KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

Supreme Court Limits 10b-5 Claims Against Mutual Fund Advisors

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On June 13, the Supreme Court issued a landmark decision that eliminates the potential uncertainty regarding whether an investment adviser to a mutual fund could be held liable under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"). Previously, the circuits employed different tests concerning who is a primary actor and a secondary actor. The Supreme Court has now held, in a decision having broad implications for all securities issuers, that actions may go forward against only the actual maker (and not a creator) of the alleged false and misleading statements.

In 1994, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the United States Supreme Court ruled that a party cannot be held liable as aider and abettor for violation of Section 10(b) of the 1934 Act.[1] The Supreme Court reaffirmed that holding in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), when it held that liability could not be imposed on a secondary actor on the ground that it participated in a scheme to defraud. The Court based its ruling on the ground that, absent an independent duty to disclose, there can be no reliance on the secondary actor's allegedly deceptive conduct. As explained in *In re Parmalat Securities Litigation*, 570 F. Supp. 2d 521, 526 (S.D.N.Y. 2008), "*Stoneridge* made plain that investors must show reliance upon a defendant's own deceptive conduct before that defendant, otherwise a secondary actor, may be found primarily liable." In other words, in order for an investor to assert a claim, the claim under Rule 10b-5 may be brought against only a primary actor.

After *Central Bank*, the courts developed a diversity of tests to determine whether a party could be liable as a primary actor. Until now, the test for who is a primary actor has devolved into two sharply divergent and conflicting tests. Under the test developed by the Second Circuit, several Circuits have applied the bright line attribution test – the statement must be attributed to the party in order for that party to be a primary actor.[2] On the other extreme, the Ninth Circuit has applied a substantial participation test – the party had to substantially participate in the preparation of the statements.[3] Some Circuits have adopted a subjective attribution test that purports to be a blend of those two tests.

In its June 13, 2011 decision in *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, 564 U.S. ___ (June 13, 2011), the Supreme Court brought an end to that conflict and adopted the bright line test to determine who is a primary actor for the purposes of Rule 10b-5, expressly rejecting the middle ground test. The Court established the rule that only the maker of the false and misleading statement can be liable and that a party that participates in the creation of that statement, regardless of its level of involvement, cannot be held liable.

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[1] Congress subsequently amended the 1934 Act to authorize only the SEC to bring enforcement actions for aiding and abetting a violation of Section 10(b).

[2] See *Pacific Management Co. v. Mayer Brown LLP*, 603 F.3d 144 (2d Cir. 2010).

[3] See *In re Software Toolworks Securities Litigation*, 50 F.3d 615 (9th Cir. 1994).

> In *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525, 564 U.S. ___ (June 13, 2011), the Supreme Court adopted the bright line test to determine who is a primary actor for the purposes of Rule 10b-5, expressly rejecting the middle ground test.

The Supreme Court reversed the decision of the Fourth Circuit that had applied the middle ground relationship test. The Supreme Court started its analysis by observing: "One makes" a statement by stating it." Consequently, the Court held:

> For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not "make" a statement in its own right. One who prepares or publishes a statement on behalf of another is not a maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed. This rule might be best exemplified by the relationship between a speechwriter and a speaker. Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit – or blame – for what is ultimately said.

The Court's opinion rejected the position advocated in Justice Breyer's dissent, which urged that the Fourth Circuit's subjective test be adopted. The Court, following the reasoning employed by the Second Circuit, observed that a bright line test is necessary in order to ensure that the Court's ruling in *Central Bank* regarding secondary liability is respected.

The Court then rejected the argument made by the SEC that the word "make" should be construed to mean "create." The Court observed: "We see no reason to treat participating in the drafting of a false statement differently from engaging in deceptive transactions, when each is merely an undisclosed act preceding the decision of an independent entity to make a public statement."
The Court also rejected the plaintiff's contention that the investment management company should be seen as the "maker" because of the close relationship between a mutual fund and its investment adviser. The Court "decline[d] this invitation to disregard the corporate form," as the Court noted "[i]t is undisputed that the corporate formalities were observed here."

Finally, the Court rejected the plaintiff's assertion that JCM should be liable because it "was significantly involved in preparing the prospectuses," stating: "But this assistance, subject to ultimate control of [the Fund], does not mean that JCM 'made' any statements in the prospectuses. Although JCM, like a speechwriter, may have assisted [the Fund] with crafting what [the Fund] said in the prospectuses, JCM itself did not 'make' those statements for purposes of Rule 10b-5."

In sum, in order for a party to be subject to a damages claim under Rule 10b-5, the plaintiff must satisfy the rule that "the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it." In contrast to liability under the Securities Act of 1933, parties that participate in the preparation of a statement cannot be liable under Rule 10b-5, no matter what their level of participation or their relationship to the maker of the statement. This rule strengthens the defense that professionals, financial service firms and investment advisors have when sued under Rule 10b-5 for statements made by someone else, such as a public company or an investment fund.

While the wider implications of the Court's holdings may take time for the securities bar to digest, the mutual fund industry has welcomed the Court's decision. If the adviser had been deemed to be the alter ego of the fund, such a holding could have undermined decades of law and practice affecting the investment management industry. Now, unless the advisor itself makes a false and misleading statement, it cannot be held liable for claims against the fund under Section 10(b).

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The Next FCPA Frontier: Banking and Private Equity?

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Earlier this year, *The Wall Street Journal* ("the *Journal*") reported that the Securities and Exchange Commission ("SEC") is investigating "whether bank and private equity firms violated the bribery laws in their dealings with sovereign wealth funds." The *Journal* indicated that the SEC sent letters of inquiry to several banks and private equity firms requesting that the entities retain documents related to these financial relationships. Sovereign Wealth Funds ("SWF") were described in the article as "investment funds owned and generally operated by overseas governments." While the *Journal* reports that the letters were not specific in stating the reasons for the inquiry, the inquiries "appear to be tied to a broad Foreign Corrupt Practices Act investigation of the banking industry." As early as two years ago, the Department of Justice ("DOJ") announced that it was reviewing investments by companies in these funds and the investment of the funds in U.S. firms. U.S. companies were warned to do the appropriate due diligence on fund representatives and to assess the representatives' ties to the foreign government. According to the *Journal*, the probe is in the early stages.

In recent years, private equity sponsors and hedge funds have increased their investment activity in emerging markets. According to Transparency International's 2010 Corruption Perceptions Index, which measures perceived levels of public sector corruption in 178 countries, countries such as South America, Africa and Asia, considered key areas for foreign investment, are perceived as corrupt. Investments in these markets are necessarily a high risk for corruption and come at a time when the U.S. has ramped up its enforcement of the Foreign Corrupt Practices Act ("FCPA" or "the Act").

By way of background, the FCPA prohibits bribery of foreign government officials, candidates for political office and political party officials. The Act applies to broad categories of entities and individuals, including private companies organized under U.S. laws or entities with a principal place of business in the U.S. and covers conduct that occurs anywhere in the world. As a consequence, the actions of U.S.-based investors are covered by the Act. In operation, the Act has been interpreted to address not only direct bribes to foreign officials but also, under the principal of vicarious liability, indirect bribery-related activity through agents, consultants or joint venture partners when corruptly made to obtain or retain business. The "obtain to retain business" element criminalizes improper payments made to obtain any favorable government action. For example, payments made to secure a contract, obtain favorable tax treatment from a foreign government or to obtain relief from foreign customs duties all fall within this element of the Act.

Enforcement actions have demonstrated that bribe payments can take many forms, including corporate provision of gifts, travel and entertainment to foreign officials. This is a slippery slope where there is no

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real guidance from the FCPA itself or its legislative history. It is worth noting that the FCPA contains an affirmative defense for bona fide business expenditures paid to foreign officials to promote a company's product. However, some companies have run afoul of this provision when the presentation of a gift or business entertainment expense is coupled with the corrupt intent to obtain or retain business.

There are several areas where private equity funds and their partners may face risks of liability under the FCPA. Issues related to foreign bribery can arise before or after investors complete the investments. For example, the fund's acquisition or investment in an entity with a pre-acquisition history of bribery of foreign government officials could lead to liability for the financial sponsor, its fund or its portfolio company. In essence, the private equity fund that purchases a company that violates the FCPA may inherit the liability of that company even if there is no evidence that the fund or its officers knew or had reason to know of the corrupt activity. This risk highlights the need for the development of a uniform and thorough due diligence approach designed to detect FCPA issues, including with consideration of its industry, country of operation, its use of agents, brokers and other third parties, and the risks raised by its customer base, particularly if that base includes sales to government or state-owned enterprises.

An example of the high risks and consequences of successor liability is the U.S. government's enforcement action against Latin Node, Inc., the first FCPA enforcement action ever brought based entirely on pre-acquisition conduct that was unknown to the acquirer when the deal closed. In this matter, eLandia International, Inc. purchased Latin Node in 2007. After the acquisition, eLandia discovered that Latin Node had engaged in bribery and corruption. eLandia investigated after the purchase and self-reported the violations to the DOJ. In the end, eLandia was assessed a $2 million fine by government regulators. The company also shut down Latin Node as an operating business and wrote off the entire $20.6 million purchase. In speaking about the case, one prominent government regulator remarked that the Latin Node settlement represented what can happen when an acquirer conducts "little, if any, due diligence."

The DOJ's 2007 criminal settlement with New York-based hedge fund Omega Advisors, Inc. ("Omega") further demonstrates the government's interest in prosecution activity directed at financial institutions and hedge funds. In this case, the government entered into a non-prosecution agreement with Omega resolving allegations related to its investment in privatization programs in Azerbaijan. The investment was aided by corrupt payments and other improper benefits provided to Azeri government officials. Although the corrupt payments were not provided by Omega, a former Omega employee was aware of the payments prior to the investment and entered into the investment with the knowledge and understanding that he was taking advantage of these payments. The Omega settlement came as a result of the criminal indictment and guilty plea by the Omega employee who admitted that he entered into investments on behalf of the company knowing that corrupt conduct was part of the investment arrangement. The case concluded with an agreement by Omega to civilly forfeit $500,000.

In essence, the private equity fund that purchases a company that violates the FCPA may inherit the liability of that company even if there is no evidence that the fund or its officers knew or had reason to know of the corrupt activity.

With regard to individual liability, an instructive example of the government's interest in pursuing cases against individuals is the U.S. government's indictment and conviction of Leo Winston Smith, the former executive vice-president and director of sales and marketing of California-based Pacific Consolidated Industries ("PCI") for, among other things, conspiring to violate the FCPA. The corrupt conduct was discovered following the completion of the sale in a post-acquisition audit by the group of private investors, composed of the private equity investment group Cherington Capital (renamed Pacific Consolidated Industries, LLC) who acquired PCI. The investors voluntarily referred the matter to the DOJ. Smith pleaded guilty in 2009. In announcing the guilty plea, Assistant Attorney General Lanny Breuer stated, "[b]ribery cannot be viewed as standard operating procedure when representatives from U.S. companies seek contracts abroad. As demonstrated by this case, the Department will hold accountable corporate representatives who solicit and make bribe payments to foreign government officials."

The lessons learned from prior enforcement actions make clear that government regulators expect senior executives to not only forgo direct personal involvement in corrupt activity but also to properly supervise activities of others that relate to interactions with foreign officials and governments.

One of the key issues raised by the SWF inquiry and in other similar investigations will be whether the employees who run these funds and other state owned enterprises would be considered foreign officials under the definition set forth in the FCPA. The FCPA defines "foreign official" as follows:

> "Foreign official" means any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization."

Given enforcement actions in recent years, government regulators clearly believe that employees of entities run or controlled by a foreign government fall within the statute's definition.

For now, financial institutions and funds need to review and assess their risk profiles, including risk that may be present within their portfolio companies. The government expects, at a minimum, that all U.S. "issuers" and "domestic concerns" will have in place compliance policies and practices that act as preventative measures against fraud and corruption in the formation of business relationships.[1] These regulations include policies intended to vet potential business relationships and contractual documents that set forth compliance obligations directly in the document. This expectation applies with equal force to private equity funds and hedge funds that fall within these definitions. The policies should include requirements of due diligence prior to the formation of business relationships, particularly in foreign countries where there is history of corruption, and gift, travel and entertainment policies that place defined and reasonable limits on these expenditures.

It is not just a company that is at risk of liability under the FCPA. Senior executives — similar to those who acted on behalf of Omega Advisors and PCI — with management responsibilities are also at risk. The lessons learned from prior enforcement actions make clear that government regulators expect senior executives to not only forgo direct personal involvement in corrupt activity but also to properly supervise activities of others that relate to interactions with foreign officials and governments. For example, in 2009, the SEC filed suit against the CEO and CFO of nutritional supplement manufacturer Nature's Sunshine based on the executives' supervisory responsibilities over others engaged in foreign bribery — conduct of which the CEO and CFO had no knowledge. These executives were charged because of the fact that they were the "control persons" over the violators and they should have supervised their actions.

Government regulators continue to cast a wide net in the area of FCPA enforcement. Private equity firms, hedge funds and other financial institutions must closely watch the events in this probe as they unfold.

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[1] An "issuer" is any entity that has a class of securities registered pursuant to the Securities Exchange Act of 1934 or that is required to file reports under that Act. This definition includes U.S. publicly traded companies and foreign public companies that may be listed on U.S. stock exchanges through the use of American Depositary Receipts.

A "domestic concern" is any individual who is a citizen, national or resident of the United States, as well as any corporation, partnership, association, joint-stock company, business trust, unincorporated organization or sole proprietorship that has its principal place of business in the United States, or that is organized under the laws of a state of the United States.

Hedge Fund Liquidity Terms

The year 2011 has seen assets under management in hedge funds increase to their highest ever level, overtaking the previous peak achieved before the financial crisis. That hedge funds have bounced back and achieved this recovery in a relatively short period of time is testimony to their resilience and flexibility. There were many who predicted only two years ago that the hedge fund industry was in a longer-term depression.

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From a legal perspective, lessons have been learned and documentation has been tightened as a result of increased scrutiny by investors requesting greater transparency over the activities of the funds that they invest in and seeking better investment terms and disclosure, particularly in relation to liquidity terms, which this article now considers.

Relations between managers and investors had deteriorated by the end of 2008 as a result of the imposition of redemption gates and the creation of side pockets for illiquid assets on the back of documentation that was not clearly understood by investors, nor based on full and frank disclosure on the part of promoters and managers. Investors expected liquidity arrangements to be in accordance with disclosures in a fund's offering memorandum and articles of association. In fact, in practice, language in a fund's governing documents has worked against funds, for example where it was found that obtaining investors consent to side pockets was necessary to effect a fund restructuring. Coming out of the downturn, it is now generally understood that liquidity terms need to differ by strategy. As assets become more liquid, those terms generally become more restrictive. The ability of a manager to impose restrictions on liquidity will depend to some extent on its own reputation and negotiating position.

Therefore, in the context of liquidity, let us consider side pockets, holdbacks, lock-ups, redemption gates, suspensions and other liquidity-related provisions.

Side Pockets

In a side pocket, illiquid assets are held in a separate pool represented by a new class of non-redeemable interests. Existing investors cannot redeem their interests in the side pocket and new investors do not participate in it. The side pocket is often capped as a percentage of fund or investor net assets and individual investors may ask for an individual cap. Investors are increasingly requesting to be excluded from side pocket arrangements, which could be problematic depending upon on how the side pocket is structured and as it might be viewed by regulators as giving preferential liquidity terms to particular investors. Board directors should therefore be mindful of their fiduciary duties in that context.

On launching new funds, managers are now aware of the need for the funds to provide expressly for side pockets to avoid the need for investor consent should the side pocket need to be activated. Offering documents are reflecting the particular terms of the potential side pocket provisions more comprehensively than hitherto. Where a side pocket arrangement is implemented, there is often a different fee structure between the side pocket and the main fund. Critics say that the imposition of side pockets blurs the line between hedge and private equity funds, but nevertheless it does avoid the scenario of "the last man standing."

Holdbacks

Where a holdback is implemented, a *pro rata* portion of illiquid assets is held back from a redeeming investor until the assets are disposed of and the net proceeds distributed to that investor. The difference with the side pocket is that only the portion of the illiquid assets attributable to the redeeming investor is side pocketed (rather than within the fund itself), and the remainder of the illiquid assets is still held in the fund in which new investors participate.

Lock-Ups

A lock-up is the period during which investors are prohibited from redeeming. In the case of a hard lock-up period no redemptions are permitted at all. Where a soft lock-up is implemented redemptions are permitted but subject to penalty. Lock-up periods typically range from one to three years from the date of the initial investment and many funds now offer tiers of fee and lock-up period combinations. That does not prevent investors from negotiating preferential withdrawal rights during lock-up periods, which, again, are subject to overriding fiduciary considerations on the part of the board. There may occasionally be specific exemptions from the lock-up, for example, a key-man clause permitting redemptions after the departure of key personnel. Other major events can be considered and included for this purpose also.

Redemption Gates

Imposing redemption gates was once seen as the kiss of death for a fund although some funds that implemented gates in 2008/09 have lived to tell the tale. Where a gate is imposed, redemptions on each redemption date are limited to a specified percentage of net assets (ranging anywhere between 5% and 25%). Issues arise as to whether deferred redemptions get priority over later redemption requests, and whether there should be a guaranteed longstop exit date. Investment managers and fund boards should be mindful that remaining investors could end up owning a greater share of the fund's illiquid assets on permitting departure on favourable or other terms to redeeming investors, and what their duty should be to the remaining shareholders in that event.

Redemption gates can be divided between fund-level gates and investor-level gates. In the former case, when the gate is triggered each withdrawal request is reduced *pro rata* which creates an incentive to submit redemption requests, or to increase the amount requested. Managers should consider whether the *pro rata* reduction should be based on an investor's withdrawal request or on the overall invested capital of that investor. With an investor-level gate, the individual investors' withdrawal is limited to a percentage of his capital, which solves the problem of inflated redemption requests as alluded to above in the context of fund-level gates.

Suspension of Redemptions

Most hedge funds have the right to suspend redemptions in order to prevent forced dispositions of assets in unfavourable markets. Care needs to be taken to define trigger events and whether these should be limited to true emergencies. Among the matters to consider is whether the fund should use best or reasonable efforts to satisfy redemptions. Where redemptions are suspended, the manager has breathing space to continue managing the fund and collecting fees, and many funds have managed to survive a suspension and even to thrive in the post-crisis world.

Redemption in Kind

Most hedge funds have the right to pay redemptions by distributing assets instead of cash. Many have used this provision in effect to create a side pocket by distributing interests in a special purpose vehicle formed to hold illiquid assets. Normally, in that case, the manager no longer receives a fee on the assets. When drafting documentation to reflect policy in this regard, investors should consider whether the manager should use best or reasonable efforts to pay redemptions in cash, or whether the manager should give the investor advance notice of in kind distributions and sell illiquid assets for the account of an investor if requested by him.

Other Liquidity Issues

Other ways of dealing with liquidity issues include:

- staggered or rolling redemption days where each investor receives multiple tranches of interests with different permitted redemption dates, in effect, a rolling lock-up or gate; and
- establishing different classes of fund shares with different fees and liquidity terms.

Document Drafting

Because liquidity has become paramount in the minds of investors, the investors themselves are scrutinizing the legal documentation relating to the fund, principally its articles of association and offering document, and lawyers acting for the promoter or manager need accurately to describe and disclose particular provisions of the articles in the offering memorandum itself. The Strategic Turnaround Cayman Islands case reaffirmed that a fund's constitutional documents govern liquidity and redemption terms, not a fund's offering documents, such that if there is a conflict between the offering document and the articles of association, the latter prevails. Suspension and redemption provisions, for example, that are too broadly or loosely drafted can lead to ambiguities and uncertainty as to when a shareholder ceases to be a part owner of a fund and becomes a creditor of the fund. Documentation for new funds now articulates in greater detail and with clarity the circumstances under which suspensions are implemented, when redemption payments are made and how a departing investor should be treated.

Increasingly, investors are seeking to influence the terms of the funds they invest in at the launch of those funds rather than acquiescing in preordained documentation. At the same time, a minor revolution is occurring in the composition of fund boards, where independent directors with hedge funds experience are bringing that to bear in decision making that is fair to investors.

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SEC Extends Deadline for Registration by, and Establishes Certain Exemptions from such Registration for, Non-U.S. and U.S. Advisers

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On June 22, 2011, the U.S. Securities and Exchange Commission (the "SEC") held an open meeting and approved new rules[1] implementing certain provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") regarding investment advisers. The new rules implement as of July 21, 2011, the exemptions contemplated by the Dodd-Frank Act to replace the eliminated private client adviser exemption, including, exemptions for private fund advisers, non-U.S. private advisers and advisers to venture capital funds.

Extension of Registration Deadline to March 30, 2012

Private fund advisers, both U.S. and non-U.S., that are required to register in accordance with the Dodd-Frank Act must register with the SEC by March 30, 2012. This extends an initial registration deadline of July 21, 2011. Nonetheless, as noted below, advisers that claim either the private fund adviser exemption or the venture capital fund exemption must file Part 1 of Form ADV between January 1, 2012 and March 30, 2012.

Private Fund Advisers Exemption

The SEC has adopted the private fund adviser exemption as proposed, which provides exemption from registration to a U.S. private fund adviser that advises an unlimited number of private investment funds[2] so long as the aggregate value of the assets of all private funds managed by such private fund adviser is less than US$150 million in assets under management ("AUM") in the United States. Where the private fund adviser has its principal place of business in the United States, the assets are deemed to be under management in the United States even though the adviser may have other offices and other AUM outside of the United States.

A non-U.S. adviser may also take advantage of the private fund adviser exemption (in addition to the "foreign private adviser" exemption addressed below) as long as all of the non-U.S. adviser's clients that are U.S. persons are qualifying private funds (as described above). Moreover, a non-U.S. adviser need not consider the type or the number of its non-U.S. clients or the amount of assets it manages outside of the United States to ascertain whether it qualifies for exemption. Thus, the size and nature of a non-U.S. adviser's advisory activities outside of the United States would not affect its exempt status. This reflects the SEC's position that non-U.S. activities of non-U.S. advisers should not incur U.S. regulatory oversight.

"Foreign Private Adviser" Exemption

The Dodd-Frank Act has narrowed the historical exemption from registration available to non-U.S. private advisers. Only non-U.S. advisers that (i) do not hold themselves out as advisers in the United States, (ii) do not have a place of business in the United States, (iii) have less than US$25 million in aggregate assets under management from clients and investors in private funds domiciled in the United States, and (iv) have fewer than 15 (in the preceding

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[1] Rule 203(m)-1 implements the private fund adviser exemption. Rule 202(a)(30)-1 defines certain terms in section 202(a)(30) of the U.S. Investment Adviser Act of 1940, for purposes of the foreign adviser exemption. Rule 203(l)-1 defines "venture capital fund" for purposes of the venture capital fund exemption. Rule 202(a)(11)(G)-1 defines the term "family office" for purposes of the family offices exemption.

[2] A private fund includes hedge funds, private equity funds and other pooled investment vehicles exempt from registration as investment companies under Section 3(c)(1) and/or Section 3(c)(7) of the U.S. Investment Company Act of 1940 ("Investment Company Act"). (Section 3(c)(1) is available to a fund that does not publicly offer the securities it issues and has 100 or fewer beneficial owners of its securities. Section 3(c)(7) is available to funds that cannot publicly offer the securities it issues and whose owners are "qualified purchasers" as defined in section 2(a)(51) of the Investment Company Act.) A private fund may also include an issuer that is excluded from the definition of an investment company in Section 3(c) of the Investment Company Act in addition to the exclusions provided by Section 3(c)(1) or 3(c)(7).

12-month period) clients and investors in private funds domiciled in the United States, will qualify for this exemption after July 21, 2011.[3] To avoid double counting, a non-U.S. adviser need not count a private fund as a client if it also counts any investor in such fund, but a non-U.S. adviser will have to count any U.S. investor in any non-U.S. fund under its management for purposes of meeting the threshold requirements of fewer than 15 clients and US$25 million assets under management. The US$25 million limitation clearly disadvantages non-U.S. advisers. We inquired of the staff of the SEC whether they intended (as permitted by the Dodd-Frank Act) to increase the US$25 million limitation but were told that there is currently no plan to do so.

Venture Capital Fund Exemption

The Dodd-Frank Act amended the U.S. Investment Advisers Act of 1940 ("Advisers Act") by creating a limited exemption for U.S. advisers who solely advise venture capital funds and directed the SEC to define the term "venture capital fund." The SEC has defined "venture capital fund" (see following paragraph) so as to distinguish venture capital funds from other private investment funds such as hedge funds and private equity funds as well as to limit systemic risks (as defined, venture capital funds should pose little threat to systemic stability, a prominent focus of the Dodd-Frank Act).

A venture capital fund is a private investment fund that:

- invests primarily in "qualifying investments,"[4] and which holds no more than 20% of the fund's capital commitments in non-qualifying investments (other than short-term holdings);
- is not leveraged other than for minimal short-term borrowing;
- does not offer its investors redemption or similar liquidity rights; and
- represents itself to investors as pursuing a venture capital strategy.

In addition, the SEC has also adopted grandfather provisions that will exempt venture capital funds from registration so long as the venture capital fund (i) represented to such fund's investors at the time of the offering of its securities that it was a venture capital fund; (ii) closed on the commitments of one or more unaffiliated investors before December 31, 2010; and (iii) held (or holds) its final closing on or before July 21, 2011.

A venture capital fund as defined by the SEC is not limited to venture capital funds advised by a "U.S. adviser." Accordingly, a non-U.S. adviser may benefit from the venture capital fund exemption if all of the non-U.S. adviser's clients are venture capital funds as defined by the SEC (and without regard to any definition that local law or practice may impart), whether or not those venture capital funds are U.S. or non-U.S funds, or if such venture capital funds fall within the grandfather provisions addressed above.

Reporting and Record-Keeping Requirement for Certain Exempt Advisors

Finally, both U.S. and non-U.S. advisers should note that although they may be exempted from registration under the Advisers Act, they are not totally free from the SEC's supervision. Rule 204-4 subjects advisers who qualify for exemption under either the private fund adviser exemption or the venture capital fund exemption to reporting requirements as an "exempt reporting adviser." Note that a non-U.S. adviser claiming the "foreign private adviser" exemption is not subject to such reporting requirements and, presumably, would not be subject to SEC examination (see below). An exempt reporting adviser must disclose whether it qualifies for exemption under either the private adviser exemption or venture capital fund exemption in an initial Form ADV (Part 1 only) with the SEC between January 1, 2012 and March 30, 2012.[5] An exempt reporting adviser must complete certain items in Part 1 of Form ADV (but not Part 2 of Form ADV) regarding its business and the fund(s) it advises and file this Form ADV with the SEC.[6] Moreover, an exempt reporting adviser must as part of its annual updates (see footnote 6) on Form ADV confirm that the exemption on which it initially relied is still applicable.

It is also important to note that exempt reporting advisers are required to maintain such records and submit such reports as the SEC determines "necessary or appropriate in the public interest or for the protection of investors". However, the SEC has not yet implemented any specific record keeping requirements; we expect such requirements to be the subject of future SEC rule making.

Although the new rules do not provide for routine examinations of exempt reporting advisers by the SEC, Chairman Mary L. Shapiro in her opening statement at the SEC's June 22nd open meeting, stated that the SEC will maintain authority to examine exempt reporting advisers.

3 As noted herein, the private fund adviser exemption and the venture capital fund exemption may otherwise be available to a non-U.S. adviser.

4 Qualifying investments generally consist of equity securities of "qualifying portfolio companies" that are directly acquired by the fund. The SEC has defined a "qualifying portfolio company" as any company that: (i) is not a reporting company and does not have a control relationship with a reporting company; (ii) does not borrow or issue debt obligations in connection with the investment by the private fund and distribute proceeds of the borrowing or issuance to the private fund in exchange for the private fund investment; and (iii) is not itself a fund (*i.e.*, is an operating company).

5 After March 30, new exempt reporting advisers must file within 60 days of relying upon the venture capital exemption or the private fund adviser exemption.

6 Question 7.B on Part 1 of Form ADV and the corresponding Schedule D sections identify basic information about the adviser such as its ownership, the name, domicile and gross assets of the funds under management, the private fund(s)' investment strategy, other business interests of the adviser and its affiliates, and disciplinary actions taken against the adviser and its employees. In addition, the Part 1 of Form ADV also requires information about the private fund(s)' auditors, prime brokers, custodians and administrators. This information is required to be updated at least annually, within 90 days of the end of the adviser's fiscal year. However, more frequent updates may be needed to reflect material changes in the adviser's business.

> *The SEC has defined "venture capital fund" so as to distinguish venture capital funds from other private investment funds such as hedge funds and private equity funds as well as to limit systemic risks (as defined, venture capital funds should pose little threat to systemic stability, a prominent focus of the Dodd-Frank Act).*

The SEC expects to conduct such examination only where it believes that there is cause, such as where there are indications of wrong doing. In addition, the SEC has asked its staff to consider and report on the adequacy of the level of reporting by exempt reporting advisers after the first year of filings.

Family Offices Exemption

The SEC adopted the exemption for U.S. advisers to family offices and expanded the exemption to permit additional family members. The Dodd-Frank Act directed the SEC to define the term "family offices" and mandated that any definition of "family offices" adopted by the SEC should be "consistent with its previous exemptive policy" and that the SEC should take into account the "range of organizational, management, and employment structures and arrangements employed by family offices."

The SEC adopted the final rule that defines a family office as one that advises only family clients.[7]

In addition, a family office must be wholly owned by family clients and does not hold itself out to the public as an investment adviser. The SEC's rationale is that a family office is essentially a family managing its own wealth and as such, the family should control the family office.

The SEC in accordance with the requirements of the Dodd-Frank Act has also incorporated a grandfather provision in the final rule and, accordingly, certain family offices will still be exempt from registration although they provide investment advice to certain clients, provided that such family office provided such services to the client prior to January 1, 2010.

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7 The SEC has broadly defined the term family clients to include:

- present and former family members, including all lineal descendants of a common ancestor, current and former spouses, all children by adoption and current and former stepchildren;
- family trusts and estates, including any irrevocable trust in which one or more family clients are the only current beneficiaries, any revocable trust in which one or more family clients are the sole grantors whether or not the beneficiaries of the trust are family members, any estate of a family member, former family member, key employee or former key employee;
- non-profit and charitable organizations, charitable trusts or any charitable organization funded exclusively by one or more other family clients;
- other family entities such as a company or a pooled investment vehicle that is wholly owned, directly or indirectly, by one or more family clients and operated for the sole benefit of family clients; and
- key employees of the family office, their estates and certain entities who are executive officers, directors, trustees, general partners, or persons serving in similar capacities at the family offices or affiliated family offices, or persons (other than solely administrative, clerical, or secretarial staff) who participate in the investment activities of the family offices or affiliated family offices and have been performing such functions for the family offices or has performed substantially similar functions on behalf of another company for at least twelve months (and key employees' spouses holding community property or shared ownership interest with the key employee).

Infrastructure Fund 101

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According to Preqin figures, general partners and managers of infrastructure funds are primarily located in Europe (38%), partly in Asia (32%) and to a lesser extent in North America (30%).

In 1986, the Channel Tunnel was one of the first notable infrastructure projects that received a lot of media coverage both in Europe and elsewhere. Unfortunately, the project planning process proved to be unrealistic and the Channel Tunnel was opened in 1994, later than planned and at a cost of £10 billion — double the initial estimate. The debt burden was staggering and in 1998 and 2007, two significant restructurings took place, with numerous shareholders losing their stake in the Eurotunnel entity.

Today, infrastructure investments in general are a much more lucrative asset class. Net IRRs in the 15–20% range are not uncommon. The IRR could be higher in in emerging market projects, brownfield projects with substantial construction elements or completely private infrastructure opportunities.

Infrastructure investments mainly cover utilities (*e.g.*, wastewater and portable water facilities, electricity grids and transmission lines, powerplants), social infrastructure (schools, hospitals, prisons), transportation (roads, highways, high speed rail, mass rapid transit, railway lines, bridges, tunnels, ports, airports) and communications infrastructure (telecom, satellite). These investments were traditionally regarded as subclasses of either private equity or real estate investments but infrastructure is now regarded as an asset class in its own right.

Investment Profile

Infrastructure investments are attractive because they are generally regarded as having a low correlation to economic cycles and to other asset classes. Their risk is limited and negative returns are very rare as the demand for the services provided by the infrastructure assets is generally inelastic. European insurance companies operating under the new Solvency II rules (*see* the related article in the IFG Newsletter, Spring 2011 Edition) may therefore increase their infrastructure exposure over the coming years, taking into account the moderate risk profile of these investments. Infrastructure investments could also generally serve as an inflation hedge as the underlying contracts often contain index-related tariffs subject to annual adjustment. In addition, infrastructure investments offer the highest risk-adjusted performance (Sharpe Ratio) of all asset classes. The returns are very stable over the economic cycles.

Infrastructure Funds

Infrastructure funds consist of both listed and unlisted investment vehicles. In addition, index- (*e.g.*, NMX) related products offer an alternative means of investing in infrastructure assets. Listed vehicles oftentimes serve as feeders for unlisted investment vehicles. Unlisted investment vehicles are generally structured as limited partnerships to provide the general partner (the sponsor) as well as the limited partners (the investors) with a maximum amount of flexibility with regard to fund governance and the distribution of investment proceeds.

In the second quarter of 2011, 131 unlisted infrastructure funds went to market, raising a total of $92.1 billion worth of commitments. Global Infrastructure Partners II ($5 billion), RREEF Pan-European Infrastructure Fund II (€3 billion) and Highstar Capital Fund IV ($3.5 billion) were the top three infrastructure funds in the market by target size.

According to Preqin figures, general partners and managers of infrastructure funds are primarily located in Europe (38%), partly in Asia (32%) and to a lesser extent in North America (30%). Europe's edge might be owed to the fact that private investments in public infrastructure have been the norm for quite some time. Although the UK's Public Finance Initiative ("PFI") did not nurture large dedicated infrastructure funds, it helped to build a track record and increased the investment in infrastructure assets by the private sector.

Financing Infrastructure Assets

Whilst governments have traditionally provided financing for infrastructure projects with cash and/or guarantees, this is not a sustainable financing model in the long-term. Financing from multilateral institutions (*e.g.*, World Bank, EBRD, EIB) as well as the private sector will become increasingly important in light of the significant deficits and sovereign debt levels in developed countries. In recent years, specialized funds focused on infrastructure investments have emerged, offering attractive yields to investors despite the current low-yield environment. In the United States, the move to a public-private partnership ("PPP") model will become more important in financing infrastructure projects and could prove to be an important source of funds so long as the governments concerned are able to demonstrate stability in policy and transactional capability to their private sector partners. With increased capital adequacy requirements for banks in the United States and Europe, however, the availability of traditional bank debt for new infrastructure projects and for refinancing existing debt will become increasingly constrained. Therefore, alternative financing options such as structured products and other capital markets solutions such as securitization will become more important. Structured finance offers a developer the ability to tap a wide range of investors, including investment funds, credit corporations and pension funds.

Outlook

As infrastructure investments in general are a very lucrative asset class because of their low correlation to economic cycles and other asset classes, their addition to a portfolio of investments provides a stable source of diversification. Infrastructure provides a vast array of investment opportunities both in developed and developing countries. In the developed countries such as the United States, existing infrastructure needs to be upgraded or expanded to keep up with population growth and improvements in the quality of life. In developing countries, infrastructure projects are greatly needed to provide basic services to their populations. According to Ernst & Young, over $53 trillion of private and public funds will flow into infrastructure investments by 2030 and RREEF reports that the infrastructure segment has already received investments of approximately $20.5 trillion.

Even the Channel Tunnel and related infrastructure projects have attracted a lot more positive attention. Two of Canada's largest pension funds, the Ontario Teachers' Pension Plan and Borealis, the infrastructure investment arm of Omers, paid £2.1 billion in 2010 to operate Britain's only high-speed railway line, the Channel Tunnel Rail Link, for the next 30 years.

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