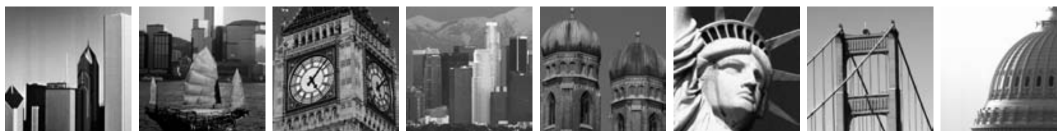
KIRKLAND**PEN**

June 13, 2008



KIRKLAND & ELLIS LLP

Private Equity Newsletter

Treasury Proposes Regulations Implementing Foreign Investment and National Security Act

PENpoints

Proposed regulations clarify the scope, nature and process of national security reviews of investments in U.S. businesses by foreign persons.

In the wake of the firestorm triggered by a Dubai company's acquisition of a U.S. port facilities operator, the Foreign Investment and National Security Act of 2007 ("FINSA") was enacted. On April 23, 2008, the Treasury Department published proposed implementing regulations.

FINSA authorizes the Committee on Foreign Investment in the United States, the interagency committee that conducts national security reviews of foreign investment in U.S. companies ("CFIUS"), to review the national security implications of transactions by or with any "foreign person," which could result in "control" of a "U.S. business" by a "foreign person," particulary for deals involving U.S. "critical infrastructure" (including major energy assets and energy sources and other critical resources and material) and U.S. "critical technologies" (such as export-controlled and nuclear equipment, software, technology and select agents and toxins).

While a CFIUS filing is voluntary,[1] the consequences of not filing could be dire, because the president may unwind a deal if CFIUS later determines that it poses a threat to U.S. national security that has not otherwise been mitigated. As a result, for deals with sensitive national security issues, CFIUS "clearance" is often a contractual condition precedent to closing.

CFIUS reviews must be completed within 30 days, although CFIUS may, and in some circumstances must,[2] initiate an additional 45-day investigation. If a transaction raises national security concerns, then CFIUS (or a lead agency acting on behalf of CFIUS) has the authority to enter into mitigation agreements with the parties or impose conditions on the transaction. If there are no unresolved national security concerns (including as a result of a mitigation agreement or conditions imposed by CFIUS), then a transaction must be cleared at the end of the 30- or 45-day investigation period. Otherwise, the matter is referred to the president, who must make a final determination within 15 days.

Under the proposed regulations, neither a start up or "greenfield" investment in the United States, nor a passive investment resulting in the acquisition by a foreign person of 10 percent or less of a U.S. company's voting securities, is a "covered transaction," subject to increased scrutiny under FINSA.

Perhaps the most significant issue addressed by the proposed regulations is when a prospective transaction results in foreign "control" over a U.S. business. The proposed regulations adopt the long standing approach of defining control as the ability to exercise power, positive or negative (except certain negative rights that protect a minority shareholder's investment expectations), over important matters affecting a business, although they do not provide any bright line test, such as a specified percentage of share ownership or numbers of board seats.

U.S. companies are currently attractive targets for foreign investors, particularly foreign private equity and sovereign wealth funds. While FINSA and the proposed regulations are not likely to chill foreign investment in U.S. businesses, foreign buyers and U.S. private equity funds selling portfolio companies should be keenly conversant with CFIUS and the risks of not making a voluntary notification.

Attorney Advertising

[1] CFIUS may initiate a review unilaterally, but more often the parties to a transaction submit a joint voluntary notice to CFIUS. The proposed regulations expressly encourage the parties to a transaction to contact CFIUS before formally filing and recommend that they "pre-file" a substantially complete draft notice. Furthermore, although Congress plays no direct role in the CFIUS process, it is often a good idea to consult with key members of Congress and officials of the CFIUS agencies likely to have the greatest interest in the transaction, even in advance of a pre-filing.

[2] For example, unless U.S. authorities certify that a transaction will not impair national security, CFIUS must undertake a 45-day review of each "covered transaction" that (1) is a "foreign government controlled transaction" or (2) would result in the control by a foreign person of "critical infrastructure" of the U.S. if CFIUS determines that the transaction could impair national security and such impairment has not been mitigated.

If you have any questions about the matters addressed in this Kirkland PEN article, please contact the following Kirkland authors or your regular Kirkland contact.

Laura L. Fraedrich
lfraedrich@kirkland.com
+1 (202) 879-5990

Daniel J. Gerkin
dgerkin@kirkland.com
+1 (202) 879-5948

Bad News: House Bill Attacks Hedge Fund Fee Arrangements

PENpoints

H.R. 6049 includes a provision eliminating the ability of U.S. hedge fund managers to defer paying tax on compensation from offshore hedge funds.

On May 21, 2008, the House of Representatives passed H.R. 6049, a bill that includes a provision that would eliminate the ability of hedge fund managers to defer paying tax on compensation from offshore hedge funds. The provision is substantially similar to one contained in legislation passed by the House, but ultimately not enacted, in late 2007.

If enacted, the bill would tax on a current basis deferred compensation received from offshore entities that are not subject to U.S. tax or to a comprehensive foreign income tax, with the principal target being offshore hedge funds. Specifically, such compensation would be taxed at the time it "vests," that is, when the service provider's right to receive the compensation is no longer conditioned on his or her future performance of substantial services. The bill would provide a grandfather rule for deferral arrangements attributable to services performed prior to December 31, 2008, which amounts could be deferred until 2017. Under existing deferred compensation rules, elections to defer compensation for services performed in 2008 generally must have been made prior to 2008. The provision is projected to raise approximately $24 billion in tax revenue over 10 years.

Many hedge fund managers have put into place deferred compensation arrangements. Under the typical approach, the hedge fund manager elects to defer its receipt of performance fees and/or management fees otherwise due to it from the offshore hedge fund for a specified period of time, typically five to ten years. During the deferral period, the fees are invested in the fund for the account of the manager. Under current law, the manager is not taxed until the compensation is ultimately paid and hence, assuming positive investment performance, the compensation grows on a pre-tax basis.

The dramatic growth of the hedge fund industry in the United States, currently estimated at more than $1 trillion, has resulted in increased scrutiny by the media and government of hedge fund compensation arrangements, including fee deferrals. A January 2008 report by the Managed Funds Association stated that this issue will be "at the forefront of the 2008 Congressional Agenda," a prediction now confirmed by the House's passage of H.R. 6049.

U.S. hedge fund managers and their tax counsel should consider the impact of this proposed legislation on their hedge fund compensation arrangements.

If you have any questions about the matters addressed in this Kirkland PEN article,
please contact the following Kirkland author or your regular Kirkland contact.

Andrew Wright
awright@kirkland.com
+1 (212) 446-4793

Good News: California Withdraws Proposed Investment Adviser Registration Rules

PENpoints

Investment advisers in California can continue to rely on existing exemptions for registration after a recent decision from the California Commissioner of Corporations.

California investment adviser regulations have exempted from registration an investment adviser with fewer than 15 clients (e.g., the general partner of several private funds) and assets under management of $25 million or more.[1] In September 2007, the California Commissioner of Corporations proposed to repeal this exemption. In May 2008, the Commissioner withdrew the proposed repeal of the exemption.

The proposed repeal of the exemption — purportedly aimed at hedge funds — would have required California registration[2] of investment advisers with a California place of business unless the adviser's clients were limited solely to "venture capital companies," generally defined as companies that control and take management rights in operating companies.

In deciding not to proceed with the proposed rule change, the Commissioner noted that the change was premature in light of comments received during the public comment period, further consideration of the rulemaking action and ongoing actions by federal regulators. As a result, an investment adviser with a California place of business and with assets under management of $25 million or more may continue to rely on the fewer than 15 clients exemption at both the federal and state level.

1 Under the current California regulations, investment advisers with a place of business in California, less than $25 million in assets under management and fewer than 15 clients are exempted from registration in California if they advise only "venture capital companies."

2 SEC investment adviser registration would also have been an option to preempt state (e.g., California) law.

If you have any questions about the matters addressed in this Kirkland PEN article,
please contact the following Kirkland authors or your regular Kirkland contact.

Scott A. Moehrke, P.C.
smoehrke@kirkland.com
+1 (312) 861-2199

Joshua P. O'Donnell
jodonnell@kirkland.com
+1 (312) 861-2159

PENnotes

The Private Equity Real Estate Summit
New York, New York
June 26-27, 2008

The Private Equity Real Estate Summit is a conference dedicated to private equity real estate professionals searching for new opportunities and strategies for fund proliferation in today's markets. Kirkland partner Jennifer M. Morgan will moderate a panel discussion entitled "Strategies for Financing Deals in a Changing Market" while partner Stephen G. Tomlinson will take part in the "Fund Sponsors' Roundtable: Strategies, Opportunities & Smart Plays." In addition, partner Nathaniel M. Marrs will moderate a discussion of "Foreign Market Opportunities."

Los Angeles Venture Association Private Equity Breakfast Series
Los Angeles, California
July 8, 2008

Kirkland partner Damon R. Fisher will moderate a panel at The Los Angeles Venture Association (LAVA) Private Equity Breakfast. LAVA supports the development of emerging growth and middle market companies in Southern California by creating an environment to provide access to financial professional and technological resources.

Kirkland's Annual Advertising & Trademark Law Seminar
Chicago, Illinois
July 15, 2008

Kirkland's annual seminar will highlight current legal developments in the advertising, marketing and promotions law areas. The seminar will be held in Chicago with videoconferencing available to Kirkland's New York and Los Angeles offices.

PLI's Understanding the Securities Law 2008
New York, New York
September 4-5, 2008

Kirkland partner Gerald T. Nowak will discuss the Securities Act, the Exchange Act, the Sarbanes-Oxley Act and related SEC regulations at this conference, which is geared toward practitioners interested in learning about and understanding the securities laws.

Chicago
Kirkland & Ellis LLP
Aon Center
200 East Randolph Drive
Chicago, IL 60601
+1 (312) 861-2000
+1 (312) 861-2200 fax

Hong Kong
Kirkland & Ellis
International LLP
8th Floor, ICBC Tower
3 Garden Road
Central
Hong Kong
+852-3761-3300
+852-3761-3301

London
Kirkland & Ellis
International LLP
30 St Mary Axe
London, EC3A 8AF
United Kingdom
+44 (0)20 7469 2000
+44 (0)20 7469 2001 fax

Los Angeles
Kirkland & Ellis LLP
777 South Figueroa Street
Los Angeles, CA 90017
+1 (213) 680-8400
+1 (213) 680-8500 fax

Munich
Kirkland & Ellis
International LLP
Maximilianstrasse 11
80539 Munich
Germany
+49 (0)89 2030 6000
+49 (0)89 2030 6100 fax

New York
Kirkland & Ellis LLP
Citigroup Center
153 East 53rd Street
New York, NY 10022
+1 (212) 446-4800
+1 (212) 446-4900 fax

San Francisco
Kirkland & Ellis LLP
555 California Street
San Francisco, CA 94104
+1 (415) 439-1400
+1 (415) 439-1500 fax

Washington, D.C.
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
+1 (202) 879-5000
+1 (202) 879-5200 fax

Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms in every major market around the world.

Kirkland has been widely recognized for its preeminent private equity practice. *The Lawyer* magazine recently recognized Kirkland as one of the "Sweet Sixteen" firms in "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In 2008, Kirkland received prestigious first-tier rankings in both private equity and fund formation from Chambers & Partners, and in 2007, Kirkland was named the "International Law Firm of the Year" by *The Lawyer* magazine.

Subscribe to Kirkland PEN

To subscribe to Kirkland PEN, please e-mail kirklandpen@kirkland.com.

This publication is distributed with the understanding that the author, publisher and distributor of this publication and/or any linked publication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this publication may constitute Attorney Advertising. Prior results do not guarantee a similar outcome.

© 2008 KIRKLAND & ELLIS LLP. All rights reserved.

www.kirkland.com