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8 Tips For Private Funds With Euro Exposure

Law360, New York (December 20, 2011, 11:49 AM ET) -- The European sovereign debt crisis and possible Euro instability raise a number of operational issues for private investment funds that are Euro-denominated, make Euro-denominated investments or otherwise have significant economic exposure to the Euro. The manager of any private fund with Euro exposure should consider the following:

1) Fund's Denomination and Functional Currency

The manager of a Euro-denominated fund or a fund with Euro-denominated capital contributions, distributions and/or reporting may be most directly impacted by the Euro's current risks and thus should assess its ability to redesignate the fund's functional currency and the numerous related operational implications of doing so.

The manager should also consider:

- whether to amend the fund's partnership agreement either to redenominate its functional currency now or authorize the general partner to redenominated the fund in the future, and
- the alternative currency and conversion ratio that would be most appropriate, as well as the investor approvals, if any, required for such redenomination.

Addressing currency issues in advance of a meltdown situation may mitigate the risks of the uncertain application of various jurisdictions' governing laws as well as investor discord over choice of replacement currency.

2) Adequacy of Risk Disclosures

A private fund manager engaged in fundraising should evaluate the adequacy of its disclosures regarding Euro-related risk, including whether supplemental disclosures should be included in offering materials and other filings, such as the manager's Form ADV, as to, e.g., the potential impact of currency instability or failure on the fund and its portfolio investments, and the cost of efforts to manage those risks.

3) Ability to Engage in Currency Hedging Transactions

A private fund is often permitted to enter into bona fide hedging transactions in connection with the acquisition, holding or disposition of a portfolio investment (but not for speculative purposes).

The manager should review fund agreements to determine if they permit the fund to engage in currency hedging transactions, both in connection with a specific investment and the operation of the fund and if not, whether to amend its agreements to include and/or expand upon such provisions in the governing documents.

Having broad, express authority to engage in currency hedging may provide the fund manager with critical tools for protecting the fund and its investments against foreign currency exchange-rate volatility.

4) Economic Treatment of Currency Hedging Transactions

Amounts paid or losses incurred by a fund in connection with hedging a portfolio investment are often treated as a fund expense with respect to the related portfolio investment, and any resulting distribution is treated as current income from that investment.

The manager should consider how such amounts should be allocated when multiple portfolio investments are hedged through a single currency transaction or program, as well as how any noninvestment-specific hedging transactions are treated.

5) Ability to Engage in Other Currency-Related Transactions

The manager should consider what other currency-related provisions may be prudent or helpful to include in its fund agreements. For example, the manager may find it helpful to include express authorization to exchange any Euros held by the fund into non-Euro currencies and vice versa.

6) Possible Amendments to Fund Agreements

In connection with reviewing and assessing potential changes to currency-related provisions in fund agreements, the manager should be mindful of any required investor and/or advisory board consents, particularly whether any such changes would trigger special consent thresholds applicable to changes affecting investors' capital commitments and/or liability. In connection with this assessment, the sponsor should review related subscription agreements and other ancillary agreements (side letters, advisory agreements, etc.).

7) Assessment of Portfolio Exposure and Fund Counterparty Risk

The manager should consider conducting additional risk assessments or "stress testing" of its investment portfolio to gauge exposure to Euro currency volatility. For some managers, sophisticated currency movement sensitivity analysis may already be a routine part of risk monitoring; for others, enhanced monitoring of these risks may be helpful to better understand and manage Euro exposure, including through hedging and making appropriate risk disclosures to investors.

In connection with this assessment, the manager should also evaluate exposure to European financial institutions, whether in the form of bank deposits, derivatives exposure or otherwise, and may want to consider whether further counterparty diversification would be prudent.

8) Increased Investor Attention

While we are not yet aware of a shift away from Euro-denominated funds — indeed sponsors of Euro-denominated private equity funds have had notable 2011 fundraising success — anecdotal reports indicate that both general partners and limited partners are now spending significantly more time discussing the impact of the macro-economic environment and the European sovereign debt crisis.

Accordingly, a general partner should be prepared to answer questions from investors regarding potential effects of currency movements and risks on the operation of its private funds and the execution of its investment program.

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