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# 16th Annual Private Investment Funds Seminar

Thursday, January 18, 2007



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### **Introduction | The Regulatory Climate**

Paul N. Roth

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Stephanie R. Breslow | Kelli L. Moll

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### **Enforcement and Litigation Update: What Are the Regulators Up To and Impact on Civil Litigation**

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### **The Whys and Why Nots to Acquire Hedge Fund Managers**

Stuart Bohart | Managing Director and Head of Alternative Investments,  
Morgan Stanley Investment Management

## About the Speakers



## Stuart Bohart

Managing Director and Head of Alternative Investments  
Morgan Stanley Investment Management



Stuart Bohart is a managing director and head of Alternative Investments at Morgan Stanley Investment Management.

Stuart joined Morgan Stanley in 1997 as a portfolio manager in the investment management business, where he co-managed a global multi-strategy equity fund. He subsequently headed risk management for the firm's prime brokerage and stock loan businesses. He became head of International Prime Brokerage in 2003 and global head of Prime Brokerage in 2005. He was appointed Head of Alternative Investments in 2006.

Stuart's previous experience includes portfolio management and trading positions at Harvard University's endowment fund, Bankers Trust and FrontPoint Partners.

Stuart graduated from Northwestern University in 1989 with dual degrees in Economics and Asian Studies. He has lived and worked in Beijing, Tokyo and London. He currently resides in New York City with his wife and two daughters.

## Stephanie R. Breslow

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Stephanie R. Breslow is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. Her practice concentrates on investment management, partnerships and securities, focusing on hedge funds and private equity funds, as well as broker-dealer and investment management regulatory advice.

Stephanie is a 1984 graduate of Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and a 1981 graduate of Harvard University. Stephanie is listed in *Chambers Global: The World's Leading Lawyers*, *Best Lawyers in America*, *America's Leading Lawyers* and *Who's Who Legal: The International Who's Who of Business Lawyers*. An author on subjects relating to private investment funds and private equity, Stephanie is the co-author of *New York Limited Liability Companies: A Guide to Law and Practice* and *New York and Delaware Business Entities*, both published by West. A frequent speaker at industry forums, earlier this year she delivered a presentation titled "Off-Shore Hedge Funds" to the Compliance Division of the Securities and Exchange Commission.

She is a founding member and former chair of the Private Investment Fund Forum, a former member of the Steering Committee of the Wall Street Fund Forum, a member of the 100 Women in Hedge Funds Lawyers Committee and a member of The Joyce Theater in New York.

## Harry S. Davis

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Harry S. Davis is a partner in the Litigation Practice Group of Schulte Roth & Zabel LLP in New York. Harry specializes in complex commercial litigation and regulatory matters for financial services industry clients, including hedge funds, funds of funds, prime brokers, auditors and administrators.

Harry has substantial experience with both securities regulatory matters and private litigation, including investigations by the Securities and Exchange Commission, U.S. Attorneys Offices, Department of Justice, Commodities Futures Trading Commission, Federal Trade Commission, state attorneys general, state securities regulators and self-regulatory organizations. Harry has also litigated numerous cases in federal and state court throughout the United States. Throughout his career, Harry has handled a wide variety of insider trading, market manipulation, short swing profit, securities and common law fraud, hedge fund advertising, breach of fiduciary duty and breach of contract cases. To detect and prevent small issues from growing into bigger problems, he also provides litigation and compliance counseling to, and conducts internal investigations for, many of Schulte Roth & Zabel's hedge fund clients.

Most recently, Harry has represented clients in connection with regulatory investigations and litigations relating to Manhattan Investment Fund, Beacon Hill, Durus and the ongoing mutual fund market timing investigations by federal and state regulators, as well as the SEC's ongoing PIPEs investigation. Harry has also won important victories on behalf of hedge funds in novel securities law and fraudulent transfer litigations that presented issues of first impression in New York and California.

Harry is a 1988 *magna cum laude* graduate of Cornell Law School, where he served as an associate editor of the *Cornell Law Review* and was a member of the Moot Court Board and the National Trial Advocacy Team, and is a 1984 graduate of The Johns Hopkins University. Prior to joining Schulte Roth & Zabel, Harry was associated with Cravath Swaine & Moore and served as a law clerk to Hon. Joseph Tauro (U.S. District Court for the District of Massachusetts). A prolific author and speaker, he is frequently quoted by the national press on topics of interest to hedge fund managers and service providers.

## Nancy R. Finkelstein

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Nancy R. Finkelstein is a partner in the Finance Practice Group at Schulte Roth & Zabel LLP. Her practice consists of representing banks, finance companies, private equity funds, hedge funds and corporate borrowers in a wide variety of finance transactions including corporate restructurings of both public and private companies and leveraged acquisitions. Nancy has extensive experience in various aspects of distressed investing and lending and regularly represents funds as borrowers through hedge fund redemption facilities, capital call loans, warehouse lines of credit and mortgage repurchase facilities. Nancy is a member of the board of directors of the New York chapter of the Turnaround Management Association.

### Recent transactions include:

- Representation of a fund in connection with loans to a public gaming company
- Representation of a lender in connection with tender offer financing for a public retail company
- Representation of a fund in connection with loans to a medical products business
- Representation of a fund in the financing of its own business through a mortgage repurchase facility
- Representation of a fund in a tender offer for a jewelry chain
- Representation of a bank funding a foreign acquisition by several private equity funds secured by capital calls
- Representation of a hedge fund in a new blended financing product offered by an investment bank

## Steven J. Fredman

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Steven J. Fredman is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. He practices primarily in the areas of investment funds (domestic and offshore), investment advisers and broker-dealers, acquisitions and financings of investment management firms, and securities regulation.

Significant transactions include:

- **Investment Partnerships and Investment Management:** Steven has structured and organized private investment partnerships and offshore funds, including general equity, arbitrage, global investment, private equity, distressed company, "small cap" and "funds of funds"; and provided counsel on issues relating to partnership law and the development of new products.
- **Regulatory:** Steven has structured and organized investment advisers and broker/dealers; handled registration of commodity pool operators and commodity trading advisors; and provided ongoing advice to investment advisers on securities law issues.
- **Acquisitions and Financings:** Steven has represented clients in connection with acquisitions and sales of investment management firms.

Steven is a 1980 graduate of Georgetown University Law Center, where he was editor of *Law and Policy in International Business*, and a 1977 *Phi Beta Kappa* graduate of Columbia University. He is a past member of the Committee on Partnership of the American Bar Association and the Committee on Art Law of the New York City Bar Association.

## Kelli L. Moll

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Kelli L. Moll is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. Her area of concentration is investment management, including organization of, and advice to, hedge funds, private equity funds and investment advisers.

Kelli has represented numerous hedge funds and their managers in connection with formation, compensation and vesting arrangements for employees, spin-offs of proprietary trading groups, acquisition of trading groups, seed capital arrangements and private equity co-investments.

A 1989 graduate of the University of Illinois at Urbana-Champaign, where she received a B.A. in finance, Kelli received her law degree in 1993 from Loyola University of Chicago, where she was a staff editor of *The Business Lawyer* and case editor of the *Loyola Consumer Law Reporter*.

Kelli has lectured extensively on hedge funds, including presentations on “The Regulations of Hedge Funds” for the Investment Management Institute, “Establishing a Framework of Internal Policies, Practices, and Controls” for the American Conference Institute, and numerous firm-sponsored seminars. She has also written extensively on a variety of issues affecting hedge funds.

## David Nissenbaum

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David Nissenbaum is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. His practice focuses on corporate, bank regulation and securities matters. He represents institutional and entrepreneurial investment managers and private investment funds in all aspects of their business.

Representative engagements and transactions have included:

- Counseling numerous institutions on issues related to running investment management businesses, including structures, compliance and managing conflicts of interest
- Representing a proprietary trading group on its spin-off from a major banking institution, on seed capital investment in the new management company and on the formation of domestic and offshore hedge funds
- Providing restructuring advice to an entire group of domestic and offshore funds of funds to comply with the U.S. Bank Holding Company Act of 1956 after the funds' investment manager was acquired by a major U.S. bank holding company
- Advising a major commercial finance company subsidiary of a foreign bank on structuring joint ventures and equity investments in U.S. and non-U.S. companies
- Preparing applications for Federal Reserve Board and state banking department approvals for numerous transactions, including in connection with the creation of The Mizuho Group (at the time, the largest banking organization worldwide in terms of assets)
- Forming, and securing SEC and NASD approvals to establish, broker-dealers for banks and M&A and other advisory firms

David is a 1993 graduate of the Brooklyn Law School, where he was an Edward G. Sparer Fellow. He is a 1990 graduate of the State University of New York at Albany and was a National Merit Scholar. He speaks frequently at industry events and before regulatory agencies.

## Martin L. Perschetz

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Martin L. Perschetz is a partner in, and co-chair of, the Litigation Practice Group at Schulte Roth & Zabel LLP. Also a member of the firm's Executive Committee, he concentrates his practice in the areas of white-collar criminal defense, SEC enforcement, securities litigation and accountant's liability. He has been at the firm for over 20 years.

Marty is a former Assistant U.S. Attorney for the Southern District of New York, where he was Chief of the Major Crimes Unit. As such, he was in charge of a team of prosecutors investigating and prosecuting federal criminal cases involving a wide variety of complex business and tax frauds. Subsequently, before coming to Schulte Roth & Zabel, he served as Chief Counsel to the Mayor of New York City's Special Commission to Investigate City Contracts and as Deputy Commissioner of the New York City Department of Investigation.

Utilizing his broad prosecutorial, investigative and trial experience, Marty has represented an array of major clients in significant matters involving federal and state prosecutors, the Securities & Exchange Commission, the New York Stock Exchange and the National Association of Securities Dealers, as well as in large and complex private civil litigation. Among Marty's clients in recent securities and financial statement matters are PricewaterhouseCoopers LLP and "Big Four" accounting firm auditors; Millennium Partners; The Clinton Group; and former senior officials at Merck, Vivendi/Universal and Kmart Corporation. Currently, he is representing a public corporation in an SEC investigation and related securities litigation resulting from allegations pertaining to stock option practices. Marty, who has practiced for almost 30 years, has been recognized by organizations such as "Super Lawyers" and "Best Lawyers in America" for his achievements and standing in the legal community,.

Marty is a 1977 graduate of the University at Buffalo Law School, The State University of New York, where he was a case and comment editor of the *Buffalo Law Review*. He obtained his undergraduate degree from the University of Maryland in 1974.

## Frederic L. Ragucci

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Frederic L. Ragucci is a partner in the Finance Practice Group at Schulte Roth & Zabel LLP and a member of the firm's Executive Committee. His practice primarily involves the representation of lenders in asset-based financings, acquisition financings, debtor-in-possession financings, subordinated debt financings, mezzanine financings and restructurings. He regularly represents hedge fund clients in lending transactions and has extensive experience negotiating intercreditor arrangements.

Significant recent transactions include:

- Representation of an affiliate of a major commercial bank in a \$110 million second lien and mezzanine financing in connection with the acquisition of the Caribbean retail operations of a U.K. company subject to an insolvency proceeding;
- Representation of the agent for a group of commercial finance companies and hedge fund lenders in a \$180 million financing facility to finance the purchase of a chemical company;
- Representation of the agent for a group of term B lenders in a \$200 million second lien credit facility to a software company;
- Representation of a hedge fund in a \$70 million credit facility to finance the acquisition of pharmaceutical assets in a 363 sale.
- Representation of a hedge fund, as collateral agent for a group of commercial finance companies and hedge funds, in a \$320 million confirmation financing facility to a diversified industrial minerals and aggregates company;
- Representation of the agent in a \$210 million debtor-in-possession financing facility to a pharmaceutical company;
- Representation of a group of commercial finance companies and hedge funds in a \$350 million credit facility to a maker of integrated nylon, performance films and resins, which financing facility was converted into a \$515 million debtor-in-possession facility.

Fred is a 1982 *cum laude* graduate of the Duquesne University School of Law, and a 1979 graduate of Pennsylvania State University, where he earned a B.S., with high distinction.

## Paul N. Roth

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Paul N. Roth is a founding partner of Schulte Roth & Zabel LLP and a member of the firm's Executive Committee. He is the head of the firm's Investment Management Practice Group, an area in which he has almost 40 years of experience representing hedge funds, private equity funds and offshore funds. In addition, his practice focuses on investment advisers and broker-dealers, cross-border acquisitions to the United States, securities regulation, mergers and acquisitions, and financial transactions.

Paul is a *magna cum laude* graduate of Harvard College, a *cum laude* graduate of Harvard Law School and was the recipient of a Fulbright Fellowship for Study of Law in The Netherlands during 1964-65. He is a Fellow of the New York Bar Association and is listed in *Who's Who in American Law* and *The Best Lawyers in America*.

Paul chairs the Subcommittee on Private Investment Entities of the American Bar Association's Committee on Federal Securities Regulation, and was formerly chair of the Committee on Securities Regulation of the Association of the Bar of the City of New York and a member of the NASD's Legal Advisory Board. He is a member of the Advisory Board of the Center on Lawyers and the Professional Services Industry at Harvard Law School, and member of the Task Force on the Undergraduate Experience at Harvard University, Faculty of Arts and Sciences. He is a past president and member of the board of the Harvard Law School Alumni Association of New York City.

# Private Investments: Navigating the Fiduciary and Compliance Waters

Steven J. Fredman | David Nissenbaum



**SchulteRoth&Zabel**

## 2007 Private Investment Funds Seminar



### **Private Investments: Navigating the Fiduciary and Compliance Waters**

**Steven J. Fredman**

**David Nissenbaum**

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**The More**  
**Private Investments**  
**The More**  
**Fiduciary and Compliance Concerns**

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**Fiduciary and Compliance Concerns**

- Expectation Gaps
- Valuation
- Conflicts of Interest
- Inside Information



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## Expectation Gaps



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## Valuation



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## Conflicts of Interest



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## Inside Information



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**Be Prepared...**

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## Private Investments: Navigating the Fiduciary and Compliance Waters Steven J. Fredman and David Nissenbaum

January 18, 2007

### 1) Overview

- a) As public markets become more efficient, hedge fund managers are increasingly looking at private investments for their funds.
- b) Some of the private investments we have been seeing (some frequently, some occasionally) include, for example:
  - i) Interests in private companies
  - ii) Loans
  - iii) Restricted stock of public companies (PIPEs)
  - iv) Structured finance securities, such as mezzanine debt and equity of CLOs and CDOs
  - v) Highly negotiated swaps and other derivatives
  - vi) Ove-the-counter commodity contracts
  - vii) Equipment leases
  - viii) Privately offered real estate securities or, occasionally, interests in real estate
  - ix) "Hard assets," such as railroad cars or shipping containers
  - x) Interests in royalty payments
  - xi) Insurance policies or investment vehicles that own insurance policies
  - xii) Warehouse financings for structured products
- c) The issues
  - i) Expectation gaps
  - ii) Valuation
  - iii) Conflicts of interest
  - iv) Inside information
  - v) Trading rules

### 2) Fiduciary Issues

- a) The Law
  - i) An adviser has a duty, created by his undertaking, to act primarily for the benefit of the client. In addition to this duty of loyalty, an adviser, as a fiduciary, owes a duty of (a) skill—that it will perform its functions with the skill that it represents itself to have, and (b) care—that it will perform its duties with attention, based on information and deliberation.
  - ii) Section 206 of the Investment Advisers Act

- iii) Common law
- b) Scope of investment program
  - i) Avoid the expectation gap. A fund's investment program, as disclosed in its offering memorandum, should permit private investments of the type the investment manager proposes to make. The fund's valuation policy should cover private investments.
  - ii) Use periodic reports to investors to keep them informed of the ongoing development of investment program.
- c) Valuations
  - i) Notwithstanding difficulty of valuation, US GAAP requires every asset to be reported at its "fair value." Accountants/auditors will look at how an asset is valued to determine whether the value represents fair value. However, accountants/auditors only look at whether the valuation methodology is reasonable and will not pass on whether the value is "correct." There may be more than one reasonable valuation methodology, so that the same auditor can accept different values of the same asset from two investment managers and both can be "fair value."
  - ii) Fiduciary issues relate to:
    - (1) basing incentive compensation on unrealized gains; and
    - (2) accepting subscriptions and permitting withdrawals on questionable valuations.
  - iii) Consider use of third-party valuation service for hard-to-value assets. Mitigates conflict because the investment manager is not determining the value. Valuation firm must have relevant expertise to value the asset.
  - iv) Consider selling piece of investment to substantiate value.
  - v) Common approach is to base value on comparable companies in comparable industries.
  - vi) Goal is to be able to credibly assert that the investment manager's own interests do not influence value.
- d) Use of special investment accounts, or "side pockets"
 

Investor participating in a side-pocket investment cannot withdraw the portion of its investment attributable to the side pocket. An investor admitted to a fund after a side pocket is established for an investment will not participate in that investment. Unrealized appreciation on special investments is not taken into consideration in determining incentive compensation.

  - i) Memorandum account established for illiquid, hard-to-value investment.
  - ii) Side pocket typically utilized when the market value is not readily ascertainable or the investment is too illiquid in light of the fund's overall liquidity.
  - iii) Establish policy with respect to determining when an investment should be designated a "Special Investment" and maintained in a side pocket.
    - (1) Certain investments might be automatically placed in side pocket (e.g., real estate or private equity).
    - (2) Other investments might be side pocketed based upon determination of a Valuation Committee (e.g., Valuation Committee makes determination which is memorialized by Legal/Compliance department).
  - iv) Criteria for placing investments in side pockets should be disclosed in the offering memorandum.
- e) Investments at different levels of an issuer's capital structure
  - i) From time to time, different funds managed by the same investment manager may invest at different levels of an issuer's capital structure.

- (1) Domestic fund for taxables invests in issuer's equity on leveraged basis. Domestic fund for tax-exempts, which avoids UBTI in making investments, makes loans to same issuer.
  - (2) Fund that focuses on distressed strategy invests in illiquid equity of an issuer. Multi-strategy fund invests in high yield debt of same issuer.
  - ii) The potential conflict of interest and how it may be handled should be disclosed in the offering memorandum.
  - iii) Before making the investment that gives rise to the conflict the investment manager should consider:
    - (1) the likelihood of conflict arising
    - (2) the actions it may take if the conflict arises and the possible effect on each fund
  - iv) Terms of the investments must be fair to each fund.
- f) Accommodation cross trades. Acquisition of an investment with intent to sell, or where there is a possibility of sale of, all or a portion of the investment to another fund at a later date.
- i) Has disclosure been made to investors in both funds that this type of event can occur? This is the expectation gap issue.
  - ii) Has the temporary investment been made on terms that make investment worthwhile from a risk/return perspective? A fund should not invest simply to accommodate another fund.
  - iii) Has the transfer, including the transfer price, been approved by a representative of the acquiring fund that is independent of the investment manager?
    - (1) Principal transaction concern under Section 206(3) of the Advisers Act.
    - (2) Even if Section 206(3) is not implicated (e.g., investment being transferred is not a security), still have fiduciary concern that would arise if the investment manager is approving the transaction for both the seller and the buyer.

### 3) Compliance Issues

#### a) Inside Information

- i) Arises in connection with investment in PIPEs, where a manager has knowledge of proposed PIPEs transaction and trades in the issuer's listed securities before the PIPE is announced.
- ii) Arises in loan context, where lending group has material, non-public information about an issuer and the public debt group wants to trade in the issuer's bonds.

Exposure to material, non-public information about an issuer in connection with making a private investment could restrict a firm's ability to trade in that issuer's public securities. If someone in the organization nonetheless trades in the securities after that person or another person at the firm has been exposed to the material, non-public information, the firm and individuals at the firm could be subject to criminal and civil liability.

- iii) Consider instituting policies to control exposure to inside information.
  - (1) Traders and portfolio managers direct initial inquiries regarding a manager's interest in a deal to the Compliance department.
  - (2) Compliance considers whether fund already has a position that would become restricted if the firm was exposed to information regarding the PIPE. If such a position exists, the firm will pass on the PIPE. If there is no position, the banker is directed back to the front office, disclosure is made and the issuer is put on the firm's restricted list until there is an announcement.
- iv) Consider information barrier. Often difficult to set up and often is not credible unless the investment manager has a large staff and separate investment teams. Information barriers usually include:
  - (1) separate personnel working on private deals

- (2) physical separation
- (3) separate servers and other technology
- (4) systematic tracking of when information about public companies may be received by the private deal group
- (5) maintaining a restricted list and watch list
- (6) policy for bringing a member of the private investment group "over the wall"

b) Trading Issues

- i) Rule 105 under Regulation M
- ii) Rule 144 under the Securities Act

# Managing Liquidity

Stephanie R. Breslow | Kelli L. Moll



**SchulteRoth&Zabel**

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**Managing Liquidity**

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## Industry Trends

- Activist
  - Distressed
  - CDO Equity
  - Private Equity
  - Seeding
- 
- Long/short Equity
  - Arbitrage
  - Macro



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## Ways to Control Outflow

- Lock-ups
- Gates
- Side Pockets
- Suspensions
- In-kind Distributions

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## Ways to Control Outflow: Lock-Ups

- Investor or Capital Contributions
- Hard vs. Soft
- Variable Pricing
- Rolling Lock-ups
- Tiered Redemption Fees
- Periodic Liquidity
- Transfers



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## Ways to Control Outflow: Gates

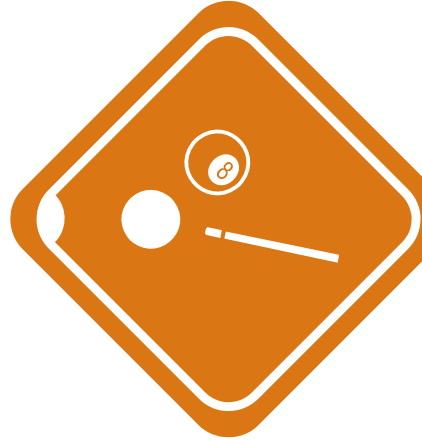
- Structuring Issues
  - **Master vs. Feeder**
  - **Size: Investor vs. Request**
  - **First in/First out**
  - **Outside Date**
  - **Manager Treatment**
  - **Effect on Other Classes**



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## Ways to Control Outflow: Side Pocket

- Structuring Choices
  - Side Pocket Size
  - Hard vs. Soft Caps
  - Fund vs. Investors
  - Addressing Gaming Risk
  - Offshore Fund Issues
  - Buy Backs
  - Performance Reporting



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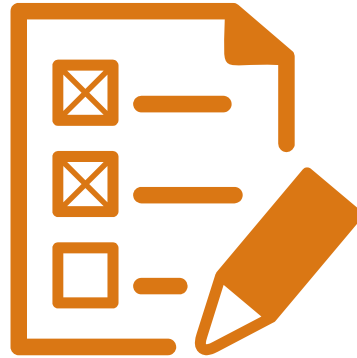
## Suspension and In-Kind Payments

- Not popular in practice
- Fair pricing issues on in-kind
- Suspension of redemption vs. payment

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## Ways to Control Outflow: Fund of Funds

- Side Pocket
  - At fund of funds
  - In underlying funds
- Credit Facilities



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## When All The Techniques Are Not Enough...

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## Managing Liquidity

Stephanie R. Breslow and Kelli L. Moll

January 18, 2007

### 1) Industry Trends

- a) In Search of Alpha — Incorporation by hedge funds of illiquid strategies.
  - i) Activist Trading. A long-term strategy involving the use of a fund manager's expertise and the fund's position as a minority shareholder of a company to effect change in such company in order to increase shareholder value.
  - ii) Distressed/Special Situations. Fund investments in distressed and special situations have trended toward private equity and other control investments.
  - iii) Credit Strategies. Fund strategies involving the acquisition of a portfolio of debt investments (including high-yield debt) as well as equity or subordinated pieces of collateralized debt obligations (CDOs) or other structured finance vehicles.
  - iv) Private Equity. Fund investments in non-public companies and "taking private" transactions, including leveraged buyouts, and venture and mezzanine investments.
  - v) Seeding Strategies. Strategies involving investments in start-up managers, including equity stakes in such managers.
- b) Use of Hybrid Structures — Involves combination of public securities and private investments, often with large side pockets and/or private equity-like terms (e.g., clawbacks).

### 2) Techniques for Managing Liquidity

- a) Use of Longer Lock-Ups
  - i) General. A typical lock-up applies for a specified period beginning on the date of the investor's admission to the fund or the date of each capital contribution made by an investor to the fund. Some funds have "rolling" lock-ups in which an investor's investment automatically locks up for the same period as the initial lock-up after the expiration of a redemption period.
  - ii) Hard/Soft Lock-Ups. A fund may use a hard lock-up (absolute) or a soft lock-up in which investors may redeem their interests subject to the payment of a redemption fee (typically between 1% to 5%). Redemption fees can be tiered so that the amount of the fee correlates to the length of time that an investor has held its interest in the fund. For example:
    - (1) 5% redemption fee for redemptions occurring within one year of investment;
    - (2) 3% redemption fee for redemptions occurring within two years of investment; or
    - (3) no redemption fee for redemptions occurring after two years of investment.
  - iii) Periodic Liquidity. Some funds limit the amount an investor may redeem on any one redemption date. For example, if a fund with a quarterly liquidity decides to limit redemptions

on any one redemption date to 25% of an investor's interest, an investor desiring to redeem 50% of its interest would be redeemed over two redemption periods (*i.e.*, two quarters) and would be subject to market risk until such redemption request is satisfied.

iv) Variable Pricing Model. An investor may choose to purchase a class of interests that pays greater fees in exchange for more favorable liquidity terms (or vice versa). For example:

- (1) a Class A investor pays a 2% management fee in exchange for quarterly liquidity;
- (2) a Class B investor pays a 1.5% management fee in exchange for annual liquidity; and
- (3) a Class C investor agrees to a 3-year lock-up in exchange for paying a 1% management fee.

The variable pricing model is a valuable marketing tool as it offers flexibility to investors, each of whom may have different liquidity preferences or requirements.

v) Transfers. A manager may seek to apply a new lock-up in connection with transferred shares/interests. A manager may decide to permit transfers to an investor's affiliate without a new lock-up.

b) Gates — Hedge fund managers use gate provisions to avoid a "run on the bank"

i) General. Typically, a gate provision provides that if, on any redemption date, a redemption request is received for more than a certain percentage of the net asset value of a fund (*e.g.*, 20%), the manager may satisfy the request or reduce it *pro rata* so that only such percentage (or more, in the manager's discretion) of the net asset value of such fund is redeemed.

ii) Calculation. A manager must decide how the gate is to be applied. Gates can either cut back investors' redemption requests *pro rata* based on the size of each request or *pro rata* based on the size of each redeeming investor's investment in the fund. In addition, a manager of a master-feeder fund must decide whether the gate will be applied at the master fund level (preferred by the investors) or at the feeder fund level (preferred by the manager).

iii) First in/First out. A manager must decide whether:

- (1) investors whose redemption requests are "cut back" by the gate provision will have priority over the redeeming investors at the next redemption date; or
- (2) all investors will be treated equally, with previously gated investors having no priority.

In addition, a manager needs to decide whether there should be a maximum number of redemption dates for which an investor can be "gated" before a redemption request is fully satisfied (*e.g.*, five quarters).

iv) Other Issues. In using a gate to control liquidity, a manager must consider how it will affect share classes having different rights and whether it will be applicable to the manager's affiliates.

c) Side Pockets

i) General. A portion of a hedge fund portfolio dedicated to illiquid or hard-to-value investments. The use of side pockets is generally capped at 10% to 30% of a fund's net asset value. Side pockets can also be structured so that they are capped for each investor (as opposed to the fund) at a specified percentage. Side pockets operate like mini private equity funds in that such investments are not marked-to-market and the incentive compensation is only taken on a realization event.

- ii) Creation of a Side Pocket. A manager should have clear guidelines as to when a side pocket is created and when a realization event would be deemed to have occurred. In the absence of such guidelines, there is the potential for a manager to be accused of timing manipulation by establishing side pockets to avoid realization of losses in the "liquid" portfolio or by failing to remove an investment from a side pocket to keep from realizing losses.
  - iii) Who Participates and How Long. Typically, investors participate in side pockets if they are investors in the fund at the time the side pocket investment is made. Managers, from time to time, provide an outside date for when side pockets must be sold or otherwise realized.
  - iv) Valuation and Management Fees. For financial reporting purposes, side pockets are required to be valued on a fair market value basis. However, for calculating management fees, managers typically charge the fees on the basis of cost or, sometimes, the lower of cost or fair market value (*i.e.*, managers often do not mark-up side pockets). Furthermore, incentive compensation is always taken on a realization basis as opposed to an unrealized fair market value calculation.
  - v) Offshore Fund Structuring Issues. As offshore funds are structured as corporations, there are often a number of issues in connection with operation and accounting of side-pocket investments. In a series roll-up fund, side pocket investment performance may, depending on an administrator's capability, not be able to be aggregated with performance of the liquid portion of a fund's portfolio. Under these circumstances, an incentive fee would be taken upon the conversion of shares both in and out of side pockets. In order to aggregate the performance of liquid and side-pocket investments, many managers are establishing offshore funds that issue series of shares on a per investor basis as opposed to utilizing a series roll-up mechanism. By issuing shares on a per-investor basis, the offshore fund more closely mirrors a domestic fund's partnership accounting.
  - vi) Buy-Back Options. Occasionally, managers will structure their funds to permit investors to redeem their investment in side pockets (as opposed to waiting for a realization event to occur). Often, the redemptions of such side pockets are made at the lower of cost or fair market value. The right to have such investment repurchased may be structured so that it can be exercised by the fund, the manager or investors.
  - vii) Other Issues. A manager should ensure that side pocket investments are consistent with the overall strategy of the fund. Furthermore, a manager must determine how it will represent the performance of a fund that participates in side pockets. For example, will the performance show the liquid portfolio separate from the performance of side pocket investments? Will the performance represent the aggregate performance of all investments? Will each investor receive individual information based on the side pockets in which it participates?
- d) Suspensions and In-Kind Payments
- i) General. Managers often retain the option of either suspending all redemption rights or paying redemptions in kind. Exercising either option to manage liquidity generally is the "kiss of death."
  - ii) Suspension. In implementing suspension rights, a fund may provide that redemptions be suspended (and let investors' interest in the fund continue to be subject to the risks of such fund) or such fund may provide for delayed payment of redemption proceeds (giving a manager time to liquidate assets, but fixing the price at which investors will be redeemed). A manager should have the right to suspend pending redemptions once a decision has been made to dissolve and liquidate a fund so that all investors can be treated similarly.
  - iii) In-Kind Distributions. Managers often have the right to distribute redemption proceeds in kind, creating valuation issues with respect to illiquid investments, potential regulatory issues for certain investors (*e.g.*, those subject to ERISA) and issues in terms of equitably distributing a fund's portfolio.

- iv) Liquidation. Funds in liquidation often issue interests in liquidating trusts (where the fund's assets have been transferred) and/or issue notes in respect of a liquidating fund's assets.

### 3) Issues for Funds of Funds

- a) Side Pockets. A fund of funds, when determining its own liquidity requirements, needs to take into account whether it should also have side-pocket provisions in connection with the types of underlying fund investments (e.g., whether the other underlying funds have side pockets or are private equity funds).
- b) Lines of Credit. Many funds-of-funds use lines of credit or other loan facilities to manage subscriptions, redemptions and the liquidity and bridging of portfolio investments.

### 4) Other Considerations When Incorporating Illiquid Strategies into a Hedge Fund

#### a) Marketing Issues

- i) Hybrid Structures. Combining hedge fund and private equity fund strategies (a hybrid structure) can create marketing issues for certain investors seeking more traditional strategies. Generally, the more unconventional the structure, the harder it is to market to investors.
- ii) Fees. Determining appropriate fee structures for hybrid funds using both hedge and private equity strategies will become a greater issue in marketing to investors.

#### b) Employee Issues

- i) Compensation. Compensating an incoming/outgoing employee is more difficult where a fund has side-pocket investments because the manager is paid on the side pocket only when a realization event occurs. Issues arise where one employee makes the side-pocket investment, then leaves, and another employee manages the investment until realization.
- ii) Clawback. If a fund has a clawback mechanism, a system needs to be implemented to hold back (or provide security for) amounts allocated to employees until such obligation is deemed satisfied.

#### c) Regulatory Issues

- i) Securities Exchange Act of 1934 (the "Act"). A manager will need to monitor its filing obligations under Section 13(d) and Section 16 of the Act where it is making side-pocket investments, as well as determine whether it must file as a "group" if it co-invests with other managers.
- ii) Other Regulatory Issues. There are often a variety of regulatory issues that can arise when making controlled illiquid investments. These come in the form of, among others, anti-trust rules (Hart-Scott-Rodino), FCC rules, banking rules and/or foreign ownership rules.

#### d) When is a Hedge Fund No Longer a Hedge Fund?

Although long lock-ups, gates and side pockets can give a hedge fund manager the flexibility to include illiquid strategies, if illiquid strategies become the primary focus of the hedge fund, these techniques may no longer be sufficient to manage liquidity. At this point, a hybrid fund structure (funds that combine hedge fund and private equity fund terms, such as drawdowns, clawbacks, etc.) or a private equity fund structure probably makes more sense.

# Issues for Funds as Providers and Users of Leveraged Loans

Nancy R. Finkelstein | Frederic L. Ragucci



**SchulteRoth&Zabel**

**2007 Private Investment Funds Seminar**



**Issues for Funds as Providers and Users  
of Leveraged Loans**

**Nancy R. Finkelstein**

**Frederic L. Ragucci**

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**Liquidity**

**Leverage**

Defaults

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Liquidity

**Leverage**

**Defaults**

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## Hedge Funds



## Second Lien Loans

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## Second Lien Loans

### Issues to Consider

Structural  
and  
valuation  
analysis

Covenant  
setbacks

Intercreditor  
agreement  
terms

Post-closing  
monitoring

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## **Loans to Private Equity Funds**

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## **Redemption Facilities for Fund of Funds**

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## **Warehouse Facilities to Fund Acquisition of Assets**

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## **Levered Funds**

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# **Linked Products as Source of Leverage**

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## Issues for Funds as Providers and Users of Leveraged Loans

Frederic L. Ragucci

January 18, 2007

### 1) Leveraged Loan Market in 2006

#### a) 2006 Was a Year of Abundant Liquidity, High Leverage and Few Defaults

- i) Leveraged loan volume in 2006 exceeded \$690 billion on Dec. 13, 2006 exceeding 2005's volume of approximately \$555 billion over the same period according to data provider Dealogic.
- ii) High-yield bond issuance totaled \$125 billion as of Dec. 7, 2006 exceeding the \$100 billion of high-yield bonds issued in 2005 according to *The Deal*.
- iii) According to Standard & Poor's, total debt-to-EBITDA leverage multiples for highly leveraged deals are at the highest level since 1998.
- iv) Private equity firms, flush with cash, are using larger amounts of leverage for buyouts and special dividends. In addition, companies already heavily in debt and losing money are also incurring larger amounts of debt.
- v) Notable deals in 2006 include:
  - (1) \$33 billion buyout in November of hospital operator HCA Inc. by KKR, Bain and Merrill Lynch — \$14.75 billion in loans and \$5.77 billion in bonds.
  - (2) Proposed \$36 billion purchase of the REIT, Equity Office Properties Trust, by Blackstone announced in November — \$29.6 billion in debt.
  - (3) Ford's recent \$18.5 billion loan package.
- vi) According to a study by Edward Altman, a professor of finance at NYU's Stern School of Business, distressed debt in the U.S. alone totaled \$620 billion as of June 30, 2006.
- vii) The percentage of debt rated below investment grade or junk has increased from slightly less than one third in 1980 to more than one half in the late-1980s to 71% today, according to a recent Standard & Poor's report.
- viii) Despite the high levels of leverage and the large amounts of distressed debt, default levels are below historical norms for loans and bonds, and the number of corporate bankruptcies are as low as they have been in the last ten years.

#### b) Reasons for Low Levels of Default During Period of High Leverage

- i) One key reason is the unprecedented levels of liquidity from non-traditional lenders, such as hedge funds and CLOs.

- ii) Some industry participants believe that hedge funds controlled the debt markets in 2006, particularly high-yield lending, similar to the way Drexel controlled the junk bond markets in the 1980s.
- iii) According to Professor Altman, the large amount of liquidity provided by hedge funds and CLOs, together with low interest rates and a fairly robust economy, have led to lower incidents of defaults.
- iv) Some have argued that the large amounts of available liquidity have created a false sense of low risk in the marketplace — large amounts of liquidity have made it easy for weak companies to finance their way out of trouble.
- v) The competition among lenders for deals in 2006 has also resulted in thinner pricing and weaker covenant packages, such as the so-called “covenant lite” deals, which provide borrowers with additional cushion on financial covenants to reduce the risk of defaults.
- vi) Views vary. Either (a) the highly leveraged companies today have better risk profiles than the highly leveraged companies during the late 1980s or the 2001-2002 period or (b) today’s deals are creating the higher default rates of tomorrow.

## 2) Second Lien Loans: What Are They, How They Started, What They Have Become

### a) What Is a Second Lien Loan?

- i) A second lien loan is typically a term loan secured by a lien on certain assets (typically, substantially all assets) of the borrower where (a) the borrower has also granted another lender (the first lien lender, which is typically a working capital lender) a lien on the same assets and (b) the first lien lender has the right to receive and apply the proceeds from the sale or disposition of, or other realization from, those assets to the payment of the first lien lender’s loan prior to the payment of the second lien loan. A second lien loan is typically not contractually subordinated debt.
- ii) In its simplest form debt subordination provides that the senior debt (as contractually defined) is paid before payment on subordinated debt. In addition, debt subordination typically includes the following: payment blocks; remedy blocks (including acceleration and commencement of bankruptcy or other proceedings); in bankruptcy, no payment on subordinated debt before senior debt is paid in full and no right to receive securities unless subordinated at least to the same extent as the subordinated debt is subordinated to the senior debt; and turnover provision covering any money/value received from any source. Examples: typical high yield bonds and certain mezzanine debt may be contractually subordinated debt.

### b) How Is a Second Lien Loan Different from Subordinated Debt?

- i) Lien subordination — no payment block; remedy blocks limited to remedies with respect to collateral; bankruptcy results in all collateral proceeds going to holder of senior lien; turnover provision only covers proceeds received from shared collateral and certain remedies related to collateral.
- ii) A true lien subordination agreement typically provides that if the lien of the first lien lender becomes unperfected, and the second lien lender receives proceeds of shared collateral, then the second lien lender retains such proceeds. If the liens of both lenders are unperfected as to certain collateral, then their liens are *pari passu* with respect to that collateral. A senior lien must be valid, perfected and enforceable for lien subordination to apply.
- iii) Debt subordination results in subordinated debt holder being behind the senior debt and *pari passu* with the unsecured trade creditors. Lien subordination results in the subordinated lien

holder being (a) behind the senior lien holder to the extent of the shared collateral and (b) ahead of the unsecured trade creditors to the extent of its collateral.

iv) Resolution of intercreditor issues in the second lien market are not as well defined as the intercreditor issues in the subordinated debt market.

c) Basic Dynamics Between First Lien Lenders and Second Lien Lenders.

i) First lien lenders do not want to suffer diminution of their expected rights and remedies as secured creditors by virtue of a second lien lender having a second priority lien on the same collateral — “they don’t want to lose anything meaningful.” First lien lenders do not want any “Monday morning quarterbacking” or other increased litigation risk. The second lien lender should not be able to use its status as a secured creditor to impede the first lien lender’s exercise of rights and remedies.

ii) Second lien lenders want to enjoy the benefits of secured creditor status, acknowledging that the first proceeds of the collateral must be used to repay the first lien lenders. The degree to which the second lien lender’s secured creditor rights are controlled or ratcheted back should be compensated for by the differential in coupon between the two classes of investments.

d) What Is the Difference Between Widely Syndicated and Middle Market Second Lien Debt?

i) “Middle Market Second Lien Deals” — Often hedge fund-originated deals.

(1) “Aggressive Second Lien.”

(2) First lien must be valid, perfected and enforceable for turnover provision to apply.

(3) Few upfront consents/waivers in a bankruptcy.

(4) Intercreditor points more often hand-crafted to address deal specifics and commercial dynamics.

ii) “Widely Syndicated Second Lien Deals” — Wall Street Institutional Second Lien Deals — Larger Syndicated Second Lien Deals; High Yield Bond Deals.

(1) “Silent Second Lien” or “Limited Silent Second Lien”; typically much deeper lien subordination.

(2) First lien need not necessarily be valid, perfected and enforceable for turnover provision to apply.

(3) More upfront consents/waivers in a bankruptcy (i.e., consent to DIP, adequate protection, asset sales, plan classification, voting).

(4) High-yield bond deals have similar structuring issues as the Wall Street Institutional Second Lien deals.

e) How Second Lien Loans Started and What They Have Become

i) Second lien loans started as a niche asset-based or rescue financing product in the late-1990s and early-2000s for borrowers facing liquidity problems.

ii) The market for second lien loans started getting attention in 2003, and it exploded in 2004 and 2005.

- iii) As the economy improved starting in 2003, second-lien loans were used not only for rescue financing but for buyout financing, dividend recapitalizations and refinancings.
- iv) According to *The Deal*, in 2003, second lien loans totaled about \$3 billion. In 2005, second lien loans rose to more than \$17 billion and, for the first 10 months of 2006, second-lien loans exceeded \$20 billion.
- v) Hedge funds, along with CLOs, have become significant investors in second lien loans.
- vi) Some recent second lien deals include:
  - (1) A \$2.25 billion second lien loan in connection with Koch Industries Inc.'s acquisition of Georgia-Pacific in February 2006.
  - (2) The financing for the acquisition of HCA, Inc. included \$1.5 billion of second lien notes.
  - (3) Other large second lien financings were made:
    - (a) To Universal Companies Systems Inc. in connection with its acquisition of Reynolds & Reynolds.
    - (b) To finance with the acquisition by Texas Pacific Group of Intergraph.
    - (c) To finance a dividend by Hanesbrands Inc. to Sara Lee Corp.
    - (d) To Calpine Corp. and Delta Airlines as debtor-in-possession financings in their bankruptcy cases.
- vii) Many market participants believe that second-lien loans have become a permanent asset class; in bull markets (like the last three years) they will be used to finance buyouts and dividends recapitalizations and in bear markets they will be used as rescue financings.
- viii) Today, many borrowers view second lien loans as preferable to mezzanine loans and high yield bonds for the following reasons:
  - (1) Faster execution than high yield bonds.
  - (2) Cheaper transaction costs than high yield bonds and lower interest rates than mezzanine loans.
  - (3) For non-public companies, no public reporting or Sarbanes-Oxley compliance.
  - (4) No onerous prepayment penalties.
  - (5) No amortization.

### **3) Significant Issues When Considering a Second-Lien Investment**

- a) Structural and Valuation Analysis — Despite what some may say, there are no standard terms and structures in the second-lien market.
- b) Covenant Setbacks — Do they provide sufficient protection?

c) Intercreditor Agreement Terms

i) Pre-bankruptcy

- (1) Extent and duration of standstill.
- (2) Should the cap on first lien debt be permanently reduced by payments?
- (3) Sales or Releases of Collateral — Waiver of prepayment by first lien lender. Can the second lien lender object to asset sales?
- (4) May a lender amend or waive its economic terms, financial covenants or other material terms without the consent of the other lender?
- (5) Does a buy-out right provide meaningful protection?

ii) Post-bankruptcy

- (1) Consents to DIP financing and cash collateral — What are the conditions?
- (2) Rights to adequate protection and post-petition interest.
- (3) Waivers with respect to Section 363 sales, classification of claims in a plan of reorganization and voting for a plan of reorganization.

d) Post-closing Monitoring — Do hedge funds have the resources to monitor and, if needed, restructure loans?

**4) Outlook for Second Lien Loans**

"The less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs." — *Warren Buffet*

## Funds as Users of Leverage (Source of Funds)

Nancy R. Finkelstein

January 18, 2007

### 1) Loans to Private Equity Funds

- a) Loans structured as short-term bridges to capital calls or longer-term facilities for broader uses.
- b) Loans are usually secured by capital calls for the specific transaction being bridged or by all capital calls; sometimes loans are unsecured or unsecured with negative pledges.
- c) Loan proceeds are used for working capital or for equity or debt investments.
- d) Often, UCC financing statement filed against the borrower, but some funds are successful in obtaining the agreement of lenders to hold UCC pending certain future events (e.g., filed within a certain period if loan not repaid); foreign funds may also have to grant liens on capital calls and perfect that lien in the jurisdiction of their organization.
- e) Often, capital calls are required to be made simultaneously with the borrowing so that lender knows its source of short-term repayment is forthcoming simultaneously with the decision to advance funds; this is especially true if the loan is not secured or there is a negative pledge.
- f) Often, investors are asked to acknowledge the bank's liens. If a fund has sufficient leverage, this requirement waived; lender is seeking to reduce defenses available to partners when capital is called.
- g) Underlying organization documents of fund must allow loans and pledge of capital calls and may need other protections; some funds restrict borrowing to bridge loans in connection with capital calls only; opinion usually required.
- h) Some loans are treated more like a corporate credit with entity-level financial tests and focus on uncalled capital levels.
- i) When used to fund acquisition of portfolio companies they are bridges to permanent financing of acquired company; in such cases, liens are taken on the equity interest acquired.
- j) In some newer iterations, the lender actually takes liens on the underlying assets of the portfolio company acquired by the fund and remains as a lender to the fund and the portfolio company until the acquisition is complete and replacement financing acquired.

### 2) Redemption Facilities for Fund of Funds

- i) Loans facilitate redemptions; may also be used where capital has been committed but not yet contributed.
- ii) Most lenders take lien on account into which proceeds of redemptions are placed and some require a custodian and the equity interest in the fund of fund be placed in the name of the custodian.
- iii) Some require signed and undated redemption notices if name of the fund of fund's interest has not been changed.

- iv) Fewer lenders require actual pledge of fund of fund interests (unless affiliated with the borrower). When required, either consent of the underlying fund necessary or interest in underlying fund must be held in the name of a "securities intermediary," so that the interest can be treated as a "security entitlement" under Article 8 of the UCC.
- v) Transactions often contain NAV calculation tests relating to the underlying fund of funds.

### 3) Warehouse Facilities To Fund Acquisition of Wide Range of Assets

- i) Traditional corporate loan agreement format.
- ii) Borrowings only permitted to the extent purchases are made of eligible assets which are extensively and, frequently, restrictively defined.
- iii) Assets acquired must fit into these specified categories and concentration with respect to those categories is limited.
- iv) Assets are often valued and the mark-to-market valuation can cause defaults and failures of future funding.
- v) Transactions are often syndicated and decision making can be more rigid.
- vi) Liens against all assets now or hereafter acquired.

### 4) Levered Funds

Funds borrow money to create levered opportunities for investors with high risk appetite.

- i) Dual fund structure: both levered and unlevered funds or classes within funds.
- ii) Monies available through derivative arrangements or custom products structured to accommodate particular needs of investors wanting leverage.

### 5) Linked Products as Source of Leverage

Investment banks focused on linking swaps, brokerage, margin lending in highly structured offshore formats with complex tax and foreign law issues but are aimed at lowering cost of funds borrowed and, in some instances, providing back-office services.

### 6) Other Approaches to Liquidity

- i) Total Return Swaps
- ii) CLOs

# **Enforcement and Litigation Update: What Are the Regulators Up To and Impact on Civil Litigation**

Harry S. Davis | Martin L. Perschetz



**SchulteRoth&Zabel**

**2007 Private Investment Funds Seminar**



**Enforcement and Litigation Update:  
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Impact on Civil Litigation**

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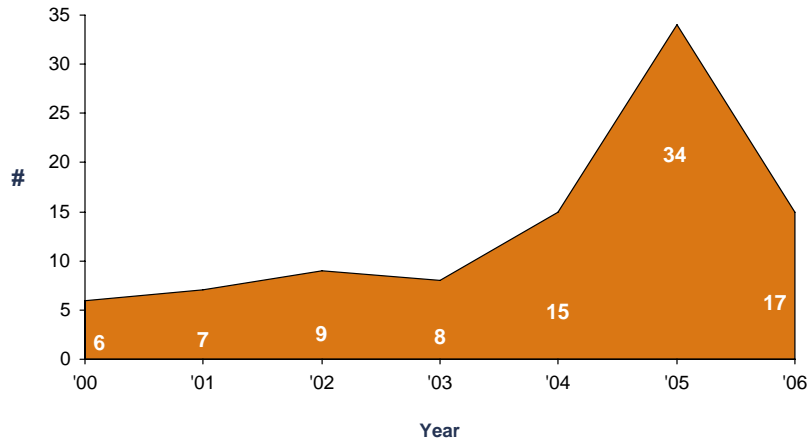
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## Statistics: Enforcement Actions Against Hedge Funds



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## How Matters Come To Regulators' Attention



- Investor Complaints
- Whistleblowers
- Press Reports
- SEC Inspections
- NYSE/NASD Market Surveillance
- Self-Reporting

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## Current Enforcement Landscape

### Types of Enforcement Actions

- Valuation Fraud
- Asset Misappropriation
- Insider Trading
- Market Manipulation
- Violations in Connection with Securities Offerings
- Naked Shorting
- Market Timing/Late Trading
- Hedge Fund Marketing
- Antitrust Issues

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## SEC's New Proposed Anti-Fraud Rule

- Prohibits IA's from
  - **Materially false or misleading statements; or**
  - **Other fraud**
- Focus on Investors

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## Differs from Other Anti-Fraud Provisions

- No scienter requirement
- No purchase or sale requirement
- No private right of action

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## Insider Trading/Market Manipulation

### Hot Button Issues



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## The SEC's PIPEs Investigation



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## The SEC's PIPEs Investigations

- Insider Trading Claims
- Market Manipulation



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## NYAG Investigation Concerning Consultants

- Consultants
- Consultant Aggregators



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## Regulation M



- The Rule
  - As written
  - As applied by regulators
- New Proposed Rule

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## Short Selling

- The Issues
- Regulatory Investigations
- Congress



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## Civil Litigation: Short Selling

- Hedge Funds Procuring False Research
- Theories of Liability



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## Civil Litigation

### The Vicious Cycle

- Regulatory Investigations
- Enforcement Actions
- Suits Against Fraudsters
- Search for Deep Pockets
  - Auditors and Administrators
  - Independent Directors
  - Lawyers



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## Civil Litigation

- Claims Against Redeeming Investors
- Theories of Liability
  - Fraudulent Transfer
  - Unjust Enrichment



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## Antitrust Enforcement



- Hart-Scott-Rodino Notification
  - **Personal Liability**
- Activist Strategies
- Interlocking Directors

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## Concluding Thoughts

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## Enforcement and Litigation Update: What Are the Regulators Up To and Impact on Civil Litigation

Harry S. Davis and Martin L. Perschetz

January 18, 2007

### 1) Incidents of Hedge Fund Misconduct

- a) A Major Justification for SEC's Recent Focus on Hedge Funds Is the Number of Investigations and Enforcement Actions Against Them.
  - i) Those statistics, however, do not show a trend, nor are they cause for alarm.
    - (1) 2000: Six enforcement actions.
    - (2) 2001: Seven enforcement actions.
    - (3) 2002: Nine enforcement actions.
    - (4) 2003: Eight enforcement actions.
    - (5) 2004: Fifteen enforcement actions.
    - (6) 2005: Thirty-four enforcement actions.
    - (7) 2006: Seventeen enforcement actions.
  - ii) Putting the number of enforcement actions into context.
    - (1) There are over 9,000 hedge funds worldwide.
    - (2) Collectively, the hedge fund industry accounts for approximately \$1.3 trillion in assets under management.
- b) Matters Come to Attention of Regulators in Wide Variety of Ways.
  - i) The most common way possible securities law violations come to the attention of regulators is through complaints by investors or other "whistleblowers," such as disgruntled present or former employees.
  - ii) Believe it or not, SEC enforcement lawyers routinely read the financial press and troll the Internet. Oftentimes, articles in the press about a hedge fund start investigations.
  - iii) The SEC's Office of Compliance, Inspections and Examinations (OCIE) also refers a significant number of matters to the SEC's Enforcement Division for investigation and possible enforcement actions.
    - (1) Over 90% of all OCIE inspections result in some sort of deficiency letter.
    - (2) As many as 10% of all OCIE inspections result in a referral to the Enforcement Division for further investigation.

- iv) Academic papers are another source of ideas for regulators. Investigations relating to securities underwriters, market-timing and late-trading, options grants and Rule 10b5-1 trading plans have all been sparked, at least in part, by academic studies, articles and other publications.
  - v) Many of the insider trading and market manipulation investigations that the SEC conducts each year start with a referral from the New York Stock Exchange (NYSE) or National Association of Securities Dealers (NASD) market surveillance groups.
    - (1) These groups constantly monitor securities trading using a variety of sophisticated, proprietary techniques.
    - (2) When NYSE or NASD spot trading anomalies (e.g., a run-up in a stock's price in advance of a positive earnings announcement or an M&A deal), the NYSE and/or NASD will conduct a preliminary investigation and then turn the results of their work over to the SEC for further investigation, if warranted.
  - vi) Finally, "no good deed goes unpunished." Thus, although the SEC encourages participants in the securities market to "self-report" any significant issues that arise in the conduct of their business, "self-reporting" almost invariably leads to an SEC investigation and, often, leads to the SEC bringing an enforcement action against the very firm that self-reported its alleged misconduct.
- c) Types of Enforcement Actions
- i) Portfolio valuation fraud
  - ii) Asset misappropriation
  - iii) Insider trading
  - iv) Market manipulation
  - v) Securities offering violations
  - vi) Naked shorting
  - vii) Market-timing/late-trading
  - viii) Hedge fund marketing
  - ix) Antitrust issues

## 2) The SEC's New Proposed Anti-fraud Rule (Proposed Rule 206(4)-8)

- a) Genesis of Proposed Rule
  - i) The SEC's new proposed anti-fraud rule is a reaction to *Goldstein v. SEC*, where the U.S. Court of Appeals for the D.C. Circuit invalidated the SEC's effort to require hedge funds to register. In that case, the Court concluded that Congress intended the word "client" to refer to the funds themselves, not individual investors in hedge funds.
  - ii) The SEC's new proposed anti-fraud rule is specifically drafted to prohibit misconduct by an investment advisor aimed at the investors in a hedge fund, and not just the hedge fund itself. Thus, the new rule speaks in terms of prohibiting certain conduct aimed at "investors in pooled investment vehicles" and not just "clients."

- iii) The proposed rule prohibits investment advisors from making materially false or misleading statements to investors in pooled investment vehicles or otherwise defrauding those investors.
- iv) The proposed rule applies to all investment advisors, not just registered investment advisors.
- v) Pooled investment vehicles are defined as including investment companies as well as any entity that claims an exemption from the definition of investment company under Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Thus, the new rule is specifically designed to apply to hedge funds, private equity funds, venture capital funds and other types of privately offered pools of capital that invest in securities, as well as investment companies that are offered to the public at large.
- vi) Even though the SEC describes its new proposed rule as an “anti-fraud” rule, the proposing release specifically indicates that—unlike Rule 10b-5 under the Exchange Act—the proposed rule does not have a “scienter” requirement. Thus, the SEC will not have to establish that an investment advisor acted with either intent to deceive or recklessness in order to establish a violation.
- vii) Similarly, although many of the SEC’s anti-fraud rules require the misconduct to be “in connection with the purchase or sale” of a security, proposed Rule 206(4)-8 does not have this limitation. Thus, materially false or misleading statements to investors would violate the rule even if the misrepresentation or omission did not relate to offering, selling or redeeming securities.
- viii) Finally, the new proposed rule makes clear that only the SEC can enforce it. The proposing release expressly states that it does not create a private cause of action against an investment advisor by an investor.

### **3) Insider Trading/Market Manipulation**

- a) Insider Trading and Market Manipulation Are Hot Button Issues in the Securities Industry Today
  - i) Many regulators are intensely focused on preventing the market dislocation and unfairness inherent in trading on the basis of material, non-public information or artificially manipulating markets.
  - ii) In the past year, the SEC has brought numerous civil insider trading cases and conducted many more insider trading investigations.
  - iii) Similarly, the United States Attorney’s Offices throughout the country have brought a number of important insider trading prosecutions.
  - iv) Not to be left behind, many state attorneys general and state securities regulators have brought insider trading and market manipulation cases and are investigating many other instances where insider trading or market manipulation is suspected.
  - v) The self-regulatory organizations (*i.e.*, the NYSE and NASD) also routinely conduct investigations relating to insider trading and market manipulation, coordinate their investigations with the SEC and federal and state prosecutors and bring enforcement actions of their own.
  - vi) Most recently, Congress has gotten involved as well. This past summer, the Senate Judiciary Committee held hearings into allegations of insider trading and market manipulation by hedge funds. Senators Orrin Hatch and Arlen Specter recently introduced legislation specifically aimed at preventing insider trading by hedge funds.

- b) The Ongoing Investigation into Private Investments in Public Equity Securities (PIPEs) Is an Important Example of the Regulatory Focus on Preventing Insider Trading and Market Manipulation
- i) The regulators have been conducting a wide ranging investigation of the PIPEs industry for the past several years. This is a coordinated investigation involving multiple offices of the SEC, federal prosecutors, the NYSE, the NASD, and state securities regulators and attorneys general.
  - ii) There have been a number of high-profile enforcement actions as well as criminal prosecutions brought against hedge funds and their personnel as well as placement agents.
  - iii) Most of the claims relate either to shorting securities being offered in a PIPE in advance of a public disclosure of the transaction and/or engaging in conduct designed to manipulate the market for the securities of the company selling its securities in a PIPE. Such manipulative activities have included matched orders, wash sales, naked shorting and other activities designed to depress the price of the subject company's stock.
- c) Rule 105 under Regulation M
- i) Rule 105 under Regulation M is an "anti-manipulation" rule that relates to secondary offerings of securities.
  - ii) The Rule, however, imposes strict liability for certain types of trades.
  - iii) As written, Rule 105 prohibits any person or entity who shorts a company's securities during the Rule 105 restricted period (typically five days prior to pricing the secondary offering) from using shares obtained in the offering to cover that short sale.
    - (1) The Purposes of Rule 105 is:
      - (a) to protect investors who participate in secondary offerings from downward market manipulation; and
      - (b) to maximize the proceeds that companies receive in secondary offerings.
  - iv) Rather than prohibiting shorting outright during the Rule 105 restricted period, the rule was expressly written to only prohibit shorting which is followed by covering the short sale that was established during the Rule 105 restricted period with shares obtained in the offering.
  - v) As with many things, however, the SEC has tried to push the envelope in a series of enforcement actions. Thus, the SEC has brought a number of enforcement actions against hedge funds that did not violate the letter of the rule but which the SEC believed violated the rule's spirit.
    - (1) Branding them "sham transactions," the SEC has brought enforcement actions against hedge funds that shorted during the Rule 105 restricted period, obtained shares in the secondary offering and later either "simultaneously" or "nearly simultaneously" sold the shares obtained in the public offering into the market while also engaging in open market covering purchases to close out the short position.
    - (2) Ethan H. Weitz and Robert R. Altman: On April 30, 2003, the SEC charged these individuals with at least 15 instances of violating Reg M by short selling during the Reg M restricted period, then covering their short sales with stock they purchased in that public offering. Profits realized were over \$500,000.

- (3) Ascend Capital, LLC (and Malcolm P. Fairbairn, and Emily Wang Fairbairn): On July 17, 2003, the SEC charged Ascend, an investment adviser, and its employees with violating Reg M on three occasions by establishing a long position with shares purchased in an offering while simultaneously maintaining a pre-pricing short position in the securities of the same issuer. Ascend then directed a trader to "cross" the positions by placing limit orders to sell and buy shares at the same price. Ascend earned over \$19,000 in profits on these transactions.
- (4) JC Management, Inc. and Crivelli: On July 27, 2004, the SEC charged JC Management, an investment advisor, and Crivelli, its sole employee, with violating Reg M by using allocated offering shares to cover its outstanding short position created during Reg M's restricted period even though Crivelli determined the stock was "overbought." Profits realized were nearly \$26,000.
- (5) Galleon Management: In May 2005 the SEC charged Galleon, an investment advisor, with creating boxed positions by establishing a long position through shares purchased in an offering while simultaneously maintaining a pre-pricing short position in the securities of the same issuer. Galleon then "collapsed the box" by offsetting journal entries or executing unwinding transactions in the open market through different brokers. Galleon netted \$1.04 million in profits.
- (6) Oaktree Capital Management: In May 2005, the SEC charged Oaktree, an investment advisor, with violating Reg M by creating boxed positions and then crossing the long and short positions against the other. The SEC alleged that the underlying trades served no economic purpose and presented no market risk. Profits realized approached \$170,000.
- (7) DB Investment Managers: In May 2005, the SEC charged DB Investment, an investment advisor, with violating Reg M by submitting a tiered indication of interest to the lead underwriter on the pricing date for each offering, but before any sale transactions in the relevant securities, and then selling short shares of the issuer in amounts representing a portion of its anticipated allocation in the deal. Profits realized were nearly \$16,000.
- (8) Compania Internacional Finaciera S.A. and Yomi Rodrig: On Dec. 19, 2005, the SEC sued this European investment vehicle and its owner for violating Reg M by participating in at least 85 public offerings to cover shares sold short during Rule 105's restricted period. Profits realized were over \$4.7 million. The federal district court approved a settlement in which Compania was ordered to pay the SEC over \$6.3 million in disgorged profits, prejudgment interest, and a civil money penalty, the largest disgorgement and penalty recovered in a SEC enforcement action for Rule 105 violations.
- (9) Graycort Financial, LLC: On Sept. 28, 2006, the SEC alleged that Graycort, a private investment fund, violated Reg M in two public offerings by purchasing shares in an offering while simultaneously maintaining a pre-pricing short position in the securities of the same issuer. Graycort then entered into a series of offsetting open market purchases and sales. Even though different brokers were used for these trades, and as much as an hour elapsed between the two legs of the trades were filled, the SEC still alleged that these transactions had no legitimate economic purpose or substance and merely served to disguise Graycort's Rule 105 violations. Profits realized were over \$100,000.
- (10) Solar Group S.A. and James J. Todd: On Nov. 6, 2006, the SEC charged Solar Group S.A., an offshore company, and its sole trader, Todd, with violating Rule 105 in connection with 176 public offerings by using shares purchased in those offerings to cover short sales made during the Reg M restricted period. Profits realized totaled nearly \$1 million.

- vi) Last month, the SEC proposed amending Rule 105 under Regulation M so as to make the rule clearer and avoid the need for the SEC to use creative theories to seek to eliminate conduct not covered by the current text of the rule.

- (1) The new proposed Rule 105 will continue to permit shorting a company's stock during the Rule 105 restricted period, but would prohibit anyone who engaged in such short sales from participating in the secondary offering.

d) Short Selling

- i) For many years, the SEC has recognized that short selling increases market efficiency. At the same time, however, the SEC has sought to ensure that short selling is not used to manipulate markets.
- ii) Effective January 2005, the SEC adopted Regulation SHO to help protect against manipulative short selling. Regulation SHO requires (among other things) a broker to locate shares that can be lent to its customer before allowing the customer to sell short.
- iii) More recently, the SEC's Enforcement Division has conducted a number of investigations of hedge funds that allegedly sold securities short without the broker first determining that the shares were available to borrow.
- iv) Although under Regulation SHO it is the broker's obligation to ascertain whether there is sufficient borrow in connection with a short sale, the Enforcement Division Staff has been taking the position that hedge funds who attempt to order short sales can be liable under theories of aiding and abetting, or causing, the broker's violation. The Staff has even taken the position that failing to inform the broker of the absence of adequate borrow can constitute a violation by the short seller of the securities laws' antifraud provisions.
- v) Additionally, a number of the PIPEs cases have involved an allegation that the hedge fund participating in the PIPE not only shorted the stock in advance of the public announcement of the PIPE transaction but did so without first obtaining borrowed shares with which to sell the securities short.
- vi) Congress, too, has gotten involved, with the Senate Judiciary Committee conducting hearings this past summer into whether or not hedge funds have been secretly arranging for independent research agencies to issue negative reports on a company based on false and misleading statements, shorting the stock in advance of the release of those negative research reports and then covering the short sales following a drop in the company's stock price after the negative research report was published.
- vii) Issuers have also gone on the offensive against what they perceive to be attacks on their stock prices by short sellers.
  - (1) This past year, we saw Overstock.com, Biovail and Fairfax all file lawsuits against hedge funds for allegedly procuring false research about those issuers for the purpose of manipulating the market in the issuers' securities.
  - (2) The theory of all of these cases is based upon alleged market manipulation.
    - (a) In each case, the Issuer was under significant pressure from short sellers who believed the company's stock was overvalued.
    - (b) The Issuers went on the offensive, suing the short sellers for market manipulation under a variety of different legal theories.
      - (i) Some of the complaints go so far as to allege a RICO conspiracy.

- (c) The basic theory is that the short sellers conspired with providers of purportedly independent research. According to the complaints, the short sellers took significant short positions in the issuers' stock—often engaging in “naked shorting” (without arranging borrow)—and induced the research companies to issue very negative research reports about the Issuers in an effort to drive down the Issuers' stock prices. In doing so, both the short sellers and the research companies allegedly knew that the negative research reports were filled with deliberate falsehoods about the Issuers and the fact that the short sellers paid the research companies to issue these knowingly false, negative research reports was concealed from the market.

#### 4) Update on Civil Litigation

- a) Lawsuits Resulting from Hedge Fund “Blow-ups” Continue To Dominate the Civil Litigation Landscape.
  - i) Whenever a hedge fund blows up, the investors who have lost money often scramble looking for deep pockets.
  - ii) The usual suspects (i.e., the defendants) in these cases include the hedge fund manager and the management company (both of whom usually have very little money available to make restitution to defrauded investors).
    - (1) For a long time, auditors and administrators were the favored deep-pocket defendants.
    - (2) More recently, independent directors have become a target of the litigation explosion that inevitably follows each significant hedge fund blow-up.
    - (3) And most recently, defrauded investors have begun suing the lawyers for the hedge funds too.
      - (a) Wood River: Wood River was a hedge fund the SEC charged with making false and misleading statements in its offering memo and for failing to file certain disclosure statements with the SEC. Wood River promised investors that it would broadly diversify its holdings when, in reality, it had highly concentrated holdings in a small-cap stock. Wood River also did not file required disclosures with the SEC in relation to its increasing stake in that stock.
      - (b) Plaintiffs recently sued Wood River's counsel for aiding and abetting the Funds in committing fraud and violating alleged fiduciary duties, negligent misrepresentation, and gross negligence. All of these claims are based on the allegation that the law firm assisted in drafting the offering memo and permitted the funds to use the law firm's name as a marketing tool with potential investors. The complaint also alleged that the law firm knew the funds broke their promises of diversification and that the law firm actively assisted the funds in the decision not to file disclosures with the SEC.
      - (c) It's too soon to say whether those claims will gain any traction, resulting inevitably in higher legal fees.
- b) Actions by Defrauded Investors or Bankruptcy Trustees Against Redeeming Investors
  - i) Typically, these claims are brought either to “recover” “fraudulent transfers” or on a theory that the redeeming investor has been unjustly enriched.
    - (1) Manhattan Investment Fund: MIF was an equity short-selling fund run by Michael Berger (who is still on the FBI's most-wanted list). By the time of MIF's collapse in January 2000, MIF lost \$400 million while reporting fictitious gains to investors. After MIF filed for bankruptcy, the Trustee sued investors who had redeemed their holdings before the

Fund's collapse, arguing that those redemptions constituted "fraudulent transfers," and sought recovery of the "phantom" profits earned, if not the entire investment itself.

- (2) Bayou: Claims have been filed on behalf of Bayou's bankruptcy estate against many "redeeming investors" on intentional and constructive fraudulent transfer theories.
  - ii) What makes claims against redeeming investors particularly troublesome for fund of funds and other hedge fund investors is that often the defendant did not do anything wrong. Rather, superior business acumen, more aggressive due diligence or even "getting lucky" may result in an investor redeeming its investment before a hedge fund blows up without the investor having either participated in the underlying misconduct or even known about it in advance.
  - iii) Despite its innocence, any redeeming investor could easily become a defendant in one of these "redeemer" lawsuits.
  - iv) Unfortunately, very few of these cases have actually been tested through litigation because oftentimes it is more economical for the redeeming investor to settle rather than fight.

## 5) Antitrust Enforcement

- a) When most hedge fund managers think about the risk of enforcement actions, they naturally think of the securities regulators. Yet there are instances where antitrust enforcement can be a significant issue for a hedge fund. Knowing the rules can help protect a fund and its investors from liability.
- b) Hart-Scott-Rodino Antitrust Improvements Act (HSR)
  - i) The HSR prohibits certain transactions without first making a filing with the Federal Trade Commission (FTC) and the Antitrust Division of the U.S. Department of Justice. That filing gives those competition authorities an opportunity to review the transaction to ensure that it is not likely to have any anti-competitive effects on an ascertainable market.
  - ii) Failure to make the required HSR filing can result in personal liability of the manager as well as liability for the hedge funds involved. The fine is \$11,000 per day.
  - iii) The FTC's recent case against Scott Sacane illustrates this point.
    - (1) Scott Sacane was the manager of the Durus Life Sciences Funds, a \$500 million master-feeder structure that focused on the healthcare space.
    - (2) Sacane "inadvertently" caused the Durus Funds to acquire 78% of one publicly traded company and 33% of another publicly traded company.
    - (3) In doing so, Sacane failed to file the required HSR forms, among other things.
    - (4) Sacane was almost a year late with his filings and faced over \$3 million in potential fines.
    - (5) Even though the transactions presented *no* competitive concerns *and* this was a first offense, the FTC fined Sacane *personally* \$350,000.
      - (a) No fine was imposed on the hedge fund in this case.
    - (6) In doing so, the FTC issued a warning to all hedge funds, fund managers and fund investors:

"This significant penalty should put hedge funds, their managers, and securities traders on notice that they are not exempt from filing pre-merger notification forms when required

to do so,” said Susan Creighton, director of the FTC’s Bureau of Competition. “The defendant in this case is an experienced fund manager who should have known and fulfilled his obligations under the HSR Act.” She noted that while the Commission only took action against the individual fund manager in that case, future enforcement actions in other cases resulting from a failure to file could be brought against a fund as well.

## Additional Information



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#### **Past topics include:**

Major Law Changes/Rules for Registration & ERISA

Activist Investing