

Hedge Funds and Private Equity Funds

Introduction

In the wake of the significant liquidity and credit contraction affecting global capital markets, the Emergency Economic Stabilization Act of 2008 (the “Act”) and recent measures taken by domestic and foreign regulatory authorities, including the Securities and Exchange Commission (the “SEC”) and the Financial Services Authority (the “FSA”), have served to target the reduction of market volatility, the increase of financial transparency, and the restoration of confidence in the financial markets. Current market conditions, as well as the new legislation and recently adopted regulations have, and will continue to have, serious implications for investment managers and for the hedge funds and private equity funds they manage, as well as direct effects on their trading strategies, compensation arrangements, disclosure requirements, and compliance obligations.

New and Proposed Legislation and Regulation

The Act does not address private investment funds directly except with respect to an important section of the Act, which will serve to generate federal revenue. Section 801 will add new provisions to Sections 409A and 457A of the Internal Revenue Code of 1986 that will restrict the ability of hedge fund managers to defer compensation offshore. Specifically, under Section 801, compensation earned after December 31, 2008 may no longer be deferred in an offshore hedge fund if that fund does not pay substantial tax in the foreign country. Additionally, back-to-back arrangements that allow employees of a fund manager to defer compensation will be similarly affected.

In addition to the Act, the SEC has recently adopted a number of new regulations applicable to the hedge fund industry, including antifraud rules designed to limit “naked” short selling and prevent deceptive actions, prohibitions against short selling of publicly traded common equity securities of an expansive list of financial services institutions, and requirements to disclose applicable short positions on certain securities. Congress and other governmental bodies may also consider further new securities markets regulation and the regulation of private investment funds specifically.

The SEC recently announced that it will expand its investigations by undertaking additional enforcement measures designed to address market manipulation and that certain hedge fund managers and institutional investors with significant trading activity in financial issuers or positions in credit default swaps will be required to disclose such positions to the SEC. Along these lines, the SEC is investigating the dissemination of false and misleading information as a means of depressing asset prices in connection with certain trading strategies, and has ordered a number of private funds to disclose trading data in connection with such investigations. The Department of Justice (the “DOJ”) recently began

investigating the subprime mortgage industry, and indicated that a variety of institutions, including private funds, could be the subject of future inquiries. Regulatory action has not been limited to the United States. The FSA recently implemented new provisions with respect to its Code of Market Conduct, including prohibiting new short positions or additions to existing short positions with respect to the securities of certain U.K. financial sector companies as well as daily disclosure requirements for investors with short positions in excess of 0.25% of the outstanding share capital of a U.K. financial sector company.

Hedge Funds and Private Equity Funds

The recently enacted rules and regulations have altered the reporting requirements of hedge fund managers and certain private equity fund managers, which may also have direct effects on the investment strategies of such funds. It is important for investment managers to understand these new rules and regulations and to determine whether they impose additional reporting requirements, investment restrictions, or other obligations and compliance requirements on such managers.

In addition to these new regulatory changes and rules, private investment funds with restricted access to available credit will need to seek alternative sources of leverage or re-evaluate their future credit demands—many funds have already taken steps to do so, and will continue to adapt their investment strategies to substantially reduce their demand for credit. It is also important for private equity fund managers to understand their contractual obligations with respect to idle funds. In particular, some managers may be required to return uninvested capital contributions to limited partners if such contributions are not invested within a specified period of time.

It is also critical for investment managers to thoroughly understand the creditworthiness and counterparty risk of the investment banking and brokerage institutions with which such managers transact business. In particular, the recent bankruptcy and acquisition of a large number of investment banks has altered the number and identity of suitable prime brokers for many hedge funds. Accordingly, investment managers need to evaluate and understand the creditworthiness of all of their counterparties, including prime brokers.

With falling asset prices and average year-to-date hedge fund returns below par, many hedge funds have experienced, and may continue to experience, an increase in investor redemption requests. With redemption requests projected by many to exceed 10% of all hedge fund assets by the end of this year, redemptions may not peak until the end of the fiscal year as many hedge funds have quarterly redemption rights subject to certain advance notice requirements (e.g., 30 to 90 days). It is important for hedge fund managers to understand their contractual and fiduciary obligations in the event that it is necessary to suspend redemptions and/or implement redemption “gates” with respect to both the implementation and the removal of such measures.

It is also important for fund managers to understand the effects that declining net asset values and performance allocations and management fees will have on their ability to retain key personnel. This includes understanding the ramifications of Section 801 of the Act and important issues associated with structuring employment agreements on a favorable going-forward basis. In a declining market, particularly when a fund’s high-water mark has not been met and performance fees/allocations are not made to a fund manager, fund managers may have to rely on management fees, short-term borrowings (to the extent available), or reserves to meet payroll obligations and maintain valuable personnel.

Institutional Investors, Funds-of-Funds, and Other Private Investors

In light of recent regulatory changes, institutional investors, funds-of-funds, and other private investors need to understand their current direct and indirect investment portfolios and risk exposure, as the recent short-selling restrictions and disclosure obligations described above may reduce the methods available to investment managers to protect investor capital through hedging practices or otherwise.

As a result of potential increases in redemption requests, investment managers may suspend redemptions or implement redemption “gates” to reduce the flow of funds out of their respective investment vehicles. In these circumstances, it is important for investors to understand the redemption and liquidity terms governing their existing investments in such funds, and the circumstances under which redemption suspensions or “gates” are implemented and lifted, as well as the process surrounding the distribution of a fund’s available cash.

Additionally, since many funds designate certain investments that are difficult to readily value as illiquid and allocate them into “side pockets” with stringent applicable redemption restrictions, investors need to thoroughly understand the terms and conditions governing hedge fund “side pocket” investments. These issues of concern include the portfolio percentage limitations on illiquid investments and the manner in which illiquid investments may be recategorized as liquid upon the availability of appropriate market valuations (and therefore subject to redemption).

Hedge funds with net asset values below their specified high-water marks or private equity funds with large portfolios of written-down assets may also create retention issues for many funds with respect to valuable management personnel. It is important for investors to understand their contractual rights in the event a “key person” departs. Such “key-person” provisions may permit investors to redeem their investments more quickly than they otherwise could or suspend the fund’s investment period, among other rights. These issues of liquidity, lock-ups, and “side-pockets” may become more important if current market conditions continue or deteriorate or if the ability of certain funds to dispose of their illiquidity securities is or continues to be impaired.

Where a fund’s redemptions have been suspended or otherwise restricted, some investors may consider alternative means of exiting existing hedge fund or private equity fund investments or meeting urgent liquidity needs. In particular, it is important for investors to understand the transfer and pledge provisions governing their existing investments, and to determine if such provisions permit, restrict, or do not address the potential transfer, sale, or pledge of existing investor fund interests. Investors with urgent liquidity needs who are unable to promptly redeem part or all of their fund interests due to lock-ups, suspended redemptions, redemption “gates,” or significant “side-pocket” allocations may seek alternative means of disposing of their respective equity interests, including by way of a sale or assignment of economic interest to secondary funds or other buyers of interests, a pledge through a swap arrangement, or otherwise.

Certain institutional investors such as university endowments and governmental or private pension plans should ensure that they continue to comply with mandated alternative investment restrictions and alternative asset allocation caps. For example, many institutional investors may not invest more than a specified percentage of their assets in alternative investments, such as hedge funds or private equity funds. Although the asset values of many hedge funds and private equity funds have declined during the past year, the aggregate asset values of many investors have declined even further. Thus, alternative investments are likely to constitute a growing percentage of total portfolio allocations for many

institutional investors. Accordingly, many investors may need to undertake remedial measures to ensure continued compliance with their fiduciary obligations and allocation policies.

Conclusion

The attorneys at Morgan Lewis have broad experience in all aspects of hedge funds and private equity funds, including fund formation issues, institutional investor issues, securities regulation, capital markets, derivatives, investment adviser and broker-dealer regulation and compliance, employment matters, and private investment fund litigation. We are ready to assist our clients in these matters.

If you have any questions or would like more details concerning any of the points mentioned in this discussion briefing, please contact the Morgan Lewis attorney with whom you normally communicate or any of the Morgan Lewis attorneys in our Financial Crisis Working Group:

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