

Cutting Edge Alternative Asset Management Deals

Wednesday, July 18, 2007



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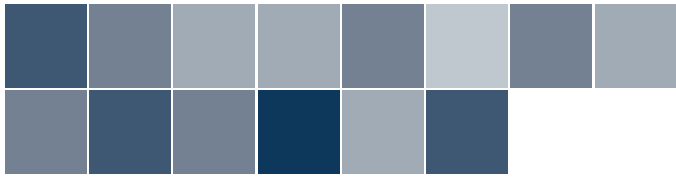
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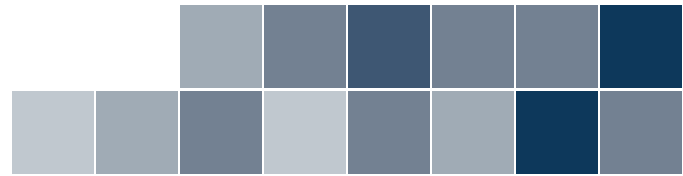
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I. About the Speakers



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Philippe Benedict is a partner in the Tax Practice Group of Schulte Roth & Zabel LLP in New York. His practice concentrates on the tax aspects of investment funds, mergers and acquisitions, international transactions, real estate transactions and financial instruments.

Philippe is a graduate of the New York University School of Law where he received a J.D. in 1990 and an LL.M. in 1993. During law school, he was a staff member of the *Journal of International Law and Politics* and a recipient of a Gruss Fellowship. He received his B.S. in 1985 from Adelphi University.

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 an editor of *Law and Policy in International Business*, and a 1977 graduate, *Phi Beta Kappa*, 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.

Michael R. Littenberg

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Michael R. Littenberg is a partner in the Business Transactions Group.

Michael has represented issuers and underwriters in capital markets transactions for over 17 years. He represents clients in registered, Regulation D, Rule 144A and Regulation S offerings. His product experience includes voting and non-voting common stock, LLC units and limited partnership interests, American Depositary Receipts and restricted depository units, preferred and convertible preferred stock, trust preferred securities, secured and unsecured, senior and subordinated high-yield debt securities, senior and subordinated investment grade debt securities, commercial paper, medium term notes and equity-linked notes. Michael has been involved in offerings on many of the world's principal securities exchanges, including dual-listed securities. He represents both domestic issuers and foreign private issuers.

Michael also represents issuers and their boards in ongoing U.S. securities law and securities exchange compliance matters, including Sarbanes-Oxley compliance.

Michael is a prolific speaker and has authored or co-authored numerous articles pertaining to U.S. securities law matters. Michael also is listed in *Who's Who in Securities Law*. He received his J.D., *magna cum laude*, from Tulane University Law School, where he was an editor of the *Tulane Law Review* and a member of the Order of the Coif, and his B.S. from Indiana University.

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. Primarily, he represents institutional and entrepreneurial investment managers and private investment funds in all aspects of their business.

Representative engagements and transactions:

- Structure fund management businesses
- Counsel principals on terms of management company partnerships
- Structure and form hedge, private equity, structured finance and hybrid funds and funds of funds
- Structure and implement scalable platforms for fund sponsors
- Restructure proprietary trading desks into investment management businesses
- Structure and negotiate seed and strategic investments
- Counsel on identification and management of conflicts of interest
- Advise on lift-outs and acquisitions of investment management businesses
- Advise on financing structures for investment funds and related regulatory issues
- Advise on regulatory and compliance issues affecting alternative investment managers
- Advise on all aspects of US banking laws that affect fund managers and funds

David is a 1993 graduate of the Brooklyn Law School where he was a 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 regularly at industry events and before regulatory agencies.

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 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*, *Who's Who in the World* 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 New York City Bar Association 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 the Task Force on the Undergraduate Experience at Harvard University, Faculty of Arts and Sciences. He is also a past president and member of the board of the Harvard Law School Alumni Association of New York City. Paul is also a member of the board of directors of the Citizens Committee for New York City and the NAACP Legal Defense and Educational Fund.

George M. Silfen

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George M. Silfen is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. He represents investment companies and their boards of directors, investment advisers and broker/dealers in connection with the organization and operation of investment products and services, including mutual funds, closed-end investment companies, business development companies, registered hedge funds, wrap accounts, and 401(k) and IRA products. He also advises clients on regulatory and compliance matters associated with investment company, investment advisory, brokerage, securities custody and transfer agent services.

George is a 1994 *cum laude* graduate of Brooklyn Law School where he was the articles editor of the *Brooklyn Law Review*, and has an M.B.A. from Baruch College. He graduated *summa cum laude* and Phi Beta Kappa from Brooklyn College in 1990, where he majored in economics. Prior to joining Schulte Roth, he worked for Morgan Stanley Investment Management.

Craig Stein

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Craig Stein is a partner in the Structured Products & Derivatives Group at Schulte Roth & Zabel LLP. His practice focuses on structured finance and asset-based transactions, synthetic CDOs, credit derivatives and fund-linked derivatives. He has been recognized by peer-review publications as a leader in the industry. *Chambers USA 2007* said of Craig: “Clients and peers have ‘nothing but great things to say about’ him. He is ‘a great thinker and excellent credit derivatives operator, as well as a great adviser for CDO transactions.’”

Craig speaks and writes widely on advanced financial products. His articles have appeared in *Credit*, *Loan Market Week*, *Derivatives Week* and elsewhere, and he has been a speaker and panelist at conferences on hedge funds, CDOs and innovative investment products.

Craig earned his J.D., *cum laude*, from the University of Pennsylvania Law School and his undergraduate degree, also *cum laude*, from Colgate University. He is a member of the American Bar Association, the New York State Bar Association and the ISDA Credit Derivatives Market Practice Committee.

Shlomo C. Twerski

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Shlomo C. Twerski is a partner in the Tax Group at Schulte Roth & Zabel LLP. His practice focuses on the tax aspects of:

- Onshore and offshore investment funds
- Private equity partnerships
- Real estate and corporate transactions
- Restructurings and workouts
- Securitizations
- Existing and emerging financial instruments

Shlomo is a 1983 graduate of Hofstra University School of Law, where he was articles editor of the *Hofstra Law Review*. He is a member of the Tax Section of the New York State Bar Association and regularly speaks on tax issues.

André Weiss

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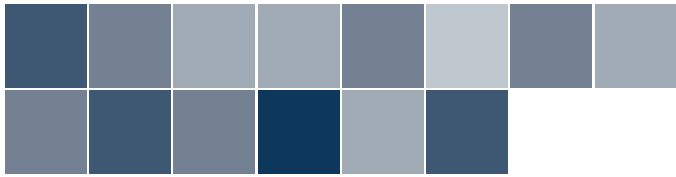


André Weiss is a partner in the Business Transactions Group at Schulte Roth & Zabel LLP. His practice focuses on public offerings, mergers and acquisitions, corporate governance, corporate finance, bankruptcy acquisitions and federal securities law.

Significant representations include:

- *Acquisitions and Dispositions.* BAWAG Bank, Baker & Taylor, LNR Property Corporation, Allegheny International (Sunbeam Oster), Newcourt Credit and SFX Entertainment
- *Offerings and Financing.* Initial public offerings for Oppenheimer Capital and The CIT Group Inc., £130 million stepped bond international offering for Toys "R" Us Inc., convertible trust preferred rule 144A offering for Golden Books Family Entertainment Inc. and \$1 billion bank credit facility for Toys "R" Us.
- *Corporate Counsel Representations.* Metrocall Holdings, Advanced Accessories and Horizon Lines
- *Asset Management Transactions:* Weiss Peck & Greer LLC, Delaware Management, Boston Partners, Ivy Asset Management, D.E. Shaw; Highbridge and Ospraie.

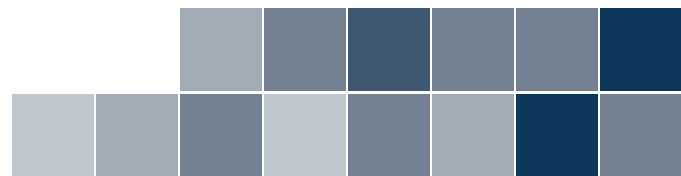
In 1974, André received his B.A. from New York University and in 1977, he was awarded his J.D., *cum laude*, from Syracuse University College of Law, where he was an editor of the *Syracuse Law Review*. After graduating from law school, he was a staff attorney with the Securities and Exchange Commission, Division of Market Regulation, an associate with Shearman & Sterling and in-house counsel with Toys "R" Us.

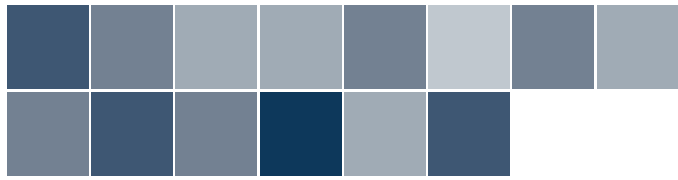


II. Public and Private Sales of Ownership in Hedge Fund Managers

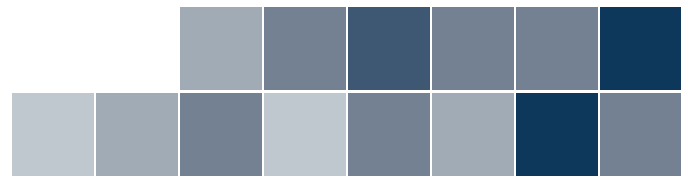
Philippe Benedict | Steven J. Fredman | Paul N. Roth | André Weiss

- A. Outline
- B. Alternative Asset Management Acquisitions
- C. Tax Issues
- D. Seeding Arrangements: Key Considerations and Current Trends
- E. Post Public Offering Organizational Structure





A. Outline



Public and Private Sales of Ownership in Hedge Fund Managers Steven J. Fredman and Tatziana Paraguacuto-Maheo

July 18, 2007

1) Private Sales

a) *Majority or Minority Interest*

- i) Change in Control - Toeholds, Footholds and It's Yours
 - (1) Under 20% vs. over 20%
 - (2) 100% sales
 - (3) Change in control triggers
 - (4) Autonomy
 - (a) Buyer's perspective
 - (b) Seller's perspective
 - (5) Seller investment lock-ups
 - (6) Restrictions or third-party investor
 - (7) Platform issues
 - (8) Effective date
- ii) Structure of purchase price
 - (1) Earn-out
 - (a) Generally 25% - 65% up-front payment
 - (b) Balance paid out over 3 - 5 years
 - (2) Installment sale vs. forward contract
 - (a) Ranges in lengths of installment periods
 - (3) Valuation range of EBITDA/AUM multiples
 - (4) Dealing with incentive fees/allocations and private equity and comparable funds
- iii) Employment agreements
 - (1) Key man
 - (2) Non-compete/non-solicitation agreements

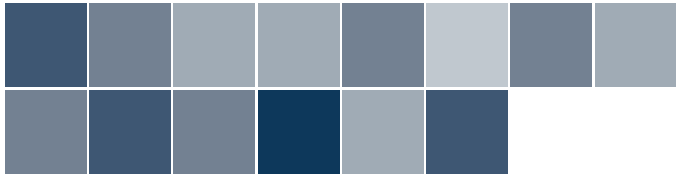
- (3) Typically funded through purchase price/earnout
- iv) Consent rights of purchaser
- b) *Tax Considerations*
 - i) Capital gains
 - ii) Preservation of deferral
 - iii) Proposed legislation
 - iv) Imputed interest
 - v) Interest charge on installment sale
 - vi) Impact of taxes on structure of transaction
- c) *Investment by Purchaser in Funds*
 - i) Commitments
 - ii) Lockup
 - iii) Reduced fees
 - iv) Ability of purchaser to replace proprietary capital with client capital
- d) *Distribution Arrangements and Capacity Rights*
- e) *Purchase Agreements*
 - i) Representations and warranties
 - ii) Indemnities
- f) *Exits*
 - i) Ability of purchaser to sell and right of first offer
 - ii) Ability of principals to sell additional interests
 - iii) Put and call/buy sells
 - iv) Tags and drags
 - v) Registration rights

2) Public Sale

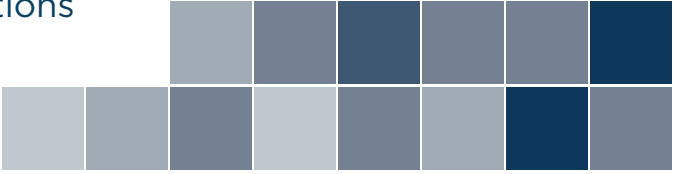
- a) *Why consider*
 - i) Raise capital to:
 - (1) Expand into new business areas
 - (2) Invest in the investment manager's funds

- (3) Pay down debt
 - (4) Finance operating activities
 - ii) Stock options or similar incentives to attract and retain top talent
 - iii) Establishes "currency" that can be used in future acquisitions
 - iv) Allows management to assign value to their stake in the company
 - (1) Current profit/gains
 - (2) Future valuation helps establish an exit strategy and plan of succession
 - b) *MLP or C Corp*
 - i) Pros and cons
 - ii) Nature of income and structuring considerations
 - c) *Sarbanes Oxley - Selected Key Provisions*
 - i) Section 404 - Internal control over financial reporting
 - (1) Documenting and testing
 - (2) Management's assessment/auditor's report on assessment
 - ii) Independence requirements
 - (1) Majority board
 - (2) Audit committee
 - (a) Audit committee financial expert
 - (3) Nominating Committee
 - (4) Compensation Committee
 - (5) MLP and controlled company exemptions
 - (a) Not required to have a majority independent board or independent nominating or compensation committee
 - iii) Prohibitions on loans to execs
 - iv) Section 302 and 906 CEO and CFO certifications
 - d) *Registration as Investment Adviser*
 - e) *Fin 46-R*
- 3) 144A Private Placement**
- a) *Oaktree/Goldman Sachs Transaction*

- i) Raised approximately \$880 million for 15% of the company
 - ii) Fewer than 50 initial investors
- b) *Pros and Cons*
- i) Sophisticated investor base
 - ii) Less public scrutiny
 - (1) Avoids regulatory oversight
 - (2) Less disclosure helps maintain greater privacy than regular public sale
 - (3) Investors have very limited participation in management decisions
 - iii) Less expense
 - (1) Faster and fewer procedures to initiate sale
 - (2) Fewer regulatory expenses
 - iv) Limited to QIBs
 - v) Not more than 500 investors
 - (1) Requires continuous attention to secondary market trading
 - (2) Difficult to use stock as acquisition currency
 - (3) Difficult to use as employment incentive
 - (4) Oaktree intends to limit to less than 400 investors, to better facilitate "direct and candid communication" with investors
 - vi) Trade through GSTrue system
 - (1) Offers liquidity without the regulations that generally apply to publicly traded companies
 - (2) Other banks are considering introducing their own trading platform
 - (a) Provide multiple platform options
 - (b) Most companies would list with banks with which they have preexisting relationships
 - (c) Will not list on multiple platforms because of the difficulty in tracking ownership



B. Alternative Asset Management Acquisitions



Alternative Asset Management Acquisitions

André Weiss and Kimberly Monroe

July 18, 2007

Over the past several years, independent, privately owned asset management firms, many of them primarily or significantly engaged in alternative asset management strategies, and their key professional employees, have been wooed by institutional suitors. As alternative asset management firms have evolved into multi-strategy firms, combining hedge fund, CDO, real estate, private equity, PIPES, global investing, distressed and debt financing strategies, among others, and attracting trillions of dollars domestically and abroad, traditional financial institutions have been seeking to capture this space in meaningful ways. These suitors have been motivated to provide attractive products to their customers and capture the clearly superior margins that have been a hallmark of the alternative asset management business. The prevailing perception of the alternative investment business is that the best asset management talent – which is almost solely what an investor is relying on – thrives in entrepreneurial firms, that, for the most part are headed, if not managed, by their partners. Moreover, with the emerging ability by asset managers to go public or enter into the 144A market for their equity interests, institutions consider investments in alternative asset managers to be excellent opportunities not only for underwriting commissions but as investments with significant near-term financial investment returns. Thus these institutional suitors seek to leverage or transplant the talent at these firms while maintaining their setting.

The attraction for the asset management firms and the reason that they are willing to give up some portion of their independence is generally financial. First and foremost, they are being offered attractive prices (including, as discussed below, earn-outs) for all or a foothold interest which will generally be taxed at capital gains rates under current law. Second, while certain alternative asset management products have been extremely attractive, many alternative asset managers feel that they do not have the distribution capacity or back-office financial, compliance and administrative capabilities that are in place at their institutional suitors. By availing themselves of essentially joint ventures with major financial institutions, even extremely successful independent asset managers can attempt to transform

themselves into global players akin to the transformation of brokerage firms and traditional asset managers in the latter half of the last century.

What are Key Features of these Investments?

- Earnouts - Contingent purchase price - Absence of employment tie-ins
- Autonomous management and governance arrangements
- Dedication of distribution capabilities
- Investment of substantial seller and, frequently, buyer moneys in target managed accounts or investment funds
- Retention arrangements for key employees not participating in the selling group
- Long-term non-competition/non-solicitation arrangements by sellers
- Client consent provisions where a change of control of the asset manager occurs

Determination of Purchase Price

We are not in a position to presume to discuss how purchase prices for these businesses are determined. What we can discuss, however, is how the purchase prices are structured. Over the years, we have seen from as little as 5% of the anticipated purchase price to over 90% of the purchase price paid at closing, with most deals in the range of 25% - 65% upfront payment. The balance of the purchase price is generally structured to incentivize the sellers to remain with the business and continue to grow assets under management. Typically, the balance is paid over a 3-to-5 year time period depending upon operating results over that period or over a shorter period immediately preceding the payment date(s). Operating results that are used as a basis for earn-outs generally parallel an EBITDA normalized to avoid the impact of the acquisition and integration expenses. Most critically for sellers, they are permitted to participate in the upside of the business, even the upside clearly contributed by buyers whether by means of direct or client investment in funds or managed accounts.

Buyers naturally request that the earn-out to any seller or seller-related entity be contingent on continued employment. However, sellers can't concede that without risking the capital gains treatment which, under current tax law, is a critical element in the sale. Almost any implication that receipt of the earn-out is tied to continued employment puts at risk the capital gains treatment to be accorded generally to the earn-out by potentially inviting the earn-out to be recharacterized as compensation income.

Typically, these transactions have been structured as acquisitions of the entire interest to be purchased, with delayed earnout payments. Whether the buyer is acquiring a foothold or a 100% interest, it acquires the totality of its interest at the first closing, meaning that the buyer participates in its full interest even though a portion, frequently very significant portion of the purchase price is due later.

A key issue for buyers when considering the purchase price is continuity beyond the earn-out period. As the buyer is acquiring a service business how can a buyer assure itself that the organization stays intact beyond the buy-out period. Non-competition/non-solicitation provisions contribute to but don't guaranty success. Ultimately, buyers must assume that the target, by the end of the earn-out period, will be so inextricably integrated and identified with the buyer's organization that continuity will be assured.

With the advent of managers of strategies involving private equity and side pocket becoming targets for buyers, one difficult element is addressing the valuation of these assets pre and post closing. Frequently, incentive allocations from existing investments at the closing are excluded from the purchase price multiple but are retained by sellers. These investments are tracked for a set period and, to the extent that these investments are held beyond that period, valuation methodologies involving third-party appraisers are utilized.

Autonomy

No issue takes up more time or emotion in these transactions than the provisions relating to the autonomy of the business post-acquisition. While the parameters of the negotiations vary based on the percentage of the asset manager proposed to be acquired, buyers expect meaningful say in foothold transactions and control in control acquisitions. Autonomy is critical for sellers from several perspectives. First, sellers are typically expecting a large percentage of their purchase price based upon their performance post-closing. To them that means no or minimal interference in the day-to-day activities of the firm. Second, buyers and sellers need to convince the firm's clients that the manner in which their money is managed will not change post-closing. Third, is psychological. Overwhelmingly, sellers began their careers at large, formally managed institutional establishments and left those institutions to organize or participate in private investment firms that take pride in their informality and, within the limits of compliance necessities, their ability to move quickly as opportunities develop.

What are a buyer's perspectives? First, is the simple premise: If the purchase involves at least a majority of the asset manager, then, certainly the buyer has ultimate authority over the target. In foothold transactions, buyers believe that with their name, reputation and customer credibility on the line, they

must have meaningful say over critical matters. In majority acquisitions, buyers need to integrate the target into its own business to fully run the business when the sellers have retired. And finally, institutional buyers typically have regulatory, compliance and reporting needs for which target company information and oversight is required.

It is within these two opposing approaches that deals get negotiated and, believe us, not easily and not quickly.

Platform

Frequently, sellers will request some contractual assurance that, within the product range of the target asset management firm, the target's products will be a buyer's exclusive or premier product. In the alternative, sellers frequently commit to making substantial direct or client investments in the funds or accounts managed by target asset managers. Buyers are, of course, reluctant to make any long-term commitment to any strategy, not merely because the target may not perform successfully, but primarily in order to avoid dedicating itself exclusively to any one organization as a long-term strategy. Buyers do not want to contractually forgo other opportunities irrespective of the target's future performance. Sometimes these platform arrangements give rise to escape clauses or early buy-out provisions on the part of the sellers, the buyer or both.

Seller Investment

As a further motivating factor for the sellers to stay on board, particularly, as noted above, since the earn-out cannot have any direct employment tie-ins, buyers frequently require that the sellers retain substantial funds under target management for the term of the earn-out and longer in some cases. Using this approach puts the sellers directly at risk for poor investment performance, thereby providing a further motivating factor. If you think of the earn-out as the carrot, the seller investment is the stick.

Employee Retention Arrangements

Nearly every asset management investment that we see is accompanied by a retention arrangement for key employees most often funded by sellers through their earnouts. As a consequence, these retention arrangements parallel the earn-out period and are contingent on the earn-out being paid. Such payment is treated as ordinary compensation income to the employees and is generally tied to such employee's continued employment.

Non-Competition/Solicitation

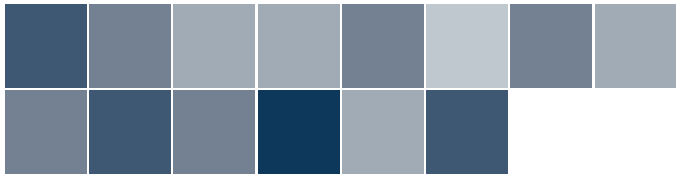
Universally, buyers demand that sellers and, to the extent obtainable, other key employees enter into long-term non-compete arrangements. These arrangements, containing standard carve-outs for personal and family investing, tend to extend well beyond non-compete periods in place for standard upper-level management employment agreements. We believe that such longer periods will be enforceable as the purchase price being paid for the target business is largely attributable to the goodwill associated with the sellers.

Client Consents

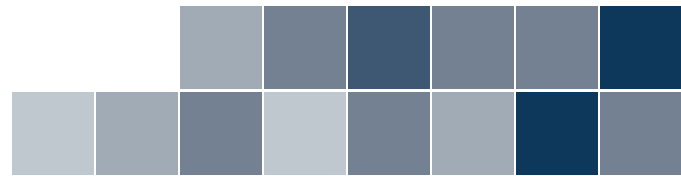
The most critical aspect of an asset management control acquisition is the assurance that clients of the target will not withdraw funds or terminate their relationships with the target following completion of the transaction. Compounding the business concerns are the requirements frequently contained in clients' agreements that require client approval of any transfer of its agreement or a change of control of the target, and, if the target is a registered adviser under the Investment Advisers Act of 1940, those consents (which, in some cases, may be satisfied by "negative consents") mandated by that act. Many asset management acquisition agreements contain closing conditions and purchase price adjustments based upon reduced assets under management or run rates arising from the failure to obtain all necessary consents, generally offset by new moneys deposited by existing or new clients following the signing date.

Conclusion

In our experience, these asset management investments tend to be very complex, with common features but without a common process to the conclusion. The competing interests of buyers and sellers, the critical need to avoid collisions during the negotiations that will poison the post-closing atmosphere, the contingent pricing based upon future performance and the emotions that the parties tend to attach to those interests ensure that each transaction will not proceed smoothly, will take substantially longer than standard acquisitions to complete and will require greater flexibility and creativity than in most acquisitions.



C. Tax Issues



Tax Issues

Philippe Benedict and David Griffel

July 18, 2007

1) Tax Treatment of Earnouts – Compensation or Deferred Purchase Price?

a) *Compensation for Services*

The following factors may indicate that all or a portion of an earnout payment is treated as compensation for services:

- (1) The Seller's right to receive the earnout payment is conditioned on the Seller's being employed by the target for a certain time period.
- (2) The earnout payment is not proportionate to the Seller's ownership interest in the target.

If the earnout payment is treated as compensation for services, the Seller will include the payment as ordinary income. The Seller will also be subject to FICA tax (including the uncapped 2.9% Medicare tax).

If the payment is considered compensation, it will result in a current tax deduction to the Buyer.

b) *Deferred Purchase Price*

i) *Capital Gain*

If the earnout is treated as deferred purchase price for a capital asset, receipt of the earnout payment will generally be taxable to the Seller as capital gain (except for the portion treated as "imputed interest").

ii) *Holding Period*

If a Seller contributes cash (or other property with a short-term holding period) to an entity treated as a partnership for tax purposes within a year prior to the sale, the Seller's holding period in the entity is bifurcated into a long-term and a short-term holding period. This results in a portion of the purchase price being taxed at the higher ordinary income tax rates.¹ A Seller with such bifurcated holding period should consider receiving a distribution from the partnership prior to the sale in an amount equal to the earlier contribution.²

iii) *Imputed Interest*

If interest is not explicitly provided for on an earnout payment treated as deferred purchase price, the Internal Revenue Code will require the recipient to impute interest as part of the earnout payment at a rate no lower than the "applicable federal rate."³ Interest on a deferred payment will be taxable as ordinary income to the Seller and will be deductible by the Buyer.

¹ Treas. Reg. § 1.1223-3.

² Treas. Reg. § 1.1223-3(b)(2).

³ IRC § 483(a); 1274.

iv) Installment Method

The Seller will be eligible to use the installment method in reporting the gain on a sale that includes an earnout.⁴ The installment sale rules do not allow a Seller to allocate his entire basis to the first payment received, which would generate no gain until all his basis is recovered. The Seller will report a proportionate part of his gain on the sale each time he collects a payment. In the context of an earnout, where some of the payments to be received are contingent, the amount of the Seller's total gain is not determinable on the sale date. If there is a maximum determinable price, the Seller must assume that the maximum price will be received in determining the recovery of basis and in reporting gain. If there is a fixed term for payment but no maximum price, the Seller recovers his basis ratably over the fixed term. In the absence of either a maximum selling price or a fixed term, the basis is recovered over a 15-year period.⁵

v) Interest Charge

The Internal Revenue Code imposes an annual interest charge on the Seller's tax liability deferred by the installment method to the extent the face amount of the installment note held by the Seller outstanding at the end of the taxable year exceeds \$5 million.⁶ If the Seller is a partnership (or other pass-through entity), the \$5 million threshold is applied, and the interest charge is computed at the partner level rather than at the entity level.⁷ In the case of an individual Seller, the interest charge is treated as personal interest and is therefore nondeductible.⁸

The amount of the interest charge that could be imposed is currently uncertain in the case of contingent payment obligations such as earnouts. Contingent payment installment notes are subject to the interest charge rules in the manner and to the extent provided in regulations.⁹ No regulations have yet been issued. One possible approach is to base the interest charge on the fair market value of an earnout. Another method would be to base the computation on the maximum amount payable pursuant to the earnout.¹⁰

vi) The Pledge Rule

If an installment obligation is used by the Seller as security for a loan, the net proceeds of that loan will be treated as a payment received on the installment obligation, thus accelerating gain recognition.¹¹

vii) Buyer's Step-Up

The Buyer will be entitled to a step-up in basis of the target company's assets (and corresponding tax amortization treatment) in the following circumstances:

- (1) The purchase of assets of the target.
- (2) The purchase of a partnership or LLC interest in target, where the target makes an IRC § 754 election for the year of the sale.¹² This step-up is available regardless of the percentage ownership acquired.

⁴ IRC § 453.

⁵ Treas. Reg. § 15A.453-1(c).

⁶ IRC § 453A(c).

⁷ IRS Notice 88-81, 1988-2 C.B. 397.

⁸ H.R. Rep. No. 495, 100th Cong., 1st Sess. (1987); IRC 163(h).

⁹ IRC § 453A(c)(6).

¹⁰ In TAM 9853002 (September 11, 1998), the taxpayer initially calculated the interest charge based on the maximum amount that could be received under the installment note. The IRS subsequently denied the taxpayer a refund of the interest charge when the initial projections of anticipated payments were reduced.

¹¹ IRC § 453A(d).

- (3) The purchase of 80% or more of the stock of a member of a consolidated or affiliated group or the purchase of 80% or more of the stock of an S corporation, provided, in each case, that an IRC § 338(h)(10) election is made.¹³

In the event of a step-up, since most of the purchase price of an asset management company is usually allocated to goodwill, the Buyer will amortize the purchase price over a 15-year period.¹⁴

In the context of an earnout, the Buyer will generally receive basis for the earnout when the payment is made. However, the 15-year amortization period will be determined from the date of sale, rather than from the date of payment.

viii) Proposed House Bill - Ordinary Income

A new House proposal (H.R. 2834) would, if enacted, treat any gains realized with respect to a disposition of a carried interest in a fund as income from services, taxable as ordinary income and subject to FICA tax. The bill has no proposed effective date.

2) Employee Retention Arrangements

a) *Funding Retention Bonus*

The funding of a Retention Bonus pool for the employees raises tax complexities. If the Seller funds the Retention Bonus with the proceeds of the earnout payment, the Seller will treat such funding as a reduction to the gain realized in connection with the earnout. Another possible structure is to have the Buyer reduce the earnout payment to the Seller and fund the Retention Bonus through the target. Each of these alternatives results in ordinary deductions to the target and in ordinary income to the employees.

b) *Issue Capital Interest to "Employee Pool"*

If individuals are granted a capital interest in the target, they can participate in the sale transaction as "Sellers." This structure would result in capital gain treatment to such Sellers and in amortization deductions over 15 years to the Buyer.

However, the granting of a capital interest should be structured as early as possible when the valuation of the target management company is low because any issuance of a capital interest results in ordinary income to the recipients to the extent of the fair market value of the capital interest received.

3) Treatment of Public Management Companies and Carried Interest Allocations

a) *Proposal to Change Publicly Traded Partnership Rules*

i) Current Exception from Corporate Taxation

Partnerships that are traded on an established securities market or a secondary market (or the substantial equivalent thereof) may still qualify for pass-through tax treatment in the United States (i.e., they are not taxed as corporations) if they are not registered under the Investment Company Act of 1940, as amended, and at least 90% of their annual gross income for tax purposes consists of "qualifying income".¹⁵ Subject to certain exceptions, "qualifying income" generally

¹² If the target owns lower-tier partnerships, the Buyer must request each lower-tier entity to make an IRC § 754 election.

¹³ The Buyer needs to confirm that an election similar to the IRC § 338(h)(10) election is also available for state law purposes.

¹⁴ IRC § 197.

¹⁵ IRC § 7704(c).

includes passive-type income, such as dividends, interest, gains from the sale of capital assets and certain other income items.¹⁶

ii) Proposed Legislation

The House and the Senate have each introduced bills (H.R. 2785 and S. 1624, respectively) to eliminate the "qualifying income" exception with respect to partnerships who derive any item of income or gain generated from (i) services provided as an investment adviser or (ii) related asset management services.

iii) Proposed Effective Date

The Senate bill proposes to make the change effective for taxable years of partnerships beginning on or after June 14, 2007, but it delays the effective date until June 14, 2012 for publicly traded partnerships who on June 14, 2007 either (i) were operating as publicly traded partnerships or (ii) filed a registration statement with the SEC in connection with an initial public offering ("IPO") of interests in the partnership. The House bill's effective date is for taxable years of a partnership beginning on or after June 20, 2007, and has no grace period, regardless of the partnership's status on June 20, 2007.

iv) IPO Impact

If either bill passes in its current form, management companies who have not filed a registration statement in connection with an IPO would not be exempt from corporate level taxation. If the Senate bill passes, companies who had already filed their registration statement prior to June 14 (e.g., Fortress and Blackstone), could still avoid corporate-level tax until their first taxable year beginning on or after June 14, 2012.

v) Non-IPO Impact

The breadth of the proposal could make the entire "qualifying income" exception worthless. The legislation refers to "any item" of income, which could affect not only funds that seed other funds in return for a piece of the incentive-based or asset-based compensation of those funds but also any partnership that invests in a corporation that provides investment management or asset management services.

b) *House Proposal to Tax Incentive-Based Compensation as Ordinary Income*

i) General Proposal

H.R. 2834 proposes to tax income received by partners for performing investment management services as ordinary income received for the performance of services, which may also be subject, in the case of many individuals, to FICA tax. Losses allocated with respect to an "investment services partnership interest" are deductible as ordinary losses, but only to the extent of prior income from the partnership treated as ordinary under the proposed provision.

- (a) *"Investment Services Partnership Interest"* is defined as an interest in a partnership which is held by a person which provides (directly or indirectly) to the partnership, in the active conduct of a trade or business, a substantial quantity of any of the following:
- (i) advising the partnership as to the value of any specified asset;
 - (ii) advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset;
 - (iii) managing, acquiring, or disposing of any specified asset;

¹⁶ IRC § 7704(d).

- (iv) arranging financing with respect to acquiring specified assets; or
 - (v) any activity in support of any of the foregoing services.
- (b) A "specified asset" includes most types of securities, commodities, derivatives, and real estate interests typically held by an investment partnership. Although many partnership interests are not included under this definition, the legislation may be implemented by adopting a "look-through" approach with respect to investments in "specified assets" made through partnerships.

ii) Effective Date

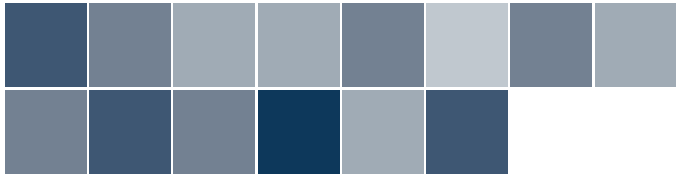
The bill has no proposed effective date.

iii) Primary Effect on IPO

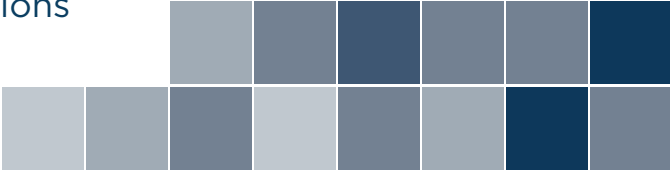
Existing publicly traded partnerships that earn performance-based allocations from other partnerships will not be able to treat such income as "qualifying income" even if the bill discussed in Section III(A) above does not pass.

iv) Certain Other Implications

- (1) Key Definitions Unclear. The legislation is intended to apply to a person who is "actively conducting a trade or business," and provides a "substantial quantity" of the enumerated services to the partnership. The intended scope of these terms is not yet clear.
- (2) No Effect on Unrealized Gains and Losses. The legislation deals with the character of income allocated by the partnership with respect to the "investment services partnership interest." It does not require that unrealized gains and losses of the partnership be recognized by the holder of the interest.
- (3) Scope of the Legislation. The legislation treats amounts allocated by the partnership with respect to the "investment services partnership interest" as ordinary income for services, but does not otherwise treat the partnership as having paid a fee. Accordingly, the incentive allocation should not be subject to the deferred compensation rules of Section 409A of the Internal Revenue Code, which do not currently apply to partnership allocations. Moreover, as under current law, individual investors in an investment partnership should not be subject to the limitations on investment deductions with respect to the incentive allocations.
- (4) ECI and UBTI. Any allocated ordinary income for services pursuant to the legislation may also be treated as "effectively connected income" which is subject to U.S. income tax (and possibly branch profits tax) in the hands of a non-U.S. person, and as "unrelated business taxable income" for a tax-exempt organization.
- (5) Effect on State and Local Taxation. The legislation's treatment of income and gain as ordinary income for services for federal tax purposes may affect the manner in which state and local jurisdictions treat these items. For example, as a result of the legislation, the incentive allocation may be treated as New York source income, on which a nonresident of New York State is subject to tax, and may also become subject to the 4% New York City unincorporated business tax.



D. Seeding Arrangements: Key Considerations
and Current Trends



Seeding Arrangements: Key Considerations and Current Trends

David J. Efron and Udi Grofman

July 18, 2007

1) Structural Issues

a) *Fund or Management Company: Which Entity is Seeded and How?*

Seed capital may be provided:

- i) to be managed for investment by the seeded manager;
- ii) as operating capital to assist the seeded manager with its own overhead expenses; or
- iii) as a combination of both.

Seed capital to be managed by the seeded manager for investment may be provided on the seed investor's own balance sheet, by funding a single investor entity to be managed by the seeded manager and offered to third-party investors at a later date, or by funding directly into a fund sponsored by the seeded manager. The seed investor may pay fees (although usually reduced fees) to the seeded manager in connection with the seed capital arrangement.

Seed capital may be provided to the seeded manager for operating purposes instead of, or in addition to, capital provided for investment. Such seed capital may take the form of a contribution of capital in exchange for an interest in the manager entity or as a loan. The seed investor may also provide office space (temporary or permanent) and/or infrastructure to the seeded manager.

b) *Active Versus Passive: What Role Does the Seed Investor Play?*

The seed investor may play an active or passive role in the venture. An active role may be taken with respect to the business and operations of the seeded manager entity or, in some cases, with respect to the portfolio management activities of the seeded manager.

An "active" seed investor may have the ability to vote or veto either ordinary course decisions or extraordinary ones. The types of decisions that may require the seed investor's consent or vote include: any sale, merger or consolidation of the seeded manager's business; admitting or terminating senior personnel of the seeded manager; approving compensation to senior personnel; determining the annual budget; sponsoring additional products; incurring indebtedness above a certain predetermined amount; and approving the seeded manager's code of ethics.

Decisions with respect to the business and operations of a seeded manager may be vested in a board of managers (or similar body) in which the seed investor may have representation. If the venture is a combination of equals, the seeded manager and the seed investor need to consider dispute resolution mechanics (e.g., arbitrator or holder of a "golden share," independent director, silent bid mechanism).

In some instances, a seed investor may have limited rights in connection with portfolio management and other matters relating to the fund managed by the seeded manager. Such rights may include: approval rights of material changes to the investment program; approval of fee rebates (since such rebates may impact the revenue flow to which the seed investor is

entitled); and veto right with respect to the fund's "gatekeepers" (*i.e.*, independent public accountant, prime broker, administrator and fund counsel).

In addition to the provision of capital, the seed investor (or its affiliates) may also provide services to the venture, including front-, middle- or back-office services; trading support; risk management; investor relations; and tax and compliance services. These services may or may not be rendered for additional payment.

c) *Economics: How is the Seed Investor Paid?*

The return that the seed investor expects on its seed investment is an ongoing revenue flow tied to the seeded manager's income (in a "gross" deal) or profit (in a "net" deal). In addition, the seed investor may receive economic benefits with respect to an "exit" event (*e.g.*, sale of the business), and, to the extent that seed capital is provided for investment purposes (as opposed to operating capital), a return on its own investment. Regardless of whether the seed investor plays an active or passive role, the seed investor may receive a revenue flow from the manager either by participating directly, as an equity holder in the operating entities of the seeded manager, or indirectly, as a profit participant in the funds (*e.g.*, as a special limited partner or co-general partner entitled to a portion of the incentive allocation allocable to the general partner). The structuring of the revenue share to the seed investor is tax driven, although regulatory issues (*e.g.*, Bank Holding Company Act concerns) may also impact the structure. From an economic standpoint, the seeded manager generally prefers that the seed investor receive its share through its holdings in the manager's operating entities as this usually means that the seed investor will receive a portion of the *net* profits of the manager (as opposed to a portion of the *gross* income). Yet, to the extent the seed investor is a corporation (for instance, a hedge fund complex that has an offshore fund participate in funding the seed investment), admitting the seed investor as a member or partner of the seeded manager's operating entities would preclude the manager from deferring the receipt of its fees from its sponsored offshore funds pursuant to a fee deferral arrangement.

Alternatively, the seed investor may receive its revenue share through a special limited partner (or similar) interest in the seeded manager's funds. While this arrangement should not interfere with the seeded manager's deferral arrangements if structured correctly, this arrangement presents structural challenges that need to be analyzed, based on the circumstances, including operational and tax aspects.

The seed investor, if a hedge fund, should consider whether to "side pocket" the seed investment or not, and if not, whether to make the investment through a master fund (or a subsidiary owned by its offshore and onshore funds) in order to ease any rebalancing of the investment among such funds.

2) Regulatory and Compliance Issues

a) *The Seed Investor Conflict: Who Gets the Benefits?*

A preliminary determination to be made by the seed investor is who should get the benefits derived from the seed arrangement. As a fiduciary matter, if the seed capital used to fund the investment involves third-party funds (as in the case of a hedge fund that seeds a manager), then any benefit derived from such investment should inure to the benefit of the hedge fund investors unless clearly disclosed to such investors in advance of their investment in the seeding fund. As mentioned above, some hedge fund managers side pocket their seed investments in order to, among other reasons, ensure that the specific investors that funded the seed investment receive the benefits of such investment.

b) *Impact on Existing Business.*

Both the seed investor and the seeded manager should consider how the seed arrangement may give rise to conflicts of interest in connection with their respective businesses and whether such

conflicts of interest can be effectively addressed. For instance, appropriate consideration should be given in the case where a broker-dealer (or an affiliate of a broker-dealer) seeds a manager that intends to use the broker-dealer for prime brokerage or execution. A manager seeding activist investors should consider the "headline risk" associated with such activities. Additionally, a manager seeding activist investors may find itself subject to pressure from issuers with which the seeding manager does business if the seeded manager trades and takes an active role with such issuers. A multi-strategy fund that seeds managers as part of its strategy should consider the likelihood that the seeding manager and the seeded manager will invest in different layers of the capital structure of an issuer and the conflict it may face in such situation.

c) *Trade Aggregation Issues.*

Section 13(d) of the Securities Exchange Act of 1934, as amended, subjects the beneficial owner of a class of securities registered under Section 12 of such Act to certain filing requirements with respect to holdings of such securities in excess of 5%. A beneficial owner is defined as a person that has or shares (i) the power to vote, or to direct the voting of, a security, and/or (ii) the investment power (*i.e.*, the power to dispose, or to direct the disposition of, such security). A seed investor that has the ability to vote, direct the voting, invest or direct the investment with respect to any security traded by the seeded manager may be deemed a beneficial owner of the securities traded by the seeded manager. Whether a seed investor has such ability is a factual question that should be analyzed based on the specific facts. This analysis should include all relevant factors including the size of the seed investor's investment with the seeded manager, the seed investor's ability to redeem capital and its ability to request a distribution in-kind from the seeded manager, the powers (or lack thereof) of the seed investor to intervene with or supersede the seeded manager's investment decisions, the real time knowledge that the seed investor has regarding the positions traded by the seeded manager, whether the seeded manager trades on the seed investor's balance sheet or separately, and whether, in light of the circumstances, the seed investor has the power to direct the investment activities of the seeded manager even in the absence of formal contractual power.

If the seed investor is found to have beneficial ownership of the securities beneficially owned by the seeded manager, the positions beneficially owned by the seed investor in its own investment vehicles will have to be aggregated for such purposes with the positions beneficially owned by it "through" the seeded manager. Additionally, since Section 16 of the Exchange Act uses the same beneficial ownership test as Section 13, the seed investor may be subject to additional reporting requirements with respect to the "aggregated" positions (Section 16(a)), disgorgement of short swing profit (Section 16(b)) and the prohibition on short selling (Section 16(c)).

d) *Issues Pertaining to Transparency.*

The transparency that a seed investor may be afforded with respect to the securities managed by the seeded manager, is not only a crucial component in the aggregation analysis above, but is also important in considering whether the seed investor should be subject to the seeded manager's restricted list and code of ethics. If certain information barrier procedures are adopted, such restrictions may be avoided.

e) *Dealings with Regulated Entities.*

If either party is a regulated entity, attention should be given to the regulatory impact of the seed arrangement.

- i) Registered investment advisers - will the seeded manager or the seed investor become a "related party" that has to be disclosed on the other party's Form ADV?
- ii) A bank holding company affiliate that seeds managers should structure the arrangement to comply with the Bank Holding Company Act and its implementing regulation, Regulation Y of the Federal Reserve.

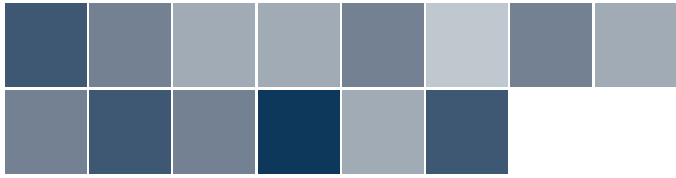
- iii) If the seed investor is a broker-dealer, the arrangement may raise issues with such broker-dealer acting in a principal capacity with respect to trades with the seeded manager's fund.

3) Economic Terms and Trends

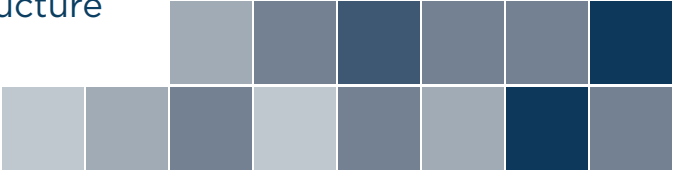
- a) Economic and other business terms depend on what the seed investor provides: amount of seed capital (both in dollar terms and relative to the seeded manager's assets under management ("AUM")), commitment period, additional services to be provided and the special circumstances of the seeded manager (e.g., does the seeded manager have a track record).

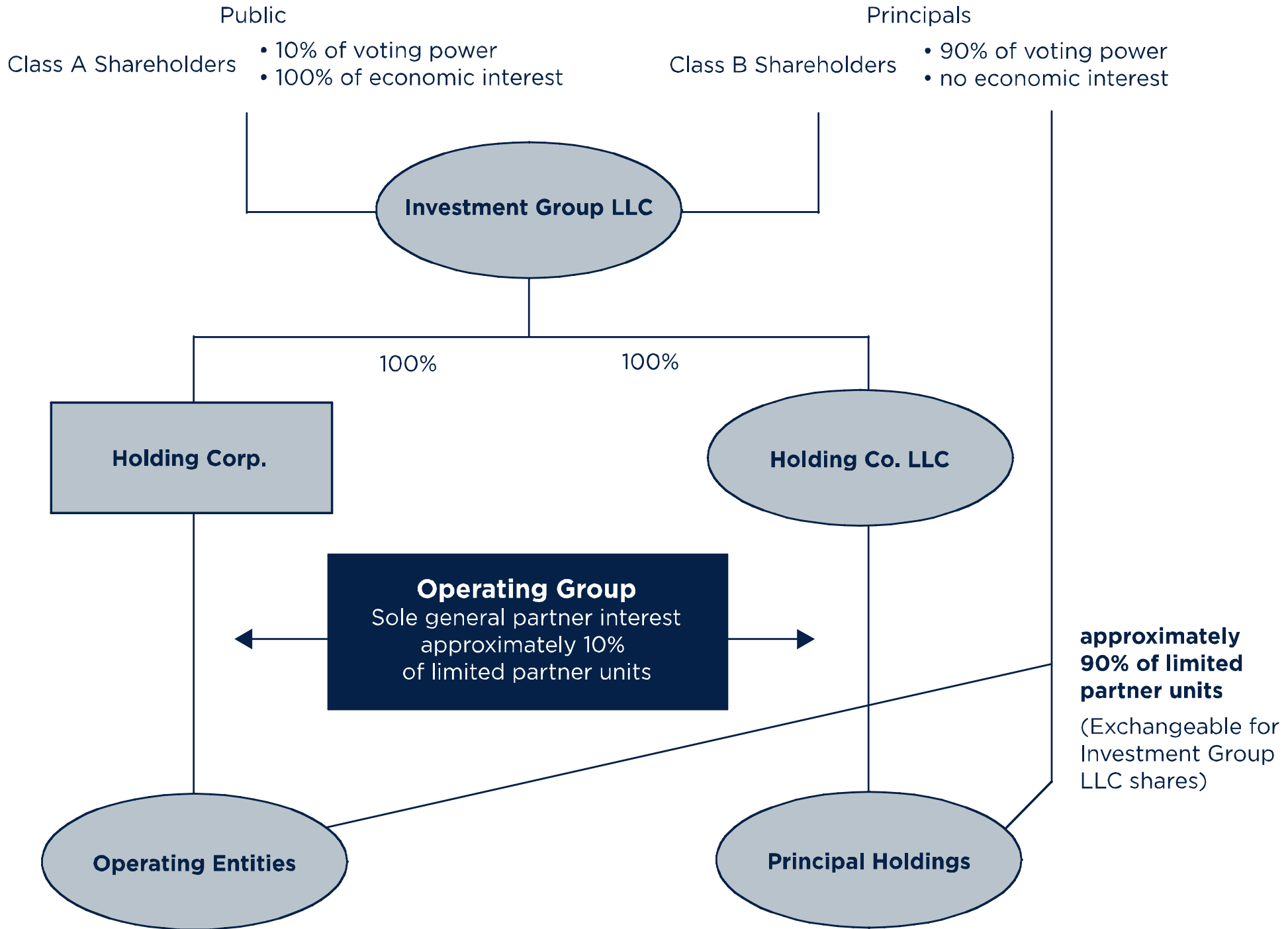
Everything is Negotiable

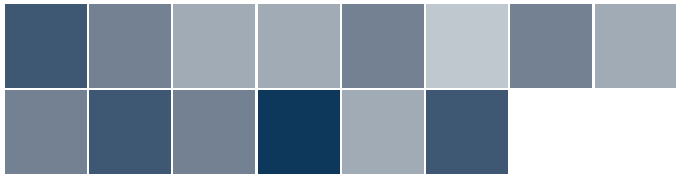
- i) Revenue share/equity: seed investor participation in management fees, incentive fees/allocations, and/or proceeds upon sale of business; application of arrangement to new funds/products
- ii) Perpetual interest in revenue flow and equity vs. declining percentage over time
- iii) Interest in revenue flow calculated on gross vs. net basis
- iv) Changing economics in accordance with certain performance and/or AUM benchmarks
- v) Fees to which seed capital is subject
- vi) Restrictive covenants
- vii) Liquidity rights: lock up, key man, performance drawdown rights, transferability
- viii) Track record and intellectual property
- ix) Transparency: inspection rights to books and records or "self policing" (e.g., compliance certificate) and veto rights with respect to "gatekeepers"
- x) Management and control rights (see discussion above)
- xi) Capacity in seeded fund; application of terms to additional investments in the seeded fund; limitation on AUM
- xii) Removal rights ("for cause")
- xiii) Termination rights
- xiv) Exit strategy
 - (1) Tag-along rights
 - (2) Drag-along rights
 - (3) Right of first refusal
 - (4) Right of first offer
 - (5) Buy-back rights



E. Post Public Offering Organizational Structure





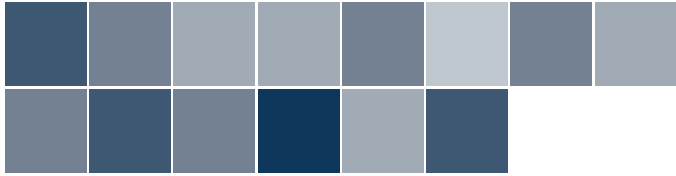


III. Permanent Capital Investment Vehicles

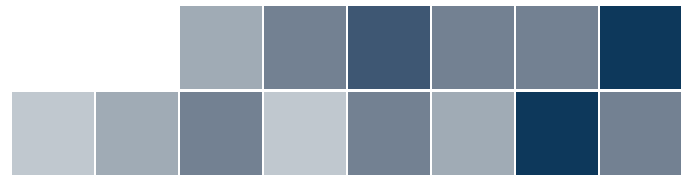
Michael R. Littenberg | David Nissenbaum | George M. Silfen
Craig Stein | Shlomo C. Twerski

- A. Outline
- B. Comparison of Permanent Capital Vehicles and Similar Structures
- C. Offshore Private Equity Permanent Capital Vehicles Diagram
- D. Offshore Hedge Fund Permanent Capital Vehicles Diagram
- E. Market Value CLO Chart





A. Outline



Permanent Capital Investment Vehicles

Michael R. Littenberg, David Nissenbaum, George Silfen, Craig Stein and Shlomo Twerski

July 18, 2007

1) Introduction

a) *Two groups of issuances seemed to have kicked off a trend in forming permanent capital vehicles:*

- i) U.S. public offerings of business development companies ("BDCs") in 2004-05
- ii) Non-U.S. public offerings of closed end funds traded in Amsterdam in 2006

b) *What makes a permanent capital vehicle desirable?*

- i) For managers, no redemption rights for investors, which enables managers to do deals that could be difficult to put in their hedge fund or private equity funds because of illiquidity or long time horizon
- ii) For investors, the ability to get into or liquidate the investment quickly and at a market price (as opposed to periodic redemption rights and a limited private secondary market)

c) *Why haven't permanent capital vehicles been used in the past?*

d) *Success so far has varied*

- i) BDCs – initially, a lot of interest, but only a few launched
- ii) A small but increasing number of non-U.S. public funds
- iii) More recently, U.S. public offerings of funds of collateralized debt obligations ("CDOs") and interest in other specialty investment vehicles
- iv) Different approach - term debt

(1) Credit hedge funds using market value collateralized loan obligations ("CLOs")

(2) Citadel's debt offering

v) Other types of specialty investment vehicles recently of interest to fund managers

e) *Questions this panel will address:*

- i) Why and how to take a fund public outside of the U.S.
- ii) Why and how to take a fund public in the U.S.
- iii) Significant issues that arise with a public vehicle
 - (1) Tax treatment for U.S. and non-U.S. funds
 - (2) U.S. offering and sales restrictions of non-U.S. funds
 - (3) Limits on investments in U.S. registered funds

(4) Reporting and compliance for U.S. and non-U.S. funds

2) Offshore Public Offerings by U.S. private equity fund managers

a) Structure

- i) Guernsey limited partnership
- ii) Issues non-voting common units to investors; limited special consent rights
- iii) No board at the issuer; managed by a managing general partner (a Guernsey limited company), which is owned by affiliates of the sponsor, and its board
- iv) Public vehicle is a holding company, and also the limited partner of an underlying intermediate holding company, which directly or indirectly has an interest in investment assets. An affiliate of the sponsor is the general partner of the intermediate holding company
- v) Public issuer is externally managed; has a services agreement with an affiliate of the sponsor
 - (1) Reduced management fee during ramp-up
 - (2) Management fees offset by management fees paid to other sponsor affiliates
 - (3) Limited ability to terminate services agreement
- vi) Carried interest is paid to an affiliate of the sponsor by the underlying investment vehicle; subject to waiver during ramp-up; no duplication on carried interest

b) Offering and trading restrictions

- i) Reg S - publicly offered outside of U.S.; listed on Euronext
- ii) Privately placed in the U.S.; Rule 144A
 - (1) U.S. securities take the form of "Restricted Depositary Units"
 - (2) Can only be offered to QIBs/AIs that are QPs, in order to avoid registration under the U.S. Investment Company Act of 1940 (the "Company Act")

c) Governance

- i) Majority independent board of the managing general partner
- ii) Majority of the seats on the nominating and corporate governance committee held by the sponsor
- iii) Independent audit committee
- iv) Certain significant actions require independent director approval
- v) Not subject to Sarbanes-Oxley Act, but follows some of the same governance requirements as a U.S. public company

d) Reporting

- i) Provides U.S. GAAP quarterly and annual financials
- ii) Provides K-1s or QEF statements to investors

e) *Tax considerations*

- i) Can be taxed as master limited partnerships ("MLPs") or corporations for U.S. purposes
 - (1) Want to avoid receiving income effectively connected with U.S. trade or business activities ("ECI")
 - (a) Partnerships need to have sufficient qualifying income to avoid publicly traded partnership status, or
 - (b) Be treated as a passive foreign investment company ("PFIC")
- ii) MLPs must provide Form K-1s U.S. investors. PFICs must provide QEF statements to U.S. investors
- iii) In MLPs, non-U.S. investors will pay U.S. corporate and branch profits tax on any ECI and will be required to file U.S. tax returns
- iv) Proposed changes to U.S. tax code

f) *Key parties (service providers), process and timing*

3) Offshore public offerings by U.S. hedge fund managers

a) *Currently one deal in the market*

- i) Structured as a Guernsey vehicle
- ii) Three classes of offered shares - dollar, sterling and Euro; offered shares to have a secondary listing on the LSE
- iii) Proceeds to be invested in an existing master fund
- iv) Expenses of the offering being paid by the manager
- v) Only fees payable are those at the fund level
- vi) Ability under certain circumstances to buy-back shares that trade at a discount to NAV
- vii) Although not required, will have a majority independent board

b) *Otherwise no U.S. hedge fund managers have completed an offshore public offering*

4) U.S. registered closed-end funds

a) Threshold issues for hedge funds and private equity funds

- i) Strategy limitations under the Company Act
 - (1) Leverage restrictions: 200% asset coverage requirement
 - (2) Affiliated transaction prohibitions: generally, no principal transactions with affiliates (which broadly includes any entity where the investment company owns 5% or more of the entity's voting securities, i.e., downstream affiliates)
- ii) No incentive compensation because of Rule 205-3 under the Investment Advisers Act of 1940

- iii) Private equity assets are problematic because large ownership positions may be prohibited affiliate transactions (but BDC's offer an alternative)

5) Business development companies

- a) *Subject to various aspects of investment company regulation*
 - i) Mandated investment activity:
 - (1) 70% of total assets must generally be invested in U.S. private operating companies
 - (2) Must make available "significant managerial assistance" to portfolio investments
 - ii) *Lighter* limitations under the Company Act
 - (1) Leverage restrictions: only 100% asset coverage requirement
 - (2) Transactions with downstream affiliates are generally permissible
 - iii) Incentive compensation allowed under Rule 205-3
 - iv) Listing requirements and process
 - v) Key parties (service providers), process and timing

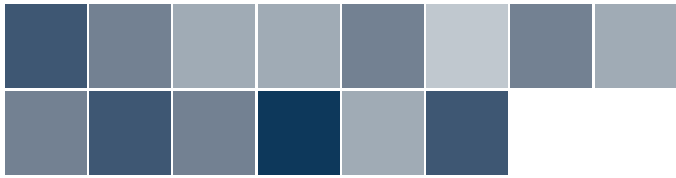
6) Specialty U.S. public fund alternatives

- a) *Funds that invest in equity of CDOs*
 - i) Rule 3a-7 exemption from ICA registration
 - ii) 60%+ assets must be invested in controlled "3a-7" exempt structured finance subsidiaries
 - iii) Taxed as an MLP
 - iv) Most CDOs held by the fund must limit trading
- b) *Credit derivatives products companies*
 - i) Provides credit protection on single names or tranches
 - ii) The operating company is capitalized by a combination of equity and longer-term (semi-permanent) rated subordinated debt
 - iii) Can be public or private, and variants of both exist in the market
 - iv) Characterized by a long lead time (often multi-year) to complete modeling and get rating agency signoff on model and documentation
- c) *Special purpose acquisition companies ("SPACs")*
 - i) Can be used to enhance or build out an acquisition strategy
 - ii) However, limited flexibility pre-acquisition
 - (1) Most of proceeds are escrowed
 - (2) In order to break escrow, most of the proceeds have to be used on the initial acquisition

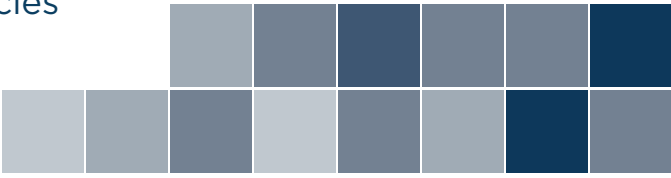
- (3) Shareholder approval required to consummate the initial acquisition
- d) *Evolving markets for private liquidity*
 - i) GStrUE
 - (1) Limited to QIBs/QPs
 - (2) More structured reporting than traditional 144A market
 - ii) NASDAQ private market; still under development

7) Market value CLO subsidiaries of hedge funds

- a) *What type of fund is this appropriate for and what are key features?*
 - i) Credit funds
 - ii) Cheaper financing
 - iii) Longer term debt
 - iv) Since equity is locked up in CLO, need to maintain liquidity at fund level
- b) *Types of collateral*
 - i) Collateral is mainly investment grade and some below investment grade debt
 - ii) Equity does not qualify
- c) *Structure, terms of notes and preference shares*
 - i) Preference shares (equity) wholly owned by hedge fund
 - ii) Notes are issued in multiple tranches, typically rated from AAA to BBB
 - iii) Notes typically callable at option of hedge fund as equity holder
 - iv) Market value drops – de-lever the transaction
- d) *Type of offering 144A/Reg S*
 - i) Reg S - publicly offered outside of U.S.
 - ii) Rule 144A private resales in U.S.
 - iii) Investment guidelines and restriction
- e) *Stages of the debt financing*
 - i) Warehouse facility
 - ii) Issuance of notes to take out the warehouse debt
- f) *Conflicts of interest*
 - i) CLO must be consistent with fund's investment program - no double-dipping of fees
- g) *Key parties (service providers), process and timing*



B. Comparison of Permanent Capital Vehicles
and Similar Structures

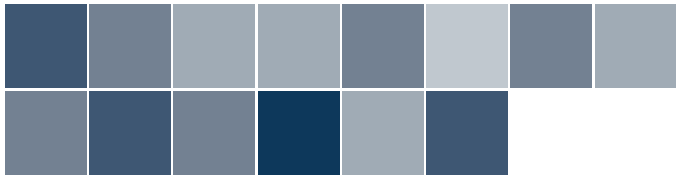


Comparison of Permanent Capital Vehicles and Similar Structures
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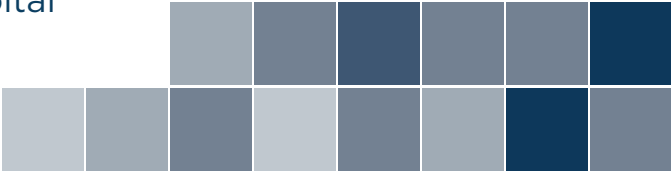
	Traditional Hedge Fund	Traditional Private Equity Fund	U.S. Listed Closed End Fund	Offshore Listed Public Fund	U.S. Listed Business Development Company	U.S. Listed Real Estate Investment Trust
Description/Typical Investment Program	Invests in any security; may use leverage and sophisticated trading strategies	Invests in securities that are not quoted on an exchange	Invests in equities, debt, cash-equivalents and related interests	Invests in (or alongside) hedge and private equity funds managed by the issuer	Invests in equity and debt of private operating companies; similar to venture capital or mezzanine debt funds	Invests in real estate and mortgage interests
Significant Restrictions on Investments/ Compensation	None	None	Incentive compensation and significant leverage not permitted	None	70%+ assets must generally be in U.S. private operating companies	80%+ assets in real estate and/or mortgage interests (including certain qualifying mortgage-backed securities)
Typical Type of Entity	Partnership or LLC (domestic); Company (offshore)	Partnership or LLC (domestic); Company (offshore)	Corporation or Trust (domestic)	Corporation or Partnership (offshore)	Corporation or Trust (domestic)	Trust (domestic)
Entity Governance (in addition to Investment Manager)	General Partner or Managing Member (domestic); Board of Directors, often independent (offshore)	General Partner or Managing Member (domestic); Board of Directors (offshore)	Board of Directors or Trustees	Board of Directors or General Partner	Board of Directors or Trustees	Trustees
Manner of Offering	Shares/interests by private placement	Shares/interests by private placement	Shares by public offering	RDUs by private placement (U.S.); Shares/interests by public offering (non-U.S.)	Shares by public offering	Shares/units by public offering
Target/Permitted Investors	U.S. AIs/QPs and non-U.S.	U.S. AIs/QPs and non-U.S.	U.S. and possibly non-U.S.	U.S. QPs & QIBs and non-U.S. (public)	U.S. and possibly non-U.S.	U.S. and possibly non-U.S.
Tax Considerations	Partnership/pass-through treatment (domestic) and PFIC (offshore)	Partnership (pass-through treatment)	No corporate tax if income is distributed annually	Partnership (pass-through treatment) or PFIC	No corporate tax if income is distributed annually	No corporate tax if income is distributed annually
U.S. Investment Company Act	Exception under Section 3(c)(1) or 3(c)(7)	Exception under Section 3(c)(1) or 3(c)(7)	No exception or exemption; regulated as a registered investment company	Exception under Section 3(c)(7)	No exception or exemption; regulated as a BDC	Exception under Section 3(c)(5)(C)
U.S. Investment Adviser Registration	Not required	Not required	Required	Not required	Required	Not required
Examples (publicly known)	-	-	Man Dual Absolute Return Fund	KKR, Apollo, Brevan Howard, Marshall Wace	Apollo Investment, Plainfield Direct	JER Investors
Liquidity Terms	Typically 1-2 yr lockup; quarterly liquidity; transfers require approval	Typically 7-10 yr term, no redemptions; transfers require approval	Exchange traded, and must also register securities under the Securities Act	Exchange traded on London or Amsterdam exchanges	Exchange traded, and therefore must register securities under the Securities Act	Exchange traded, and therefore must register securities under the Securities Act

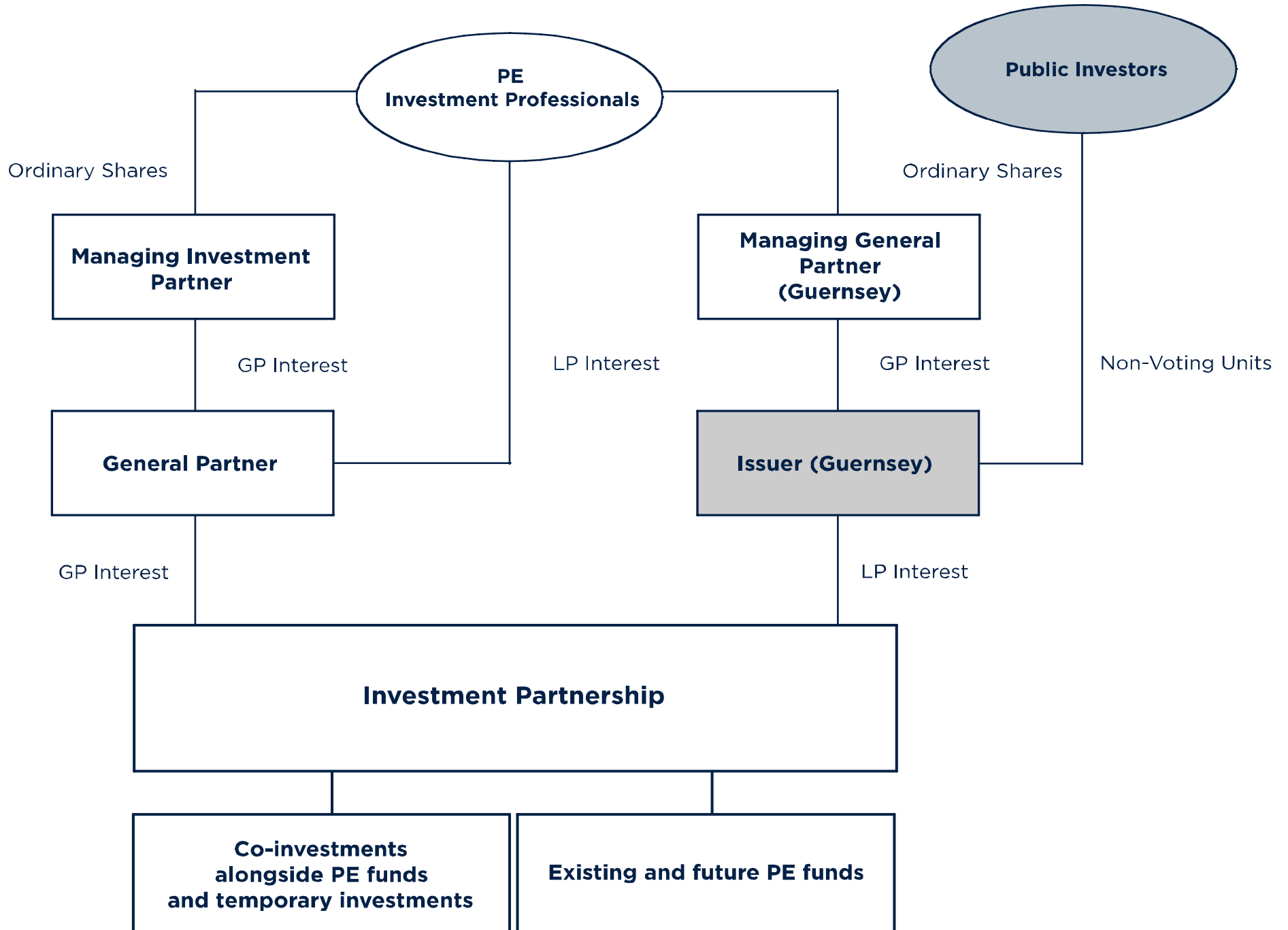
Comparison of Permanent Capital Vehicles and Similar Structures
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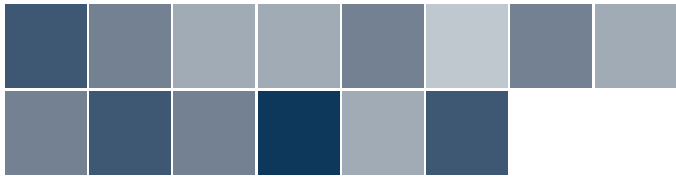
U.S. Listed Fund of CDOs	Credit Derivative Product Company	U.S. Listed Special Purpose Acquisition Company	Market Value CLO	Term Debt	U.S. Listed Investment Management Firm	
Invests in equity and notes of structured finance subsidiaries	Writes credit default swaps	Makes buyout investments but raises money and then looks for opportunities; not used to hold portfolios	Invests in loans and bonds; flexible multiple tranching long term debt financing	Medium-term note program; proceeds used to finance hedge funds run by investment manager	Provides investment advice to investment funds and individual clients	Description/Typical Investment Program
60%+ assets must be invested in controlled "3a-7" exempt structured finance subsidiaries	60%+ assets must be in credit default swaps or other non-securities assets	Must invest capital within 12-18 months of raise	No legal restrictions; subject to rating agency and investment guidelines	Subject to rating agency guidelines; restrictive covenants placed on funds (e.g. distributions)	None	Significant Restrictions on Investments/ Compensation
Trust or Partnership	Private deals - LLC; public deals - Company (offshore)	Corporation (domestic)	Company (offshore)	Company (offshore)	Partnership or LLC (domestic)	Typical Type of Entity
Trustee or General Partner with Board of Directors	Board of Directors	Board of Directors	Board of Directors (trustee for debt holders appointed under trust indenture)	Board of Directors	General Partner or Managing Member with Board of Directors controlled by current management	Entity Governance (in addition to Investment Manager)
Shares by public offering	Shares/units by private placement or public offering	Shares/units by public offering	Notes by private placement/144A resale	Notes by private placement/144A resale	Shares/units by public offering	Manner of Offering
U.S. and possibly non-U.S.	Private deals - U.S. AIs & QPs and non-U.S.; public deals - U.S. and possibly non-U.S.	U.S. and possibly non-U.S.	U.S. AIs & QIBs and non-U.S.	U.S. and non-U.S. QPs & QIBs	U.S. and possibly non-U.S.	Target/Permitted Investors
Partnership (pass-through treatment) or PFIC	Disregarded entity, Partnership or PFIC	Corporate taxation	Disregarded entity, Partnership or PFIC	Taxed as debt (except equity/most subordinated tranches)	Partnership (pass-through treatment) or corporate taxation	Tax Considerations
Section 3(a)(1)(C) exemption under Rule 3a-7	Section 3(a)(1)(C) operating company	Section 3(a)(1)(C) operating company	Exemption under Section 3(c)(7)	Exemption under Section 3(c)(7)	Section 3(a)(1)(C) operating company	U.S. Investment Company Act
Not required	Not required	Not required	Not required	Not required	May be required	U.S. Investment Adviser Registration
Highland Financial	Primus Guaranty (public)	-	-	Citadel Finance	Fortress, Blackstone	Examples (publicly known)
Exchange traded, and therefore must register securities under the Securities Act	Exchange traded, and therefore must register securities under the Securities Act	Exchange traded, and therefore must register securities under the Securities Act	Transfers permitted through private resales under Rule 144A	9-month to 40-year maturities; transfers permitted through private resales under Rule 144A	Exchange traded, and therefore must register securities under the Securities Act	Liquidity Terms



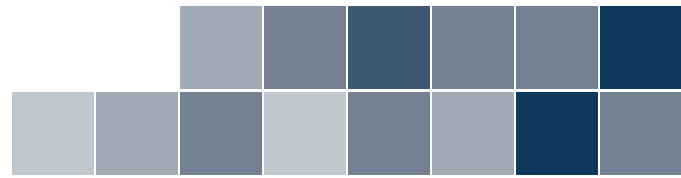
C. Offshore Private Equity Permanent Capital Vehicles Diagram

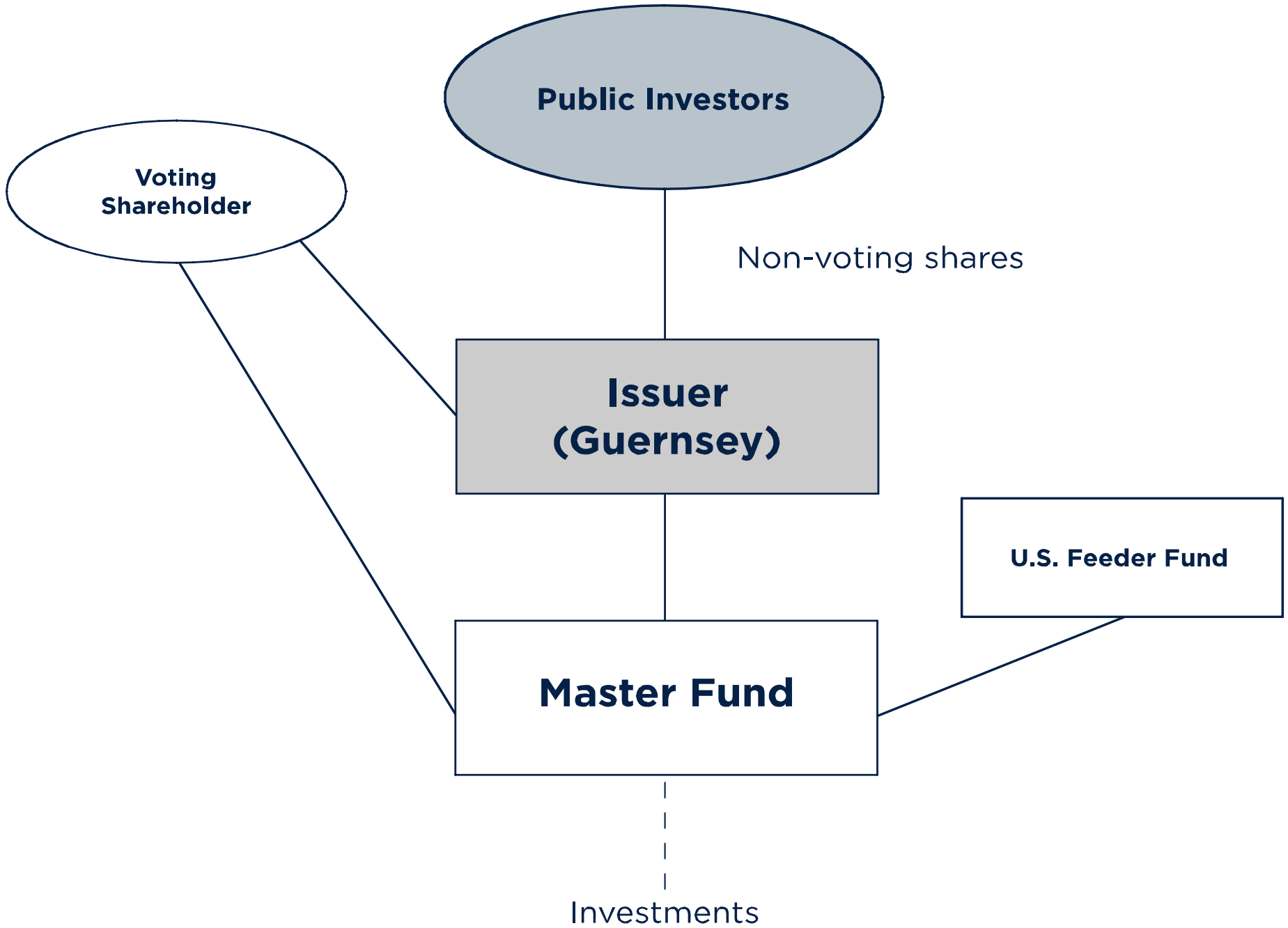


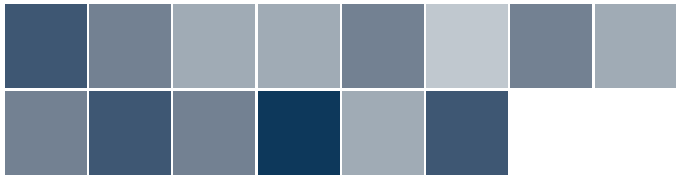




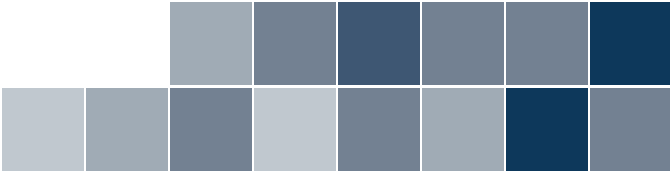
D. Offshore Hedge Fund Permanent Capital Vehicles Diagram

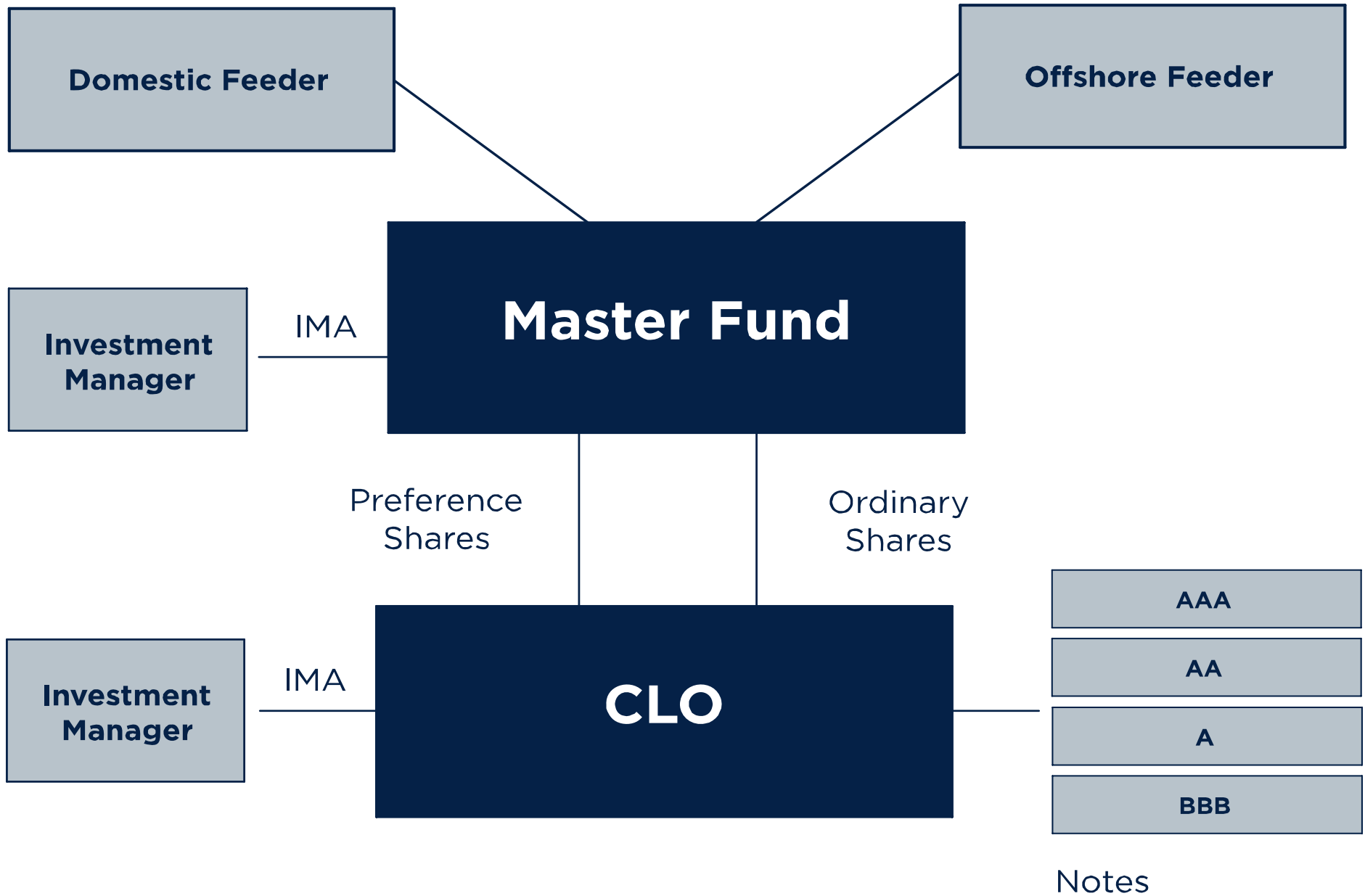






E. Market Value CLO Chart





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