

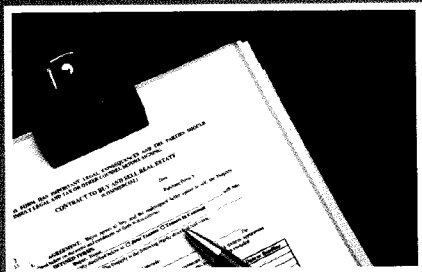
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## Legal and tax advice for alternative fund managers



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The dual effect of a new US administration and the economic downturn has pushed the alternative investment industry in the USA and indeed globally into the spotlight. President Obama has unveiled a raft of proposals designed to limit the ability of fund managers to optimize tax results for managers and investors, while a series of scandals, such as Madoff's Ponzi scheme, has led to proposals for tighter regulation.

Ron Geffner, partner with law firm Sadis & Goldberg LLP in New York, says these problems require alternative fund managers to look for legal guidance to aid them with the ever changing landscape.

Roger Lorence, another partner with Sadis, adds that President Obama's proposals will reinstate the maximum individual rate of tax of 39.6% and raise other taxes on high income individuals.

Mr Lorence said: "Under the proposal, the carried interest (the re-allocation of profit in a domestic hedge fund from the investors' capital accounts to the manager's capital account) would be treated as income subject to self-employment taxes. Only the income and loss on the manager's own invested capital (that is, capital contributed plus carried interest left in the partnership) would be eligible for capital treatment."

Mr Lorence added: "Any person performing services for the entity and holding a 'disqualified interest' (generally, convertible or contingent debt, options or other derivatives, but not an interest in the partnership) would be treated as receiving ordinary income with respect to such interest. The proposal would be effective for taxable years beginning after December 31, 2010."

There are ways to mitigate tax paid on proceeds from fund activ-

ity, by implementing deferred compensation plans or trading in more tax efficient contracts such as derivatives.

Mr Lorence said: "The manager of the domestic fund will face challenges to tax efficiency if the carried interest proposal is enacted. All managers will benefit from being more proactive about taxes, particularly the timing of when income is realised and deductions taken. Going back to basics, choosing the more tax-advantaged products, and being more mindful of timing issues, could relieve many managers of much of the sting of the loss of the carried interest."

The Madoff catastrophe almost certainly means changes to the regulatory landscape and the implementation of more rules and regulations. Investment managers need to understand how their operations will be affected.

Mr Geffner says that being reactive to future regulation, rather than proactive, will further reduce a manager's competitive edge.

Mr. Geffner added: "A manager should implement and revisit compliance policies and procedures prior to registration as an investment adviser. Upon registration with the U.S. Securities and Exchange Commission ("SEC"), the new registrant can expect to be visited within the initial twelve months from the date of registration by the SEC for an examination. By testing policies and procedures in advance of registration, a manager materially decreases the risk of committing regulatory violations."

The economic downturn has prompted a wave of redemption requests with hedge funds and commitment disputes between venture capital/private equity funds and investors.

Litigation within the alternative investment community has subsequently increased.

Skilled legal counsel can materially impact the direction of negotiations with angry investors. In many instances, there are several roads that a manager may take.

Mr Geffner believes that working with lawyers who have taken more than one road and who can offer feedback to the manager, both with regard to the likelihood of the outcome of litigation, as well as the impact on the ongoing operation of the manager and its employees and ongoing viability of the business is essential.

## Bahamas – the smart choice for investment fund domicile

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Since the enactment of the Investment Funds Act and Regulations in 2003, The Bahamas has seen a significant response to the Specific Mandate Alternative Regulatory Test Funds, or SMART Funds, which were introduced as part of the updated and enhanced regulatory regime. SMART Funds have proven to be tremendously popular, meeting a specific need within the market for a streamlined investment fund vehicle that can be used in a broad range of circumstances. These vehicles have been used by boutique investment managers to create niche products, by banks with global presences to meet specific requirements imposed by very high net worth clients and by family offices to enhance their planning and investment programs.

Linda Beidler-D'Aguilar, partner at Graham, Thompson & Co in The Bahamas, says her international practice is largely focused on the structuring of SMART funds and Professional Funds, but also in the creation of Standard Funds for Bahamian retail investors.

She said: "At the moment there's a real dichotomy in the work that we're seeing – we work with some managers who are expanding and increasing their funds as well as managers who've been severely challenged by the economic crisis. As to the former, we're seeing expansions in existing Professional Funds, largely those with master-feeder structures, principally in the expansion of opportunities for off-shore investors."

She added: "On the other hand, funds that have significant

redemption requests are also seeking our advice, and we're working with them to balance the needs of redeeming investors against those of the investors who want to stay with the manager's program. This is particularly challenging where a fund's investments are largely illiquid – such as, for instance, where the portfolio is largely comprised of private equities – or the fund has experienced substantial losses."

Ms Beidler-D'Aguilar says that, if the portfolio is illiquid, the establishment of a special purpose vehicle can reduce some of the pressure on the fund and its managers; the implementation of gates (where the constitutive documents so permit) will also reduce pressure in the case of an illiquid portfolio and permit an orderly disposition of assets without undue prejudice to the remaining investors.

Ms Beidler-D'Aguilar says the flexibility and willingness of the Bahamian government to consider innovative suggestions from the private sector to enhance the regulatory regime will continue to ensure that The Bahamas is a jurisdiction of choice for discerning and demanding clients. In fact, in February 2009, at the request of the local fund industry, legislation was passed to establish an additional SMART Fund model designed to permit funds to separate illiquid or hard to value assets from other more liquid investments, while still using a licensed structure to hold such assets.

As the global economic crisis continues, The Bahamas is seeing some changes to the models used for investment funds from hedge funds per se to funds that are established to invest in distressed properties, insurance products, wines, art and other non-traditional and alternative asset classes.

Whether this is a trend that will continue is hard to predict, but it has created opportunities for creative thinking and new products, particularly using SMART Fund models.

Ms Beidler-D'Aguilar adds: "Historically, the principal sources of business for The Bahamas were largely from North America and Europe; however, we are in fact seeing some changes to this model, including the development of ties elsewhere in the Americas as well as in Asia. It's an exciting time for us, and we are looking forward to enhancing our global presence."