

Greenwich Private Investment Funds Seminar

Wednesday, May 9, 2007



I. About the Speakers

II. Lift-Outs: Both Sides of the Story

Kelli L. Moll | Holly H. Weiss

III. Seeding Arrangements: Key Considerations and Current Trends

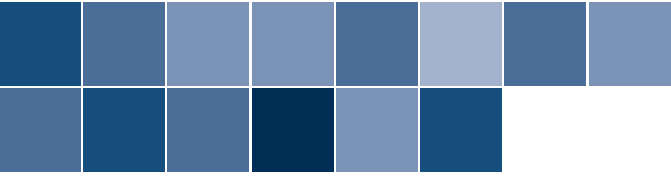
David J. Efron | Udi Grofman

IV. Recent Developments in Private Equity Transactions

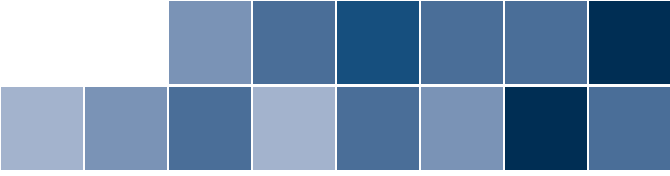
Benjamin M. Polk | Richard A. Presutti

V. Compliance Matters: Hot Button Issues for 2007

Marc E. Elovitz | Kenneth S. Gerstein



I. About the Speakers



Harry S. Davis

919 Third Avenue

New York, NY 10022

212-756-2222 | harry.davis@srz.com



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. Over the course of 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 minor 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 Asset Management, Durus Investors and the ongoing mutual fund market timing investigations by federal and state regulators, as well as the SEC's ongoing PIPEs investigation. Harry also has 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.

David J. Efron

919 Third Avenue

New York, NY 10022

212-756-2269 | david.efron@srz.com



David Efron is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. His practice focuses on domestic and offshore hedge funds, including structuring seed capital and joint venture arrangements. Additionally, he represents hedge fund managers in connection with SEC regulatory issues and on compliance-related matters.

David is a 1993 graduate of Syracuse University College of Law and has an LL.M. degree in securities regulation, *with distinction*, from the Georgetown University Law Center. He received his B.A. in 1990 from Vassar College.

Marc E. Elovitz

919 Third Avenue
New York, NY 10022
212.756.2553 | marc.elovitz@srz.com



Marc E. Elovitz is a Partner in the Investment Management and Litigation Practice Groups at Schulte Roth & Zabel LLP. His area of concentration is regulatory compliance and enforcement.

Marc's clients are primarily private investment funds and broker-dealers whom he advises on regulatory and compliance matters associated with investment advisory services, as well as on trading and anti-money laundering issues. Marc regularly represents clients in connection with investigations and enforcement actions involving the Securities and Exchange Commission, New York Stock Exchange and National Association of Securities Dealers.

A 1990 graduate of New York University School of Law, Marc is a member of the American Bar Association's Litigation Section and the New York City Bar Association. A former adjunct professor at Rutgers University School of Law, he has written extensively on securities regulation and regularly speaks on regulatory compliance and enforcement issues.

Kenneth S. Gerstein

919 Third Avenue

New York, NY 10022

212-756-2533 | kenneth.gerstein@srz.com



Kenneth S. Gerstein is a partner in the Investment Management Practice Group at Schulte Roth & Zabel LLP. He represents investment advisers, broker/dealers and banks in the organization and operation of investment funds and services, including mutual funds, hedge funds, closed-end investment companies, business development companies, bank collective funds, wrap accounts and other investment products. He also advises clients on a broad range of securities regulatory and compliance matters.

Ken has worked with clients in developing novel hybrid fund products, including registered hedge funds and registered hedge funds of funds.

Ken is a graduate of the James E. Beasley School of Law at Temple University, where he was a member of the *Law Quarterly*, and received an LL.M. from Georgetown University Law Center. He received his undergraduate degree from the Wharton School at the University of Pennsylvania.

Ken is a member of the American Bar Association's Committee on the Federal Regulation of Securities and its Subcommittee on Investment Companies and Investment Advisers, and is a member of the New York City Bar Association's Committee on Investment Management Regulation. He is a frequent speaker and author on issues related to investment funds and investment advisers. Prior to entering private practice, he served as special counsel in the SEC's Division of Investment Management in Washington, D.C.

Udi Grofman

919 Third Avenue
New York, NY 10022
212-756-2298 | udi.grofman@srz.com



Udi Grofman is a partner in the Investment Management Group at Schulte Roth & Zabel LLP. His practice focuses on hedge funds, private investment funds and their sponsors, in connection with fund formation, formation of management companies and compliance and trading matters.

Udi's experience includes:

- Structuring and organizing domestic and offshore private investment funds, including hedge funds, hybrid funds and fund-of-funds;
- Structuring and negotiating joint venture arrangements between advisory firms, and providing legal advice on the regulatory aspects of advisory joint ventures;
- Organizing investment advisory firms;
- Providing legal and regulatory advice on the acquisition, sale and restructuring of advisory firms; and
- Advising on securities laws matters and regulatory compliance.

Udi is a *magna cum laude* graduate of the Tel-Aviv University School of Law and received an LL.M. from the New York University School of Law. He began his legal career at Yigal Arnon & Co., one of Israel's largest law firms. He also practiced with David Liabi & Co., a litigation firm headed by a former Minister of Justice of the State of Israel. Udi lectured at the School of Law and the School of Business Management at the Interdisciplinary Center in Herzliya, Israel. He is a captain (*res.*) in the Israeli Defense Forces.

Kelli L. Moll

919 Third Avenue
New York, NY 10022
212-756-2557 | kelli.moll@srz.com



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.

Kevin J. O'Connor United States Attorney, District of Connecticut



Kevin J. O'Connor was appointed by President George W. Bush and unanimously confirmed by the United States Senate as Connecticut's 48th United States Attorney in 2002. Mr. O'Connor also currently serves as an Associate Deputy Attorney General of the United States.

Prior to his appointment as United States Attorney, Mr. O'Connor was a partner in the law firm of Day, Berry & Howard in Hartford, Connecticut. Mr. O'Connor also served as Corporation Counsel for the Town of West Hartford, Connecticut from 1999 to 2001.

From 1995 to 1997, Mr. O'Connor served as Staff Attorney and Senior Counsel in the Division of Enforcement of the United States Securities & Exchange Commission in Washington, D.C. From 1993 to 1995, Mr. O'Connor was a litigation associate with the law firm of Cahill Gordon & Reindel in New York City. From 1992 to 1993, Mr. O'Connor served as a law clerk to the Honorable William H. Timbers of the United States Court of Appeals for the Second Circuit.

Mr. O'Connor is a 1992 graduate, with high honors, from the University of Connecticut School of Law and a 1989 graduate, with honors, from the University of Notre Dame.

Mr. O'Connor currently serves as an Instructor at the University of Connecticut School of Law and previously served as an Adjunct Professor at the National Law Center at George Washington University.

Martin L. Perschetz

919 Third Avenue

New York, NY 10022

212-756-2247 | martin.perschetz@srz.com



Martin L. Perschetz is a partner in Schulte Roth & Zabel LLP, co-chair of the Litigation Practice Group and 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. 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 SEC, the NYSE and the NASD, as well as in large and complex private civil litigation. Marty's clients in recent securities and financial statement matters have included 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 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.

Benjamin M. Polk

919 Third Avenue

New York, NY 10022

212-756-2476 | benjamin.polk@srz.com



Benjamin M. Polk is a partner in the Business Transactions Practice Group at Schulte Roth & Zabel LLP. He practices primarily in the areas of private equity, mergers & acquisitions, leveraged buyouts, corporate finance and securities regulation.

Benjamin is a 1976 graduate of Cornell Law School and a 1973 graduate, *with high honors*, from Hobart College. A member of the American Bar Associations, he has authored numerous articles on such topics as director independence and the IPO process.

Significant representations include:

- Organization and representation of Veritas Capital, a private equity investment firm, in negotiated buyouts of defense and aerospace companies, and other transactions.
- Representation of Veritas Capital in the acquisition of DynCorp International LLC from Computer Sciences Corporation.
- Representation of Integrated Defense Technologies Inc. in initial public offering, acquisitions and sale to DRS Technologies Inc.
- Representation of Veritas Capital in leveraged joint venture acquisition of Raytheon Aerospace from Raytheon Company.
- Representation of Veritas Capital in sale of Vertex Aerospace to L-3 Communications Corporation.
- Representation of founder of major entertainment conglomerate in the formation of a fund of funds with Credit Suisse Private Equity.
- Representation of Century Communications Corp. in issuance and sale of \$250 million principal amount of senior notes.
- Representation of NAI Technologies Inc. in private placement of convertible subordinated promissory notes and warrants to purchase common stock.
- Representation South Korean steel manufacturer in the acquisition of steel mills in the United States and Canada from Rio Algom Limited and Atlas Steel Inc.
- Representation of buyer in the acquisition of Hansen Natural Corporation and Hansen Beverage Company.

Richard A. Presutti

919 Third Avenue

New York, NY 10022

212-756-2063 | richard.presutti@srz.com



Richard A. Presutti is a partner in the Business Transactions Practice Group at Schulte Roth & Zabel LLP. He practices primarily in the areas private equity, mergers & acquisitions, leveraged buy-outs, and general corporate and securities matters.

Significant transactions include:

- Represented consortium of Cerberus Capital Management, Citigroup, Azora Bank and PNC Bank in the acquisition of 51% of GMAC LLC from General Motors Corporation.
- Represented Sport Brands International in its sale of Fila Luxembourg S.a.r.l.
- Represented Cerberus Capital Management in a series of bus industry acquisitions, including North American Bus Industries, Blue Bird and Optima Bus.
- Represented SSA Global Technologies in its sale to Infor.
- Represented Cerberus Capital Management and Blackacre Capital Management in their acquisition of LNR Property Corporation.
- Represented Veritas Capital in its acquisition of DynCorp International.
- Represented Cerberus Capital Management in its acquisition of the assets of Georgia Pacific's distribution division.
- Represented First Data Corporation in its acquisition of a majority interest in NYCE Corporation.
- Represented Cerberus Capital Management in its acquisition of the worldwide operations of the Alamo and National car rental brands.

Richard graduated *cum laude* from Tulane Law School in 1996 and from Bentley College in 1992.

Paul N. Roth

919 Third Avenue
New York, NY 10022
212-756-2450 | paul.roth@srz.com



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 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.

Holly H. Weiss

919 Third Avenue

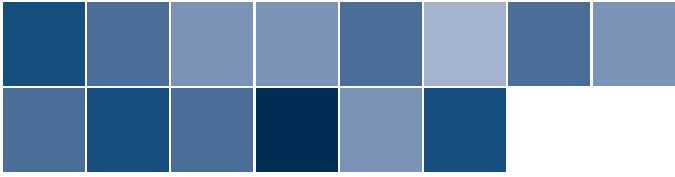
New York, NY 10022

212-756-2515 | holly.weiss@srz.com



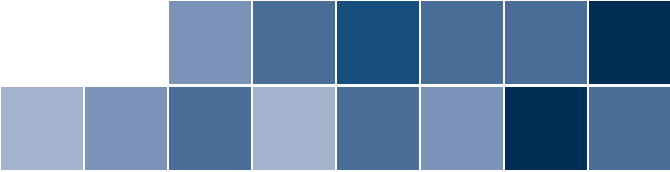
Holly Weiss is a partner in the Employment and Employee Benefits Practice Group at Schulte Roth & Zabel LLP. She represents employers in all aspects of employment law and employee relations including employment discrimination matters, ERISA matters, and issues involving executive compensation and employment agreements, non-competition agreements and other post-employment restrictions and related litigation. Holly successfully defended an employer at trial in the Southern District of New York in a case in which the plaintiff claimed his employment was terminated in violation of ERISA.

Holly is a 1991 graduate of the University of Virginia School of Law. She graduated, *with highest honors*, Phi Beta Kappa, from Emory University in 1987. She is a member of the New York State Bar Association Labor and Employment Law Section's Individual Rights and Responsibilities Committee and Alternative Dispute Resolution Committee. She has authored numerous articles on employment and employee benefits-related matters and is a frequent speaker at industry and professional development seminars, including presentations for the NASD Institute for Professional Development, the New York County Lawyers Association, the New York University Center for Labor and Employment Law and the Institute for Federal Judges at New York University.



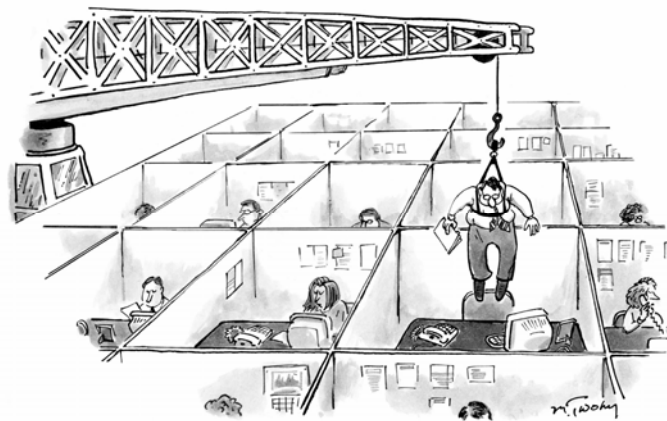
II. Lift-Outs: Both Sides of the Story

Kelli L. Moll | Holly H. Weiss



Lift-outs: Both Sides of the Story

Kelli L. Moll | Holly H. Weiss



© The New Yorker Collection
2005 Mike Twonky from cartoonbank.com. All Rights Reserved.

Litigation



© The New Yorker Collection
1989 Frank Modell from cartoonbank.com. All Rights Reserved.

"I still say you never can tell which way a jury will go."

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

“On the Defense”

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

“On the Defense”

Contractual Protection

- Non-solicitation
- Anti-Poaching
- Confidentiality

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

“On the Defense”



*“While we’re protecting like hell against brain-drain,
they come in and raid all our brown-noses!”*

© The New Yorker Collection, 2002
Mike Twohy from cartoonbank.com. All Rights Reserved.

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

“On the Defense”

Legal Steps

- **Write Letters**
- **Evaluate Agreements**
- **Gather Evidence**
- **Talk to Investors**
- **Talk to Employees**

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



“On the Defense”

Business Steps

- **Reorganize**
- **Prevent Defections**
- **Comfort Investors**

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



“On the Offense”

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



“On the Offense”

Recruit Prudently

- Target Key Person
- Interview with Smarts
- Review Contracts

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



“On the Offense”

Cover the Bases

- **Representations**
- **Legal Counsel**
- **Indemnification**

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Settle or Litigate?

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Lift-outs: Both Sides of the Story

Kelli L. Moll | Holly H. Weiss

May 9, 2007

1) Defending Against A Lift-Out

a) *Lift-Out Precautions*

It may be difficult to prevent a lift-out. However there are steps an employer can and should take to deter lift-outs, or increase the employer's leverage should a lift-out occur.

i) Implement Policies Regarding Confidential Information and Employer Property.

While common law protections exist with respect to an employer's information and property, it is far more useful to have a written policy prohibiting the use and disclosure of confidential, proprietary and trade secret information during and after employment. The policy should prohibit the disclosure of confidential information by any means, including, specifically, by transmitting the information electronically. The policy should also require the return of employer property upon termination of employment or upon the employer's request at any time. All employment contracts should contain confidentiality provisions, as should the firm's handbook. Employees who do not have contracts should be required to sign copies of the firm's policy.

Information is confidential only if the firm treats it as such. Critical information, such as client lists, should not be readily accessible within the firm. The more readily available information is within the firm, the less likely it will be found to be protected from disclosure. Confidential information should be secured, for example, by numbering copies, using appropriate legends on confidential documents and locking up documents. Computer-use policies should, among other things, cover the transmission of confidential information and make it clear to employees that they do not have privacy rights with respect to communications using the firm's systems.

ii) Implement Enforceable Post-Employment Restrictions.

Key employees should be required to execute non-compete, non-solicitation and anti-poaching agreements that are enforceable. Courts are not as willing to "red-pencil" overly aggressive restrictions as they once were.

(1) Non-compete provisions should be narrowly drafted to cover the specific concerns of the employer. For example, the firm may have more stringent prohibitions on a portfolio manager than on an analyst.

(2) Non-solicitation arrangements preventing employees from contacting the employer's clients/investors and/or counterparties should contemplate both the employee engaging in such activities and such employee's new employer. To address the issue that is often disputed in these provisions (i.e., "who solicited whom"), the employer may want an agreement that states that the employee cannot "provide services" to the employer's investors, or do business with a counterparty, in place of, or in addition to, a non-solicitation provision.

(3) Anti-poaching provisions are used to prevent employees from soliciting other employees to leave the employer. Consideration should be made as to whether to provide that such anti-poaching provisions should prevent the solicitation of both employees currently

employed by the employer as well as those that were employed by the employer for a period prior to an employee's departure (e.g. six months prior to departure). A provision that prohibits the solicitation of a prior employee will cover a situation where more-junior team members quit prior to the key employees leaving so that such key employees can avoid the application of an anti-poaching covenant. In addition, anti-poaching restrictions can be written to preclude the "hiring" of an employee, in addition to the solicitation of an employee, to avoid the issue of "who solicited whom."

- (4) An employment agreement can provide the employer the right to hold back certain deferred compensation to a departing employee until the expiration of the restrictive covenant period applicable to such employee. Such an agreement would also provide that the withheld compensation would be forfeitable in the event of a violation by the employee of his or her restrictive covenants.

iii) **Keep an Eye Out for Suspicious Behavior.**

Advance knowledge of an impending lift-out can go a long way toward salvaging the situation. If, for example, an employee asks to copy the investor list or asks for after-hours access to the office, or a manager asks to see the resumes of employees he or she recruited, and reasonable explanations for the requests are not forthcoming, it would be wise to perform some due diligence. If an impending lift-out is confirmed, the employer should take fast action, which, depending on the circumstances, could include hiring replacements and negotiating new deals with employees.

2) Dealing With the Lift-Out

Following are some steps that an employer should take upon learning of an impending lift-out:

a) *Gather and Review Relevant Agreements.*

Gather and review with counsel the personnel files, employment contracts, confidentiality agreements and other agreements or acknowledgments of the targeted employees. The employer's counsel will have difficulty assessing the matter without a complete understanding of the contractual commitments of the employees.

b) *Gather and Review Relevant Employer Policies.*

Gather and review with counsel employer policies regarding confidential information, trade secrets and employee loyalty. Even if the targeted employees have not executed employment or confidentiality or other applicable agreements, unilaterally established employer policies may be useful in litigation.

c) *Preserve Evidence.*

In connection with a dispute, evidence that an employee breached his or her duty of loyalty to the employer or engaged in wrongdoing with respect to confidential information may have a substantial impact on the ultimate resolution.

Audit existing security measures. For example, make sure that lobby and elevator video cameras, if any, are working, that security logs are being properly maintained and that card-key access doors are working. Preserve security records by temporarily suspending their routine destruction. Similarly, preserve, to the extent permitted by law, targeted employees' e-mail messages as well as records or recordings of voicemail messages, records of computerized file access, records of employee access to, and removal of, materials from document depositories or file rooms, internet use records, records of photocopier use, records of telephone use, taped telephone conversations (if any) and materials stored on individual hard drives.

Consider retaining an experienced investigative firm to perform all or some of these tasks. Internal MIS personnel may do damage to the case if they do not properly obtain and record the evidence.

d) *Talk to Employees.*

At the time some or all of the targeted employees announce that they are leaving, interview employees within the targeted employees' group or department (whether or not they are leaving) to determine whether they were solicited and, if so, when and by whom. Avoid tipping off employees who have no knowledge of a competitor's interest in the targeted group. Proceed cautiously with such interviews if the firm is simultaneously negotiating to retain the targeted employees. Consider whether retaining outside counsel to perform this task might further deter defections.

e) *Carefully Consider Client Communications.*

Employers nearly always communicate with their key clients upon a lift-out in an attempt to retain their business. It may also be worthwhile to talk to some clients once the whiff of a possible lift-out is in the air to obtain information about any client-solicitation attempts by the targeted employees. The potential benefits of such communications should be weighed carefully against the potential costs.

f) *Protect Confidential Information and Employer Property.*

At the time an employee leaves, conduct a formal exit interview. During the interview, remind the employee of his or her continuing obligations to the firm with respect to confidential information. Some employment agreements specifically permit the employer to share the employment agreement with the employee's new firm to notify it of the employee's contractual obligations. Provide the employee in writing with a description of employer property and confidential information, and instruct the employee that he or she may not take such property and information and, if such property and information is elsewhere, that he or she must return it. (Property that should be returned includes laptops, cell phones, credit cards, access cards, keys, documents, files, diskettes, databases and other information (whether in electronic, paper or other form.)) Have the employee sign a writing indicating that the employee has returned all employer property and confidential information. If the employee is signing a release, incorporate confidentiality provisions into the release agreement.

Prepare a list of the documents and other employer property returned. Search any boxes that the employee intends to remove from the building and retain all company property, or materials that might contain company property (such as computer disks), until disputes regarding ownership are resolved.

Once the departing employee has resigned, cut off the employee's access to company premises and remote access to the company's computer systems, e-mail and voicemail.

g) *Carefully Consider Internal and External Communications.*

Consult counsel with respect to internal and external communications regarding the lift-out. Statements regarding the impact of the lift-out (i.e., "the departure of the group will have no effect on the firm's bottom line") may be used to the firm's detriment in subsequent litigation.

h) *Mitigate Damages.*

Although some of the actions above will lessen the impact of the departures, there are additional steps the employer can take to mitigate the damages that flow from the departures. Take steps to prevent loss of business (i.e., communicate with clients/investors), recruit new employees and reorganize internally, as appropriate. Also, communicate with the competitor (by a lawyer's letter) and inform it, at a minimum, that its use of the firm's information for its benefit is illegal.

3) Essential Offensive Tactics

a) *Recruit Prudently.*

i) *Use the Right Channels.*

- (1) If the firm is targeting a group of a competitor's employees, the prudent route is, in the first instance, to solicit the group's leader rather than the entire group all at once. Instruct the leader not to solicit his or her colleagues to join the firm. Regardless of whether the employee is bound by a non-solicitation agreement, the employee cannot lawfully solicit his or her fellow employees to leave while he or she is still employed. A single improper contact with a target group member could destroy the lift-out.
- (2) If the firm already employs someone familiar with the personnel at the target firm, it is not a good idea to use that person as a recruiter. While, in the absence of a contractual restriction, a former employee is free to solicit the employees of his or her former employer, direct solicitation may raise a red flag for the target.

ii) Interviewing: Set the Right Tone at the Outset.

Job interviews of targeted employees should focus on the education, skills, experience and qualifications of the prospective employee. Advise recruits that the firm is not interested in learning about the competitor's confidential or proprietary information or trade secrets or information about the competitor's personnel. Avoid inquiries about the personnel, business and prospects of the competitor. Do not solicit or accept any materials from recruits that are property of the competitor, which disclose any confidential or proprietary information or trade secrets of the competitor, or that copy or excerpt any materials prepared by the competitor or by the applicant for the competitor.

iii) Solicit Away from the Target's Location.

Communications between the firm and the targeted employees should, to the extent feasible, be in person and away from the competitor's offices. Telephone conversations can be taped. Voicemail messages and e-mails can be reproduced. Even an innocuous e-mail to a recruit — "let's get together for lunch" — can turn out to be the "smoking gun" in a litigation.

iv) Get the Facts on Post-Employment Restrictions.

- (1) Find out if the targeted employees have employment agreements or other agreements that restrict their ability to work for the firm, or to solicit their employer's clients/investors or employees. Obtain from the employee and analyze all available and applicable employment agreements (including offer letters, stand-alone confidentiality or non-disclosure agreements and non-solicitation and non-compete agreements) and policies of the competitor regarding competition, solicitation, trade secrets, inventions, confidential information, etc. If post-employment restrictions exist, review with counsel their enforceability and strategize appropriately. There may be relatively simple ways to avoid violating a restriction, such as limiting the new employee's job duties for a time.
- (2) Get relevant information about the restriction: When was it signed? What were the circumstances of its execution? Did the employee bring restricted clients to the employer or did he or she build relationships only while employed by the competitor?
- (3) To the extent post-employment restrictions exist, consider disclosing to the competitor the firm's intent to hire the employees early on.

v) Recruit People that the Firm Needs.

Lifting out a group of employees and then sending them on vacation is problematic. The new employer should be in a position to argue that the employees were hired because the firm needed their services, not for former employer's confidential information or to destroy the competitor's business.

b) Getting the Employees Safely on Board

i) Everyone Needs a Lawyer.

The targeted employees should retain independent counsel to advise them as to their obligations to their former employer. Counsel may also prove highly useful in the event of litigation or settlement negotiations. Employers typically pay the fees of their new employees' counsel.

ii) Instruct New Employees.

Instruct the new employees that the firm does not want anything from the competitor. Instruct the new employees not to communicate with the competitor's clients/investors or employees until after they have resigned, and then only if it will not violate a non-solicitation and/or anti-poaching provision.

iii) New Employee Contracts.

The new employees should be required to represent, in writing, that 1) they are not subject to agreements or restrictions that will be breached if employed by the firm; 2) they have not and will not violate any existing restrictions; 3) they do not have any property of the former employer; and 4) they have been instructed not to use or disclose and will not use and disclose any confidential, proprietary or trade secret information of their former employer in connection with their duties.

Note that in negotiating the terms and conditions of employment, the savvy new employee will request to be indemnified for legal fees and costs by his or her new employer if the former employer sues. Carefully consider this request.

c) *The Aftermath.*

i) Don't Fan the Flames.

While it might make business sense to publicize the new hires, it may inflame the situation to name the competitor from which the firm hired the employees or to make reference to the business the employees may have taken away. All marketing materials should be carefully vetted. Communications with the press should be circumspect. The focus should be on the bright future of the firm — not the devastating effect on the competitor.

ii) Take the Lawyer's Letter Seriously.

More often than not, the victim of a lift-out will send a threatening letter prior to filing a lawsuit. Should such a letter arrive, the firm should acknowledge receipt immediately, communicating the message that a response is forthcoming.

4) Litigate or Settle

a) *Considerations If You Have Been Raided:*

i) Setting an Example.

If the employer does not litigate an otherwise strong case, other employees may not take their obligations as seriously, and competitors will see the firm's employees as easy targets.

ii) Consider the Costs.

In addition to attorney's fees and investigative costs, there will be non-pecuniary costs, including business disruption costs, as executives are side-tracked to assist in the litigation.

iii) Consider the Publicity of Litigation.

Publicity may cut both ways. News that the firm will fight hard can prevent future lift-outs. However, the firm's clients may be more interested in obtaining assurances that the firm will

not be adversely effected by the departures — something that may be difficult to illustrate, if, for example, the court papers filed by the firm disclose enormous claimed damages.

iv) Consider Creative Settlements.

Creative and even mutually beneficial solutions can be obtained in a settlement. A court may only issue an appropriate injunction and award damages. Opportunities for mutual gain should be explored.

v) Timing is Critical.

It is wise, even if litigation is not necessarily going to be continued, to move quickly to protect the firm's rights. The longer the firm waits, the less likely it will be able to establish irreparable harm resulting from the lift-out.

b) *Considerations If You Are the Raider:*

i) Settlement Generally the Best Bet.

(1) It is likely to be in the firm's best interest to resolve issues without litigation. Settlements may be achieved in some cases without any money changing hands.

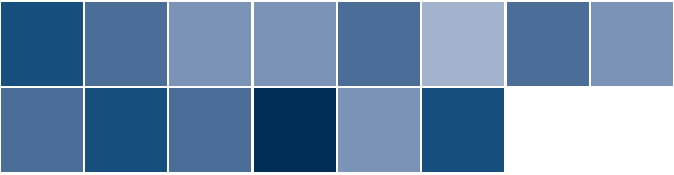
(2) The timing of any settlement is key. Once an injunction is issued, the battle is, for the most part, lost.

(3) Seek smooth transitions, the firm may need cooperation of the former employer (e.g., use of track records, systems, etc.) and settlement with economic benefit to the former employer may be the best result for all involved.

ii) Look at Evidence Against Firm.

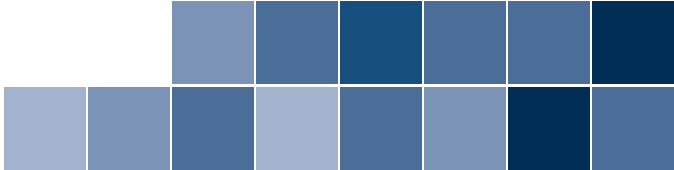
(1) If the firm's own employment contracts are not reasonable or are more onerous than the former employer's contracts, it may be difficult to challenge the enforceability of the former employer's contracts in litigation.

(2) Review all correspondence with the competitor's employees to ensure that breaches of employees' obligations to competitor were not encouraged by anyone at the firm.



III. Seeding Arrangements: Key Considerations and Current Trends

David J. Efron | Udi Grofman





Seeding Arrangements: Key Considerations And Current Trends

David J. Efron | Udi Grofman



- **Structural Issues**
- **Regulatory and Compliance Issues**
- **Economic Terms and Trends**

Structural Issues

- **Fund or Management Company: Which Entity is Seeded and How?**
- **Economics: How is the Seed Investor Paid?**
- **Active Versus Passive: What Role Does the Seed Investor Play?**

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Regulatory and Compliance Issues

- **Conflicts of Interest**
- **Trade Aggregation Issues**
- **Issues Pertaining to Transparency**
- **Dealings with Regulated Entities**

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Economic Terms and Trends

Everything is Negotiable!

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Seeding Arrangements: Key Considerations and Current Trends

David J. Efron and Udi Grofman

May 9, 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.

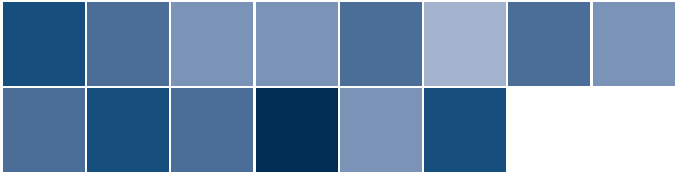
- iii) If the seed investor is a broker-dealer, the arrangement may raise issues with such broker-dealer acting in a principal capacity with respect to trades with the seeded manager's fund.

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).

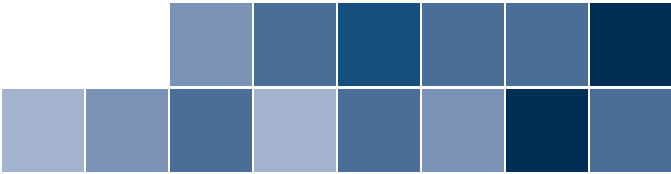
Everything is Negotiable

- 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



IV. Recent Developments in Private Equity Transactions

Benjamin M. Polk | Richard A. Presutti



Recent Developments in Private Equity Transactions

Benjamin M. Polk | Richard A. Presutti





Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007





Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007





Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007





Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

“Go-Shops”

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Advantages

Time is on Your Side



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

What to Negotiate

- **Time Period**
- **Rights to Information**
- **Break-up Fees**

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Recent Developments in Private Equity Transactions

Benjamin M. Polk and Richard A. Presutti

May 9, 2007

1) Private Equity Funds Successfully Compete with Strategic Buyers

- a) *Historical success of strategic buyers in M&A transactions*
 - i) Over the seven-year period from 1999 to 2005, private equity and hedge funds ("Financial Buyers") have accounted for as little as 2%, and as much as 15%, of all U.S. annual M&A activity
 - ii) Strategic buyers have typically outbid Financial Buyers in competitive auctions
- b) *Financial Buyers have become a preeminent force in the market*
 - i) Financial buyers played a hand in 27% of U.S. M&A activity in 2006
 - ii) In 2006, Financial Buyers were responsible for seven of the 10 largest leveraged buyouts of all time and five of the 10 largest transactions in the U.S.
 - iii) Globally, in 2006, Financial Buyers struck deals worth over \$700 billion, twice that recorded in 2005
- c) *Presenting the most valuable offer to sellers*
 - i) Sellers consider a number of factors, in addition to the offering price, in evaluating the bids of interested companies
 - (1) Degree of certainty that the transaction will be consummated
 - (2) Time frame for the consummation of the transaction
 - (3) Foreseeable disruptions to the target company
 - (a) To operations
 - (b) To the business culture
 - ii) The winning bid is the one that presents the best value to the seller, as determined by the target's Board of Directors ("BOD")
 - (1) The winning bidder may or may not be the bidder who offers the highest price
- d) *Financial Buyer bids provide target companies with unique opportunities and value*
 - i) Post-sale benefits for the target management team
 - (1) Retention of the target's management team after acquisition
 - (a) Strategic buyers often replace target's management

- (2) Management may be offered incentives to remain with the target after acquisition
 - (a) Incentives may include equity in the company and a bonus structure including stock and options
 - (i) Target management can receive as much as a 10% stake in the reorganized company
 - (ii) This opportunity is unique to a purchase by a Financial Buyer
- ii) Post-sale access to capital and expertise
 - (1) Financial Buyers can provide board-level financial and operational expertise
 - (a) Includes acquisition experience, growth assistance and corporate direction
 - (i) Cut excess costs
 - (ii) Focus on higher growth products
 - (iii) Dispose of underperforming business lines
 - (2) The Financial Buyer's capital base may be utilized to expand the target via internal growth or external acquisition
- iii) Minimal disruption to the target company as a going concern
 - (1) Financial Buyers are less likely to change the target's basic management and operational structure
 - (a) Decrease likelihood of termination or relocation of management or rank and file workers
 - (b) Operations and/or headquarters will likely remain in their pre-sale location
- iv) Financial Buyers are quick, efficient and sophisticated bidders
 - (1) Financial Buyers' specific abilities, experience, and access to outside experts and capital allow them to move quickly in acquisition situations
 - (2) Financial Buyers' market experience enable them to obtain financing and perform due diligence in an expedited and efficient manner
 - (a) This may be of paramount significance if financial problems or regulatory issues are the cause for a target's sale
 - (b) Strategic buyers often slower-moving than Financial Buyers
 - (i) They rely on staff specialists who may not be as quick
 - 1. Less experienced at reviewing companies for purchase
 - (ii) Bureaucracies that may exist in larger strategic buyers may slow the due diligence and deal processes
- v) Limited antitrust/regulatory risks and delays
 - (1) Antitrust and other regulatory concerns may either limit a strategic buyer's ability to purchase a target or slow down the deal process for a strategic buyer

- (2) Financial Buyers are less likely to raise antitrust or regulatory issues.
 - (3) In the U.S., most deals that exceed approximately \$50 million (based on periodic adjustments, the threshold is currently \$59.8 million) in value require a Hart-Scott-Rodino ("HSR") filing
 - (4) Some transactions by Financial Buyers do not require a HSR filing
 - (a) The filing is required only if they exceed a higher (currently \$239.2 million) threshold if three or more funds each own less than 50% of the acquisition vehicle
 - (b) This higher threshold is rarely available to strategic buyers due to their structure
 - (5) There will be some delay prior to closing for both Financial Buyers and strategic buyers, as the HSR filing is prepared and the parties observe the statutory 30-day waiting period
 - (6) It is likely that the Federal Trade Commission and Department of Justice will grant "early termination" of the waiting period within 10 to 20 days for a Financial Buyer unless it has interests in firms that compete with the target
 - (7) In the face of a prospective merger among significant competitors, the antitrust authorities might need to assess the competitive consequences of the transaction
 - (a) Under those circumstances, they would issue a request for additional information which will extend the waiting period until 30 days after the parties certify compliance with this second request
 - (b) Compliance often can take many months
 - (8) Sarbanes-Oxley has forced public strategic buyers to focus more on implementation of internal controls and developing existing businesses
 - (9) Acquisitions increase the risk of adequate control at the target company
- vi) Targets must be wary of strategic buyers' interests
- (1) Strategic buyers may feign interest in bidding on a target
 - (a) The goal in bidding may be to learn more about the target's operations
 - (2) Information concerning the abilities and areas of expertise of a target's employees during diligence can be obtained
 - (a) Bidders may attempt to hire employees away
 - (3) Confidential information will be available
 - (a) There is a greater degree of risk that information will be improperly utilized or disclosed when disclosing proprietary or sensitive information
 - (i) Especially true if a potential suitor is a direct competitor
 - (ii) There is still a risk of disclosure or improper use of information even if a confidentiality agreement is signed
- vii) The likelihood of disclosure and confidentiality issues arising is less prevalent with Financial Buyers

- (1) Target companies may disclose sensitive information to a Financial Buyer, versus a strategic buyer
 - (a) This presumes that the portfolio companies of such Financial Buyer are not competitors
 - (b) Additional information would allow a Financial Buyer to bid with better substantive background information
 - (c) This could lead to a higher bid price by a Financial Buyer, based on the additional information to which it has access

viii) Additional risk tolerances of Financial Buyers

- (1) Financial Buyers may bid more because they have higher risk tolerances

2) Go-Shop Provisions

a) *Conventional public bidding process*

- i) Public auction is the conventional way to sell a public company
 - (1) Enables the seller's Board of Directors ("BOD") to identify interested parties and the terms of their bids
 - (2) Generally allows the BOD to meet its fiduciary duty of getting the most value for their shareholders
 - (a) Often referred to as "Revlon Duties"
 - (b) The general standard that courts use to evaluate a BOD's decision is the business judgment rule (BJR),
 - (i) A BOD may be held to a higher standard, depending on the specific situation
 - (c) Value is not only based on the price obtained for the company
 - (i) BOD can consider all factors that would impact the long-term value of the company as a going concern, not just the short-term sale price
 - (ii) This gives the BOD flexibility in their evaluation of bids and which bid they ultimately accept
- ii) After the bidding process is over and the deal is signed, typically a "No-Shop" provision is signed by the seller
 - (1) Covenant not to solicit better offers from third parties
 - (2) Seller's BOD can always entertain unsolicited offers from third parties because of the BOD's fiduciary duties

b) *Go-Shop provisions in the sale of public companies*

- i) Go-shop provisions are used in privately negotiated agreements which are not the product of a public bidding process
 - (1) Recent use of go-shop provisions began with non-shopped deals of founder/management-led LBOs

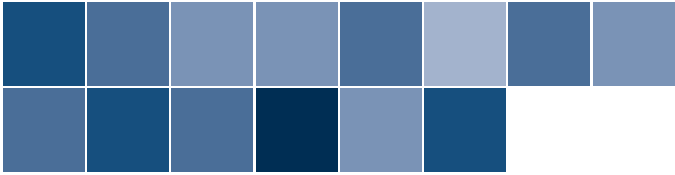
- (2) They have been used more recently in other types of LBOs
 - (a) Used in situations where shopping was limited because other interests of the parties took precedence
- ii) Go-shop provisions allows a seller to actively solicit better offers from other bidders for an agreed upon period after the signing
 - (1) This may enable a seller's BOD to demonstrate that it met its fiduciary duties to company shareholders to seek the best value possible
- c) *Typical terms of a go-shop provision*
 - i) Length of the go-shop period
 - (1) 20-30 days is the most common, but has ranged from 15-55 days in length
 - ii) Limits on solicitation
 - (1) The vast majority of go-shop provisions permit solicitation from an unlimited number of strategic and Financial Buyers
 - iii) Seller's post go-shop period negotiation rights
 - (1) Vast majority of go-shop provisions permit the seller to continue negotiations with interested third parties after the end of the go-shop period
 - (2) Unsolicited bids are always permitted
 - iv) Buyer's right to be updated
 - (1) Vast majority of go-shop provisions provide for the buyer's right to be updated as to alternative bids solicited during the go-shop period
 - v) Time of proxy filing
 - (1) Vast majority required the merger proxy to be filed with the SEC as soon as practicable following the execution of the merger agreement
 - vi) Break-up fees
 - (1) Generally, in any public company sale, if a seller invokes a fiduciary out it generally must pay a break-up fee to the buyer
 - (a) Usually 2-3% of the equity value
 - (2) Fiduciary break-up vs. go-shop break-up
 - (a) Some go-shop provisions apply the same break-up fee regardless of whether the fiduciary out was exercised for a bid solicited during the go-shop period or a later, unsolicited bid
 - (b) Other go-shop provisions use a discount fee if a seller abandoned the transaction in favor of a bid obtained during the go-shop phase
 - (i) Discounted fee ranged from 1/3 to 2/3 of the full break up fee
- d) *Advantages for initial buyers, who avoid an auction by signing an agreement with a go-shop provisions*

- i) All bidders are generally on equal footing during pre-signing auctions
 - ii) The relatively short go-shop period may deter prospective follow-up bidders
 - (1) Go-shop periods generally average from 20-30 days in length after the deal with the initial buyer is signed
 - (a) Follow-up bidders may not have enough time for due diligence, building relationships with management and identifying financing sources
 - (b) Initial buyer may enjoy a natural advantage over other bidders due to its pre-existing knowledge of the company and its relationship with the management
 - (c) Private equity firms may want to appear to be intruding into an industry peer's deal,
 - (i) However, intrusion in deals has become more common
 - iii) Initial buyers are compensated if their deal is topped
 - (1) Prospective buyers who lose a pre-signing auction are left empty-handed
 - (2) Losing a transaction as a result of a post-signing auction leaves the initial buyer with a break-up fee
 - iv) Go-shop clauses expedite the sales process
 - (1) By enabling the seller to simultaneously test the market and satisfy closing conditions with the buyer, a go-shop provision enables the going private process to be completed more quickly
- e) *Advantages for sellers*
- i) Privacy
 - (1) Avoiding an auction process allows companies to sign an agreement with little to no publicity
 - (a) Seller may not want its employees or other stakeholders to know about an impending sale of the company
 - (b) Control information leaks
 - ii) Speed
 - (1) As previously mentioned, a go-shop provision enables the going private process to be completed more quickly by enabling the seller to simultaneously test the market and satisfy closing conditions with the buyer
 - iii) Avoid disclosure of information to strategic buyers
- f) *Concerns with the use of go-shop clauses*
- i) May be used as a means to protect the sellers BOD without actually providing a meaningful opportunity to maximize shareholders value
 - ii) Topping bids during the go-shop period have rarely been received or accepted
 - (1) Triad Hospitals Inc was the first time that this occurred recently

- (a) Triad sold to rival Community Health Systems Inc., who topped a prior deal with CCMP Capital Advisors, LLC and Goldman Sachs & Co.'s private equity arm during the go-shop period
- (b) This is an example where a strategic buyer took advantage of a unique opportunity made possible by a go-shop provision
 - (i) A strategic buyer, who might normally be treated as a hostile bidder by a target's board, may have a better chance of submitting a successful bid during the go-shop period because of the go-shop mandate

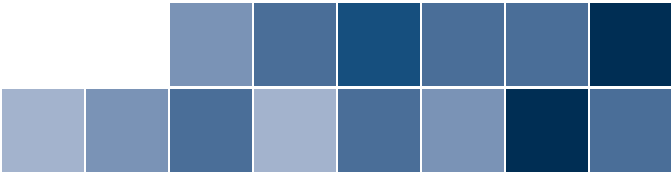
g) Current status of go-shop provisions

- i) Go-shop provisions remain rare
 - (1) In 2006, of the more than 170 going-private deals announced by early December, only 13 included a go-shop provision
 - (2) Most of the go-shop provisions were signed in deals involving private equity firms
 - (a) Private equity firms sponsored more than 90 of these recent transactions, including 12 with go-shop provisions
- ii) Some experts believe that the downward trend in break-up fees in go-shop provisions is likely to continue
 - (1) The result of that could be an increase in number of topping bids because of the decrease in the target's cost of breaking up a deal



V. Compliance Matters: Hot Button Issues for 2007

Marc E. Elovitz | Kenneth S. Gerstein



Schulte Roth & Zabel



Compliance Matters: Hot Button Issues for 2007

Marc E. Elovitz | Kenneth S. Gerstein



Headlines

The New York Times

S.E.C. Chief Looks to Regain Power Over Hedge Funds

THE WALL STREET JOURNAL.

Connecticut Steps Up Hedge-Fund Oversight

FT
FINANCIAL TIMES

US Regulators
Target Hedge Funds

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Get with the Program

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Valuation

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Valuation



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Side Pockets

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Side Pockets



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Fund Expenses



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Service Provider Relationships

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Service Provider Relationships



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007



Service Provider Relationships



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Service Provider Relationships

Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Side Letters



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Value Added Investors



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Information Sharing



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Consultants



Greenwich Private Investment Funds Seminar | © Schulte Roth & Zabel LLP 2007

Compliance Matters: Hot Button Issues for 2007

Marc E. Elovitz | Kenneth S. Gerstein

May 9, 2007

1) Background and Current Regulatory Environment

Over the past several years, there has been considerable focus on matters relating to the regulation of hedge funds.

- a) *The growth of the hedge fund industry led to an investigation of and report on hedge funds by the staff of the Securities and Exchange Commission (the "SEC"), Implications of the Growth of Hedge Funds (September 29, 2003). The report included a recommendation that the SEC adopt a rule requiring registration of hedge fund managers under the Investment Advisers Act of 1940 (the "Advisers Act") and was followed by a proposal to adopt such a rule.¹*
- b) *In December 2004, the SEC adopted Rule 203(b)(3)-2 under the Advisers Act (the "Registration Rule"), which essentially required most hedge fund managers to register as investment advisers with the SEC.² Approximately 2,000 hedge fund managers registered with the SEC as a result of the Registration Rule.*
- c) *On May 16, 2006, Susan Ferris Wyderko, the then-Director of the Office of Investor Education and Assistance at the SEC, testified before the Subcommittee on Securities and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs about hedge funds, the role they play in the securities markets and the SEC's role in their oversight.³*
- d) *On June 23, 2006, the United States Court of Appeals for the District of Columbia Circuit issued its decision in Goldstein v. SEC (the "Goldstein Decision"), which vacated the Registration Rule. The court held that the SEC lacked the authority to require that investors in private funds be counted as "clients" in determining the availability of the exemption from registration provided by Section 203(b)(3) of the Advisers Act, under which investment advisers that have had fewer than 15 clients during the preceding 12 months and do not hold themselves out generally to the public as investment advisers are not required to register.*
- e) *On September 26, 2006, the Director of the SEC's Division of Enforcement, Linda Chatman Thomsen, testified before the U.S. Senate Committee on the Judiciary regarding insider trading.⁴ She emphasized the SEC's focus on enforcing the securities laws, especially rules relating to insider trading, on hedge funds and their managers.⁵*
- f) *On December 27, 2006, the SEC proposed the adoption of two new rules in response to the Goldstein Decision.⁶*

¹ Release No. IA-2266 (July 20, 2004).

² Release No. IA-2333 (December 2, 2004).

³ Written testimony available at: <http://www.sec.gov/news/testimony/ts051606sfw.htm>.

⁴ Written testimony available at: <http://www.sec.gov/news/testimony/2006/ts092606lct.htm#asterik>).

⁵ "More recently, globalization, the technology boom, a renewal of merger activity, and our concern about insider trading by hedge funds have shifted our enforcement focus yet again." *Id.*

⁶ Release No. IA-2576 (December 27, 2006).

- i) Proposed Rule 206(4)-8 under the Advisers Act would make it a "fraudulent, deceptive, or manipulative act, practice, or course of business" within the meaning of Section 206(4) of the Advisers Act for an investment adviser (whether registered or unregistered) to a pooled investment vehicle to make false or misleading statements of material facts or to "otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in a pooled investment vehicle." The rule is intended to assure a basis for the SEC to bring enforcement actions under the Advisers Act against hedge fund managers that defraud hedge fund investors or prospective hedge fund investors in light of statements in the Goldstein Decision that investors in a hedge fund are not clients of the fund's manager.
 - ii) Proposed Rule 509 under the Securities Act of 1933 (the "1933 Act"), together with a proposed amendment to Rule 501, would add an additional qualification requirement that would need to be met by natural persons investing in hedge funds relying on Section 3(c)(1) of the Investment Company Act of 1940 (the "Investment Company Act") in order for such persons to be deemed "accredited investors" as defined in Rule 501 of Regulation D under the 1933 Act.⁷ Under this new requirement, a natural person would need to be an "accredited natural person," which is defined to mean a person who has "investments" of at least \$2.5 million.⁸ Natural persons would continue also to be required to meet either the net worth test or the income test set forth in Rule 501 of Regulation D. The SEC believes that the new qualification requirement will help assure that investors in hedge funds are capable of evaluating and bearing the risks of their investments.
- g) *The Goldstein Decision has also led to renewed Congressional interest concerning the regulation of hedge funds and hedge fund managers. For example:*
- i) Rep. Mike Castle, R-Del., introduced legislation (passed by the House on September 27, 2006) that would require the President's Working Group on Financial Markets to study the hedge fund industry and analyze various issues, including whether hedge fund investors are able to protect themselves adequately from the risks associated with their investments and to make recommendations concerning, among other things: the need for legislation imposing disclosure requirements on hedge funds; and the oversight responsibilities that members of the President's Working Group have over hedge funds.⁹
 - ii) Rep. Barney Frank, D-Mass., introduced legislation that would amend the Advisers Act to authorize the SEC to define the term "client" for purposes of Section 203(b)(3) so as to include hedge fund investors.¹⁰
 - iii) Sen. Chuck Grassley, R-Iowa, sent a letter to members of the President's Working Group on October 16, 2006, soliciting their views on how Congress can improve hedge fund transparency.¹¹

⁷ Regulation D provides a "safe harbor" for private offerings made in reliance on the private placement exemption from registration made available by Section 4(2) under the 1933 Act, including offerings of interests in hedge funds. Under its provisions, there may not be more than 35 purchasers in a private offering; however, "accredited investors" are not counted as purchasers for purposes of this limitation.

⁸ The term "investments" is defined similarly to the definition of such term in Rule 2a51-1 under the Investment Company Act (which defines "investments" for purposes of determining whether an investor is a "qualified purchaser" eligible to invest in a hedge fund that relies on Section 3(c)(7) of the Investment Company Act). The \$2.5 million threshold would be adjusted for inflation every five years, beginning April 1, 2012.

⁹ H.R. 6079, 109th Cong., 2d Sess.

¹⁰ H.R. 5712, 109th Cong., 2d Sess.

¹¹ Press Release, U.S. Senate Committee on Finance, "Grassley Seeks Multi-Agency Response on Lack of Transparency, Expresses Alarm at Risk to Pension-holders" (October 16, 2006). Available at: <http://www.senate.gov/~finance/press/Gpress/2005/prg101606.pdf>.

- iv) Hedge fund regulation has also been a subject of interest to state attorneys general, foreign regulatory organizations and international securities regulator associations.

2) The SEC Examination Program

An important part of the regulatory framework established by Section 204 of the Advisers Act is the authority of the SEC to conduct periodic, special, or other examinations of the books and records of registered investment advisers. Pursuant to this authority, the SEC staff conducts examinations of registered advisers. If violations of the securities laws or SEC rules are identified in an examination, the examination staff may send a deficiency letter to the adviser identifying the violations and requesting that remedial actions be taken or may refer the matter to SEC enforcement staff for possible enforcement action.

a) *The SEC staff conducts three types of examinations:*¹²

- i) Cause examinations: These examinations are conducted when there is reason to believe that there is a compliance problem at a firm. Examinations of this type may be conducted in response to investor complaints, tips or media reports, or in the case of advisers that have had "a high probability of problematic activities."¹³
- ii) Sweep examinations: These examinations are special reviews that focus on a single issue.
- iii) Routine examinations: These examinations are conducted on a periodic basis. In these examinations, the SEC staff reviews a broad range of compliance matters at the firm subject to the examination.

b) *The frequency of routine examinations is generally based on a firm's risk profile as determined by the SEC staff.*¹⁴ *The staff classifies advisers into two categories: those perceived to have a high-risk profile and those perceived to have a low-risk profile. Advisers deemed to have a high-risk profile are typically subject to routine examination on a three-year cycle. Advisers deemed to have a low-risk profile are selected for examination using a random selection methodology and are not examined on a cyclical basis. The three factors used to determine an adviser's risk profile are:*

- i) The adviser's assets under management;
- ii) The adviser's Form ADV responses; and
- iii) The strength or weakness of the compliance environment of the adviser.¹⁵

¹² Memorandum from Lori Richards, Director, Office of Compliance, Inspections and Examinations, to Chairman William H. Donaldson (March 10, 2004) (describing the SEC's investment company and investment adviser examination programs). Written remarks available at: <http://www.sec.gov/news/extra/apx-ts031004lar.pdf>.

¹³ Remarks of Gene A. Gohlke, Associate Director, Office of Compliance Inspection and Examinations, before the Fund of Funds Forum (Nov. 14, 2005). Written remarks available at: <http://www.sec.gov/news/speech/spch111405gag.htm>.

¹⁴ *Id.*

¹⁵ "Having a strong compliance culture with a strong compliance program is in the best interests of securities firms, because what's good for investors, is good business for those who serve investors.... A firm that has a strong compliance program should be predictably more compliant, and thus not as deserving of our examination. **"We spend our limited examination resources focusing on those firms and those areas within firms, where compliance is relatively weak."** Remarks of Lori A. Richards, Director, Office of Compliance and Inspections, before the National Membership Meeting of the National Society of Compliance Professionals (Oct. 19, 2006) (emphasis added). Written remarks available at: <http://www.sec.gov/news/speech/2006/spch101906lar.htm>.

- c) *In recent years, use of the examination program as a tool to identify matters for possible enforcement referral has grown. At the same time, the threshold as to the nature of conduct that should be the subject of an SEC enforcement action has been lowered, and actions have been brought in situations where non-intentional violations have resulted in losses to fund investors, notwithstanding the absence of fraud or any intent to harm investors.*¹⁶

3) The Advisers Act Compliance Rule

Rule 206(4)-7 under the Advisers Act requires a registered adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act by the adviser or any of its supervised persons. Under the Rule, registered advisers must review, no less frequently than annually, the adequacy of their compliance policies and procedures and the effectiveness of their implementation. Rule 206(4)-7 also requires an adviser to designate an individual (who is a supervised person of the adviser) to be responsible for administering the adviser's compliance policies and procedures (*i.e.*, a chief compliance officer).

- a) *Taken together, the requirements of Rule 206(4)-7 and the SEC's examination program make it imperative that a registered adviser maintain and update, as needed, a compliance program that appropriately addresses: new regulatory requirements; regulatory developments; and compliance risks associated with new products or services offered by the adviser.*
- b) *Although hedge fund manager that are not SEC registered are not subject to Rule 206(4)-7 or the SEC examination program, it is nonetheless important that such advisers implement compliance programs.*
- i) The SEC has authority to bring enforcement actions against unregistered advisers, including actions based on an adviser's failure to reasonably supervise, with a view to preventing violations of the federal securities laws by, another person if such other person is subject to the adviser's supervision.¹⁷
- ii) An important available defense to a claim that an adviser has failed to supervise its personnel is that the adviser established procedures, and a system for applying those procedures, which would reasonably be expected to prevent and detect, insofar as reasonably practicable, violations by such personnel, and has reasonably discharged the duties imposed under those procedures and system without reasonable cause to believe that they were not being complied with.
- iii) Relying on this authority, in 2003, the SEC brought its first enforcement action against a principal of an unregistered adviser based on a failure to supervise.¹⁸
- c) *Now that Rule 206(4)-7 has been in effect for over two years, the SEC staff is interested in how advisers have conducted annual reviews of their compliance programs. The staff believes that advisers must be able to demonstrate that they have conducted meaningful annual reviews in a manner consistent with the requirements of the Rule.*
- i) Rule 206(4)-7 does not require a written report regarding the annual review. However, Rule 204-2(a)(17)(ii) under the Advisers Act requires an adviser to maintain any records documenting the annual reviews of its compliance policies and procedures. Such records

¹⁶ *In the Matter of Bridgeway Capital Management, Inc.*, Release No. IA-2294 (September 15, 2004) (violation of Section 205(3) of the Advisers Act based on use of improper method to compute mutual fund performance-based advisory fee).

¹⁷ Section 203(e)(6) and Section 203(f) of the Advisers Act.

¹⁸ *In the Matter of Robert T. Littell and Wilfred Meckel*, Release No. IA-2203 (December 15, 2003) (principal of unregistered investment adviser sanctioned for failing to supervise associated personnel of the adviser who violated various antifraud provisions of the federal securities laws).

could include the report on the annual review, as well as all work papers, testing procedures and other documents relating to the review process, its findings and its recommendations.

- ii) If an adviser has not prepared a written report that fully summarizes the annual review process and the findings and recommendations of the review, it is likely that SEC examination staff will ask to see various documents relating to the review process in order to determine whether the kind of annual review contemplated by Rule 206(4)-7 was conducted.

4) Creating and Maintaining an Effective Compliance Program

Given the requirements of Rule 206(4)-7 and the prospect of SEC examinations, it is essential that registered advisers implement comprehensive compliance programs that are tailored to their operations and the particular risks of their businesses. The requirement that advisers conduct annual reviews of their compliance programs, which must include a review of the adequacy of the programs and the effectiveness of their implementation, means that an important part of any compliance program is to establish a process for identifying new areas of risk and new regulatory requirements that need to be addressed and to revise compliance procedures accordingly.

a) *In a speech before the National Society of Compliance Professionals,¹⁹ Lori Richards, Director of the SEC's Office of Compliance and Inspections, outlined the key components of an effective compliance program.*

- i) Oversight of Compliance: Senior management must set a "tone at the top" and communicate the expectation that personnel will act ethically and in a manner consistent with the adviser's fiduciary and legal obligations. The actions of management should make clear that non-compliance will not be tolerated (e.g., violations should be dealt with promptly and in a meaningful way).
- ii) Standards, Policies and Procedures: A firm should have a code of ethics or code of conduct, and operating and compliance policies and procedures that implement those standards.
- iii) Exercise Due Diligence in Delegating Responsibilities: Significant compliance monitoring responsibilities should not be delegated to individuals who have engaged in misconduct or conduct inconsistent with an effective compliance and ethics program. The specific responsibilities of particular individuals with respect to monitoring compliance should be clearly defined.²⁰ Compliance should be incorporated in employee evaluation standards and be a factor that is considered in setting compensation.
- iv) Communication, Education and Training: A firm should ensure that its personnel clearly understand their obligations under the firm's compliance policies and procedures; particularly, those persons who have specific responsibilities under the firm's procedures.
- v) Monitoring and Auditing: Compliance procedures should include processes to detect violations. These may include surveillance, exception reporting, hotlines to report violations and internal audit departments. Greater use of technology to automate compliance monitoring may be an effective way to identify problems and to simplify the process of reviewing large amounts of data. Testing procedures should be used, either as part of the annual review process or on an ongoing basis, to assess whether compliance procedures are working as intended.
- vi) Enforcement and Discipline: A firm should encourage compliant actions and appropriately sanction non-compliant actions. Immediate action should be taken to discipline personnel

¹⁹ See note 15, *supra*.

²⁰ One effective practice to help assure proper delegation is the use of a responsibility matrix that assigns particular compliance related responsibilities to specific persons. The matrix should be kept up to date and procedures should be implemented to assure that personnel are performing their assigned responsibilities.

who engage in intentional violation of the law. Problems should be dealt with quickly and appropriately through discipline, disgorgement of profits, and amendments to existing policies and, if appropriate, by notifying regulators or making a public announcement.

- vii) Response, Prevention and Evaluation: A firm must respond to indications of problems and periodically assess its compliance program to ensure that compliance risks are being effectively addressed.
- b) *A risk assessment process should be implemented to assure that new legal requirements and risks are identified and appropriately addressed in a firm's compliance procedures.*
- i) In adopting Rule 206(4)-7, the SEC noted that: "[e]ach adviser, in designing its policies and procedures, should first identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular operations, and then design policies and procedures that address those risks."²¹
 - ii) With respect to the required annual review of compliance programs, the SEC noted that: "the review should consider any compliance matters that arose during the previous year, any changes in the business activities of the adviser or its affiliates, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures."²²
- c) *In developing a risk assessment program, the following points should be considered:*
- i) An inventory of risks needs to be created and those risks should be "mapped" to the firm's compliance procedures to assure that there are procedures that deal with the risks that have been identified. Checklists may be used as part of this process. However, as the SEC staff has noted, every firm has "unique risk exposures due to its personnel, business model, structure, or affiliations. If these exposures are not widely shared by your peers, they may not appear on a checklist."²³
 - ii) A review to identify and inventory conflicts that have the potential to be a source of compliance issues.
 - iii) The effectiveness of a firm's compliance procedures should be tested by utilizing transactional, forensic and periodic testing. Some firms make use of third-party service providers to gauge the firm's culture of compliance and to identify areas where revised or additional procedures may be needed.
 - iv) Compliance procedures should be amended, as needed, to incorporate procedures to assure compliance with newly adopted regulatory requirements.
 - v) New products and changes in organizational structure can give rise to new types of risks and additional regulatory requirements that need to be identified and addressed.
 - vi) Careful attention should be paid to announcements of enforcement actions against other firms (and news reports and other disclosures of pending investigations of other firms). If the issues associated with them are relevant to your firm's operations, they need to be addressed in your firm's compliance procedures. Similarly, no-action and interpretive letters issued by

²¹ Release No. IA-2204 (December 17, 2003).

²² *Id.*

²³ Remarks of John H. Walsh, Associate Director and Chief Counsel, Office of Compliance and Inspections, before the NRS 21st Annual Spring Compliance Conference (April 18, 2006). Written remarks available at: <http://www.sec.gov/news/speech/2006/spch041806jhw.htm>.

the SEC staff and speeches of SEC staff should be used to spot emerging issues and areas of regulatory concern.

- vii) It is important to implement new or amend existing procedures to prevent compliance deficiencies that come to light as a result of the annual review of compliance programs or SEC deficiency letters. An enforcement action, which included a finding of violation of Rule 206(4)-7, was brought against an advisory firm that failed to implement new procedures after an SEC examination revealed the firm was including inaccurate information in its responses to requests for proposals ("RFPs").²⁴
- viii) The process and responsibilities for risk assessment should be formalized to be part of a firm's compliance program and should include the involvement of appropriate investment, accounting, marketing and operations personnel (and not just legal and compliance personnel). Some firms have established risk assessment committees to assume responsibility for assuring that their compliance procedures are updated as may be required by both internal and external developments.

5) Key Compliance Issues for 2007

Regulatory developments during 2006 provide helpful guidance in identifying areas that will likely be the focus in SEC staff examinations of hedge fund managers this coming year. In addition, recent statements by the SEC staff have noted specific issues relating to hedge funds that will be reviewed in SEC examinations.²⁵ Hedge fund managers that are registered with the SEC should review their compliance procedures to assure that these areas and issues, to the extent relevant, are addressed.

- a) *Side-by-Side Management:* Some hedge fund managers also serve as advisers to other accounts, including mutual funds and other "long only" accounts, that do not pay performance fees (or performance-based incentive allocations). In these situations, there are conflicts that create incentives for a manager to favor its hedge funds over other clients in allocating trades.
 - i) The staff intends to focus on whether appropriate controls and procedures are in place to address these conflicts and on whether the manager has favored its hedge funds in allocating trades.
 - ii) Hedge fund managers that also manage non-performance fee paying accounts should review their trade allocation procedures to assure that the full range of potential conflicts are addressed. They should also periodically review allocations to determine that, in practice, all clients have been fairly treated.
 - iii) Potential conflicts in trade allocations may also arise if a firm manages proprietary accounts (or if the amount of proprietary capital in different funds varies) and should also be addressed in trade allocation procedures.
- b) *Side Letters:* Hedge fund managers sometimes enter into "side letter" agreements that provide certain investors preferential terms or rights that are not given to all investors in a fund. Some types of side letter provisions are not of concern to the SEC staff (e.g., rights relating to "capacity" or agreements to charge lower management fees or incentive allocations). However, the staff believes that other types of provisions can raise troubling conflicts (e.g., provisions that give certain investors enhanced liquidity rights or transparency to portfolio holdings).
 - i) The staff has said that it will focus on whether appropriate disclosure of these arrangements and the related conflicts are being made to investors.

²⁴ *In the Matter of CapitalWorks Investment Partners, LLC*, Release No. IA-2520 (June 6, 2006).

²⁵ Testimony of Susan Ferris Wyderko, note 3, *supra*, and also "As hedge fund industry awaits further regulation, SEC official lists exam focus areas." *IA Week*, October 16, 2006 (reporting comments of Thomas Biolsi, Associate Regional Director for Examinations, Northeast Regional Office of the SEC).

- ii) Hedge fund managers should review existing disclosures relating to side letters to assure that conflicts are properly disclosed and should implement procedures to assure that any new side letters do not require additional disclosures.²⁶
 - iii) It should be recognized that side letters relating to capacity and lower fees may create conflicts that should be disclosed to investors and, in addition, that certain side letter provisions may raise issues that cannot be cured simply by means of disclosure.
- c) *Information Sharing with Other Firms: Professional and personal relationships among investment professionals at different firms may lend themselves to a sharing of trading information and investment ideas between different advisory firms or provide a hedge fund manager access to information that might not generally be available to others. The SEC staff is concerned that relationships of these types pose a potential for front running of trades by another firm, trading on material non-public information and market manipulation.*
- i) Relationships that appear to be of interest to the staff include: portfolio managers or analysts that are investors in hedge funds managed by other firms; and personal relationships with colleagues at other hedge fund management firms or at brokerage firms or investment banks.
 - ii) The SEC staff will expect advisers to identify these types of relationships involving their personnel and to adopt policies and procedures to address related compliance risks. In addition to insider trading policies prohibiting the use of material non-public information, an adviser should include provisions in its code of ethics or its business conduct code prohibiting its personnel from disclosing portfolio positions and investment plans to personnel of other firms.
 - iii) Another focus of the SEC staff in this area will be on joint trading activities and whether there are any agreements to act as a "group," within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934 (the "Exchange Act"), that have not been disclosed in a Form 13D.
- d) *"Value Added" Investors: The SEC staff has expressed concern that investors in hedge funds who are affiliated with other hedge fund firms or are senior executives at public corporations may provide trading information relating to other funds or non-public information to the managers of the funds in which they invest, and that this information will then be used by those managers to earn profits to the detriment of other investors.²⁷*
- i) Firms should have policies and procedures that are designed to prevent this type of trading.
 - ii) Given the staff's concerns about "value added" investors, it is possible that in connection with the examination of one firm that manages a fund in which a professional of another firm is an investor, the staff may want to obtain and review trading information of funds that are managed by the other firm to determine whether there was any abusive trading.
- e) *Conflicts from Service Provider Relationships: The SEC staff said its examinations of hedge fund managers will focus on whether personnel of the managers have personal or other relationships with personnel at brokerage firms or other organizations that provide services to the manager's hedge funds, or financial interests in such firms, that create conflicts of interest. It will expect advisers to have policies and procedures requiring disclosure of relationships with service*

²⁶ In March 2006, the U.K. Financial Services Authority (the "FSA") issued a Guidance Note under which FSA registered managers are required to disclose material terms of side letters.

²⁷ See, *SEC v. Michael K.C. Tom*, Release No. Lit-19729 (June 15, 2006) (consent to issuance of injunction based on insider trading where bank employee provided material non-public information about a planned acquisition by the bank to manager of hedge fund in which the employee and her husband were investors prior to public announcement of the acquisition).

provider firms and their personnel as well as policies relating to the receipt of gifts from service providers.

- i) Two recent SEC enforcement actions involved excessive gifts and entertainment given by a brokerage firm salesman to traders at a large mutual fund advisory firm that were intended to obtain more business from the traders.²⁸
 - ii) In the case of managers of hedge funds of funds, policies and procedures should be established to prohibit the "gate keepers" from receiving gifts or other forms of personal benefits from managers of the underlying hedge funds.
 - iii) Monitoring procedures should be established to identify conduct inconsistent with a firm's policies. For example, a significant increase in a firm's direction of trades to a specific broker should trigger a review and appropriate inquiries of personnel responsible for selecting brokerage firms for the execution of trades.
- f) Portfolio Valuation: The SEC staff will be looking at whether portfolio investments of hedge funds are valued in a manner consistent with applicable pricing guidelines and procedures, and the fairness of valuation procedures being used, in view of the conflict managers have to inflate values to increase their compensation.²⁹
- i) Compliance procedures should include monitoring of valuation of portfolio holdings; particularly in the case of "manually priced" investments such as private placements and derivatives.
 - ii) It has been reported that the SEC staff has been looking at the improper use of side pockets to conceal poorly performing investments and to increase performance compensation derived from non-side pocket investments.³⁰
 - iii) Managers of funds of funds need to consider how interests in side pockets of underlying hedge funds are being valued for purposes of valuing the assets of the funds of funds and whether their practices are consistent with applicable valuation policies.
- g) Fund Expenses: The SEC staff says it will look at disclosures relating to expenses that are "passed through" to hedge funds, including through the use of "soft dollars."
- i) The staff expects clear and complete disclosure of arrangements where a fund pays expenses of its manager either directly (e.g., paying travel costs associated with investment research) or indirectly (e.g., use of soft dollars for non-research services).
 - ii) Services that a hedge fund manager receives from a prime broker that are not brokerage or research services, as well as any benefits a manager receives from an administrator or other service provider to a fund, would be expenses of the type that should be disclosed.³¹

²⁸ *In the Matter of Jeffries & Co., Inc.*, Release No. 34-54861 (Dec. 1, 2006) and *In the Matter of Kevin W. Quinn*, Release No. 34-54862 (Dec. 1, 2006).

²⁹ Recent SEC actions relating to valuation include: *SEC v. Joseph W. Daniel*, Release No. Lit-19427 (October 13, 2005) (securities fraud action against hedge fund manager who failed to write down value of private placement investments) and *SEC v. Conrad P. Seghers*, Release Lit-19631 (March 30, 2006) (injunction against hedge fund manager who marketed fund without disclosing that assets of fund were overstated and that substantial losses had been incurred by fund investors).

³⁰ See, e.g., "The SEC Isn't Finished With Hedge Funds," *Business Week*, July 17, 2006.

³¹ See, e.g., *In the Matter of BISYS Fund Services Inc.*, Release No. IA-2554 (September 20, 2006) (administrator of mutual funds that agreed to pay expenses of the funds' advisers was found, among other things, to

- iii) The SEC barred a hedge fund manager from association with any investment adviser based upon the manager's guilty plea to a criminal indictment alleging violations of the antifraud provisions of the Advisers Act resulting from the failure to disclose arrangements under which companies in which the fund invested agreed to issue stock to the manager or to pay personal expenses of the manager.³²
 - iv) Any directed brokerage arrangements where a hedge fund manager directs a fund's trades to brokers who sell interests in the fund should be fully disclosed.
- h) *Use of Soft Dollars:* In 2006, the SEC issued revised guidance relating to the use of "soft dollars," interpreting the scope of the safe harbor provided by Section 28(e) of the Exchange Act for the use of client brokerage commissions to obtain brokerage and research services.³³ Generally, Section 28(e) provides that a money manager will not be deemed to have acted unlawfully or to have breached any fiduciary duty under state or federal law solely by reason of having caused a client account to pay a broker a commission for effecting a securities transaction in excess of the commission another broker would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by executing broker. In general, the new guidance narrows the scope of brokerage and research services that fall within the safe harbor, but expands the availability of the safe harbor to third-party research services.
- i) Services constituting research are limited to: (i) advice regarding the value of securities, the advisability of investing in, purchasing or selling securities; and (ii) analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts. Services considered outside the safe harbor include: mass-market publications of general circulation; tangible products and services, such as travel, entertainment and meals associated with attending seminars; overhead items, such as office equipment, furniture, rent, business supplies, salaries, membership dues, professional licensing fees and software to assist with administrative functions, and the cost of computer hardware and delivery mechanisms associated with the delivery of research.
 - ii) Brokerage services include those products and services that relate to the execution of a trade from the point at which the money manager communicates with the broker for purposes of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account. Connectivity services (e.g., a dedicated line to a broker or settling custodian) and trading software used in routing trades are considered to be brokerage services. However, hardware (such as computers and telephones), software used for recordkeeping or administrative purposes, and software used to test hypothetical situations are not considered to be brokerage services. Also outside the safe harbor are products and services used for compliance testing, trade financing, error correction, and custody and recordkeeping services provided after the settlement of transactions.
 - iii) Soft dollar arrangements and compliance policies and procedures relating to the use of soft dollars should be reviewed and revised as necessary to conform to the new SEC guidance on Section 28(e). (The compliance date is January 24, 2007.)

have aided and abetted violations of the antifraud provisions of the Advisers Act under circumstances where the arrangements were not disclosed to independent directors of the funds or fund investors).

³² *In the Matter of Vincent Montagna*, Release No. IA-2551 (September 22, 2006). See also, *In the Matter of James A. DeMatteo*, Release No. IA-2556 (September 26, 2006) (president of mutual fund advisory firm barred from association with any investment adviser based on submission of inflated and fictitious third-party invoices, and submission of invoices for services provided to the fund adviser, to fund administrator as part of fraudulent scheme in which fund assets were used to pay salaries, rent and other expenses of the adviser).

³³ Release No. 34-54165 (July 18, 2006) (Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Exchange Act).

- i) Insider Trading: *The SEC staff has also indicated that one focus of examinations of hedge fund managers will be on trading activities and whether there has been trading on material non-public information.*
- i) During 2006, there were a number of enforcement actions relating to insider trading by hedge funds,³⁴ and insider trading by hedge funds "remains a substantial concern" and a "significant focus" of the SEC's enforcement efforts.³⁵
 - ii) The retention of consultants (including "match" services) to provide information regarding products, industries or issuers or to provide scientific or other expertise that may be useful in making its investment decisions can create the potential for trading on material non-public information. Policies should be developed that govern contacts with consultants to help assure that consultants do not provide material non-public information and to avoid any improper use of information obtained from consultants.
- j) Marketing Materials: *The SEC staff can be expected to focus on marketing materials used in offering hedge funds and, in particular, whether statements in those materials are consistent with the funds' investment programs and with disclosures made in the funds' offering memoranda.*
- i) An effective compliance program should include procedures to assure pre-use review and approval of all marketing materials. These procedures should apply to all materials sent or made available to investors or prospective investors.
 - ii) Responses to RFPs and due diligence questionnaires and information provided to database services should also be included within the types of marketing materials subject to review and approval. In 2006, the SEC brought enforcement actions against advisers that made inaccurate statements in response to RFPs and provided false information to database services.³⁶
 - iii) Although hedge fund managers that registered with the SEC because of the Registration Rule are not required to maintain records that form the basis of or demonstrate the calculation of performance prior to February 10, 2005,³⁷ the SEC staff may nonetheless scrutinize how a fund's investment performance for periods prior to its manager's registration has been computed.

³⁴ See, e.g., *SEC v. Nelson J. Obus*, Release No. Lit-19667 (April 25, 2006) (complaint alleging trading in advance of public announcement of merger agreement); *SEC v. Deephaven Capital Management, LLC*, Release No. Lit-19683 (May 2, 2006) (hedge fund and its portfolio manager consent to injunction based on short sales of stock of issuers prior to public announcement of PIPE deals by the issuers); and *SEC v. Langley Partners, L.P.*, Release No. Lit-19607 (March 14, 2006) (same).

³⁵ Testimony of Linda Chatman Thomsen, Director, Division of Enforcement, before the U.S. Senate Committee on the Judiciary, December 6, 2006. Written testimony available at: <http://www.sec.gov/news/testimony/2006/ts1205061ct.pdf>.

³⁶ *In the Matter of CapitalWorks Investment Partners, LLC*, Release No. IA-2520 (June 6, 2006) (false and misleading responses to RFPs were found to be violation of antifraud provisions of the Advisers Act) and *In the Matter of Warwick Capital Management, Inc.*, Release No. IA-2530 (July 6, 2006) (adviser distributed false and misleading information regarding its assets under management, number of clients, investment performance and other matters through third-party subscription service).

³⁷ See, Letter to Subcommittee on Private Investment Entities of the American Bar Association (pub. avail. August 10, 2006).

This information has been prepared by Schulte Roth & Zabel LLP for general informational purposes only. It does not constitute legal advice, and is presented without any representation or warranty whatsoever as to the accuracy or completeness of the information. Distribution of this information is not intended to create, and its receipt does not constitute, an attorney-client relationship between SRZ and you or anyone else.

Electronic mail or other communications to SRZ (or any of its attorneys, staff, employees, agents or representatives) resulting from your receipt of this information will not, and should not be construed to, create an attorney-client relationship. No one should, or is entitled to, rely in any manner on any of this information. Parties seeking advice should consult with legal counsel familiar with their particular circumstances.