KAYE SCHOLER LLP

# INVESTMENT FUNDS NEWSLETTER

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## IN THIS ISSUE



## Islamic Investment Funds — A New Frontier for Fund Managers and Sponsors

Modern Islamic banking is just 35 years old, increasing from US$10 million in 1975 to now over US$250 billion under management with dedicated Islamic banks, together with another US$200 billion with units of conventional financial institutions. This rapid expansion in just three decades has not only attracted the interest of conventional bankers and borrowers, but also increasingly of investment fund structurers and promoters. Western financial institutions are working closely with their Islamic counterparts to develop this sector and meet the needs of a huge customer base worldwide.

It is worthwhile noting that Islamic finance is not confined to Muslim countries but is spread over Europe, the United States and the Far East; nor is it limited to Islamic borrowers, but is also used by many companies as an alternative source of funds. The principles of Islamic banking are similar in many respects to conventional banking, asset financing and project financing principles commonly used and applied under English law worldwide.

### Islamic Finance

Islamic finance is the application of the *Sharia* to the finance sector. Although it is most well known for its prohibition of interest, *Sharia* is, in fact, a wholly different "philosophy" from the conventional western outlook of finance. The *Sharia* explains in detail the Islamic concepts of money and capital, the relationship between risk and profit, and the social responsibilities of financial institutions and individuals. Based on this philosophy, *Sharia*-compliant instruments and techniques have been developed and successfully used by Islamic finance units and customers worldwide in the funding of items such as property, ships, hotels and power plants.

The payment or receipt of all forms of usury (*Riba*) is strictly forbidden by the *Quran*, as well as gambling and uncertainty. Therefore, all sorts of interest payments common in conventional banking fall under the category of *Riba*, whether disguised as "commission," a fixed or variable add-on or a discount.

The purpose of this prohibition is to prevent exploitation from the use of money and to share profit and loss. Money should be used for a proper economic purpose and not treated as a commodity on which a return can be made by reference to time. Islamic scholars agree money is simply a means of exchange and not an asset, and should therefore not grow over time. However, capital can earn the returns derived from the productive use of capital.

It is also forbidden for any Islamic institution or investment fund to deal in the following goods:

(a) alcoholic drinks;

(b) pork, ham, bacon and related by-products;

(c) dead animals (*i.e.*, those not slaughtered according to the rules of the *Sharia*);

(d) gambling machines;

(e) anti-social and immoral goods such as tobacco, pornography, drugs, *etc.*;

(f) gold and silver, except for spot cash; and

(g) armaments and destructive weapons.

Since almost all of today's companies deal with some form of interest or otherwise prohibited activity, some *Sharia* advisory boards have determined an upper limit to what percentage of a company's income can be earned through interest and/or such activities. It would be unacceptable to invest in a firm that exceeds this limit.

## Islamic Investment Funds Structures

As shown above, Islamic instruments can be used in many types of fund structures. *Sharia*-compliant property funds, in particular, are increasingly being used in the U.K. and are promoted by many institutions. Investors from the Middle East have long regarded commercial real estate as a favorite form of investment, with an emphasis on certain commercial property sectors and geographic regions.

Islamic investment funds operate by investors contributing money that is then invested so that profit can be earned in a manner compliant with *Sharia*. The validity of the units, shares or certificates issued in the fund is subject to two conditions.

First, they must carry a *pro rata* profit actually earned by the fund, instead of a fixed return being tied up with their face value. As stated earlier, neither principal nor profit can be guaranteed and profit/loss must be in proportion to how successful the fund is. If the fund earns large profits, the return on the investor's subscription will increase to that proportion. However, if the fund suffers a loss, the investor will also have to share in the loss.

Second, the amounts pooled must be invested in *Sharia*-compliant trading activity companies. If, for example, the fund invests in the hotel or leisure sector, the *Sharia* board must be satisfied that the income that will be used to repay the investors, in the form of rental or return on investment, is not made up of income from the sale of prohibited items such as alcohol. If it is, then such income must be below certain thresholds (as agreed by the *Sharia* board); otherwise, the proportion of income derived from interest or alcohol that exceeds such thresholds must be given to charity.

In *Ijara* funds, the amount subscribed is used to purchase real estate (via a special purpose vehicle) for the purpose of leasing out the real estate and charging rental, which then forms the income of the fund that is distributed *pro rata* to subscribers, who hold certificates of proportional entitlement that represent *pro rata* ownership of their holdings in the tangible assets of the funds (also known as *sukuk*). These funds are normally marketed to high-net-worth individuals or banks. The life of the fund is usually fixed.

A *sukuk* is fully negotiable and can be bought and sold on the secondary market. New purchasers of *sukuk* "step into the shoes" of the original holder, taking the certificate (ownership) and hence, all the profit, but also the rights, obligations and liabilities that accompany it.

Requirements for validity include that leased assets must have some usufruct, assets must be *Sharia* compliant in their nature and the lessor must abide by any ownership responsibilities imposed by *Sharia*. In addition, rental must be fixed and known by the parties (or ascertainable by means of a formula) at the beginning of a contract.

## *Sharia* Advisory Boards

All financial institutions that offer *Sharia*-based services or products (such as investment funds) will have a *Sharia* committee or board. These boards are comprised of Islamic scholars and practitioners who provide the Islamic financial institutions with guidance and supervision. The *Sharia* board members are independent of the Islamic finance institution and are not employees. Like an audit by an accounting firm, these boards often submit a *Sharia* audit for the annual report of the Islamic institution they represent and issue *Sharia* compliance certificates.

The *Sharia* advisory board works closely with the bankers and lawyers to structure instruments so that they meet *Sharia* and commercial requirements. Standard documentation has been developed by the financial institutions covering their main areas of activities. However, they will need to refer back to the board whenever there is a deviation to ensure that no inadvertent breach of *Sharia* or the compliance certificate has occurred.

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# Limitation on Bankruptcy Filings for LLCs and Partnerships — Issues for Funds[1]

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Domestic private equity funds, hedge funds and real estate funds are primarily structured using either limited partnerships or limited liability companies. On December 6, 2010, in an unpublished opinion, the Bankruptcy Appellate Panel ("BAP") of the Tenth Circuit Court of Appeals addressed significant issues with respect to commonly found provisions in LP and LLC agreements limiting the authority of such entities to file bankruptcy petitions.[2] The Court declined to invalidate provisions of a limited liability company operating agreement that restricted the right of a manager, without unanimous consent of the LLC's members, to take steps to institute a bankruptcy.

The opinion is the latest in a long line of decisions considering who is authorized to file bankruptcy petitions on behalf of business entities. While the decision fails to break new ground, discussing it provides a good opportunity to review drafting considerations for fund organizational documents that may be impacted.

## Background

The debtor, DB Capital Holdings, LLC ("DB"), was a Colorado limited liability company formed to develop two condominium buildings. Its LLC agreement ("Operating Agreement") contained two provisions that are central to the decision. The first was an express bar to the filing of a bankruptcy, which had been added to the Operating Agreement by an amendment that likely incorporated covenants from a secured loan agreement.[3] The second was what appears to be a standard "boilerplate" provision requiring the manager ("Manager") to operate the business in the ordinary course and granting it authority to take actions deemed required or appropriate to accomplish that objective.

DB defaulted on its secured loans, the secured lender filed a receivership proceeding in Colorado state court, and then DB sought relief under Chapter 11 of the Bankruptcy Code through a petition signed by the Manager (one of two members in the LLC). In response, the LLC's other member "filed a motion to dismiss the Chapter 11 case pursuant to 11 U.S.C. § 1112(b), alleging that Manager had filed the petition both without authorization and in bad faith." The Bankruptcy Court agreed that the Manager did not have authority to file the case, and DB, through the Manager, appealed. The 10th Circuit BAP considered the issues on appeal.

## Agreement Among LLC Members Not to File Bankcruptcy

The first issue considered was the absolute bar against filing bankruptcies contained in the Operating Agreement.[4] The opinion

*The circumstances surrounding this decision reinforce several concepts that may be useful in structuring loans to investment funds structured as LLCs and similar entities.*

[1] A version of this article was published in the March 2011 edition of the *Banking Law Journal*. Sheldon L. Solow and Uday Gorrepati, *Can Lenders Prevent LLC Bankruptcy Filings? A Recent Decision Highlights the Debate*, 128 Banking L.J. 220 (2011).

[2] *DB Capital Holdings, LLC v. Aspen HH Ventures, LLC, and WestLB AG*, BAP No. CO-10-046 (B.A.P. 10th Cir. December 6, 2010) ("DB BAP Opinion").

[3] We reach this conclusion based on the form of the amendment and reference in that amendment to loan documents for the definition of capitalized terms. The amendment is available at *In re DB Capital Holdings, LLC*, Case No. 10-23242 [Docket No. 11, Exhibit E] (Bankr. D. Co. June 3, 2010).

[4] The provision in question states: "The Company ... to [the] extent permitted under applicable Law, will not institute proceedings to be adjudicated bankrupt or insolvent; or consent to the institution of bankruptcy or insolvency proceedings against it; or file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy ...." *In re DB Capital Holdings, LLC*, Case No. 10-23242 [Docket No. 11, Exhibit E] (Bankr. D. Co. June 3, 2010).

noted that pursuant to Colorado law, the Operating Agreement governs whether the Manager by itself can file a bankruptcy petition.

While the Operating Agreement did not allow the Chapter 11 petition, the Manager argued that the bar against filing bankruptcies should not be enforced on public policy grounds — specifically, because a third party had required the condition as part of a commercial transaction. The BAP found the evidentiary record offered was insufficient to address the question of "whether, under the right set of facts, an LLC's operating agreement containing terms coerced by a creditor would be unenforceable." Perhaps significantly, neither the BAP nor the Bankruptcy Court agreed that the *ipso facto* case law cited by the Manager "[stands] for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy ...." It may also be significant that the challenge to the bankruptcy filing in this case was brought by a member of the LLC, not a creditor (though the secured lender filed a joinder to the creditor's motion to dismiss the bankruptcy case), which made it easy for the court to analyze the issue as a dispute over internal governance.

The BAP decision raises an interesting question — should lenders insist on such provisions in organizational documents? The question was not discussed in detail by the BAP or Bankruptcy Court, other than to note the lack of on-point opinions or relevant evidence, nor were the BAP or Bankruptcy Court forced to rely on the provision under the circumstances of this case (as discussed below, the Operating Agreement's restrictions on manager activities were held to preclude a unilateral bankruptcy filing). We believe that while the BAP's decision raises an interesting question, it cannot be relied on for the proposition that "no-bankruptcy" language placed in organizational documents as part of a transaction with lenders can be enforced.

## Filing Bankruptcy Petitions is Not Management of the Company's Business

The second issue related to whether the Manager had authority, notwithstanding the provision discussed above barring bankruptcy filings in general, to file a bankruptcy petition on behalf of DB. The BAP found that it did not because: (i) Colorado law "requires each member's consent to authorize an act of the LLC that is not in the ordinary course of the business of the LLC, unless the operating agreement provides otherwise;" (ii) the Operating Agreement only authorizes the Manager to take actions consistent with carrying on the ordinary business of the company; and (iii) the Court noted that the Operating Agreement required unanimous prior written consent of all members for any act taken by the Manager that would make it "impossible to carry on the ordinary business of the company."

The Manager argued that a debtor still conducts business under Chapter 11, but the BAP emphasized that operating in Chapter 11 was well outside of the ordinary course of business due to the myriad of requirements imposed by the Code.

## Our Thoughts

The circumstances surrounding this decision reinforce several concepts that may be useful in structuring loans to investment funds structured as LLCs and similar entities. First, it is clear that the BAP and Bankruptcy Court were inclined to enforce the terms of the Operating Agreement. Second, lenders must always assume that any protections in organizational documents they negotiate can be removed by a requisite number of equity holders or circumvented by creditors. We provide guidance below based on our reading of the BAP's decision in conjunction with other cases and experience:

### *Provisions barring bankruptcy filings*

We believe reliance on this type of clause alone is dangerous — at best, it may subject lenders to a "facts and circumstances test" to determine their role in its adoption. It is clear that if the coerced prohibition or restriction is contained in a separate agreement it will not be enforced. While there are no cases directly on point, it is likely that if a court determines that a similar provision in an Operating Agreement was obtained via coercion, and if it violates public policy, it will be deemed unenforceable. Further, in the event that the LLC's members agree a bankruptcy filing is appropriate, as the Bankruptcy Court in this case pointed out, they could simply amend the provision.[5]

### *Reasonable restrictions on extraordinary actions, including filing bankruptcy petitions*

A better way to protect against a Chapter 11 filing is to place reasonable restrictions on the authority to file. One such tactic is to require that a supermajority of members vote to permit certain significant events. These events might include amending the management agreement, selling the project, dissolving the LLC, and filing a bankruptcy petition. By including a number of activities, it is clear that the provision is designed to rest major decision making power in the members, leaving only day to day man-

[5] *In re DB Capital Holdings, LLC*, Case No. 10-23242, June 21, 2010 hearing transcript at 11:24 [Docket No. 71] (Bankr. Co. 2010).

> *A better way to protect against a Chapter 11 filing is to place reasonable restrictions on the authority to file. One such tactic is to require that a supermajority of members vote to permit certain significant events.*

agement to a manager. By failing to single out the filing of a bankruptcy petition, it makes it less likely that a court will consider the provision to be an invalid ipso facto clause. If state law is favorable, as in this case, lenders could consider drafting language that clearly indicates that aside from those specific activities listed, others are subject to that state law (in this case, the unanimous consent requirements under Colorado LLC law).

### *Independent directors or managers*

The approach outlined above is of limited utility where there are only a small number of members. In such circumstances it may be too easy to obtain the requisite supermajority. If that is a real concern, an alternative technique may be preferable.

In this circumstance, a lender might require that (i) the borrower's board of directors or managers contain at least one independent director or manager and (ii) certain key decisions be approved by a unanimous vote of the directors or managers.

While these provisions might be viewed as having been coerced, they should not run afoul of the prohibition against *ipso facto* clauses so long as the director or manager is truly independent and not merely a "shill" for the lenders. Accordingly, in the event the LLC encounters financial difficulty, the independent director or manager will be required to act as a fiduciary to the LLC and, if it has entered into the zone of insolvency, to its creditors.

Thus, there remains the possibility that even with independent directors or managers, the borrower may choose to file a Chapter 11 petition.[6]

### *No method is guaranteed to work*

We generally note that these methods are unlikely to protect against a unified, organized member body filing bankruptcy petitions. Also, an independent director's or manager's fiduciary duties are to the company and its shareholders (or creditors, depending on the company's solvency), not to the secured lender. Fiduciary duties of members and managers of an LLC can be modified to a degree that would not be possible with a corporation. Similarly, independent directors or managers could be replaced, and an anti-bankruptcy provision could be amended, by the borrower.

Further, under the facts and circumstances of a particular case, a court may disregard corporate requirements either based on the parties' prior course of conduct or on the equities in that case. *In re American Globus Corp.*, 195 B.R. 263 at 265 (Bankr. S.D.N.Y. 1996) (under New York Law, organizational requirements can be modified through course of use/non-use, and "whether to honor corporate formalities is an equitable one"). *See also Windels Marx Lane & Mittendorf, LLP v. Source Enterprises, Inc., et al.*, 392 B.R. 541 at 555 (D. S.D.N.Y. August 12, 2008). The lesson here is that lenders should make sure that corporate formalities are being followed even when there is no sign of trouble.

Finally, even where a voluntary bankruptcy filing is avoided, an involuntary bankruptcy is still possible. In the case of DB, the Bankruptcy Court judge ended up entering an order for relief under Chapter 11, based on an involuntary petition, on November 29, 2010.[7] Thus, if there are three creditors who agree with the manager and desire a bankruptcy, they can be used to avoid the restrictions in an operating agreement.

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[6] Independent directors or managers could also be replaced during the run-up to bankruptcy. *See, e.g., In re General Growth Properties, Inc.*, 409 B.R. 43 at 67-70 (Bankr. S.D.N.Y. August 11, 2009).

[7] *In re DB Capital Holdings, LLC*, Case No. 10-25805 [Docket No. 91] (Bankr. Co. November 29, 2010).

# CFTC Proposals to Rescind Exemptions of Commodity Pool Operators and Commodity Trading Advisors

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On January 26, 2011, the U.S. Commodities Futures and Trading Commission ("CFTC") proposed rules that would eliminate or limit certain exemptions of commodity pool operators ("CPO") and commodity trading advisors ("CTA") from registration. The proposed amendments, if adopted, would require investment advisers who rely on these exemptions to register as CPOs or CTAs, as applicable, become members of the National Futures Association ("NFA"), and comply with the CFTC and NFA rules. In addition, the CFTC has proposed (i) to require annual filing notices claiming exemptive relief from registration as a CPO or CTA; and (ii) additional filings by CPOs and CTAs, with certain information in those filings to be considered confidential by the CFTC.

The CFTC's proposals are notable as the elimination or narrowing of the current CPO or CTA exemptions is not explicitly required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). The CFTC has stated that the proposals are to bring the CPO and CTA regulatory regime into alignment with the stated purposes of Dodd-Frank.

### Background

Dodd-Frank amended the Commodities Exchange Act ("CEA") to change the definition of CPO and make other amendments affecting CTAs so that the definitions of CPO and CTA, respectively, include person operating or advising pools entering into swaps. Therefore, upon the effectiveness of Dodd-Frank in July 2011, entities trading swaps will be included under CEA, in addition to entities trading futures and options.

### Certain Exemptions from CPO Registration

Under current law, Rules 4.13(a)(3) and 4.13(a)(4) exempt CPOs from registration with respect to certain commodity pools and are the two exemptions most commonly relied upon by private fund managers and advisors. To be eligible for Rule 4.13(a)(4) relief, the offering must be exempt from registration under the Securities Act of 1933 (the "Securities Act") and the CPO must reasonably believe at the time of purchase, or conversion to an exempt pool, that investors meet a two-pronged sophistication test.

Natural person investors (including self-directed plans) must meet a higher standard and be qualified eligible persons as defined in Rule 4.7(a)(2), which includes "qualified purchasers," "knowledgeable employees" and certain affiliates. Entity investors may qualify as "qualified eligible persons," as defined in CFTC Rule 4.7, either generally or as "accredited investors" as defined in Rule 501(a)(1)-(3), (a)(7) and (a)(8) of Regulation D under the Securities Act ("Reg D").

Since funds exempt from registration under Section 3(c)(7) of the Investment Company Act ("ICA") are sold to qualified purchasers, virtually all managers of such a fund qualify for relief from registering as a CPO with respect to such fund under Rule 4.13(a)(4). While funds exempt from registration under Section 3(c)(1) of the ICA may be less likely meet the 4.13(a)(4) stan-

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dard, a fund with a more institutional client base may be able to qualify.

To be eligible for Rule 4.13(a)(3) relief, (i) the offering must be exempt from registration under the Securities Act, (ii) the CPO must reasonably believe at the time of purchase or conversion to an exempt pool that investors are "accredited investors" as defined in Reg D, and (iii) one of the following tests must be met:

- The aggregate initial margin and premiums required to establish such positions, determined at the time the most recent position was established, will not exceed 5 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into; or

- The aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into.

### Recision of CPO Exemptions

The CFTC proposed amendments would rescind the exemptions pursuant to Rules 4.13(a)(3) and 4.13(a)(4) in their entirety, which would eliminate the an important exemption to many private fund managers and advisors. The CFTC has stated that the amendments are necessary because many market participants "have fallen outside of the oversight of regulators" and some advisors have engaged in "regulatory arbitrage" between the SEC and CFTC. The CFTC seems to be attempting to make amendments similar to those made by the SEC pursuant to Dodd-Frank, as Dodd-Frank requires private investment advisers that were previously exempt to register with the SEC. According to the CFTC, requiring most managers of commodity trading funds to register as CPOs will give the CFTC greater oversight of market participants and a more comprehensive view of commodity market risk, which is consistent with the legislative mandate of Dodd-Frank.

Many fund managers currently rely on the Rule 4.13(a)(3) or Rule 4.13(a)(4) exemptions to avoid registration with the CFTC as a CPO. The CFTC's proposals would require many fund managers to register with the CFTC as CPOs and become members of the NFA, or rely on another exemption, if any, to the extent that they trade commodities for their accounts. As a registered CPO, the fund manager would become more transparent and would be required to comply with CFTC and NFA rules, including disclosure, reporting and recordkeeping requirements, and periodic examinations by NFA.

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### Reinstate Trading Criteria for Registered Investment Companies to Qualify for CFTC Rule 4.5

CFTC Rule 4.5 currently provides an exclusion from the definition of CPO for operators of certain otherwise regulated entities, such as companies registered under the ICA, without regard to the extent of futures trading engaged in by such entities. To reestablish oversight over the operators of such entities that seek to offer investors exposure to the commodities markets, the CFTC is proposing to reinstate the restrictions that were in effect prior to 2003, requiring the operators of such entities to (i) limit their use of commodity futures and options contracts (and additionally, swaps) for non-bona fide hedging purposes to 5 percent of the relevant entity's liquidation value, and (ii) refrain from marketing such entities to the public as commodity pools or otherwise as vehicles for trading in, or seeking investment exposure to, the commodity markets. The CFTC's principal stated reason for reinstituting such conditions is that it became aware that certain registered investment companies were offering de facto commodity pool interests in reliance of the Rule 4.5 exclusion.

### Disclosure on Proposed Forms CPO-PQR and CTA-PR

Citing a lack of transparency and concerns regarding systematic market stability, the CFTC has proposed new Rule 4.27, requiring CPOs and CTAs to file Forms CPO-PQR and CTA-PR, respectively. The CFTC plans for the new forms to parallel the proposed Form PF and to allow the

*The CTFC believes that this more detailed pool information is necessary from mid-sized and large CPOs, as these CPOs and their pools are more likely to be a source of risk to both the commodity futures and derivatives markets as well as the financial markets as a whole.*

CFTC to provide systematic risk information to the Financial Stability Oversight Counsel ("FSOC") and other regulators.

The information required by the two new forms will vary depending on both the size of the manager or advisor and the size of the advised pools, based on the premise that the larger CPOs or CTAs are more likely to present greater risk to the financial stability of the markets.

All registered CPOs and CTAs, even those that file Form PF,[1] would be required to file Schedule A on Forms CPO-PQR and CTA-PR, respectively, but CPOs and CTAs, regardless of size, that file Form PF would not have to complete the other schedules on Forms CPO-PQR and CTA-PR. Schedule A essentially contains the same information that the NFA currently collects through Form CPO-PQR, and PR for CTAs, consist of limited questions regarding self-identification, general operations of the CTA and whether the CTA directs assets for commodity pools with assets under management equal to or exceeding $150 million.

Additionally, CPOs with assets under management equal to or greater that $150 million would be required to file Schedule B to provide additional information about commodity pools they manage, and CPOs with assets under management equal to or greater than $1 billion would also have to file Schedule C to provide aggregated information about such pools as well as information about commodity pools with a net asset value exceeding $500 million. Similarly, CTAs with commodity pool assets under management equal to or greater than $150 million would be required to file Schedule B in order to provide information regarding CTA's trading programs, identification of their client pools and position data for each commodity pool they advise.

### Proposed Scedule A

Generally, the information required under proposed Schedule A will be substantially similar to that required under Form PF. Proposed Schedule A would be required of all CPOs that are registered or required to be registered and incorporates all of the information currently required by the NFA's PQR data collection instrument. Proposed Part 1 of Schedule A seeks basic identifying information about the CPO, including its name, NFA identification number, and the CPO's assets under management. Proposed Part 2 of Schedule A requires the reporting of information regarding each of the CPO's pools, including the names and NFA identification numbers for the pools operated during the reporting period, position information for positions comprising 5 percent or more of each pool's net asset value, and the pool's key relationships with brokers, other advisors, and administrators. CPOs that advise multiple pools will be required to complete and file a separate Part 2 of Schedule A for each pool that they advise. Proposed Part 2 also requires the identification of each operated pool's carrying brokers, administrators, trading managers, custodians, auditors, and marketers. This information would enable the CFTC to determine which entities are exposed and connected to commodity pools.

### Proposed Scedule B

CPOs with assets under management equal to or in excess of $150 million would be required to report detailed information for all commodity pools operated or advised by such CPO, including information regarding each pool's investment strategy; borrowings by geographic area and the identities of significant creditors; credit counterparty exposure; and entities through which the pool trades and clears its positions. The CTFC believes that this more detailed pool information is necessary from mid-sized and large CPOs, as these CPOs and their pools are more likely to be a source of risk to both the commodity futures and derivatives markets as well as the financial markets as a whole.

### Schedule C

Part 1 of Schedule C would require certain aggregate information about the commodity pools advised by large CPOs, such as the market value of assets invested, on both a long and short basis, in different types of securities and derivatives, turnover in these categories of financial

[1] The SEC and CFTC have proposed new regulations requiring certain registered investment advisers to file new "Form PF."

*CTAs with commodity pool assets under management equal to or greater than $150 million would be required to file Schedule B in order to provide information regarding CTA's trading programs, identification of their client pools and position data for each commodity pool they advise.*

instruments, and the tenor of fixed income portfolio holdings, including asset-backed securities. Proposed Part 2 of Schedule C would require large CPOs to report certain information about any commodity pool that they advise with a net asset value of at least $500 million as of the end of any business day during the reporting period.

### Removal of Exemptive Relief From Certification Requirement in Rule 4.7 Pool Annual Reports

Rule 4.7 currently provides relief from certain disclosure, reporting and recordkeeping rules for registered CPOs and CTAs whose pools are privately offered to "qualified eligible purchasers." In particular, Rule 4.7(b)(3) currently exempts CPOs from including certified financial statements in the annual reports provided to participants in Rule 4.7 pools. The CFTC has proposed eliminating the certified financial statement exemption.

The CFTC explained that certification by an independent public accountant ensures accuracy and that the vast majority of annual reports for Rule 4.7 pools are already audited by independent public accountants. The CFTC said that CPOs and CTAs may still petition for exemption from the auditing requirement pursuant to the CFTC's general exemptive authority in Rule 4.12(a). (Additionally, in order to incorporate changes to the SEC's "accredited investor" definition mandated by Dodd-Frank as well as any future changes, the CFTC has proposed eliminating Rule 4.7's verbatim restatement of the SEC's "accredited investor" definition and related net worth and income standard and instead replacing it with a cross-reference to the definitions contained in SEC Regulation D.)

### Annual Notice Requirements for All Exemptions Under Rules 4.5, 4.13 and 4.14

The CFTC proposal also would require any person who files a notice of claim of exemption under any of the exemptions under Rules 4.5, 4.13 and 4.14 to affirm the exemption annually, withdraw the exemption due to cessation of activities requiring exemption, or withdraw the exemption and apply for registration within 30 days of the anniversary of the initial filing. Failure to comply with the annual filing requirement would be deemed a withdrawal of the exemption or exclusion and could result in enforcement action.

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# Solvency II — No Alternative(s) for European Insurers?

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Insurers play an important role as limited partners in European private equity and hedge funds. According to preliminary EVCA figures, they represented 5.3% of the European private equity LP base in 2010. It remains to be seen whether European insurers will keep their remarkable appetite for alternative investments. The Solvency II rules will impose increased capital requirements for those investments thus threatening to render a whole group of asset classes unattractive to insurance companies.

## Solvency II's Three Pillars

Solvency II is the framework directive that sets out strengthened EU requirements on capital adequacy and risk management for insurance companies. It is to replace the relatively simple 1970's Solvency I rules. All EU member states have to transpose the directive into national law by October 31, 2012.

Solvency II is based on three pillars:

(I) minimum capital requirements,

(II) corporate governance rules and risk management plus

(III) IFRS-related transparency and information requirements.

Under pillar I, the current Solvency II implementation proposals require insurers to value annuity liabilities with a risk-free interest rate. If implemented, insurance companies would either have to switch their investments from hedge funds or private equity funds to investments with lower yields or hold higher reserves.

## Solvency Capital Requirement Determination

Insurers will have to calculate their Solvency Capital Requirement ("SCR") either using a standard model or their own internal models.

Under the current proposal, investments in private equity would be subject to a stress factor capital requirement of 55 percent applying to "Other Equities" under the standard model (at least relatively reasonable delta compared to "Global Equities" at 45 percent). The 55 percent SCR would not increase if the private equity allocation stays below a 35 percent threshold of the total equity exposure, which in itself should rarely be a problem even taking into account certain denominator effects in times of falling stock markets. Hedge fund investments would be subject to the same 55 percent SCR.

Internal models might lead to a lower capital requirement in the range of 25 to 35 percent according to calculations by Swiss-based alternative asset manager Partners Group. According to the QIS 4 Study conducted by the Committee of European Insurance and Occupational Pensions Supervisors ("CEIOPS"), 63 percent of insurers are considering to develop internal models. These models have to meet a certain standard with regard to the quality and depth of the underlying data.

An insurer with an equity allocation of 10 percent would therefore have to add 30 Cents to his capital reserve for every additional Euro invested in private equity.

*Solvency II is the framework directive that sets out strengthened EU requirements on capital adequacy and risk management for insurance companies. All EU member states have to transpose the directive into national law by October 31, 2012.*

> *Therefore, it remains to be seen whether Solvency II will lead to the flight of major insurance companies out of Europe. The Solvency II-driven acceleration of annuity and guaranteed interest rate decline might clearly be an argument in favor of a relocation.*

Private equity is accretive to an insurer's portfolio both within the overall equity allocation and within the overall allocation. The stress test for mortality risk has also been strengthened under Solvency II.

Solvency II also applies to annuities and the management of contract-based schemes that are part of an insurance company's life assurance business. In the U.K., it would most affect DC scheme members. In France, the bulk of long-term savings are in the hands of the insurers due to a lack of pension funds.

### National Rules in Germany

We briefly want to have a look at the current national rules dealing with private equity and hedge fund investments in Germany, where there are pension funds but the insurance companies still play a big role as institutional investors.

The Insurance Supervisory Law (*Versicherungsaufsichtsgesetz, VAG*) in its Sec. 54 is defining the basic requirements for insurer's investments, which are security, profitability and liquidity. The Investment Ordinance (*Anlageverordnung*) contains further interpretations of Sec. 54 VAG. With regard to private equity and other alternative investments, it lays out that up to 15 percent of the committed assets might be invested in assets that are not included in an organized market (which includes all riskier investments). In addition, 1 percent of the committed assets might be invested in a single target (fund). As on average, German insurers invest below 1 percent of their assets in private equity, the current national rules can be regarded as a reasonable framework for their exposure to alternative investments. With regard to hedge funds, 5 percent of the committed assets might be again invested in such funds that have to be located in the EEA. Commodity funds now form a separate asset class. On average, German insurers again invest around 1 percent of their assets in hedge funds.

### Possible Consequences

Solvency II will apparently change the picture not only in Germany. Even if internal models might lead to acceptable capital requirements, the greater administrative burden will potentially steer insurance companies' asset managers away from alternative assets. This is not good news for policyholders as at the same time, the German government thinks about further reducing the guaranteed interest rate of currently 2.25 percent to probably 1.75 percent. This used to be 4.0 percent from 1994 to 1999.

The message is clear: Insurance companies' asset managers just have to hit market returns in the area of fixed income to meet the guaranteed interest rate requirement. A policy that would also take the policyholder's interests into account doesn't require to turn every insurer's asset management unit into Yale University Investment Management. Still, a reasonable amount of risk should, above all, improve policyholders' return.

Therefore, it remains to be seen whether Solvency II will lead to the flight of major insurance companies out of Europe. The Solvency II-driven acceleration of annuity and guaranteed interest rate decline might clearly be an argument in favor of a relocation. This might especially be true for countries with insurance companies that post high equity quotas like the northern countries or the U.K. Still, pension schemes might lack the overall flexibility to go abroad.

Other less radical solutions might be of structural origin: The insurer would have to transfer the risk to a third party. Simple solutions like fund-linked notes or guaranteed zero-coupon bonds will likely not pass this test. Securitization might be the option of choice. Securitized fund-linked notes under which trenches of junior and senior bonds are transferred to an SPV or closed investment companies that issue bonds are options that have to be further analyzed.

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## NEWS ALERT — Taxpayers with Offshore Assets Get Second Chance

U.S. taxpayers have been given another opportunity to disclose hidden offshore bank accounts to the IRS. Fifteen months after the expiration of the previous voluntary disclosure effort, the IRS unveiled on February 8 a new Offshore Voluntary Disclosure Initiative ("OVDI") to encourage taxpayers with undisclosed foreign accounts and assets to come forward and comply with U.S. tax law. Taxpayers who come forward by August 31, 2011, will receive some assurance that they will not be criminally prosecuted in exchange for the payment of back taxes, interest and reduced penalties.

In light of recent Justice Department investigations into small Swiss cantonal banks and IRS efforts in several jurisdictions around the world outside of Switzerland, it is clear that the IRS was not satisfied with the concessions made by UBS to turn over its U.S. customers. As these investigations continue, information also streams in from whistleblowers, the most recent example of which was the receipt of Swiss bank data by WikiLeaks on January 17.

With this pressure mounting, taxpayers with hidden offshore accounts are again being encouraged to come forward voluntarily or risk facing criminal prosecution and the complete confiscation of their offshore accounts. "Tax secrecy continues to erode," IRS Commissioner Doug Shulman said. "We are not letting up on international tax issues, and more is in the works. For those hiding cash or assets offshore, the time to come in is now. The risk of being caught will only increase."

The IRS reported that the 2009 voluntary disclosure effort netted almost 15,000 taxpayers with accounts in 60 countries and another 3,000 coming forward after the program had closed. The IRS expects that there are thousands more taxpayers who continue to hide their assets abroad. In the words of Commissioner Shulman, this new OVDI allows these taxpayers "a last, best chance to get back into the U.S. tax system" and addresses several concerns that were brought to light during the previous effort.

The principal penalty feature of the new OVDI is a miscellaneous penalty equal to 25 percent of the highest aggregate amount of a participant's foreign bank account between 2003 and 2010. This penalty represents a 5 percent increase over that offered in the 2009 program. Additionally, participants will have to pay up to eight years of taxes owed plus interest, rather than the previous, six year, term. Although the penalty provisions of the new OVDI are generally harsher, the miscellaneous penalty may be reduced to 12.5 percent or 5 percent where the participant's offshore account balance is less than $75,000 or where the participant had minimal involvement with the account activity, respectively.

Taxpayers who want the benefits of the OVDI must submit their tax returns, paperwork, and a payment to the U.S. Treasury by the August 31, 2011 deadline, and are thus encouraged to begin preparations as soon as possible. If you have any questions please do not hesitate to contact us.

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