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Dear Clients and Friends,

We bring you this issue to highlight some key aspects and considerations of the rise of pooled investment vehicles and similar private equity funds from the ashes of the traditional credit and capital markets. The market conditions in which we are delivering this issue are unprecedented in our time. The credit markets are frozen and much of the equity capital is on the sidelines waiting for the market bottom to appear. The hallmark of this year and much of the last has been efforts to raise capital when traditional sources of funding have ceased to function.

During this period of economic uncertainty, there has been a noted increase in opportunistic spirit and entrepreneurship as companies and their principals have sought creative solutions to raise capital for their ongoing concerns and to seize on opportunities to purchase distressed assets in nearly all asset classes. To access capital and seize on these opportunities, there has been a movement towards pooled investment vehicles and similar private equity funds in an effort to deploy sidelined capital.

We have prepared this issue to discuss some of the tax, regulatory, structuring, and economic considerations of putting together an investment vehicle of this type. Indeed, you will see that, while these transactions provide a vehicle to access investment capital, they are not to be entered into without careful analysis and structuring.

Very truly yours,  
Snell & Wilmer L.L.P.  
Business & Finance Group

# Fund Formation Basics: Early Considerations for Structuring a Real Estate Fund

*By Brian Burke and Marc Schultz*

With the current upheaval in the credit and capital markets, there is a general undersupply of capital across the United States. Much of this upheaval has resulted in nervousness in the markets as a whole, leaving much of the equity capital cautiously on the sidelines. Regionally, the southwestern United States has been among the harder hit areas with respect to property values and availability of capital. This has resulted in the southwestern United States becoming a fertile field for investors seeking to purchase distressed real estate and, to that end, there has been a marked rise in sourcing capital from outside investors to acquire these assets.

While investment and exit strategies may vary, a common vehicle to acquire these assets has been the pooling of funds through a private real estate fund. In these funds, the fund sponsor issues equity interests in the fund to multiple investors. Often times, these offerings are structured to avoid the registration requirements of the federal securities laws. This article discusses the basic economics and considerations concerning capital raising, deployment, and disbursement of these funds.

## Documentation and Investor Preference

Private real estate funds are typically organized as either limited partnerships or limited liability companies in which the investors receive limited partnership interests or membership interests (as the case may be) in exchange for cash contributions. The decision of which entity to use is fact intensive and depends to a large extent on the size of the fund and the anticipated investors. In our experience,

institutional investors prefer the limited partnership form whereas high net worth investors are largely indifferent to form. In making the decision as to which entity to use, it is important in this competitive market for investment capital not to be novel with entity choice.

In connection with the solicitation of the offering, investors are typically provided a private placement memorandum, which details the opportunities and risks, and sets forth the parameters and economics of the fund. While there is room to market the positive aspects of the investment, this document is the first line of defense and an important protection against investment underperformance or failure. Accordingly, the document should fairly and completely detail all of the risks inherent with the investment.

The private placement memorandum (together with the applicable fund governing document, e.g., the partnership agreement) will also detail the restrictions and governance of the investments of the fund, such as whether leverage is permitted, sources and uses of funds, restrictions on assets to be purchased, geographic concentration of capital deployed, whether and on what terms an advisory board will be consulted prior to making investments, how capital will be drawn, and how distributions of capital will be made (as discussed in more detail below). The private placement memorandum (together with the applicable governing document) will also detail the compensation and reimbursements to which the fund sponsor will be entitled. These typically include reimbursement (often subject to a cap) of organizational and start up expenses, fees for management, and an allocation of profits from the fund. Depending on the nature of the fund, acquisition, disposition, development, and property management fees may also be applicable.

## Structural Considerations

At the infancy stages of the fund's formation and prior to beginning work on the private placement memorandum and applicable governing document, there are four basic structuring considerations that a fund sponsor must understand, each discussed in turn below.

### Capital Commitments

Potential investors often times prefer to commit to provide the fund sponsor with a certain amount of capital, but not part with their cash until the fund sponsor has identified an actual investment for the fund. The obligation of the investor to meet these future contributions is referred to as a capital commitment.

Typically, a fund sponsor will seek firm commitments of capital from investors over a certain period of time. Once the sponsor identifies an investment for the fund, the fund sponsor will issue a "capital call" notice to its committed investors specifying the total amount of capital needed by the fund. Each committed investor is then contractually required to deliver that investor's portion of such total needed capital (based upon the investor's capital commitment percentage relative to the entire pool of commitments). Committed investors have a prescribed amount of time to make the capital contribution and the failure to do so is typically a default under the partnership agreement or limited liability company agreement (as the case may be). The applicable governing agreement will set forth the remedies available to the fund sponsor for such a default and could include loss of the entire investment, forced sale, or other enumerated penalties, plus other actions available at law.

Capital commitments can provide a distinct benefit to the fund sponsor, in that most funds are structured such that the investors' preferred return on their capital contributions does not start to accrue until the capital contributions are actually made, as opposed to the time the fund obtains the investors'

capital commitments. As a result, the capital commitment process provides the fund sponsor with a contractual commitment that requested funds will be available when needed, but the clock on the preferred return owed to investors with respect to such funds will not start running until the fund is ready to deploy capital to acquire the investment and contributions are, in fact, made to the fund.

### Subsequent Investors

The fund documents usually permit the sponsor to seek additional capital commitments from "new" investors after obtaining capital commitments from the "initial" investors. However, there is an inherent problem with permitting subsequent investments in that, if not structured properly, new investors could get a "free look" at the performance of the fund prior to making an investment. In order to encourage investors to be the first in, the fund documents must be set up in contemplation of the "free look" problem, such that the new investors are undertaking the same degree of risk as the initial investors. To address this problem, many funds require the new investors pay an additional amount to the fund as a fee or a premium on their investment.

### The Distribution Waterfall and the Sponsor's Interest in Profits

Private investment funds typically employ a "waterfall" distribution structure. The waterfall distribution structure provides investors with a priority distribution of proceeds based upon the capital contributions prior to the distribution of any profits to the investors and the sponsor. These priority distributions often include a rate of return on the capital contributed by the investors, typically based upon the capital contributed to the fund by such investor at an agreed upon rate per annum, and a return of the investor's capital contribution.

After the priority distributions are made, profits are distributed to the investors and sponsor. Typically, the sponsor receives a certain percentage of the profits (i.e., its carried interest). The sponsor receives its

carried interest in return for services that the sponsor provides to the fund. If structured appropriately as a “profits interest” for federal income tax purposes, such carried interest can receive the benefit of more favorable income tax rates. The carried interest can be structured as a profits interest if the fund is structured such that, upon a hypothetical sale of the fund’s assets and liquidation after the grant of the interest to the sponsor, the sponsor would not receive any of the available liquidation proceeds.

### **Investor Redemptions**

Currently, investors are demanding flexible exit strategies including the ability to cause the fund to redeem their interest. However, an investor redemption right could be challenging for the sponsor because real estate assets may not be a source of liquidity for the fund.

Sponsors should consider a set duration of existence of the fund so that the investors will know exactly how long their cash investment will be held. It is also common for the fund sponsor to have the ability to extend the duration of the fund for a certain period of time. The ability to extend the term of the fund is important to avoid a forced sale of the assets for distressed prices in the event that the term expires in the middle of a down real estate market.

These are just a few points for a fund sponsor to consider when forming a private investment fund. It is important to work out these structuring details as early as possible and certainly before drafting the offering documents for the fund.

## Raising Money in a Down Market: Beware Unregistered Broker-Dealers

*By Brian Burke and Eric Kintner*

In recent months, there has been unprecedented turbulence in financial markets, including the implosion of Bear Stearns, the bankruptcy filing of Lehman Brothers, the injection of hundreds of billions of dollars into banks across the United States, other federal government bailouts, and a seemingly unending succession of bank failures. In addition, the financial markets have been adversely affected by reports of massive losses, causing a mass exodus of capital providers from the traditional credit, capital, and stock markets. In the trail of this tempest, there have been reports of FBI and SEC probes into many areas of the financial and securities markets. Recently, the SEC and state securities regulators have reported enforcement actions against individuals for securities fraud and for acting as unregistered broker-dealers.

In this environment, many early-stage companies seeking to grow have turned to outside sources of capital, often using “finders” to help them identify willing investors. Others have conducted capital raising through in-house managers and employees. While these efforts can result in the raising of needed capital, many companies do not realize that their use of “finders” or in-house salespersons may result in adverse legal consequences.

Persons or entities engaged in the business of effecting securities transactions are considered “brokers” or “dealers” and, absent an exemption, are required to be registered as such under federal law, most state laws, and self-regulatory organizations such as the Financial Industry Regulatory Agency (FINRA). Finders or salespersons that do not restrict

themselves to a very narrow set of permitted activities are acting as unregistered broker-dealers and could be subject to regulatory and legal action by the SEC and state securities regulators. In addition, companies using an unregistered broker-dealer could jeopardize the validity of the securities law private placement exemptions on which they may have relied, thus giving the purchasers of the applicable securities the ability to rescind their entire investment in the company.

### Definitions of “Broker” and “Dealer”

Under federal law, a “broker” is any person or entity “engaged in the business of effecting transactions in securities for the accounts of others.” Unlike a broker who acts as an agent for someone else, a “dealer” acts as a principal and is defined as any person or entity “engaged in the business of buying and selling securities for his own account, through a broker or otherwise.” In making the determination of whether a person or entity has acted as a broker-dealer, the SEC looks at the actual activities the person or entity performed. Factors indicating that a person is “engaged in the business” of effecting securities transaction include:

- receiving transaction-related compensation, such as a commission;
- holding oneself out as a broker, as executing trades, or as assisting in settling securities transactions;
- participating in the securities business with some degree of regularity; and
- soliciting securities transactions.

Generally, companies that issue securities, including private equity funds, rely on the so-called “issuer exemption,” which dictates that they are not “brokers” because they are selling securities for their own accounts and are not “dealers” because they do not buy and sell their securities for their own

accounts as part of a regular business. However, the issuer exemption does not apply to “associated persons” (described below) of the company, such as the company’s managers, employees, or affiliated entities. To avoid regulatory or legal action, such associated persons must rely on their own exemption from broker registration.

### Safe Harbor from Broker Registration (Rule 3a4-1)

Associated persons of an issuer can be excluded from broker registration if their activities meet certain conditions under Rule 3a4-1 of the Exchange Act. The associated persons of the issuer that may be excluded from broker registration under this safe harbor include:

- natural persons who are either partners, officers, directors, or employees of an issuer;
- a corporate general partner of a limited partnership that is an issuer;
- a company or a partnership that controls or is controlled by the issuer; or
- a registered investment advisor of an issuer that is a registered investment company under federal law.

Note: No definitive authority exists as to whether natural persons who are managers of a limited liability company that is the general partner of an issuer would also be found to be associated persons of an issuer; however, many practitioners believe that such natural persons could utilize the safe harbor protections.

To take advantage of the safe harbor, associated persons of an issuer must meet four conditions. First, the associated person must not be subject to any statutory “bad boy” disqualification under the Exchange Act. These so-called “bad boy” disqualifications include (1) conviction of any felony

or misdemeanor involving specified securities laws within ten years of the offering; (2) being temporarily or permanently enjoined or restrained in connection with such specified securities laws within five years prior to the offering; (3) suspension or expulsion from association with a member of a national securities exchange or national securities association or (4) being subject to a United States Postal Service false representation order.

Second, the associated person may not receive a commission or other remuneration, directly or indirectly, based either on transactions in securities; or, put differently, the associated person must be effecting transactions in securities within the normal salary structure and cannot be hired solely to perform this function for a limited or specific employment.

Third, the associated person must not be an “associated person of a broker or dealer,” which generally means a partner, officer, director, manager, or other employee of a broker or dealer, with the power to manage the operations of such broker or dealer, or an entity that controls (directly or indirectly) such broker or dealer, as well as any person who is required under the laws of any state to register as a broker or dealer.

Finally, the activities of the associated person must meet the description of one of the following scenarios:

- the associated person’s participation was limited to excluded types of transactions such as: transactions with broker-dealers, insurance companies, banks, and the like; transactions approved by the vote of the security holders, such as a merger, consolidation, or plan of acquisition involving an exchange of securities; or transactions that are made pursuant to a employee benefit plan (such as a bonus, profit-sharing, retirement, or stock option plan for employees of the issuer);
- the associated person’s participation in the transaction in securities was restricted to: preparing or delivering written communication without oral solicitation (and the content was approved by the issuer); responding to inquiries of potential purchasers in communication initiated by the potential purchaser (if the substance of the response is limited to information included in the offering document); or performing ministerial and clerical work involved in effecting any transaction.
- the associated person primarily performs substantial duties for the issuer other than in connection with transactions in securities, is not a broker-dealer, investment advisor, or an associated person of either within the past 12 months, and has not participated in the sale of securities on behalf of any issuer within the preceding 12 months other than in reliance on the first two scenarios listed in the bullets above. Note: the SEC has indicated that this 12-month waiting period is meant to prohibit associated persons from selling securities of *any* issuer within the 12 months prior to the issuer’s offering.

Generally, associated persons rely on the third scenario discussed above. The SEC has stated its belief that broker-dealer registration is appropriate and necessary with respect to persons who are regularly engaged in the sale of securities, such as promoters of limited partnership interests. Accordingly, associated persons for themselves and issuers (when hiring associated persons) must be ever vigilant with respect to the number and timing of transactions in securities effected by such associated persons. By way of example, in September 2008, the SEC charged an individual and his company with misappropriating funds from investors through different investment schemes, alleging that they had misrepresented to investors that the invested funds were fully insured and were guaranteed a high rate of return. In February 2009, the Arizona Corporation Commission announced charges against several

individuals for making misrepresentations to investors and failing to register as securities dealers or salespersons under Arizona law. In one case, the Arizona Corporation Commission charged an individual with fraudulently offering and selling unregistered stock in a start-up company that was formed to sell boats, alleging that he had misrepresented that there was no risk in the investment and that the investor was guaranteed to receive, at a minimum, a return of the principal investment amount. As part of the settlement with the Arizona Corporation Commission, the individual admitted to selling stock without being registered as a securities dealer or salesman in Arizona.

### Non-Safe Harbor Cases

Failure of the application of the safe harbor under Rule 3a4-1 described above does not necessarily mean that associated persons must register as brokers. The SEC has noted that other facts and circumstances may justify a determination that registration as a broker-dealer is not required, even upon failure to satisfy all applicable “safe harbor” conditions. Specifically, the broker-dealer rules provide that no presumption shall arise that an associated person violated the rules even if the conditions the safe harbor have not been met.

Associated persons that fail to meet the requirements of the safe harbor may still be exempt from registration if they are not “engaged in the business” of effecting securities transactions. In making the determination of whether a person or entity is “engaged in the business,” the SEC examines (among other things) whether the associated person’s securities activities are extensive, the extent to which funds or securities are held for others, and the extent of the associated person’s contact with the public.

The SEC views receipt of compensation related to the sales of securities as an important factor in the “engaged in the business” analysis. Even if commissions or other transaction-related fees are not

paid, such person may be required to register if he or she proposes to locate issuers of securities, solicits new clients, and/or acts as an agent in structuring or negotiating the transactions. The SEC has issued substantial guidance and No-Action Letters with respect to different factual scenarios involving issuers and associated persons; however, each analysis is based on the individual facts and circumstances of each securities transaction. Accordingly, each transaction must be specifically evaluated.

### Consequences of Failing to Register as a Broker-Dealer

The failure of a broker to register with the SEC could subject the broker to monetary penalties and to certain injunctive actions by the SEC. The SEC is authorized to seek civil injunctions in federal district court against persons violating, or about to violate, the provisions of the Exchange Act, including the broker registration requirements. The SEC also has the authority to issue a cease-and-desist order in response to a violation of these provisions. In addition, the SEC is authorized to refer the matter to the United States Attorney General for prosecution and may notify state prosecutorial agencies in certain situations. Finally, failure to register when required is grounds for denial by the SEC of a later application for broker registration.

### Avoiding Common Pitfalls When Raising Capital

Companies seeking to raise capital by engaging in securities transactions should be careful to avoid these common pitfalls. If the company seeks to engage a third-party “finder” or use in-house salespersons to help identify willing investors, the best approach is to ensure that such persons are registered broker-dealers. If this option is not available, companies should, at a minimum, structure their offering and arrangements taking into account the following:

- Agreements between the company and the finder should carefully detail the finder's role in the transaction, including prohibiting the finder from making recommendations, assisting in the negotiation of deal terms, performing due diligence, or providing valuations.
- Agreements with finders should avoid paying any commissions or other transaction-based compensation and, instead, provide for a flat fee arrangement not based on the amount of capital raised or the deal outcome achieved.
- If the company proposes to use in-house salespersons to sell its securities, such sales persons should limit their participation in any securities offerings to once every 12 months in order to take advantage of the safe harbor from broker registration.

While these steps alone cannot guarantee compliance with the broker-dealer laws and regulations, they go a long way towards avoiding many of the most common pitfalls.

## Recent Proposals to Increase Regulation and Taxation of Private Equity Funds and Their Advisors

*By Marshall Horowitz and Anthony Ippolito*

### Introduction

Private equity funds have long been popular vehicles for pooling money to make investments in private companies because, among other things, they are able to avoid the burdensome reporting and regulations of regulated investment companies.

With private equity funds and hedge funds being blamed, in part, for current market conditions, there has been a call for increased regulation of these types of entities and the people who manage them. Recently, a number of new laws have been proposed that would affect the regulatory environment for private equity funds.

In January 2009, Charles Grassley (R-Iowa) and Carl Levin (D-Mich.) introduced the Hedge Fund Transparency Act ("HFTA") into the United States Senate. While the name of this legislation indicates that hedge funds are its target, make no mistake about it: the proposed law would affect private equity and venture capital funds as well. HFTA would subject most private equity funds to SEC registration, various reporting and public disclosure requirements, and anti-money laundering programs.

Another proposed law, the Hedge Fund Advisor Registration Act of 2009 ("HFARA"), presently under consideration in the U.S. House of Representatives, would eliminate the exemption currently provided to private equity fund advisors with fewer than 15 clients, thus requiring them to register as "investment advisors" under the Investment Advisors Act of 1940 ("IAA").

In addition, President Obama has stated his intent, as part of his new budget plan, to raise taxes on the carried interest that private equity firms earn. This article discusses each of these new proposals below.

### SEC Registration Requirements

The Investment Company Act of 1940 ("ICA"), not surprisingly, regulates investment companies, which are generally defined as companies that are in the business of investing, reinvesting, or trading in securities. They are generally required to register with the SEC and are subject to various ongoing, detailed reporting requirements. Transactions between investment companies and their affiliates are regulated, and their investment activities are subject

to various restrictions. For example, investment companies are not allowed to purchase securities on margin, short sell securities, or participate in joint trading accounts. In addition, their advisors are required to register as “investment advisors” under the IAA and are subject to separate SEC regulation.

Private equity funds are currently excluded from the definition of “investment company,” but HFTA would expand that definition to include those private equity funds that manage assets worth at least \$50 million. The distinction may seem subtle, but the impact could be substantial.

These funds and their advisors are currently exempt from SEC registration under Section 3(c)(1) or 3(c)(7) of the ICA if (i) they are either beneficially owned by fewer than 100 persons and are not making, and do not propose to make, a public offering, or (ii) they are only sold to “qualified purchasers,” i.e., high net worth individuals or companies. Under HFTA, private equity funds that meet the old exclusions and manage assets of less than \$50 million would still be exempt from the provisions of the ICA, but those managing assets in excess of \$50 million would be required to register and file an information form with the SEC, maintain such books and records as the SEC may require, and cooperate with any request for information or examination by the SEC in order to remain exempt.

### Reporting/Disclosure Requirements

The proposed SEC information form would require disclosure of certain data about the structure of the investment company, as well as the names of its primary accountant and primary broker, the name of any company with an ownership interest in it, the current value of the fund’s assets and the assets under the fund’s management, and the name and address of each natural person who is a beneficial owner. Not surprisingly, this latter category raises serious privacy concerns. The sponsors of HFTA, however, have subsequently indicated that their

intent is not to require the disclosure of the names and addresses of the funds’ investors, but rather to require identification of the people who profit from the fees generated in operating the funds. We will have to wait and see whether the language of HFTA changes to reflect that intent.

### Anti-Money Laundering Program

Under HFTA, all private equity funds, regardless of their size, would be required to establish an anti-money laundering program and report suspicious transactions in order to remain exempt from the provisions of the ICA. The Secretary of the Treasury, in consultation with the Chairpersons of the SEC and the Commodity Futures Trading Commission, would be charged with establishing rules to govern the anti-money laundering programs, but the rules would likely require private equity funds to conduct some sort of due diligence of potential investors and to generate suspicious activity reports in certain circumstances. Many private equity funds have already implemented such programs, so this additional requirement is unlikely to have a significant adverse impact on them.

### Registration As “Investment Advisors” Under the IAA

#### HFTA Requirements

HFTA would not only result in additional regulation of the private equity funds themselves, but it would also subject their advisors to additional regulation. Currently, private equity fund advisors are generally not required to register as “investment advisors” under the IAA if they have fewer than 15 clients, do not hold themselves out to the public as investment advisors, and do not advise registered investment companies. In addition to requiring private equity funds managing assets of at least \$50 million to register under the ICA, advisors to such funds would have to register as “investment advisors” under the IAA. It is unclear whether or not this effect was intended by the sponsors of HFTA. The SEC,

however, previously adopted Rule 203(b)-2 in 2004, which attempted to require private fund advisors to register as “investment advisors” and be subject to SEC regulation by changing the method by which the number of their advisees was calculated. Private equity and venture capital industry groups immediately went into action to block implementation of this Rule, and eventually were successful in having it overturned by the United States Court of Appeals for the District of Columbia Circuit in *Goldstein v. SEC* (2006) 451 F.3d 873. Therefore, it is certainly possible that the sponsors of HFTA intended to subject private equity fund advisors to the IAA as a response to the *Goldstein* case.

If private equity fund advisors are required to register with the SEC, they will likely also have to register with the states in which they do business, if they have not already done so. For example, California does not currently require registration by hedge fund and private equity fund advisors that do business within its borders if the advisor (i) does not hold himself out to the public as an investment advisor; (ii) has fewer than 15 clients; (iii) is exempt from SEC registration by virtue of IAA Section 203(b)(3); and (iv) either manages assets of at least \$25 million or provides investment advice only to venture capital companies. The state’s definition of “client” is borrowed from IAA Rule 203(b), which counts the entire fund as a single investor, rather than counting each investor individually. Thus, if HFTA passes, since private equity fund advisors would no longer qualify for exemption from SEC registration under IAA Section 203(b)(3), they would also no longer qualify for the California exemption and would thus be required to register in California.

If private equity fund advisors are required to register as “investment advisors,” they will be subject to anti-fraud provisions, disclosure obligations, requirements regarding their books and records, restrictions on contractual and fee provisions, advertising restrictions, and a host of other regulations

promulgated by the SEC and potentially by each state in which they operate.

#### **HFARA Requirements**

Like HFTA, HFARA would affect advisors to private equity funds as well as hedge funds. But unlike HFTA’s indirect and patchy approach, HFARA would explicitly eliminate the exemption currently provided to private equity fund advisors by striking Section 203(b)(3) of the IAA, which currently provides an SEC registration exemption to advisors who have fewer than 15 clients, do not hold themselves out to the public as investment advisors, and do not advise registered investment companies. This would result not only in private equity fund advisors being required to register with the SEC, but, as with HFTA, many advisors would also likely be required to register with the states in which they do business. For example, California’s registration exemption specifically requires that advisors be eligible for exemption from SEC registration under Section 203(b)(3). If that exemption is repealed, then advisors in California would be required to register with that state as well.

As discussed above, registration as an “investment advisor” under the IAA would subject private equity fund advisors to anti-fraud provisions, disclosure obligations, requirements regarding their books and records, restrictions on contractual and fee provisions, advertising restrictions, and a host of other regulations promulgated by the SEC and potentially by the states in which they do business.

Most hedge fund managers are already registered as investment advisors with the SEC or with a state counterpart. As a result, they would be less affected by the adoption of HFTA and HFARA than private equity and venture capital fund managers, who are not commonly registered as investment advisors. Private equity and venture capital fund managers are currently not required to disclose the names of their investors, as they would be required to do under HFTA as currently drafted. These new

regulations could have a chilling effect both on the number of people willing to become fund managers and, more importantly, on the number of investors willing to invest in these types of funds, creating another impediment to the availability of capital to start-up companies and many small businesses.

### Tax on Carried Interest

In February 2009, President Obama revived another initiative from years past, announcing that, beginning in 2011, he intends to raise taxes on the “carried interest” earned by private equity funds. Typically the general partner of a private equity fund receives a management fee based on capital committed by investors (commonly one percent of committed capital) and a carried interest based on the profit a fund makes upon the disposition of its investments (commonly 20 percent of profits). The President’s proposal would more than double the tax rate on income that partnerships receive based on profits that they make for their clients, increasing it from the current capital gains tax rate of 15 to 39 percent. The Administration claims that increasing the tax rate on carried interest will generate revenues to the federal government of approximately \$2.7 billion in 2011 and \$4.3 billion in 2012.

Most private equity fund managers are not organizing funds to capitalize on the one percent management fee; rather they are expending considerable time and effort for the possible benefit of receiving the carried interest, a benefit that often depends on the risky business of identifying profitable young companies and is generally subject to hurdle rates, claw-backs, and other reductions. In the end, the value to fund managers that balances the risk is the opportunity to share in a proportion of the capital gains that the other investors are receiving.

The effect of an increase in taxation on the carried interest is as yet unknown. One might expect that there will be fewer private equity funds created, thus reducing the amount of capital available to private

companies in an already trying time. For the funds that do get created, perhaps the higher tax rate will provide the advisors with reason to increase their carried interest percentage rate above the long-held standard 20 percent in order to mitigate the additional taxes they would be required to pay.

### Conclusion

While it is generally difficult to predict whether any of these proposals will become law and, if they do, in what form, it is clear that Congress and the President are primed to take action against an industry they perceive to be at least partially responsible for our nation’s current economic situation. Recent Obama Administration appointees, including the new Chairperson of the SEC and the new Secretary of the Treasury, have testified that they favor additional regulation of private investment funds and their advisors. The uncertainty may be more about the type and extent of regulation that will be imposed on private equity funds and their advisors than whether or not they will remain largely unregulated. It seems quite likely that Congress will decide that one or all of these proposals, in one form or another, will provide the answer they are looking for.

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