduction of the Trace reporting system for corporate bonds in 2002, which reduced the bid-ask spread on investment-grade corporate bonds from approximately seven basis points to four basis points.[16]

Because of the large financial stakes in the over-the-counter derivatives market and the worldwide political saliency of financial regulation in the wake of the current credit and liquidity crisis, the regulation of credit default swaps is likely to be a much-debated and ongoing project in the coming months and years. Whether or not the proposed changes will themselves change, it remains virtually certain that the credit default swap is on the cusp of major regulatory reinvention.

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[13] *See* Department of the Treasury, Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation, available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.
[14] Wells, Robert and Sarah N. Lynch. "Obama Wants SEC, CFTC to Police Derivatives." *The Wall Street Journal,*. June 18, 2009.
[15] Rega, John. "EU Revamps Bank Capital, Asset-Backed Rules in Crisis." *Bloomberg*, May 6, 2009.
[16] Leising, Matthew. "Regulators Seek Trace-Like Reporting for Derivatives." *Bloomberg*, May 14, 2009.

Legal Due Diligence Considerations for Hedge Fund Investors

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The current turmoil in global capital markets, as well as the recent wide-scale frauds allegedly perpetrated by Bernard Madoff, Robert Allen Stanford, and Paul Greenwood and Stephen Walsh have reaffirmed the importance of the due diligence process in making well-informed investment decisions.[1] For potential investors in hedge funds or similar pooled investment vehicles, about which little or no public information is typically available,[2] due diligence is essential in order to obtain the information material to an assessment of such an investment. This article will focus on legal issues related to hedge fund investments that should be considered by the investor and its legal counsel in conducting this due diligence.

With bank failures a real possibility in the current environment, having several reputable prime broker relationships reduces the fund's exposure to counterparty and liquidity risk.

The Due Diligence Process

The due diligence process should be a wide-ranging investigatory exercise conducted by an investor in conjunction with the investor's legal, tax, accounting and financial advisers. This investigation should include, among other things, requests for information from and interviews with the hedge fund manager, its principals and related parties, counterparties and service providers. The due diligence process should be designed to gain a full understanding of the business and operations of a hedge fund, with a view toward accurately assessing the particular risks involved and if possible, negotiating more favorable terms for the investor.

These goals may be complicated by the competing objective of the hedge fund manager to preserve confidentiality in order to maintain a competitive advantage. While this concern may be legitimate, intentional obfuscation or even reluctant cooperation by the hedge fund manager in the due diligence process should be taken seriously by the investor, as it may indicate larger issues. The circumstances surrounding the Madoff situation should be instructive on this point. Mr. Madoff reportedly rejected prospective investors who asked too many questions about the potential investment.[3]

While each potential hedge fund investment opportunity is unique and the legal

1 Neither Bernard Madoff ("Madoff") nor Robert Allen Stanford ("Stanford") structured his investment vehicles as hedge funds. Madoff investor funds were ostensibly held as individual accounts in the broker-dealer arm of Bernard L. Madoff Investment Securities LLC ("BMIS"), an entity controlled by Madoff. Madoff's investment strategy was then purportedly executed in each account by the investment adviser arm of BMIS, which had discretionary authority to make trades in the accounts. The alleged Stanford scheme involved the sale of what were nominally high-yield certificates of deposit by the Stanford-controlled Stanford International Bank, acting through affiliated broker-dealer and investment adviser entities. However, a significant number of both Madoff and Stanford's investors were themselves hedge funds (see the "Funds of Funds" section of this article).

2 A movement toward increased regulation of private funds and their advisers may be underway. Legislation has recently been proposed that would require, among other things, fund manager registration, ongoing reporting requirements and stricter investor suitability standards. See S. 344: http://grassley.senate.gov/private/upload/01292009-2.pdf and H.R. 711: http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.711.IH:. However, a rule enacted in December 2004 by the Securities and Exchange Commission ("SEC") requiring many hedge fund managers to register as investment advisers under the Investment Advisers Act of 1940 was overturned by the United States Court of Appeals for the District of Columbia. Goldstein v. Sec. and Exch. Comm'n, 2006 WL 1715766 (D.C. Cir. June 23, 2006).

3 Paul Katzeff, "How You Can Avoid Ponzi Schemes," Investor's Business Daily, Dec. 24, 2008, available at 2008 WLNR 24613100.

due diligence process should be tailored accordingly, investigation and analysis of the following areas are likely to prove useful: the terms of the investment, the rights of the investor relative to other investors, the fund's relationships with its service providers, operational issues, structuring issues, and issues related to the nature of the fund's proposed investments.

Investment Terms

The documents that govern the terms of the investment and the day-to-day operations of the fund provide a starting point. While the basic terms of a hedge fund investment will typically be described in an offering memorandum, review of the constituent documents of the fund entities, as well as binding fund subscription materials, is critical. Unsurprisingly, hedge fund investment terms generally favor the hedge fund manager.[4] However, the investor and its legal counsel should carefully consider the following issues and, if appropriate and feasible, seek to negotiate[5] the relevant investment terms:

- <u>*Limitations on Redemptions*</u> — Limitations on an investor's ability to redeem its interest in the fund may include: lock-ups, penalties for early withdrawal and gates. While restrictions on redemptions may, to a certain extent, serve the legitimate purpose of protecting non-redeeming investors from a "run" on the fund's assets, counsel, in consultation with the investor's other advisors, should, at a minimum, confirm that such restrictions appear reasonable in light of the nature and liquidity profile of the fund's underlying investments.

- <u>*In-Kind Distributions*</u> — Hedge fund agreements commonly include provisions that permit in-kind distributions of the fund's assets to hedge fund investors. A distribution in-kind of such securities would result in the investor holding the securities in its own name, along with any contractual obligations attendant to those securities, including margin calls, payments, guarantees or other liabilities. Investors should consider negotiating for limitations on the ability of the manager to make in-kind distributions of securities with such accompanying obligations.

- <u>*Conflicts of Interest*</u> — Managers may manage several funds that compete for investment opportunities. In order to deal with any fiduciary duties that may otherwise restrict the manager's ability to make differing investment decisions among its managed funds, hedge fund agreements will typically (i) disclose that the manager manages other funds and that investments made by the manager may not be allocated *pro rata* among the managed funds and (ii) expressly permit the manager to engage in transactions and arrangements in which the manager has a conflict of interest. Managers generally consider lack of approval procedures for their engaging in interested transactions as necessary to allow them to implement their investment strategies and to react quickly to changes in the market for the underlying investments, without the cumbersome process of approval by independent directors or another governing body. Counsel should, at a minimum, confirm that the lack of restrictions appears reasonable in light of the manager's investment strategy and the nature and liquidity profile of the fund's underlying investments. Counsel should also confirm, or consider negotiating for, restrictions on the manager's ability to engage in interested transactions with respect to side pockets, where the manager's ability to react quickly to changes in the market for underlying assets is generally not a concern.

- <u>*Side Pockets*</u> — Hedge fund agreements may allow the fund to hold certain investments that are illiquid or of indeterminate value in segregated pools known as "side pockets." Investments held in these side pockets are valued separately from the rest of the fund's portfolio, typically at the lower of acquisition cost or fair value, and the investors' participation in the side pocket may be involuntary. Unlike assets held in the general fund portfolio, fund managers typically do not receive performance fees on the side pocket assets until the assets are liquidated or become readily valued. Likewise, investors' interests in side pocket assets are typically held until such assets are liquidated, at which time the investor is paid its *pro rata* portion of the liquidation value, subject to applicable fees and expenses.

4 Reasons for this historical trend include the "intent of hedge funds to invest with minimal constraints, a focus on liability concerns, and supply and demand considerations in the investment marketplace." Report of the Investors' Committee to the President's Working Group on Financial Markets, Principals and Best Practices for Hedge Fund Investors, 43 (January 15, 2009), available at http://www.amaicmte.org/Public/Investors%20Report%20-%20Final.pdf.

5 Recently, certain hedge fund managers have shown an increased willingness to negotiate investment terms. (See, e.g., David Walker and Stephanie Baum, "Perry Halves Performance Fee," The Wall Street Journal, February 22, 2009, available at http://online.wsj.com). New hedge fund managers have historically been more willing to negotiate terms and provide concessions, as compared to more established and successful managers. Negotiation of investment terms by an investor will typically be accomplished through the use of side letters.

Concerns have been raised that "hedge funds may hide poor-performing assets in side pocket accounts to exclude such assets from the fund's valuation for purposes of calculating performance fees."[6] Counsel should consider the manager's authority to transfer portfolio assets into side pockets and should confirm that investors are entitled to adequate disclosure of allocation and removal of assets from side pockets as well as the related valuation procedures.

- Key Man Provisions — Many hedge funds rely significantly on the expertise and capabilities of certain individuals, such as a portfolio manager, and the success of a fund may be highly dependent on the contributions of such individuals. A hedge fund agreement may or may not include a redemption right that is triggered by the loss of such individuals. Counsel should inquire about the risks associated with the loss of particular individuals and ascertain whether any such redemption provisions are present.[7]
- Valuation of Fund Assets — While it is common for fund agreements to afford managers broad discretion in the valuation of fund assets, many larger hedge funds will seek valuation opinions from independent third parties, including, for example, accounting firms, prime brokers, broker-dealers and, for certain types of esoteric assets, a third-party with specialized knowledge of such assets. Counsel should identify any third party valuators and inquire as to their valuation methods to ensure that such third parties do not rely too extensively on information provided by the fund manager (and not otherwise verified) in making their valuations. If the fund does not employ third-party valuators, counsel should consider negotiating for the requirement that the manager retain a third-party valuator that is acceptable to the investor.
- Other Powers of the Hedge Fund Manager — Hedge fund agreements typically limit the fiduciary duties owed by the fund manager to its investors and provide broad and unrestricted power for the hedge fund manager, including the authority to implement the fund's investment strategy and, in certain circumstances, to withdraw as hedge fund manager. Counsel should evaluate these powers and authorities and should also review the extent to which the fund manager may unilaterally amend the terms of the fund agreements

Rights Relative to Other Investors

Counsel should closely review the rights of the investor relative to other investors in the fund. It is common practice for hedge fund managers to enter into side letters, particularly with large investors or investors making early investments in a fund. Although hedge fund managers have historically been reluctant to make them available, counsel should request disclosure of the terms of any side letters. More favorable terms offered to other investors may profoundly affect the calculus of risks associated with the investment.

Counsel should closely review the rights of the investor relative to other investors in the fund. It is common practice for hedge fund managers to enter into side letters, particularly with large investors or investors making early investments in a fund.

Investors should be particularly wary of side letters providing for preferential liquidity or transparency terms for other investors. For example, a side letter that affords another investor greater transparency rights would provide that investor with a first look at any problems developing with the hedge fund, and would effectively give that investor the opportunity to redeem its interest before other investors knew of the problems. Any such effective redemption preference has particular importance in the context of a failed hedge fund.

In general, in an action by the receiver of a failed hedge fund to recover amounts paid to a redeeming investor prior to the collapse of such hedge fund, courts have allowed the redeeming investor to retain the amount of its initial investment, provided that the

[6] Scott J. Lederman, *Hedge Fund Regulation*, Practising Law Institute, Rel. #1, §2:3.3 (March 2007), *citing* Remarks of Roel C. Campos, SEC Commissioner, before the SIA Funds and Alternative Investment Conference (June 14, 2006).

[7] Report of the Investors' Committee at 21.

redemption payment was valid and proper under the governing documents of the fund, and that the redemption was taken by the investor in good faith. This has the effect of depleting the remaining assets available to creditors of the failed fund, including any investors that did not redeem in advance of the fund's collapse.

Service Providers

Counsel should review and evaluate the relationships between the hedge fund and its service providers. The absence of reputable, independent service providers should raise a red flag in the due diligence process. For example, it has been widely reported that Madoff utilized an affiliated broker-dealer as custodian of the securities of his investors and to purportedly execute trades on behalf of their accounts. This lack of third-party involvement allegedly allowed Madoff to falsify account statements and to operate for years without ever actually executing a trade.[8] In addition, despite the size of the Madoff operation (allegedly in excess of $50 billion), a relatively unknown, three-employee outside auditor was engaged to conduct the fund's audit.[9]

Perhaps the most important third-party relationship, for purposes of the due diligence process, is that of the fund's prime broker. A prime broker provides a hedge fund with services including custody of assets, clearing and settlement of trades with executing brokers, financing for trading positions, reporting and record keeping. The close and often long-term nature of the relationship between a prime broker and a hedge fund makes the prime broker a key source of information in the due diligence process. A prime broker will typically have day-to-day interaction with the hedge fund and will therefore have an inside look at any operational deficiencies of the fund. Likewise, reputable prime brokers will themselves often conduct rigorous due diligence on hedge funds prior to providing the fund with financing, particularly given the current state of credit markets.

Counsel should inquire whether it would be possible to interview representatives of the prime broker and perhaps seek to obtain the prime broker's diligence materials. Investors should inquire whether the fund has ever been denied financing by a prime broker or had a relationship with a prime broker terminated outright. With bank failures a real possibility in the current environment, having several reputable prime broker relationships reduces the fund's exposure to counterparty and liquidity risk.

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Operational Issues

Studies have indicated that a significant percentage of hedge fund failures result from operational deficiencies,[10] which may include, among other things, inadequacies in a hedge fund's processes or the controls in place to prevent conflicts of interest with individuals involved in the hedge fund's operations. Although it is common for the fund manager to have broad control of a fund's operations, a fund's risk management and compliance functions can mitigate potential conflicts of interest, abuse of power and fraud. Counsel should inquire whether the fund has an independent and comprehensive risk compliance function that is segregated from portfolio management and whose compensation is unrelated to the fund's performance.[11]

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8 *See, e.g.,* Diana B. Henriques, "Madoff Never Made Supposed Investments," *The New York Times,* February 20, 2009, available at http://www.nytimes.com.

9 *See, e.g.,* Floyd Norris, "More Oversight for Auditor of Madoff," *The New York Times,* January 8, 2009, available at http://www.nytimes.com.

10 Yarden at 18, *citing* Stephen Brown, William Goetzmann, Bing Liang and Christopher Schwartz, "Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration," *Journal of Finance* (forthcoming, Yale ICF Working Paper No. 06- 15, dated: April 23, 2008, available at Social Science Research Network), p. 6.

11 Report of the Investors' Committee at 26.

Structure and Domicile

Some hedge funds employ structures including multiple offshore entities. While such structures are often driven by tax considerations, counsel should consider whether the resulting governance arrangements raise particular issues.[12] If the investor's direct interest is to be held in an offshore entity or fund assets are held in offshore entities, counsel should consider, with respect to the foreign jurisdiction: the level of regulatory oversight of hedge funds, whether the fund manager is equipped to fulfill the jurisdiction's regulatory obligations, whether the judicial system will provide adequate recourse in the event that litigation is necessary, whether the jurisdiction requires compliance with U.S. Generally Accepted Accounting Principles or International Financial Reporting Standards, the jurisdiction's bankruptcy and insolvency laws, and the political stability of the jurisdiction.[13]

Funds of Funds

There are many types of hedge fund investments, including funds of hedge funds, a common variation of a traditional hedge fund that invests in other hedge funds rather than making direct investments in publicly-traded securities or other instruments. While such variations may have certain advantages for investors when compared with traditional hedge funds, they present a challenge to conducting effective due diligence.

Any due diligence performed on a fund of funds may be insufficient to expose deficiencies and risks that exist in the underlying funds. It may be impractical or impossible for an investor in a fund of funds to conduct any due diligence on the underlying funds. Therefore, the investor is forced to rely on the due diligence conducted by the fund of funds on its underlying investments. Counsel to investors in funds of funds should seek to review the investment due diligence procedures of the fund of funds and consider their adequacy. To the extent available and practical, counsel should also seek to review due diligence materials provided by the underlying funds to the fund of funds.

Conclusion

Today's economic climate has placed a renewed emphasis on the utility of a rigorous due diligence process in making informed investment decisions. Legal due diligence helps to identify many of the risks associated with a prospective hedge fund investment and, when considered in conjunction with due diligence conducted by the investor's tax, accounting and financial advisers, will assist the investor to base its investment decision upon a comprehensive analysis.

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[12] In particular, oversight by an independent board of directors of an offshore hedge fund structured as a corporation may counterbalance the broad authority a fund manager. Report of the Investors' Committee at 40-41.

[13] Report of the Investors' Committee at 42-43.

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