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Aircraft Finance — A New Opportunity for Private Equity and Hedge Funds?

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Introduction

According to the Federal Aviation Administration's "FAA Aerospace Forecast (Fiscal Years 2011–2031)," the commercial air carrier industry will grow by a remarkable 3.7% over the next five years. System capacity in available seat miles – the overall yardstick for how busy aviation is on a global scale – will increase 4.5% in 2011 and is expected by the FAA to grow thereafter at an average annual rate of 3.6% through 2031.

In light of the limitation of available funding by commercial banks, private equity and hedge funds maintain an important position in the aviation leasing market and provide a significant source of much needed equity, lending and leasing capital. Fundraisings, financings and transactions that involve significant capital commitments over the past two years include: The Carlyle Group/RPK Capital Management; Cerberus Capital Management/AerCap Holdings; various financing entities managed by Doric Asset Management; CVC Capital Partners; Cinven; Oak Hill Capital Partners/Avolon; the Guggenheim Aviation Partners/Guggenheim Aviation Investment Fund II, LP; the National Bank of Abu Dhabi/DVB Bank joint venture; Oaktree Capital Management/Jackson Square Aviation; and TPG Credit Management's Airline Credit Opportunities II fund.

The types of assets that are suitable for private equity and hedge fund investments include:

- Aircraft and lease asset-backed securities
- Direct investment in aircraft and aircraft-owning entities
- Equity investment in aircraft leasing firms or joint ventures
- Secured and unsecured privately placed notes
- Loans secured by aircraft or aircraft-owning entities
- Co-investments with other investors/other funds in all of the above

IN THIS ISSUE

Advantages of Aircraft Investments

Apart from this relatively broad range of assets that meet financial sponsors' needs, there are additional characteristics that seem to attract private equity and hedge funds to the aircraft finance market. It is worth noting that significant amounts of capital can be put to work in aircraft-related transactions.

Business cycles, aircraft assets, particularly newer aircraft, have generally not been subject to heavy valuation fluctuations. From the U.S. tax point of view, aircraft investment can be structured in the form of asset-backed securities that qualify as debt with no U.S. withholding tax on the interest payments, thereby allowing a wide range of international entities to invest and participate.

In comparison to other alternative asset classes, which are subject to delayed repayments (the so-called "J Curve" or "hockey stick"), aviation leasing assets from the start provide current lease income and certain tax benefits to investors. Aviation assets also are "hard assets" with fairly ascertainable market and residual values to which investors tend to flock in turbulent times. Finally, the learning curve for the establishment of relationships, technical expertise as well as the documentation of operating leases and purchase transactions help protect the aviation investment and finance industry from complete market overrun and structurally provide a limit to competitors.

Opportunities for Private Equity and Hedge Funds

Aviation finance by its very nature is capital-intensive, taking into account the 2011 list prices for, *e.g.*, a Boeing 787 Dreamliner at ($185–218 million) or an Airbus A380-800 at ($375 million) per aircraft. Financial sponsors can also benefit from the maturing of the aircraft market which leads to a standardization of the documentation for the leasing and financing of aircraft. In the current economic climate, balance sheet commitments from large strategic sponsors need to be replaced and private equity and hedge funds stand ready to fill this gap. Finally, the fast growing emerging markets in Asia, the Middle East, Africa and Latin America add to the need for additional financing sources. The recent bankruptcy filing by American Airlines may also serve to move debt toward the aircraft leasing entities financed by hedge funds and private equity funds rather than directly to the airlines.

Sponsor Requirements

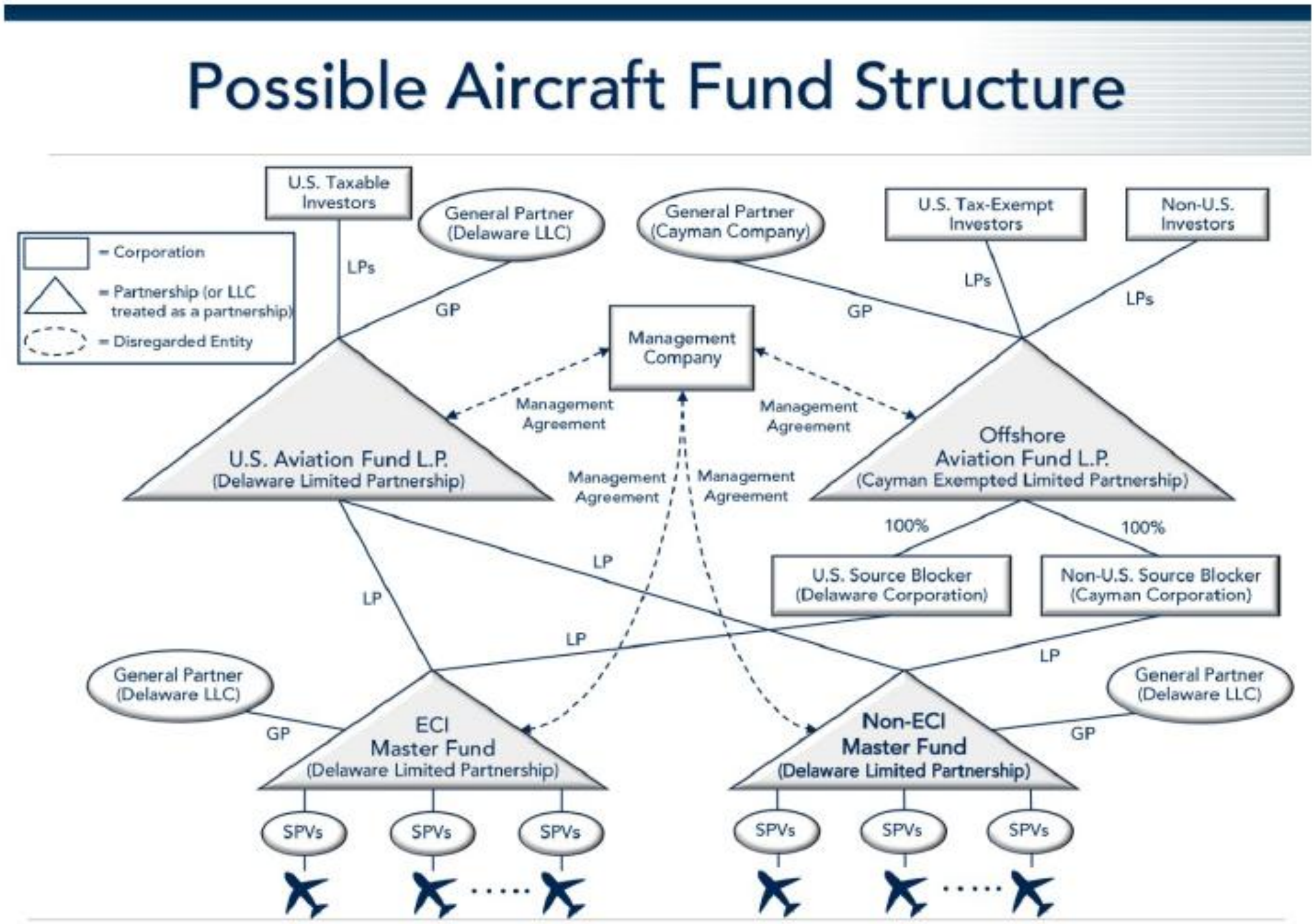
A private equity or hedge fund general partner would expect certain qualities from potential aircraft investments. Those would include synergies across aircraft-related investment platforms, opportunities based on market dislocations and illiquidity of financing availability, excess risk-adjusted returns and inflation protection in an asset that resets financial terms on a regular basis. Maximizing the pass-through of available tax benefits to U.S. taxable investors from ownership of aircraft, and minimizing tax and tax compliance burdens on non-U.S. and/or tax-exempt investors will also be a concern and will drive fund structure, as discussed below.

From the U.S. tax point of view, aircraft investment can be structured in the form of asset-backed securities that qualify as debt with no U.S. withholding tax on the interest payments, thereby allowing a wide range of international entities to invest and participate.

Tax-Optimized Fund Structure

The attached chart shows a sample for a parallel fund structure that would cater to the needs of U.S. taxable investors, U.S. tax-exempt investors as well as non-U.S. investors.

The parallel non-U.S./offshore fund structure shown allows U.S. taxable investors to access depreciation and other deductions, while sheltering non-U.S. investors from the obligation to file a tax return in the United States and directly to pay U.S. tax on lease or sales income treated as derived from a U.S. trade or business ("ECI"), while avoiding U.S. tax to such investors on fund income that is not ECI, including certain interest income on aircraft-secured debt and non-U.S.-based sales and rental income. U.S. tax-exempt investors, who would otherwise be directly liable for U.S. income tax on rental income (and, in some cases, sales income), should also be able to avoid direct filing and tax payment obligations under this structure. Lease-in/lease-out structures using fund-owned special purpose vehicles to hold, lease and sublease aircraft may be able to be availed of to avoid non-U.S. withholding taxes on aircraft rental income.



Additional Tax Considerations

Use of a traded corporate fund domiciled in a treaty jurisdiction may minimize income and withholding tax if real operations are present in the treaty jurisdiction. Sales and use taxes and VAT on sales of aircraft based on the location of the aircraft at the time of sale must be considered and will vary among jurisdictions, with some exemptions available. Allowable tax depreciation will vary among jurisdictions and may depend upon where aircraft is used.

Aviation assets also are "hard assets" with fairly ascertainable market and residual values to which investors tend to flock in turbulent times.

Exit Strategies

Exit strategies for aircraft investors include portfolio sales, portfolio (part-out) liquidations, the securitization of portfolios and the issuance of asset-backed/secured notes. Several IPOs of aircraft-finance related vehicles like Aircastle, AerCap Holdings or Air Lease Corporation have occurred in the recent past. Financial sponsors regard an IPO as an important exit strategy that usually offers attractive returns. In addition, asset management firms such as Doric Asset Management have tapped the IPO market to fund new entities that purchase designated aircraft, and lease such aircraft to a specific airline, thereby bringing the investor directly into the ownership of a specific aircraft lessor. These financing structures have been utilized most recently to finance the purchase of A380 aircraft as well as large shipping vessels.

2012 — The Outlook

This summary has so far highlighted that aircraft finance presents significant opportunities for financial sponsors. Still, some risks should be taken into consideration that may or may not materialize in the near future. For example, the base value appraisals supporting legacy secured debt capital markets transactions may be optimistic — especially with respect to older aircraft. Also, there is a potential book value problem lurking below the surface of some existing aircraft portfolios. The potential write-offs or write-downs could be material. Economic useful lives for new aircraft may be shorter than the historical averages due to the acceleration of new deliveries and new technologies in the aircraft market. New FASB and IFRS lease accounting rules will push debt attributable to operating leases back onto the balance sheet of airlines, which may negate some of the benefits of operating leasing transactions compared to debt financing of aircraft by airlines. The financial crisis, new financial regulations and in particular, new capital requirements on financial institutions are all putting pressure on the existing profitability of aircraft lenders, increasing the costs of borrowing, and again, favoring the ownership of aircraft by well-capitalized entities. Finally traded leasing companies may face difficult disclosure obligations relating to the implications of all the risks mentioned above — which may yet push the advantage in favor of the privately owned leasing firms.

The financial crisis, new financial regulations and in particular, new capital requirements on financial institutions are all putting pressure on the existing profitability of aircraft lenders, increasing the costs of borrowing, and again, favoring the ownership of aircraft by well-capitalized entities.

In spite of the foregoing, 2012 should prove to be a year of opportunity for hedge funds and private equity funds to create investment vehicles specifically designed for large scale investment in aircraft portfolios to take advantage of current market pricing (for both used and new commercial aircraft) and capital needs of both leasing companies and airlines.

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Some Practical Questions to Ask When Setting Up Your Prime Brokerage Arrangements in the Current Financial Environment

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The recent entry into liquidation (in the U.S.) and administration (in the UK) of the brokerage business of MF Global has brought to the fore the lessons learnt by prime brokerage customers (the "Customer") in the aftermath of the demise of Lehmans.

This article (i) sets out some of the main issues a Customer should consider in light of those lessons, (ii) poses some questions that the diligent Customer should be asking his/her prime broker in light of these issues and (iii) offers some practical solutions in response to the answers the Customer is likely to receive to such questions.

Some universal truths. Let's start with some basic facts about the current prime brokerage market:

(i) Most Customers will now want to have more than one prime broker and no one prime broker is a backup or a secondary broker. Apart from the benefits to pricing on individual trades that competitive tension will create, it will also allow Customers to manage any over-concentration of credit exposure to any single financial institution.

(ii) No single Customer is going the able to get standardized documents from his/her various prime brokers. The prime brokerage documents reflect the way a prime broker's operations are set up. They have evolved as the systems have evolved. What a prime broker can or cannot agree to in relation to the points raised below will, in most part, be determined by what it's operating systems will allow it to do. The optionality that a custom built operating system, which a new entrant into the prime broking market can offer, may not be possible for an established prime broker whose systems have been bolted onto its institution's existing functions.

(ii) No single Customer is going to be able to require that a prime broker change its institution's systems to meet that Customer's risk appetite. All a Customer can hope to achieve is (1) an understanding of how that prime broker's systems work in order to evaluate his/her risks, (2) require regular disclosure of the relevant risks by his/her prime broker and (3) building into his/her prime brokerage documentation sufficient flexibility so that he/she can switch between prime brokers with a minimum of disruption to trading activities.

Bilateral Termination Rights upon the insolvency of either party. Since Lehmans (and more so since MF Global), most prime brokers will agree to give the Customer the right to terminate his/her prime brokerage

How does this help the Customer? Once a prime brokerage arrangement is terminated, provisions relating to how to calculate a termination close-out amount in respect of all the trades and positions entered into under the prime brokerage arrangements will be applied and a net payment amount will be determined (the "Global Close-out Amount"), which may be payable by the prime broker or by the Customer.

arrangements with that prime broker if the latter becomes insolvent or that such arrangements will be automatically terminated, though what constitutes "becoming insolvent" will be subject to some debate.

How does this help the Customer? Once a prime brokerage arrangement is terminated, provisions relating to how to calculate a termination close-out amount in respect of all the trades and positions entered into under the prime brokerage arrangements will be applied and a net payment amount will be determined (the "Global Close-out Amount"), which may be payable by the prime broker or by the Customer. That net amount, if payable by the prime broker, will allow the Customer to file a proof with the trustee in liquidation (if in the U.S.) or administrator or other relevant insolvency practitioner (if in the UK) for a single amount.

To the diligent Customer, when entering into the prime brokerage arrangements, that's only the tip of the issue. What he/she then needs to work through with his prime broker (and ensure it is reflected in the documents), is how to work out that Global Close-out Amount. The issues the Customer needs to think about include:

- Can this amount be determined objectively, especially since when the Customer needs to work this amount out, they will be unlikely to get any input or assistance from the prime broker, which will be in the midst of its insolvency proceedings?
- What are the components to the Global Close-out Amount? As prime brokerage agreements are a suite of agreements, including the umbrella prime brokerage agreement (which would include any loan/leverage arrangements), the ISDA agreements (which has their own close out amount definition) and the GMSLA — the Customer needs to agree with the relevant prime broker how (i) each component amount is determined, (ii) if there is any double counting between each component amount (and if so, how the double counting is to be resolved) and (iii) how each component amount will be aggregated in order to work the actual Global Close-out Amount. Some prime brokers have master netting arrangements where the above is clearly set out, some arrangements are silent as to this point, in which case, the Customer should get the prime broker to explain how their operating systems work in order to ascertain the Global Close-out Amount if the Customer were to become insolvent, so that the Customer is able to run a similar exercise if the tables were turned.

It should also be noted that some prime brokers will offer a parent guarantee in order to give Customers comfort that their claims for the Global Close-out Amount will not only be against a insolvency entity. In light of the current dispute in the U.S. between the creditors of MF Global's parent and MF Global's prime brokerage customers (see *Bloomberg.com, 5 December 2011, 6.34pm GMT "MF Global Holdings should give priority to Brokerage Claims, Funds Say" and 6 December 2011, 5am GMT "MF Global Parent Creditors Clash with Brokerage Customers"*), the value of such parent guarantee should be scrutinized from a credit perspective.

Rehypothecation, the right to resell and the pricing impact. There are three possible positions in respect of the prime broker's ability to rehypothecate or resell the Customer's securities. The prime broker can have (i) the right to use all of the Customer's securities ("Full Right to Use"), in which case if the prime broker becomes insolvent, such securities will form part of the prime broker's estate and the Customer will only have an unsecured claim in respect of such securities, (ii) a limited right to use the Customer's security ("Limited Right of Use"), usually linked to the amounts which the Customer has borrowed under the prime brokerage arrangements and (iii) no right to use any of the Customer's securities ("No Right to Use"), which is the ideal legal position as coupled with appropriate client account arrangements (c.f., see *Client Accounts — More than just a label*, below), such securities will fall outside the prime broker's estate if it becomes insolvent and not be available to other creditors of the prime broker.

Prime brokers will tell customers that as the right to use securities becomes more limited, the pricing offered under the prime brokerage arrangements will have to increase as a portion of the fees generated by the ability of the prime broker to freely use such securities for other transactions (for example as part of repo arrangements entered into by the larger institution) are no longer available to be passed on to the Customer.

While that is not disputed, what the diligent Customer should be asking is how that pricing differential is determined. It is not unusual that as the details of how the pricing differences are worked out, basis points can be shaved off such increased pricing.

Sometimes, it is just as likely that the Customer will discover that the prime broker's systems do not offer the granularity of information necessary to ascertain the pricing differential and that the initial offered price differential was just a best guess!

A number of points for the Customer to be aware of:

- Just because a prime broker's systems can track the use of the Customer's securities operationally in the Full Right to Use and Limited Right to Use scenarios, that does not necessarily mean that legally, the Customer's rights to such securities can be traced through the insolvency of a prime broker.
- Even if the parties agree to a Limited Right of Use or a No Right to Use arrangement, it does not mean that in the insolvency of the prime broker, they will automatically be able to seize those securities out of the hands of the relevant insolvency practitioner. In order to do that, express provision for the re-delivery of securities in these circumstances will need to be built into the prime brokerage agreements and relevant insolvency legal advice taken as to the efficacy of such re-delivery obligations where the prime broker is insolvent.

Client Accounts — More than just a label. The practical fallout of the Lehmans cases, is that it has become obvious that just because a Customer's cash and/or securities are held in an account that is labeled a Client Account and/or the prime broker is required under the prime brokerage arrangements to hold such assets in a client account, it does not necessarily mean that the courts will recognize that label and/or the contractual obligation of the prime broker to do so.[1] In a number of the Lehmans English cases (though by no means in all of them), the courts have determined that, on the facts and as a matter of substance (notwithstanding the express contractual provision to the contrary), certain accounts were treated as not segregated from Lehmans' estate.

What is the diligent Customer to do if (a) he/she can't rely on what the contract says and (b) the prime broker cannot as a commercial reality agree to change its operating structure for just him/her as a separate client? The answer is that he/she must be informed and vigilant in managing his/her credit risk exposure to the prime broker.

To ensure that the Customer has the necessary information to be vigilant, he/she could also require the prime broker to deliver revised Schedules in the event that the prime broker's internal operation and treatment of such accounts change or if the information in the Schedule is no longer materially accurate.

To ensure that the Customer is informed, we would suggest that the prime brokerage agreement contain a schedule (the "Schedule") describing how (i) each type of client/custody account is set up within the institution, (ii) the key features of such account, (iii) the legal status of such account within the prime broker's institution (for example if the prime broker was Lehmans, would this account's contents be swept into Lehmans' centralized RASCALs clearing system) and with the FSA and (iv) the prime broker's envisaged status of such account in the event of its insolvency — such information does not have to be presented in words but can be presented as diagrams, so long as it has sufficient detail to allow the Customer to ascertain how the account is actually being operated and treated by the institutional group that the prime broker is a member of — and a representation in the agreement stating that as at the date of the agreement, this is how the relevant accounts will be operated.

To ensure that the Customer has the necessary information to be vigilant, he/she could also require the prime broker to deliver revised Schedules in the event that the prime broker's internal operation and treatment of such accounts change or if the information in the Schedule is no longer materially accurate.

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[1] Contrast this with the current mood in the NY Bankruptcy courts in relation to the bankruptcy of MF Global Inc. and the recovery of money held in client accounts where the trustee in liquidation has indicated that it intends to pursue all legally available assets from parties that have mislabeled money as being in client accounts. See *Bloomberg.com, 8 December 2011, 11.49am ET "MF Trustee to pursue 'legally available' Assets"*

With this as a basis, the Customer should have the information necessary to ascertain how his/her accounts are being treated and therefore be able to make an informed decision when managing the credit exposure to such accounts.

Conclusion. This article sets out some of the main issues and developments in the prime brokerage space since the Lehmans insolvency and is by no means exhaustive. However, as the current MF Global insolvency continues to work itself out in the U.S. and the UK, Customers and prime brokers will get to see if those developments have proven effective in shielding the Customers' operations from the inevitable disruptions that occur when a node in the prime brokerage market becomes insolvent. Some of these features, such as the parent guarantees, will likely become less prominent as they prove to be less effective at protecting customers and others, more common, such as having two or more brokers, as they prove to be more effective in ensuring the continued smooth operation of the Customer's trades.

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Investment advisers with less than $150 million of assets under management in the United States and that advise only private funds are exempt from the registration requirements of the Advisers Act.

Registration as an Investment Adviser under the Investment Advisers Act

Investment advisers are regulated in the United States under the U.S. Investment Advisers Act of 1940 ("Advisers Act"). The Advisers Act reflects congressional recognition of the delicate fiduciary nature of the advisory relationship, as well as Congress' desire to eliminate, or at least expose, any conflicts of interest that might cause advisers to render advice that is not disinterested.

As of July 21, 2011, Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") eliminated the private adviser exemption that many investment advisers relied on to avoid registering with the U.S. Securities and Exchange Commission (the "SEC"). These advisers must register with the SEC by March 30, 2012, and will be subject to the same registration requirements, regulatory oversight and other requirements that apply to other SEC-registered investment advisers.

Who Is an Investment Adviser?

The Advisers Act defines an "investment adviser" as any person or firm that (i) is engaged in the business of (ii) providing advice to others or issuing reports or analyses regarding securities (iii) for compensation. While a person or firm must satisfy all three elements to fall within the definition of "investment adviser," there are several exclusions from the investment adviser definition available to persons who presumably satisfy each element. These exclusions are available to the following individuals and entities: U.S. banks, bank holding companies and federal savings associations (excluding investment adviser subsidiaries of such banks or bank holding companies); certain lawyers, accountants, engineers and teachers; brokers and dealers registered with the SEC that provide advice that is given solely incidental to the conduct of their business as brokers or dealers without receiving any "special compensation"; publishers; government securities advisors; credit rating agencies; and the U.S. government, state governments and their political subdivisions. A person or firm eligible for one of the exclusions is not subject to the registration requirements of the Advisers Act.

Which Investment Advisers Must Register Under the Advisers Act?

An advisory firm or person that falls within the definition of "investment adviser" and has at least US$100 million of assets under management is required to register with the SEC unless it qualifies for an exemption. Although the definition of "investment adviser" applies to many individuals who are employed by investment advisers, the SEC generally does not require these individuals to register as advisers with the SEC. Individuals who are employed by an investment adviser that is required to be registered are required to be disclosed as investment adviser representatives.

Historically, many investment advisers to private funds relied on an exemption (the "Fifteen Client Exemption") from registration under Section 203(b)(3) of the Advisers Act available to those advisers with fewer than 15 clients in the preceding 12 months who do not hold themselves out to the public as investment advisers and who do not act as advisers to registered investment companies or business development companies. As noted above, the Dodd-Frank Act repealed this Fifteen Client Exemption, requiring many previously unregistered advisers to register with the SEC by March 30, 2012.

An advisory firm or person that falls within the definition of "investment adviser" and has at least US$100 million of assets under management is required to register with the SEC unless it qualifies for an exemption.

On June 22, 2011, the SEC adopted rules pursuant to the Dodd-Frank Act that created three new exemptions from the registration requirements of the Advisers Act:

Private Fund Adviser Exemption. Investment advisers with less than $150 million of assets under management in the United States and that advise only private funds are exempt from the registration requirements of the Advisers Act. Such investment advisers are still required to file Part 1A of Form ADV within 60 days of first relying on the exemption (the first such filing must be made between January 1 and March 30, 2012) and within 90 days of the investment adviser's fiscal year end on an annual basis thereafter.

Foreign Private Adviser Exemption. "Foreign private advisers" are also exempt from the registration requirements of the Advisers Act. Under the Dodd-Frank Act, an investment adviser qualifies as a "foreign private adviser" if it (i) has no place of business in the United States; (ii) has fewer than 15 U.S. clients and investors in private funds advised by the adviser; (iii) has less than US$25 million (or such higher amount as the SEC may determine by rulemaking) of aggregate assets under management attributable to U.S. clients and investors in private funds advised by the adviser; and (iv) does not hold itself out as an investment adviser in the United States.

Venture Capital Fund Adviser Exemption. Investment advisers to "venture capital funds" are exempt from the registration requirements of the Advisers Act as well. To qualify for such exemption, an investment adviser may only advise venture capital funds. Investment advisers claiming exemption are subject to the same reporting requirements as those investment advisers relying on the private fund adviser exemption described above.

Mid-Sized Advisers Rule. The Dodd-Frank Act also created a new category of "mid-sized advisers." A mid-sized adviser is not required to register with the SEC if the investment adviser (i) has less than US$100 million of assets under management; (ii) is required to be registered as an investment adviser with the state(s) in which it maintains its principal office(s) and place(s) of business; and (iii) upon registering in the state(s), would be subject to examination as an investment adviser by such state(s).

How Does an Investment Adviser Register Under the Advisers Act?

Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities. It provides the means for registered firms to comply with their obligations to disclose material financial and disciplinary information to clients. Within 45 days, the SEC must grant registration or institute an administrative proceeding to determine whether registration should be denied. The SEC can deny registration if the investment adviser makes false or misleading statements in its application, has been convicted of a felony, or if it or any of its related persons has any securities-related convictions, injunctions or similar disciplinary events.

Investment advisers to "venture capital funds" are exempt from the registration requirements of the Advisers Act as well. To qualify for such exemption, an investment adviser may only advise venture capital funds.

The current version of Form ADV consists of Parts 1 and 2 and a series of Schedules:

Part 1 is primarily for SEC use. Part 1 requires information about the adviser's business, ownership, clients, employees, business practices (especially those involving potential conflicts with clients), and any disciplinary events of the investment adviser or its employees.

Part 2, which can be given to clients to satisfy the "brochure rule," is primarily for client use. It contains information such as the types of advisory services offered, the adviser's fee schedule, and the educational and business background of management and key advisory personnel of the adviser. It also contains information about arrangements that the adviser has that involve conflicts, such as when the investment adviser engages an affiliate to execute client transactions.

All applications for registration as an investment adviser with the SEC must be submitted electronically through an Internet-based filing system called the Investment Adviser Registration Depository. Once registered, an adviser must update Form ADV at least once a year, and more frequently if required by instructions to the form.

Part 1 and Part 2 of Form ADV are posted for public viewing on the SEC's Investment Adviser Public Disclosure website at www.adviserinfo.sec.gov.

All applications for registration as an investment adviser with the SEC must be submitted electronically through an Internet-based filing system called the Investment Adviser Registration Depository. Once registered, an adviser must update Form ADV at least once a year, and more frequently if required by instructions to the form.

An adviser may withdraw from registration by filing Form ADV-W if it: (i) ceases to be an investment adviser; (ii) is entitled to an exception from the registration requirements that also does not require reporting on Form ADV; or (iii) is no longer eligible for SEC registration (*e.g.*, it no longer has more than $100 million of assets under management).

It should be noted that investment advisers that are subject to registration and relying on the exemptions created by the new SEC rules must file Form ADV no later than February 14, 2012, to satisfy the 45-day review period before the March 30, 2012 registration deadline.

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Important Modifications to Accredited Investor Definition — Effective Late February 2012

On December 21, 2011, the Securities and Exchange Commission adopted amendments[1] to the definition of an "accredited investor" under Regulation D, promulgated under the Securities Act of 1933. This amendment implements the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

By operation of law, upon enactment of the Dodd-Frank Act on July 21, 2010, the definition of "accredited investor" in Rule 501(a)(5) of the Securities Act was modified to provide that to qualify as an accredited investor based solely on net worth, an individual must have (alone or together with his or her spouse) a net worth in excess of $1 million, *excluding the value of his or her primary residence*. Dodd-Frank required the SEC to adjust the accredited investor net worth standard in Securities Act Rules 501 and 215[2] to conform these rules to the modified standard.

As amended, the individual net worth standard requires that, in calculating net worth:

- the primary residence not be included as an asset; and
- debt secured by the primary residence not be included as a liability, *except that*
    - if the amount of debt secured by the primary residence has increased in the 60 days preceding the accredited investor determination, other than in connection with the acquisition of the residence, the amount of such increase must be included as a liability; and
    - if the amount of debt secured by the primary residence exceeds the estimated fair market value of the primary residence, the amount of such excess must be included as a liability.

The amended rule provides that "incremental debt" secured by an investor's primary residence that is incurred in the 60-day period before the purchase of securities will be included as a liability.[3] The Release specifically states that when performing the net worth calculation, an investor who has re-financed his or her primary residence within the 60-day look-back period must treat the incremental debt as a liability *even if the value of the primary residence exceeds the amount of the debt* secured by the residence.

1 See Sec. Act Release No. 33-9287 (Dec. 21, 2011) (the "Release").

2 17 CFR 230.501(a)(5) and 230.215(e).

3 See amended rule at § 230.501(a)(5)(i)(B).

As noted, the value of the primary residence is not included in calculating an investor's net worth. If debt is incurred by the investor in connection with the acquisition of the primary residence, the debt is also excluded from the calculation. However, if the mortgage is underwater, the excess of the mortgage over the fair market value of the primary residence will be included as a liability in the net worth calculation.

As under the prior rule, net worth is calculated at the time of the purchase of securities. The rule requires only an estimated fair market value and no third party valuation or appraisal is required.[4]

The amendment also includes a transitional provision — the former accredited investor net worth test[5] will apply to acquisitions of securities pursuant to rights to acquire securities if:

- the rights were held on July 20, 2010;
- the person qualified as an accredited investor on the basis of the net worth definition at the time the rights were acquired; and
- the person held securities of the issuer, excluding these rights, on July 20, 2010.

As under the prior rule, net worth is calculated at the time of the purchase of securities. The rule requires only an estimated fair market value and no third party valuation or appraisal is required.

These grandfathering provisions apply to the exercise of statutory rights which may include pre-emptive rights arising under state law; rights arising under an entity's constituent documents; rights of first refusal; and contractual rights to acquire securities upon exercise of an option or warrant or upon conversion of a convertible security.

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4 The Release, at page 34.

5 Under the former standard, the value of a primary residence could be included in a calculation of net worth in determining whether an individual was an accredited investor.

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To address this issue, the Proposed Regulations provide that an entity will not be considered to engage in commercial activities if it conducts only "inadvertent commercial activity."

IRS Issues Proposed Section 892 Regulations

The IRS has recently issued proposed Treasury Regulations (the "Proposed Regulations") that provide guidance relating to the taxation of the income of foreign governments from investments in the United States under Section 892 of the U.S. Internal Revenue Code of 1986, as amended. The Proposed Regulations impact foreign governmental entities that derive income from sources within the United States and, as such, are relevant to sponsors of private equity and hedge funds with sovereign wealth fund or other non-U.S. governmental entity investors.

Section 892 — In General

In general, Section 892 exempts from U.S. income taxation certain qualified investment income (*e.g.*, income from certain investments in stocks, bonds and other securities) derived by a "foreign government." The term "foreign government" means only the "integral parts"[1] or "controlled entities"[2] of a foreign sovereign. The exemption from U.S. income tax under Section 892 does not apply to income (1) derived from the conduct of any "commercial activity" (defined below), (2) received *by* a "controlled commercial entity" or received (directly or indirectly) *from* a "controlled commercial entity," or (3) derived from the disposition of any interest in a "controlled commercial entity." The term "controlled commercial entity" is defined as any entity owned by the foreign government that meets certain ownership or control thresholds and that is engaged in commercial activities anywhere in the world.

An *integral part* of a foreign sovereign that derives income from both qualified investments and from the conduct of commercial activity is eligible to claim the Section 892 exemption with respect to the income from qualified investments, although not with respect to the income derived from the conduct of commercial activity. By contrast, if a *controlled entity* of the foreign government engages in commercial activities anywhere in the world, it is treated as a controlled commercial entity, and **none** of its income (including income from otherwise qualified investments) qualifies for exemption under Section 892. In addition, none of the income derived from the controlled entity (*e.g.*, dividends), including the portion attributable to qualified investments of the controlled entity, will be eligible for the Section 892 exemption in such case. This "all or nothing" approach has represented a significant administrative and operational burden for foreign governments and a trap for unwary foreign governments that inadvertently conduct even a small level of commercial activity.

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[1] In general, an "integral part" of a foreign sovereign is any person, body of persons, organization, agency, bureau, fund, instrumentality or other body, however designated, that constitutes a governing authority of a foreign country.

[2] The term "controlled entity" generally means an entity that is separated in form from a foreign sovereign, is wholly owned and controlled by the foreign sovereign (directly or indirectly), is organized under the laws of the foreign sovereign, the net earnings of which are credited to its own account or to other accounts of the foreign sovereign, with no portion of its income inuring to the benefit of any private person, and the assets of which vest in the foreign sovereign upon dissolution.

Exception for Inadvertent Commercial Activity

To address this issue, the Proposed Regulations provide that an entity will not be considered to engage in commercial activities if it conducts only "inadvertent commercial activity." Commercial activity will be treated as "inadvertent commercial activity" only if: (1) the failure to avoid conducting the commercial activity is "reasonable"; (2) the commercial activity is promptly cured; and (3) certain record maintenance requirements are met. **If commercial activity is treated as inadvertent, the income derived from such inadvertent commercial activity will not itself qualify for the exemption under Section 892, but the entity will not lose its entitlement to the Section 892 exemption entirely (*i.e.*, the entity will remain eligible for the exemption under Section 892 on qualified (non-commercial activity) investment income)**.

In determining whether an entity's failure to avoid conducting a particular commercial activity is "reasonable," the Proposed Regulations provide that due regard will be given to the number of commercial activities conducted during the taxable year, as well as the amount of income earned from, and assets used in, the conduct of the commercial activity in relationship to the entity's total income and assets. A failure to avoid conducting commercial activity will not be considered reasonable unless adequate written policies and operational procedures are in place to monitor the entity's worldwide activities. **As such, controlled entities of foreign governments are well advised to adopt such policies and procedures as soon as possible.**

The Proposed Regulations include a safe harbor under which, **provided that there are adequate written policies and operational procedures in place to monitor the entity's worldwide activities**, the controlled entity's failure to avoid the conduct of commercial activity during a taxable year will be considered "reasonable" if: (1) the value of the assets used in, or held for use in, the activity does not exceed five percent (5%) of the total value of the assets reflected on the entity's balance sheet for the taxable year as prepared for financial accounting purposes; and (2) the income earned by the entity from the commercial activity does not exceed five percent (5%) of the entity's gross income as reflected on its income statement for the taxable year as prepared for such purposes.

Annual Determination of Controlled Commercial Entity Status

The Proposed Regulations provide that the determination of whether an entity is a "controlled commercial entity" will be made on an annual basis. **Accordingly, an entity will not be considered a controlled commercial entity for a taxable year solely because the entity engaged in commercial activities in a prior taxable year**. Although this was generally considered by tax practitioners to be the rule prior to issuance of the Proposed Regulations, this is a helpful clarification.

Definition of Commercial Activity — In General

The existing Treasury Regulations under Section 892 provide rules for determining whether income is derived from the conduct of a "commercial activity," and specifically identify certain activities that are not commercial, including certain investments, trading activities, cultural events, non-profit activities and governmental functions. The Proposed Regulations clarify that only the nature of an activity, not the purpose or motivation for conducting the activity, is determinative of whether the activity is a commercial activity. Furthermore, the Proposed Regulations clarify that an activity may be considered a commercial activity even if the activity does not constitute a trade or business for other U.S. federal income tax purposes.

Definition of Commercial Activity — Financial Instruments

The existing Treasury Regulations under Section 892 provide that investments in financial instruments (generally defined to include any forward, futures or options contract, swap agreement or similar instrument in a functional or nonfunctional currency or in precious metals), are not treated as "commercial activities" if held in the execution of governmental financial or monetary policy. The Proposed Regulations modify this rule by providing that investments in financial instruments will not be treated as commercial activities irrespective of whether such financial instruments are held in the execution of governmental financial or monetary policy. Similarly, the Proposed Regulations expand the existing exception from commercial activity for trading of stocks, securities, and commodities to include financial instruments, without regard to whether such financial instruments are held in the execution of governmental financial or monetary policy.

The foregoing modifications address **only** the definition of commercial activity for purposes of determining whether a government will be considered to derive income from the conduct of a commercial activity, or whether a controlled entity will be considered to be engaged in commercial activities. They do not address whether income from activities that are not commercial activities will be exempt from U.S. tax under Section 892. As such, the Proposed Regulations do not change the existing rule that only income derived from investments in financial instruments held in the execution of governmental financial or monetary policy qualifies for the exemption under Section 892.

Definition of Commercial Activity — U.S. Real Property Interests

In general, a nonresident alien or foreign corporation is required to take into account gain or loss from the disposition of a U.S. real property interest (a "USRPI") as if the taxpayer were engaged in a trade or business within the United States during the taxable year and as if such gain or loss were effectively connected with that trade or business. **The Proposed Regulations provide that a disposition (including a deemed disposition by way of "capital gain" dividends from a real estate investment trust or certain regulated investment companies) of a USRPI, by itself, does not constitute the conduct of a commercial activity. However, the Proposed Regulations do not change the existing rule that the income derived from the disposition of a USRPI (other than a non-controlling interest in a so-called "U.S. real property holding corporation") does not qualify for the exemption under Section 892.**

Investments in Partnerships

In general, commercial activities of a partnership are attributable to its general and limited partners (the "partnership attribution rule"), subject to a limited exception for partners of publicly traded partnerships ("PTPs"). The Proposed Regulations provide a more general exception for limited partnership interests. Under this revised exception, an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a "limited partner in a limited partnership," including a PTP that qualifies as a limited partnership.

For this purpose only, an interest as a limited partner in a limited partnership is defined as an interest in any entity classified as a partnership for U.S. federal tax purposes if the holder of the interest does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the law of the jurisdiction in which the partnership is organized or under the entity's governing agreement.

Notwithstanding the above, a limited partner's distributive share of partnership income attributable to commercial activity will be considered to be derived from the conduct of commercial activity, and therefore will not be exempt under Section 892. Furthermore, in the case of a partnership that itself is a controlled commercial entity, no part of the foreign government partner's distributive share of income from such partnership will qualify for the exemption under Section 892.

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