

# PwC alternatives

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## Fair value implementation for alternative investment managers

by Shannon Detling and Sam May

The Financial Accounting Standards Board's (FASB) FAS 157, the fair value measurement reporting standard, was issued in September 2006 and became effective in fiscal years beginning after November 15, 2007. FAS 157 defines fair value, provides guidance on how to apply the definition to measure the fair value of financial and nonfinancial assets and liabilities and requires expanded disclosures about those measurements. FAS 157 implementation is still under way at many alternative investment companies, and some are seeking clarification on how it is to be applied to their operations.

While the requirement to measure investments at fair value is not new, FAS 157 provides a more robust definition of fair value than previously, defining it as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" and explaining how to apply that definition to various fair value measurements.

FAS 157 created a three-level hierarchy for fair value based on the inputs used for measurement. Level 1 consists of values based on quoted prices in active markets for identical assets or liabilities. Level 2 consists of values other than Level 1 for which all significant inputs are observable. Level 3 consists of values based upon significant unobservable inputs.

FAS 157 also requires new disclosures, including valuation techniques used, the level in the fair value hierarchy in which specific measurements fall, and additional disclosures for the assets and liabilities in Level 3, whose measurement is based upon significant unobservable inputs.

### Implementation challenges

Implementing the new standard has been complex for several reasons:

- There is significant subjectivity, because some aspects of fair value measurement are more judgmental and principles-based than previous standards issued by the FASB.
- As a new standard, FAS 157 requires education of staff and, sometimes, external parties such as investors.

- FAS 157 has a pervasive impact on investment companies which measure their investments at fair value.
- Implementation efforts involve a broad cross-section of the organization, including senior management, reporting and operations staff and investment portfolio managers.

## Valuation issues

Some of the issues faced by alternative investment managers are described below.

### Valuation of illiquid investments

FAS 157 assumes an ordinary sale of an asset or transfer of a liability in hypothetical market transaction. This presents valuation challenges for investments which are illiquid and do not trade but rather are bought and held until realized through maturity, call, exercise, settlement, or other market event (such as an IPO). In addition, valuation and thus, implementation efforts, have been further complicated by recent market conditions, especially a reduction in liquidity and price transparency for many fixed-income investments.

### Investments in funds

Questions have arisen about the hypothetical sale of an investment in a fund, including whether the fair value of the investor's interest is represented by its net asset value (NAV) or the reported capital balance of the fund. This question has arisen even in cases in which the investee fund is reporting its NAV using the fair value of the funds assets (as is required under US generally accepted accounting principles). This issue especially affects funds of funds.

Fund investments provide numerous challenges when it comes to fair value measurement. In many cases, there is limited market activity for sales of investments in funds. Many interests in funds have transfer restrictions. Open-end funds may have some activity in the form of subscriptions and redemptions, albeit infrequently in some circumstances. Many closed-end funds, however, have very little activity or secondary trading. In many cases, this secondary trading occurs too infrequently to be a source of ongoing pricing information.

Determining whether an adjustment to a fund's NAV is appropriate and, if so, how to compute the adjustment has been the subject of much discussion. To address this issue, the American Institute of Certified Public

Accountants is considering initiatives to provide high level guidance on factors to consider in coming to a conclusion.

### Transaction price versus fair value

Another area that has been the subject of much discussion is how observed transaction data should be considered in measuring fair value. FAS 157 requires that valuation techniques maximize the use of observable inputs, including transaction data. However, it also suggests that there may be instances in which a transaction price or the price paid to acquire an investment may not represent fair value. Some examples in which this might be the case include when the transaction:

- Is between related parties
- Is a forced transaction or the seller is under duress
- Is just one element of a bundle or group of other assets and liabilities
- Occurs in a different market than the one in which the company would exit the position
- Includes transaction costs, or there is a significant bid/ask difference

This question often arises for firms investing in distressed or unique assets but also may arise in other cases in which there are very few transactions for a particular item. Determining whether these factors are present in a transaction, especially one in which the entity is not involved as a buyer or seller, can be challenging.

### Use of external pricing sources

Companies are refining their valuation processes and scrutinizing the methodologies and inputs used by external pricing sources, such as pricing vendors, broker/dealers, appraisers and valuation firms. Since the accuracy of valuations is the responsibility of management, companies generally need to gain and document this understanding in order to ensure that the valuation used in the company's financial statements complies with FAS 157's definition of fair value and to determine the appropriate level in the fair value hierarchy (Level 1, 2 or 3). Some companies are using additional pricing sources for certain asset classes and increasing oversight of valuations.

Resolution of these issues requires careful consideration given the facts and circumstances of each case. Consistency across companies is likely to increase as implementation efforts continue.

## Potential changes to pricing process

In implementing FAS 157, many companies are considering adjustments to their valuation processes to reflect market participant assumptions for attributes of assets or the market that were not previously considered in the valuation including: restrictions attached to the item; liquidity of the item; and credit or nonperformance risk of a counterparty or company (especially for derivative assets and liabilities).

In addition, some companies have made bid/ask adjustments to reflect where they would transact within the bid/ask spread. Some companies have made changes to their valuation processes to reflect additional market information to comply with the standards' requirement to maximize use of observable market data. Many companies are expanding the use of backtesting in the pricing process.

## Need for stakeholder education

Investment companies should also consider the need to explain to external stakeholders, especially investors, specifically how FAS 157 has affected the valuation process. Companies also should provide additional explanation of the fair value hierarchy and what the hierarchy levels mean. In particular, stakeholders should understand that the hierarchy level does not necessarily indicate the quality of an investment or the quality of management's pricing process. Instead, they should make it clear that the hierarchy level results from the type of investment, the price transparency in the investment and the inputs available in pricing.

The market systems available for different asset classes also affect the hierarchy level. The existence of equity exchanges which give daily closing prices publicly provide more price transparency for public equities than what exists for many fixed-income securities. As a result, equity funds which invest in liquid public equities will generally have more of their investments categorized in Level 1 than a debt fund which invests in private fixed-income securities.

## Looking forward

The impact of fair value reporting and FAS 157 will continue to grow because it not only affects an investment company's financial statements, but also may provide insight into how fair value measurements shape the financial statements of investee companies.

FAS 159, the fair value option, was issued in February 2007 and provides companies with an irrevocable option to measure certain financial assets and liabilities, including their own debt, at fair value in fiscal years beginning after November 15, 2007.

In addition, the FASB is contemplating permitting companies to record certain nonfinancial items at fair value. In the future, other accounting standards may require or permit fair value measurements which can affect analyses of investee companies.

# International financial reporting standards for US investment companies

by Lori Kulok and Tom Romeo

## What are the issues?

Today, more than 100 countries require, permit, or are converging toward International Financial Reporting Standards (IFRS), including the members of the European Union, Australia, Canada, Brazil, India, China and other major capital markets. Nine of the top 10 global capital markets either already employ IFRS or are in the process of converting to them: only the United States continues to employ US Generally Accepted Accounting Principles (US GAAP) as its exclusive accounting and reporting framework.

The US Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) have taken the first steps toward a transition from US GAAP to IFRS. In fact, within the next few years, the SEC is likely to designate a date for mandatory adoption of IFRS by all US public companies, including US investment companies.

An IFRS conversion will present some upheaval and uncertainty as investment managers and the users of their financial statements grapple with the new standard of accounting. IFRS is not only an accounting and reporting matter, but will also affect operations including fund design, marketing and investor relations. Conversions typically take more than one year to complete, and involve not only internal accounting functions but also shareholder servicing, management and vendor contracts, information systems, debtor/lender agreements and tax reporting and compliance. Many people working in these functions for investment companies are not trained in IFRS.

## Background

The shift to IFRS is driven by a confluence of factors, including the globalization of business and finance, the increasing complexity of US GAAP standards, the costs of maintaining and complying with two separate sets of standards by some and the potential for substantial

savings and efficiencies garnered from utilizing a common set of global accounting standards. There is a growing consensus among regulators, standard-setters and leading public companies that IFRS adoption is desirable, and the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have had IFRS-US GAAP convergence projects under way since 2002.

However, progress on convergence has been slow. Although the frameworks and concepts underlying both IFRS and US GAAP are essentially similar, even the few converged standards issued thus far do not offer perfectly identical accounting treatments for all transactions. Numerous, sometimes significant, differences remain between IFRS and US GAAP, adding to the complexity of convergence efforts.

US regulatory bodies are moving ahead to advance adoption of IFRS. The SEC recently eliminated the US GAAP reconciliation requirement for non-US companies listed on US exchanges that use IFRS, and has found stakeholder support for allowing US issuers to report using IFRS as well.

We expect the SEC to issue a proposed rule in 2008 which will provide some or all US issuers with the option to use IFRS as early as 2009. Some observers believe that the SEC ultimately will make the use of IFRS mandatory for US public companies in the 2012–2015 timeframe. Given the relatively short timeframe and the demands associated with IFRS conversion, many companies have already begun to consider a conversion process, identify what resources will be required for adoption and evaluate the impact of conversion on their operations and financial positions. The convergence to IFRS is not solely affecting registered funds. Many offshore hedge funds already report under IFRS and there is increasing demand from investors for hedge funds and other private funds to report under IFRS.

## What is our response?

We believe that adoption of IFRS in the US is inevitable. IFRS has become the *de facto* global accounting language, and the growth of globalization alone will result in a market-driven change to IFRS in the US. Increasingly, investors, exchanges, regulators and counterparties are likely to request or even require IFRS financial statements from US companies, including US investment companies. We do not expect any “carve-out” for investment companies from this conversion movement.

Companies contemplating the conversion should consider taking a “clean sheet of paper” approach and not simply try to force their historical US GAAP policies and procedures to fit into IFRS in order to shortcut the conversion process. This approach allows the company to take advantage of the benefits provided by IFRS principles. Also, conversion project teams should include broad representation from within the company, since new financial reporting principles can affect many aspects of operations. Integrating IFRS principles into operations from the ground up is important since layering IFRS on top of a GAAP system will burden internal controls over financial reporting and increase the risk of reporting errors.

The US GAAP financial reporting model for investment companies is designed to meet the specific needs of fund investors and, importantly, underlies the production of the net asset value of funds that is used to price and trade fund shares in the open market on a daily basis. Much of the US GAAP model was developed specifically from regulatory rules and guidance over time and is codified in the *AICPA Audit and Accounting Guide: Investment Companies*, rather than from FASB pronouncements. IFRS does not provide accounting standards or guidance specific to the investment company industry. Rather, IFRS is principle-based with very limited industry carve-outs or specifics. IFRS guidance would result in different asset and liability measurement and financial statement presentations for investment companies in certain areas, as well as different net asset valuation methods as compared to the Investment Company Act of 1940 (1940 Act). For example:

- IFRS requires the use of bid prices to value securities traded in active markets for financial reporting purposes. This could create a conflict with the values used for processing fund share transactions. FAS 157, *Fair Value Measurements*, and various SEC pronouncements permit the use of other estimates of fair value.
- Shares of open-end investment funds are typically redeemable at the holders’ option, and meet the definition of a financial liability under IFRS, rather than equity under US GAAP. As a result, net assets, traditionally defined as the value of assets minus liabilities, could be zero, impacting

numerous contract terms (such as the calculation of management fees).

- The consolidation principles of IAS 27, *Consolidated and Separate Financial Statements*, and SIC Interpretation 12, *Consolidation—Special-Purpose Entities*, require reporting entities to consolidate entities, including noninvestment company entities, that they control. Control is presumed to exist if the fund has more than half of the voting power of another entity. Thus, a feeder fund would be required to consolidate the master fund if it owns a majority of the master fund’s voting shares. Additionally, entities such as Business Development Companies (BDCs) or private equity funds owning greater than 50% of an operating company would be required to consolidate the operating company. Depending on the circumstances, these consolidations may not be required, or may even be prohibited under US GAAP.

In addition to these significant differences, IFRS requires additional data regarding comparative risk disclosures, including sensitivity analyses. This two-year data historically has not been captured by fund complexes. Investment companies will need to consider data availability and the adequacy of their current systems. Additionally, investment companies need to review their inventory of offering documents and agreements (such as prospectus, statement of additional information, management agreements and other contracts) to determine the need for revisions in connection with the conversion to IFRS.

One thing which has become clear: the switch to IFRS is not simply an accounting exercise that can be tackled at financial year-end. Most IFRS conversions will take longer than initially expected. A key to success is starting early, before the investment company faces externally imposed deadlines, thereby allowing a systematic, methodical assessment and implementation.

## What does this mean?

Decades of increasing complexity in US GAAP threaten to make it a competitive disadvantage for US capital markets. While IFRS is no silver bullet, adoption of IFRS by US companies is expected to help address this issue. US investment companies currently reporting under US GAAP generally are viewing the conversion to IFRS as an onerous undertaking without significant payback. However, based on our experience in other territories, the conversion to IFRS is very manageable if properly planned with sufficient lead-time. Additionally, IFRS will have benefits for US investment companies and investors, including a high-quality, principles-based framework, greater transparency for the economics

of transactions, fewer rules and fewer exceptions, increased simplicity of application and the ability to exercise more professional judgment. Most significantly, IFRS will provide a common global platform that has the opportunity for further improvement.

Investment company management and their agents should monitor IFRS and US GAAP developments, in particular the SEC's pronouncements, and make their voices heard in the ongoing industry debates. They also should begin to identify the implications of a shift to IFRS, identify financial reporting, operating, treasury and tax systems, processes and contracts that may require modification and determine what resources will be required for a successful conversion. Training in IFRS should be considered early on for personnel affected by this conversion. As the demand from investors for IFRS reporting increases, hedge funds and other private funds may have to accelerate their conversion process.

# Higher preparer penalty standards: what clients can expect for tax returns filed in 2008

by Rochelle Hodes

A taxpayer's role in the tax system is different than that of the tax return preparer. The taxpayer's role is to accurately report its tax liability, whereas the preparer's role is to assist taxpayers in fulfilling that obligation. The system recognizes that, ultimately, the liability for tax and the decisions relating to reporting the tax liability rest solely with the taxpayer. However, both the preparer and the taxpayer are bound by separate, but related, standards of accuracy in tax return reporting. These standards are embedded in civil accuracy-related penalties: Section 6662 for taxpayers and Section 6694 for preparers.

Section 6694 was amended in 2007 to impose a higher level of accuracy on the preparer than on the taxpayer. Before the change, the law imposed a higher level of accuracy on the taxpayer than on the preparer. By shifting this paradigm and requiring a higher level of accuracy for the preparer, the new law created a potential conflict of interest between preparers and their clients. The government quickly responded to concerns about this potential conflict and issued interim guidance on preparer disclosure that significantly reduced the potential for these issues to arise. This article describes the disclosure rules in the interim guidance and explains what clients should expect from preparers with respect to returns and claims for refund that will be filed in 2008. (This article does not address proposed preparer penalty regulations issued in June 2008 that would generally apply to tax returns and claims for refund filed *after* December 31, 2008.)

## Section 6694 preparer penalty

Section 6694 of the Internal Revenue Code imposes a penalty on tax return preparers for understating a taxpayer's liability. Section 7701(a) (36) generally defines a preparer as any person who prepares for compensation, or who employs one or more persons to prepare for compensation, a return of tax or claim for refund. The preparation of a substantial portion of a return or claim for refund is treated as preparation for this purpose. There may be multiple preparers with respect to a single return or claim for refund and both the individual preparer

and the preparer's employer/firm can be subject to the Section 6694 penalty with respect to the same return or claim for refund. In addition, not all preparers sign the return. Generally, those who do and who have primary responsibility for the overall substantive accuracy of the preparation of the return are called "signing preparers," while other preparers are called "nonsigning preparers."

## 2007 amendment of Section 6694

With passage of the US Troop Readiness, Veteran's Care, Katrina Recovery and Iraq Accountability Appropriations Act of 2007, Section 6694 was amended to raise the standard for undisclosed positions from the "realistic possibility of success" standard, which is generally a one-in-three likelihood of success if challenged by the IRS, to "a reasonable belief that the position would more likely than not be sustained on the merits." "More likely than not" generally means that the likelihood of success if challenged by the IRS is greater than 50 percent. The Act also extended the penalty, originally applicable only to income tax, to all taxes, raised the standard for disclosed positions from the "not frivolous" (rather than "patently improper") standard to the higher "reasonable basis" standard, and raised the penalty amounts.

These changes were effective for returns prepared after the Act's passage on May 25, 2007. However, the Treasury Department and the IRS provided transition relief so that the amendments made by the Act generally apply to tax returns filed after December 31, 2007 (January 31, 2007 in the case of excise and employment taxes). In Notice 2008-13, the Treasury and the IRS provided interim guidance on these provisions effective for returns and claims for refund filed after 2007 (interim guidance).

## Section 6662 taxpayer penalty

Section 6662 imposes a penalty on taxpayers for underpayment of tax. Except in the case of tax shelters, the taxpayer standard for undisclosed positions is

“substantial authority” and the standard for disclosed positions is “reasonable basis.” In the case of tax shelters, taxpayers can avoid the penalty only if the position taken with respect to the tax shelter item satisfies the “more likely than not” standard and has “substantial authority.” Section 6662(d)(2)(C)(ii) defines a tax shelter as a partnership, entity, plan or arrangement with a significant purpose of avoidance or evasion of Federal income tax. Thus, the taxpayer standards under Section 6662 are lower than the preparer standards under Section 6694. This difference creates a potential for conflict of interest between the taxpayer and the preparer. The government reduced the potential for such conflicts in interim guidance which, among other things, sets forth rules for preparers to satisfy disclosure under Section 6694 in light of taxpayer disclosure rules under Section 6662.

### Adequate disclosure under the interim guidance

The interim guidance provides the method for preparers to satisfy the preparer’s disclosure obligations under Section 6694. The guidance sets forth different rules for signing and nonsigning preparers, which are described below.

Proposed regulations that will affect returns filed after 2008 were published in June 2008. These regulations are expected to be published as final regulations by the end of 2008, to be effective for returns filed in 2009 and later years. If these regulations are finalized as proposed, the rules regarding adequate disclosure will be similar to the rules announced in the interim guidance.

### Non-tax shelter positions

#### Signing preparers

In non-tax shelter cases, a signing preparer satisfies the adequate disclosure requirements for a position that is not supported by substantial authority if the position has at least a reasonable basis and is disclosed on Form 8275, Form 8275-R, or in accordance with the annual revenue procedure.

If a non-tax shelter position has at least substantial authority, a signing preparer has made adequate disclosure if the preparer advises the client about the differences between the taxpayer and the preparer penalty standards and the preparer contemporaneously documents this advice.

#### Nonsigning preparer

In non-tax shelter cases, a nonsigning preparer satisfies the adequate disclosure requirements for a position that is not supported by substantial authority if the position has at least a reasonable basis and the nonsigning preparer advises the taxpayer about penalty exposure and the opportunity to avoid penalty through disclosure.

This penalty advice must be provided to the client in the same manner, whether oral or written, as the underlying substantive advice. In other words, if the nonsigning preparer is providing written return preparation advice and the position is not supported by substantial authority (but there is a reasonable basis for the position), the preparer also must provide the taxpayer with written advice regarding the taxpayer’s penalty exposure and the opportunity to avoid penalty through disclosure. If a nonsigning preparer provides advice on a non-tax shelter position that is supported by substantial authority, a statement to the taxpayer would not be required for the preparer to satisfy adequate disclosure under the interim guidance because the taxpayer does not have penalty exposure.

### Tax shelter positions

In tax shelter cases, no amount of disclosure will assist a taxpayer in avoiding the Section 6662 penalty. Therefore, the interim guidance provides that the preparer will satisfy disclosure in this case if the preparer informs the taxpayer about the taxpayer’s penalty exposure and the preparer contemporaneously documents this communication. If the preparer is a nonsigning preparer, this penalty advice must be provided to the client in the same manner, whether oral or written, as the underlying substantive advice.

### Conclusion

The interim guidance’s formulation of the preparer disclosure requirements is intended to resolve the conflict between the preparer and the client where a position does not meet the “more likely than not” standard. Without the interim guidance, a conflict could arise if the preparer is required to disclose a position to avoid penalty under Section 6694, but the client does not benefit from the disclosure (either because the position is not subject to penalty under Section 6662 or, in the case of tax shelters, because no amount of disclosure would protect the taxpayer from penalty under Section 6662).

These rules encourage a dialogue between preparers and their clients regarding the likelihood that a position will prevail in the event of a challenge by the IRS and the potential penalties that may apply. Clients should expect preparers to discuss ways for them to avoid penalties through disclosure and the differences between the client’s disclosure rules and the preparer’s disclosure rules. Clients also should expect preparers to document these matters and to provide this documentation to them in certain cases.

Discussion around the appropriate amount of disclosure and the penalty standards will continue, in the context of the new preparer penalty regulations. Practitioners and their clients also should keep a close eye on Congress to see

what changes may occur with regard to penalty standards. However, for returns filed in 2008, the interim guidance provides certainty around the applicable standards.

## Comparison of adequate disclosure for 2008 filing season


### An analysis of interim §6694 guidance in Notice 2008-13

		Taxpayer		Preparer		
		Non-tax shelter	Tax shelter <sup>†</sup>	Non-tax shelter	Tax shelter <sup>†</sup>	
% level of confidence	90%	Will (at least 90%)				
	70%	Should (at least 70%)				
		More likely than not (at least >50%)				
	>50%	Substantial authority (at least 40%)			Disclosure is adequate if: <ul style="list-style-type: none"> <li>• <b>Signing preparer:</b> Preparer advises taxpayer that the position has substantial authority and that preparer has a disclosure obligation and preparer contemporaneously documents this advice in the preparer's file.</li> <li>• <b>Nonsigning preparer:</b> No statement to the taxpayer or disclosure is required. PwC will document the position in its files.</li> </ul>	Disclosure is adequate if: <ul style="list-style-type: none"> <li>• <b>Signing preparer:</b> Preparer advises taxpayer of penalty exposure and preparer contemporaneously documents this advice in the preparer's file.</li> <li>• <b>Nonsigning preparer:</b> The preparer advises the taxpayer of penalty exposure. The penalty advice must be provided in the same manner (oral or written) as the underlying substantive advice. PwC will document its advice in its files.</li> </ul>
	40%	Realistic possibility of success (at least 33%)	Disclosure is adequate if: Form 8275 or Form 8275-R attached to return or claim, or if made on return or claim in accordance with annual revenue procedure.		Disclosure is adequate if: <ul style="list-style-type: none"> <li>• <b>Signing preparer:</b> Preparer provides taxpayer with Form 8275 or Form 8275-R, even if taxpayer ultimately chooses not to attach it to the return or claim.</li> <li>• <b>Nonsigning preparer:</b> The preparer advises the taxpayer about penalty exposure and how to avoid the penalty through disclosure. The penalty advice must be provided in the same manner (oral or written) as the underlying substantive advice. PwC will document its advice in its files.</li> </ul>	Same as above.
	33%	Reasonable basis (at least 15%)	Same as above.		Same as above.	Same as above.
	15%	Non-frivolous (at least 10%)				
	10%	Frivolous (below 10%)				
	0%					

<sup>†</sup>A tax shelter is any entity, plan, or arrangement with a significant purpose of avoidance or evasion of federal income tax. A taxpayer may avoid penalty only if: 1) there is substantial authority for the position and 2) it is more likely than not to prevail.

 = No disclosure required

 = No penalty if disclosure

 = Penalty even with disclosure

# Finance readiness and effectiveness for the alternative asset manager

by Michael Savelloni

Despite volatile markets, alternative asset managers in the US continue to explore initial public offerings (IPO). These IPOs are bringing a new dimension to the industry, together with new challenges and increasing demands on finance departments.

Launching an IPO brings a number of new requirements, including compliance with SEC reporting requirements. The quarterly 10-Q and annual 10-K require financial statements (e.g., balance sheet, income statement, statement of shareholder equity and cash flow) and management's discussion and analysis of the entity's financial condition and results from operations. The SEC requirements and ongoing reporting also require public companies to submit this information by a specific date from the end of the reporting cycle. For example, the 10-Q may be 45 days from the end of the quarter, but this time period could be shorter if and when the company is deemed to be an accelerated filer.

Adding the SEC and public entity reporting requirements on a quarterly and annual basis will require finance departments to do more while keeping pace with the continued growth of assets under management.

The following provides some guidance on how to ease the burden on finance departments by defining the challenges while an IPO is under consideration and providing recommendations on how to alleviate constraints. Many of these actions also are relevant for fast-growing managers who are not planning IPOs but may want to improve their finance operations.

## Challenges for the finance department due to an IPO

Some of the challenges an alternative asset manager's finance organization will face while an IPO is under way include:

- Assigning new roles and responsibilities for staff due to new public entity reporting and process requirements;
- Documenting and preparing for Sarbanes-Oxley compliance;
- Defining, designing, and implementing repeatable processes which incorporate "must meet" due dates, such as the quarterly SEC 10-Q filing;
- Meeting and delivering on new management reporting requests as well as financial planning, analysis, and budgeting requirements; and
- Managing and securing high-quality financial data for analysis and reporting.

## Additional contributing factors

A number of factors contribute to the challenges faced by alternative asset managers when they decide to launch an IPO:

- Fund managers and controllers previously may have been focused on net asset value (NAV) reporting to investors and assisting with "managing the book and risks" with traders and risk managers; however, after an IPO, they will have to deal with the processes required to produce financial statements which include an income statement, balance sheet, cash flow, disclosures and footnotes;
- Technology investments may have been focused more toward trading and investment analysis applications than general ledger applications and business performance management applications;
- Significant growth in the alternative sector has outpaced firms' abilities to hire finance, accounting and tax staff;

- The growth in assets under management (AUM) and complexity of deal structures and funds have increased the complexity and tasks required to complete the financial close; and
- The pace of new instruments, investors and funds has made establishing repeatable, automated processes for the monthly, quarterly and annual financial close cycles a challenge for finance departments.

## Finance focus areas

How can the finance departments of alternative asset managers prepare for an IPO? What activities can fast-growing alternative asset managers who are not planning an IPO do to implement and enhance controls, automation and efficiency?

Bringing focus and resources to bear on the following areas can improve the effectiveness of the alternative asset manager's finance department while also providing significant value to managers in achieving their IPO objectives. Tasks include:

- Document each finance and tax staff member's role and responsibilities and confirm these definitions with each individual;
- Consider upgrading the manager's general ledger and other supporting finance and tax applications while reviewing these applications against the manager's growth plan for the next two to three years;
- Assess the various business performance reporting applications, or enterprise reporting and analysis applications, to facilitate meeting management, regulatory and SEC reporting requirements within a public company structure;
- Seek out process automation opportunities by reviewing manual workarounds within the financial close process and standalone spreadsheets that can be migrated to the general ledger or other finance applications;
- Establish and document formal financial close processes, calendars and owners to enhance efficiency, effectiveness and communication;
- Document the preparer, reviewer and approver when establishing financial closing process and procedures to facilitate upcoming Sarbanes-Oxley requirements; and
- Document data definitions whenever possible to assist with the overall financial data model in order to facilitate scaling operations and ongoing financial reporting.

## Conclusion

Finance effectiveness and efficiency has become an important issue in the alternative asset management industry due to the dynamic growth in AUM as well as the IPO initiatives planned or currently under way.

Alternative investment managers can make the path to IPO, regulatory reporting and compliance more efficient by focusing on a handful of key activities. These include defining the roles and responsibilities for the finance staff, focusing on process automation and leveraging existing IT applications, streamlining the financial close process, and eliminating stand-alone spreadsheets whenever possible. Regardless of whether or not an IPO is pursued, an asset manager will derive considerable benefit from these steps.

# FAS 161: new disclosure requirements for derivative instruments and hedging activities

by Josh Klavan

The Financial Accounting Standards Board (FASB) has been focused on improving the transparency and usefulness of financial statements. In March 2008, FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. The new standard, commonly referred to as FAS 161, amends FAS 133, *Accounting for Derivative Instruments and Hedging Activities*.

A derivative instrument, as defined by FAS 133, is generally a financial instrument or contract that has one or more underlyings, notional amounts and/or payment provisions, that requires little or no initial net investment and that requires or permits net settlement.

FAS 161 is intended to address concerns that current derivative disclosures do not provide adequate information about the impact these instruments can have on an entity's financial position, results of operations and cash flows. FAS 161 enhances derivative disclosures to explain, among other things, why and how these instruments are used.

Effective for interim and annual reporting periods beginning after November 15, 2008 and applicable to all entities that issue or hold derivative instruments, FAS 161 requires qualitative disclosures about the objectives and strategies for using derivatives.

The new guidance distinguishes between instruments used to manage risk and those used for other purposes. By providing disclosures based upon each instrument's primary underlying risk (e.g., interest rate risk, credit risk, foreign exchange rate risk), users of financial statements will benefit from greater transparency about how and why entities use derivatives to manage their risks. FAS 161 encourages, but does not require, additional qualitative disclosures of all risk exposures, even those not managed through the use of derivative instruments.

Historically, most alternative investment funds have disclosed their objectives for using derivatives and the strategies they employ to achieve those objectives. Alternative investment fund managers may choose

to enhance the quality of their current disclosures by reorganizing the disclosures by risk and providing greater detail as to how their derivative investments manage those risks.

Under FAS 161, entities are required to disclose information that would enable users of their financial statements to understand their volume of derivative activity. Principles-based disclosure permits entities to select the most appropriate form of disclosure for their own circumstances, so alternative investment funds with significant derivative portfolios will need to analyze their activity and determine what information would best meet the disclosure objective. Investment managers and advisors also will need to maintain systems to ensure timely recording of volume-related information in sufficient detail to enable the preparation of the disclosure in a timely fashion.

To assist the users of financial statements in assessing the impact derivative instruments can have on an entity's financial position, results of operations and cash flows, FAS 161 requires specific tabular disclosures that detail the fair value amounts of derivatives and where they are reported on the balance sheet, as well as the amount of derivative gains and losses and where they are reported on the income statement. These disclosure tables were developed primarily to improve the transparency of the financial statements of entities that use derivatives as hedging instruments under FAS 133.

Under FAS 133, the gains or losses on certain hedges appear minimally or not at all on the income statement if the hedges are effective or the gains or losses are presented in "other comprehensive income," depending on the type of hedge. To enhance the usefulness of the financial statements, two tabular disclosures are required that identify the specific fair value and gains and losses from derivative instruments.

Alternative investment funds currently present the fair values and gains and losses on derivative instruments in the financial statements. The new disclosure requirements call for specific fair value and gain/loss information by

type of derivative instrument on a gross basis. Although entities may have a policy to net certain derivative contracts under FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39), on the balance sheet and income statement, all information included in the table will be presented gross. As a best practice in financial statements, alternative investment funds can reconcile amounts disclosed within the footnotes to the amounts netted under FIN 39.

For the purposes of alternative investment funds, the most significant new required disclosure is of information about the existence and nature of credit risk-related contingent features in derivative instruments. Funds are now required to disclose the existence, nature and fair value of such features, such as a material adverse change clause or a payment acceleration clause, and the circumstances in which the features could be triggered in derivative instruments that are in a net liability position.

Additional required disclosures include the aggregate fair value of assets that are already posted as collateral at the end of the reporting period, of additional assets that would be required to be posted as collateral, and of assets needed to settle the instrument immediately, if the contingent features were triggered.

Alternative investment funds that have a large volume of derivative activity may wish to identify and track credit risk-related contingency features in all of their derivative instruments that currently are, or could eventually become, a net liability. This can reduce the effort needed to prepare the information at the end of each period, and thus reduce operational difficulties in meeting interim reporting timeframes, should a market movement change a derivative instrument from a net asset to a net liability position.

Although not effective for most alternative investment funds until 2009, FAS 161 will have a significant impact on the way these entities report and track their derivative investments. Their managers should begin to evaluate their implementation of the FAS 161 disclosure requirements so they can be made in a timely, accurate and efficient manner.

This article draws upon materials from FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*, and FASB meeting minutes. This article presents a number of disclosure requirements described in FAS 161. For a complete listing of all the disclosure requirements, readers are encouraged to review the standard.

# IRS issues first guidance on carbon trading

by Matthew Haskins

In a recent edition of *PwC alternatives* [<http://www.pwc.com/images/us/eng/fs/im/alt/MC-NY-08-0712-Alt-Haskins-FIN.pdf>], we analyzed tax issues presented by trading in European Union-issued carbon emissions allowances and other forms of carbon credits. We noted that there was no Internal Revenue Service (IRS) guidance on the treatment of carbon credits under either Subpart F or the US “trading safe harbor” of Section 864(b)(2).

On June 20, 2008, the IRS issued its first private letter ruling on those issues. In PLR 200825009, the IRS considered a situation in which a taxpayer’s European Union affiliate was granted allowances under the European Union Emissions Trading Scheme and sold off its surplus allowances (those not needed to cover its own emissions). The IRS ruled that the taxpayer need not treat the income from those sales as current Subpart F inclusions on the grounds that the allowances were as “intangible property held for use in a trade or business” rather than property held to generate passive income.

The ruling also noted, however, that the IRS is currently studying whether it may be appropriate to treat emissions allowances as commodities, leaving open the possibility that they may be so characterized either under Subpart F or other provisions of the Code. Commodities treatment would be beneficial to investors who wish to trade carbon credits in the US under the trading safe harbor.

With increased attention to the European Union’s carbon markets and the possibility that similar markets will develop in the US, we anticipate increasing interest from both industrial companies and investors in carbon trading and continuing efforts to clarify the application of other tax rules, such as the trading safe harbor, to carbon trading.

by Puneet Arora, Punit Shah and Oscar Teunissen

The past few years have seen explosive growth in emerging markets, including India, with opportunities for alternative investment funds to generate significant returns. Notwithstanding the fact that India remains a complex, high tax jurisdiction, funds continue to invest heavily in its economy.

Indian regulators have been busy rationalizing the tax and regulatory framework to keep pace with the changes in the global economy. The Securities and Exchange Board of India, which regulates markets, has been continuously updating regulations to provide a sound foundation for investing in India.

On the treaty front, the Indian government is reevaluating some favorable treaties, which they feel result in tax leakage.

Despite the fact that many major investment firms invest in India in some way, the dynamic business environment remains an enigma for companies wishing to do business there. This article summarizes and simplifies some of the key developments that could affect investments in India.

## Income tax developments

### The Vodafone case

The Indian revenue authorities have been taking action on cross-border transactions which they believe affect revenues that rightfully belong to the Indian government. This has resulted in their seeking to tax transactions involving the transfer of shares of an Indian company several tiers up, rather than at the immediate holding level.

In the case of British-based telecommunications company Vodafone plc, the Indian revenue authorities have attempted to tax profits generated outside India on the transfer of shares by one nonresident to another on the grounds that the underlying asset is the “controlling interest” in the Indian company.

Under Indian tax law, any payment to a nonresident which is taxable in India is subject to withholding of tax by the payer (buyer of shares). The authorities therefore have issued a notice regarding Vodafone’s alleged failure to withhold tax on payments made to the seller of shares.

Vodafone, for its part, has filed a writ petition in the Bombay High Court challenging the right of the Indian tax authorities to levy capital gains tax on transfer of shares outside India of a foreign company by one nonresident to another nonresident. The matter is currently pending adjudication before the Bombay High Court. In a related vein, the Indian revenue authorities are aggressively investigating M&A deals involving the transfer of underlying interest in Indian companies and have proceeded to issue notices to several multinational companies in similar situations.

### Overseas derivative instruments

Trading in Indian public securities requires registration in India as a Foreign Institutional Investor. However, investors who may not qualify for registration or view registration as onerous may still want to take positions in the Indian equity markets. Historically, this has been done by using overseas derivative instruments such as participatory notes (P-Notes). P-Notes are over-the-counter products issued by funds registered as Foreign Institutional Investors to investors who are not themselves registered in India. As transactions in P-Notes are entered into outside India, they were not subject to tax within India (while Indian domestic law provides specific guidance on the taxation of American Depository Receipts and Global Depository Receipts, the tax treatment in India of P-Notes is not clearly discussed).

The Indian tax authorities have recently issued notices to various Foreign Institutional Investors requesting that they provide details of their P-Note transactions. The authorities have been trying to draw an analogy for taxation of P-Notes from the Vodafone case by arguing that the underlying assets being traded are the securities of an Indian company.

In the event that Vodafone is not able to defend its case before the Bombay High Court and the tax authorities successfully apply the analogy to the taxation of P-Notes, it could have adverse implications for P-Note holders as well as Foreign Institutional Investors issuing P-Notes.

Given these developments, funds should be prepared to consider alternative routes for their Indian investments.

### Change in rate of short-term capital gains tax

Capital gains realized on the sale of short-term assets (including shares held for 12 months or less) are taxed at a concessional rate, provided the sale is over a recognized Indian stock exchange and the transaction has been subject to the Securities Transaction Tax.

The Indian Budget 2008-09 (which received Presidential assent on May 10, 2008) has increased the effective tax rate in the case of foreign corporations/corporate Foreign Institutional Investors (with taxable income over INR 10 million) from 10.56 percent to 15.84 percent. Similarly, for noncorporations/noncorporate Foreign Institutional Investors, the effective tax rate in cases in which taxable income exceeds INR 1 million has been increased from 11.33 percent to 16.995 percent.

The new rates are effective from April 1, 2008.

### Characterization of income—business profits vs. capital gains

The characterization of income generated by a Foreign Institutional Investor from trading in India is still under debate.

Income characterized as business income should in principle be subject to 42.23 percent tax on a net basis under Indian domestic law. However, if the Foreign Institutional Investor is eligible for treaty benefits, the right to tax business income is allocated to India only if the Foreign Institutional Investor has a permanent establishment in India or is considered to have its place of effective management in India.

In the alternative, capital gains could be subject to tax in India unless the Foreign Institutional Investor has made its investment through a treaty jurisdiction so as to obtain capital gains exemption.

The Indian Authority for Advance Rulings has rendered conflicting decisions on this matter, treating the income as business profits in one case and as capital gains in another. Subsequently, the Indian tax authorities issued a circular setting forth guidelines to determine whether the income should be treated as business income or capital gains. The circular, however, has not been conclusive and merely reiterates the guidelines which have been followed in the past for the characterization of income.

Structuring investments in India assumes significance in light of these developments to ensure that the Foreign Institutional Investor is adequately protected.

### Dividend distribution tax

Unlike most jurisdictions, India levies a dividend distribution tax on Indian companies declaring or distributing dividends. This results in the dividends being tax-free in India in the hands of the shareholders.

The US Internal Revenue Service has not issued guidance on whether the dividend distribution tax will qualify as a foreign tax credit. Given that this is a tax levied at the Indian company level, the possibility of treating it as an indirect tax credit for the purpose of claiming Section 902 credit could be considered. There is also a possibility of obtaining reduced rates of tax as qualified dividend income treatment subject to meeting the requirements for such treatment (as set out in Listed Notice 2006-101).

### Indian tax treaty update

Historically, investments in India have been structured through Mauritius and Cyprus in order to leverage the beneficial tax treaties that India has with these countries. However, the Indian government has been actively pursuing renegotiation of these treaties to introduce a limitation of benefits clause.

### Cyprus

India and Cyprus initiated renegotiation of their tax treaty some months ago.

Press reports suggest that the renegotiated treaty is likely to introduce a clause seeking to tax gains from the sale of shares of a company in the country where the company is resident. Cyprus has not yet accepted this proposal and it could be difficult for Cyprus to do so as long as other treaties exist which give taxing rights only to the country of residence of the seller.

Given that the proposed amendment is likely to significantly affect the structuring of both inbound as well as outbound investments, Cypriot structures may have to be revisited if the proposal is approved. The treaty has yet to be ratified by either country.

### Mauritius

Historically, Mauritius has been the most popular jurisdiction for investments in India, primarily on account of the favorable capital gains treatment offered by the treaty and potentially lower thresholds for permanent establishment.

However, the treaty has been undergoing scrutiny for some time now over alleged misuse of the capital gains exemption. Analysts argue that foreign companies obtain

Mauritius tax residency without adequate substance and apply the beneficial treaty provisions. While Mauritius has sought to tighten its regulations in the last few years, the Indian government may seek to renegotiate the treaty to include provisions such as a limitation of benefits clause.

### Luxembourg

India recently signed a tax treaty with Luxembourg which provides for a 10 percent withholding tax rate on interest, royalties and fees for technical services. Capital gains arising on sale of shares of a company will be taxed in the country in which the company whose shares are being sold is located. The treaty also contains a limitation of benefits clause to disentitle treaty benefits in cases where the main purpose of the structure was to obtain the treaty benefit.

### Regulatory developments

The Securities and Exchange Board of India (SEBI) issued a press release in October 2007 specifying certain policy measures relating to registration of Foreign Institutional Investors, issuance of P-Notes by such investors or subaccounts and the nature of measures to be implemented relating to participation of foreign entities in Indian markets. The key proposals included:

- i. Foreign Institutional Investors and subaccounts were barred from issuing or renewing overseas derivative instruments (P-Notes) with underlying assets as derivatives. However, there was no bar on renewal of such contracts, provided the renewal did not exceed 18 months. Current positions were required to be wound up over 18 months (i.e., by March 2009).
- ii. Subaccounts of Foreign Institutional Investors were prohibited from a further issuance of overseas derivative instruments. Subaccount applicants transitioning to register as Foreign Institutional Investors would be treated as if they held that status as of September 30, 2007, the date decided for calculation of assets under custody. Current positions were required to be wound up over 18 months (i.e., by March 2009).
- iii. Foreign Institutional Investors currently issuing overseas derivative instruments with the notional value of P-Notes outstanding (excluding derivatives) at less than 40 percent of their assets under custody in India would be allowed to issue further overseas derivative instruments only at the incremental rate of 5 percent per annum of their assets under custody in India. SEBI has clarified that assets under custody has been defined to mean the market value of the position held as of a particular date. One unanswered question

is whether derivatives would be included within the ambit of assets under custody. The effective date for calculation of the assets under custody for purposes of determining the notional value of P-Notes issued as a percentage of assets under custody is decided as of September 30, 2007.

- iv. Foreign Institutional Investors with the notional value of P-Notes outstanding (excluding derivatives) at more than 40 percent of their assets under custody could issue P-Notes only against the cancellation, redemption or closing out of existing P-Notes of at least an equivalent amount.
- v. Overseas derivative instruments or P-Notes could be issued only to “regulated entities” rather than “registered entities.”

These policy measures were incorporated in the SEBI regulations issued on May 22, 2008.

The SEBI has in the new regulations also clarified persons who may be regarded as “regulated entities” for the purpose of issuance of P-Notes. They are:

- i. Any person who is regulated, supervised and licensed or registered by a foreign central bank;
- ii. Any person who is registered and regulated by a securities or futures regulator in any foreign country or state; and
- iii. Any broad-based fund or foreign portfolio or proprietary fund of a registered Foreign Institutional Investor or university fund, endowment, foundation, charitable trust or charitable societies whose investments are managed by a person covered by the first two clauses above.

The Indian markets provide an enormous opportunity for significant capital appreciation and gains for investors willing to invest in India. While the regulatory and tax environment that investors face has been simplified, the rapid developments in this area require understanding and careful planning to harness the true potential of the opportunity in India.

# New Technical Practice Aids for investment companies

by Stewart Luedke

The American Institute of Certified Public Accountants (AICPA) recently issued four new Technical Practice Aids (TPAs) affecting financial reporting issues for investment companies. TPAs 6910.25 -.28, which are discussed below, address cash flow presentation issues, presentation of deferred management and incentive fees and the presentation of financial highlights for nonregistered unitized funds.

The TPAs do not have a stated effective date, and the guidance in these TPAs should be considered for financial statements that have not yet been issued.

## **TPA 6910.25: Considerations in evaluating whether certain liabilities constitute “debt” for purposes of assessing whether an investment company must present a statement of cash flows**

Financial Accounting Standards Board (FASB) Statement No. 102 (FAS 102), *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale, an amendment of FASB Statement No. 95*, provides investment companies with an exemption from the requirement to include a statement of cash flows in their financial statements based on whether certain criteria are met. One of those criteria is that the fund must have had “little or no debt, based on the average debt outstanding during the period, in relation to average total assets.”

FAS 102 generally excludes covered options written from classification as debt for purposes of meeting the criteria, but does not address whether other transactions such as uncovered options, short sales and reverse repurchase agreements should be treated as debt.

The TPA provides some clarification to this debt classification issue, and states that classification depends on the nature of the transaction activity. Securities classified as fund liabilities which represent financing transactions, such as the receipt of cash on margin, reverse repurchase

agreements, securities lending or other credit facilities, would be considered debt for purposes of evaluating the criteria in FAS 102, unless the proceeds are invested in cash or cash equivalents.

Other trades or transactions, such as short sales of securities and other derivative transactions, would not be considered debt so long as the form and intent of the transaction represents an investment and not a financing transaction. Certain securities, such as custom basket and total return swaps and long-term warehouse agreements, may be executed for both trading and leverage purposes. For securities such as these, management should consider whether the structure of these transactions is based largely on financing considerations.

It is important to note that the qualifications for exemption from the inclusion of a statement of cash flows in the financial statements should be considered at each reporting period. Investment managers considering excluding a statement of cash flows because they have met the criteria in this TPA should reflect on their intent to enter into future financing transactions which would require the inclusion of a statement of cash flows in the financial statements at that time. As this TPA provides fund management with the option to exclude a statement of cash flows, management may decide to continue to include a statement of cash flows for consistency of presentation in future periods.

## **TPA 6910.26: Additional guidance on determinants of net vs. gross presentation of securities purchases and sales/maturities in the statement of cash flows of a nonregistered investment company**

This TPA addresses under what circumstances a nonregistered investment company can net purchases and sales/maturities of securities in the statement of cash flows. Registered investment companies are excluded from the provisions of this TPA.

The AICPA Audit and Accounting Guide, *Investment Companies* (the Guide), requires that cash flows from operations should separately include purchases of long-term investments, sales of long-term investments and net purchases/sales of short-term investments. Technical Information Service 6910.20 added further clarity by requiring nonregistered investment partnerships to present cash flows from purchases and sales of securities on a gross basis for investments with no stated maturity or with maturities greater than one year.

However, the AICPA noted that paragraph 8 of FAS 102 permits certain financial institutions, such as banks, broker/dealers and “other enterprises that carry trading securities,” to net purchases and sales from such trading securities in the statement of cash flows.

In this TPA, the AICPA has concluded that, if a nonregistered investment company is required to include a statement of cash flows under FAS 102, the trading style, investment objectives and portfolio turnover of the fund will be the primary determinants of net versus gross reporting. If a nonregistered investment company’s overall strategy and activity is consistent with trading, as discussed in FAS 102 and FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, then netting purchases and sales in the statement of cash flows would be permissible.

However, it is important to note that nonregistered investment companies qualifying for and choosing to net purchases and sales in the statement of cash flows should continue to segregate the net activity of transactions for long positions from transactions for short positions.

The qualifications for netting purchases and sales should be considered at each reporting period. Managers of nonregistered investment companies considering the option to net purchases and sales based on this guidance need to review issues such as the fund’s future investment strategy and whether changes, such as future investments in illiquid securities, could force management to revert to gross presentation of purchases and sales in subsequent reporting periods.

### TPA 6910.27: Treatment of deferred fees

This TPA addresses the presentation in the financial statements, including related disclosures, of deferred management and incentive fees for investment companies domiciled in offshore jurisdictions.

The governing documents for offshore investment funds have often included provisions that permit investment advisers to elect to defer payment of their management fee and/or incentive fees earned from the fund. Under a

fee deferral arrangement, funds retain the deferred fee balance and are obligated to pay the investment adviser the deferred fees in cash at a later date adjusted for the fund’s appreciation or depreciation over the period, as provided for in the governing documents.

In practice, the presentation of deferred management and incentive fees in the financial statements and the related disclosures has varied. The implementation of this TPA by offshore funds with deferred fees will result in consistent presentation and disclosure of deferred fee arrangements in the financial statements.

In this TPA, the AICPA has concluded that funds with such agreements should record the cumulative deferred fees and the associated unrealized appreciation or depreciation resulting from the return on the fund as a liability titled “deferred incentive fees payable” on the statement of assets and liabilities.

The appreciation or depreciation related to the deferred fees should be recorded in the statement of operations as an expense (net appreciation on deferred fees) or, conversely, a negative expense (net depreciation on deferred fees) of the fund. The appreciation or depreciation on the deferred fees should be presented separately from the management fee or incentive fee incurred in the current period.

Additionally, the fund should disclose the key terms of the deferred fee arrangement, including the priority of claim in the event of liquidation preferences, the current and cumulative amounts deferred, the cumulative net appreciation or depreciation on the deferred fees, the date that the deferred fees are required to be paid and the allocation of net appreciation or depreciation on the cumulative deferred fees.

Below is an example of a roll-forward of deferred management and/or incentive fees payable that should be considered for inclusion in the notes to financial statements:

Deferred fees payable as of January 1, 2008	\$1,000,000
Appreciation on deferred fees for the year	100,000
Management/incentive fees deferred for the year ended December 31, 2008	2,000,000
Deferred management/incentive fees paid during the year	(500,000)
Deferred fees payable at December 31, 2008	<u>\$2,600,000</u>

The AICPA also concluded that the financial highlights data, including the per share information, and the net

investment income and net expense ratios, should be presented including the impact of the deferred fee amount, and the related expense resulting from the net appreciation or depreciation on the deferred fees. However, in order to reflect the effect of the adjustment on the fund's expense ratio, the fund also may present an expense ratio that excludes the amount of deferred fee expense or negative expense.

In practice, the financial highlights would include an additional line in the expense ratios section for the percentage of net appreciation/depreciation on the deferred incentive fees. The following table provides an example of an expense ratio disclosure:

Expenses excluding incentive fees	1.20%
Incentive fees	1.40
Total expenses	<u>2.60</u>
Change in net appreciation on deferred fees	<u>(0.35)</u>
Total expenses excluding change in net appreciation on deferred fees	<u>2.25%</u>
Net investment income	<u>3.50%</u>

**TPA 6910.28: Reporting financial highlights, net asset value (NAV) per share, shares outstanding, and share transactions when investors in unitized nonregistered funds are issued individual classes or series of shares**

This TPA addresses how a nonregistered investment fund with a unitized structure that issues a separate series of shares to each individual investor should present its financial highlights (per share data, ratios and total return), and how share transactions for each series of shares should be disclosed in the financial statements.

It is important to note that the provisions of this TPA will not affect unitized funds that have net asset values consistent across an entire class or series within a class.

A nonregistered investment fund organized in a unitized structure may issue, in accordance with its governing documents, a separate series of shares unique to each individual investor, which are not periodically “rolled up” into a single series or class of shares. In such cases, each investor’s series of shares remains outstanding until that investor fully redeems those shares. As a result, each investor will have a net asset value per share that may be different from other series in the same class; however, each series of shares may have the same allocation and participation rights as other series in the same class. This method of recording share transactions is functionally similar to partnership accounting.

**Presentation of the financial highlights**

The issuance of a separate series of shares unique to each individual investor permits a nonregistered investment fund to allocate net investment income and realized and unrealized appreciation or depreciation to each investor similar to the allocation to an individual partner’s capital account in a limited partnership.

Statement of Position (SOP) 03-4, *Reporting Financial Highlights and Schedules of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2 (SOP 03-4)*, requires that each permanent series of a class of shares be presented separately in the financial highlights. If each investor has a separate series of shares with a unique net asset value, reporting the financial highlights for each outstanding series of shares could result in financial highlights being presented for every investor in the fund.

The AICPA staff concluded that the financial highlights should be presented in the aggregate for the entire permanent series of shares. Additionally, the financial highlights should be similar to the financial highlights applicable to a nonregistered investment partnership. As a result, the ratios to average net assets and total return would be presented, but per share data would not be included.

Since the issuance of SOP 03-4, the calculation and presentation of the financial highlights for unitized funds that follow partnership accounting has been diverse in actual practice, especially with regard to the net asset value per share disclosures. Some funds have disclosed the information based on a representative shareholder, some have disclosed the information based on an average for the entire class and others have based it on a theoretical shareholder assuming a new investment at the beginning of the year. This TPA provides for a consistent presentation of the financial highlights, and related disclosures, for unitized funds that follow partnership accounting.

The TPA also states that it is acceptable for such a nonregistered unitized fund to present supplemental financial highlights for a single series of shares that management determines to be “representative” for its class. If a representative series of shares is used, management should select a series that has been outstanding the entire year, and that has a fee arrangement that is similar to the majority of the investors in that class of shares. The basis of calculation and presentation of the financial highlights, including the criteria used to select the representative series of shares, should be disclosed in the financial highlights.

## Presentation of share transactions and total shares outstanding

The Guide requires disclosure of the type, par value, authorized shares, net asset value per share and total shares outstanding for each class of shares. The Guide also requires disclosure for each permanent class of shares of the number and value of shares issued and redeemed, shares issued in reinvestment of distributions, shares reacquired by the fund and the net change in shares outstanding. For funds which issue a separate series of shares to each individual investor, these share transactions and amounts should be disclosed on an aggregate level for each permanent class of shares from which the individual series of shares have been issued.

PricewaterhouseCoopers is committed to helping our clients, including both investors in alternative products and fund managers, understand how this new guidance will be interpreted and applied in practice.

Specific advice and assistance may be sought from your PricewaterhouseCoopers engagement team or from any of the partners in our Alternative Investment Funds Group.

To view AICPA TPA 6910.25 -.28, Investment Company TPAs, visit [www.aicpa.org/download/acctstd/TIS6910\\_25\\_28.pdf](http://www.aicpa.org/download/acctstd/TIS6910_25_28.pdf)

# Private equity funds investing in public credit markets: key compliance considerations

by Kent Knudson

## Introduction

Seeking to take advantage of turmoil in the credit markets, a number of private equity managers have started distressed debt funds. One estimate is that \$20 billion raised over the past year awaits investment in distressed debt, mortgage, bank loan and other credit funds. The opportunities exist: The pool of distressed debt, consisting of issues paying more than 10 percent above US Treasuries, has grown to \$200 billion, compared to just \$11 billion last year. In an ironic twist, some private equity managers are purchasing corporate bonds and bank debt used to finance the purchase of the very companies whose equity they own—and that poses a significant compliance issue.

A key consideration in such arrangements is the potential for misuse of material nonpublic information which could provide a private equity manager with key financial, operational or management insight that is not yet public and may provide an advantage when trading in credit and debt securities related to a privately held company.

This article describes general compliance considerations, but it is not a substitute for proper legal advice. Investors and financial services firms should consult with their legal advisors regarding US securities and insider trading laws.

## Credit markets are subject to insider trading law

Some have argued that, because corporate officers and directors do not owe a fiduciary duty to debt holders, insider trading in these securities cannot be construed as unlawful. The fact that most enforcement cases involve equities trading may have encouraged this thinking. Regardless of theoretical legal arguments, the SEC's enforcement history makes this a perilous position to take.

For example, in 2007 the SEC settled a case against an asset manager who traded corporate bonds using

information learned as a member of various creditor committees. In addition, the SEC said the following regarding certain credit derivatives:

“Credit default swaps that involve terms similar to credit default options, but that are otherwise excluded from the definition of security because they are qualifying swap agreements, remain subject to the Commission's antifraud jurisdiction (including authority over insider trading)...”

Participants in US financial markets should have no doubt that the SEC can bring enforcement cases related to insider trading in debt securities, just as it can in equities trading.

## Private equity managers may be privy to nonpublic information

As a result of large private equity deals and generous credit and lending terms between 2004 and 2007, some private equity portfolios now hold companies whose bonds and bank debt may trade publicly or are subject to privately negotiated sales between institutions. For example, some banks are now securitizing and selling the loans that they made to private equity funds which were used by the funds to make leveraged private equity investments. In some cases, private equity managers are even purchasing from these banks, at a discount, the very loans that were made to their funds.

Private equity holders often have access to information beyond that which a company has disclosed publicly as part of its bond issues and other borrowings. This includes information such as current financial conditions and prospects, recent business plans, detailed management projections, financing alternatives and proprietary analyses. Indeed, private equity managers may have started distressed debt funds precisely to capture value in the publicly-traded securities of companies that they own, know and believe in.

Because private equity managers may have material nonpublic information related to issuers in their portfolios, they must implement information controls (i.e., so-called “Chinese Walls”) and/or related policies and procedures to avoid entering into securities transactions based on that information.

This will be a key concern as private equity firms begin to manage new funds focused on debt issued by companies in their portfolios. Essentially, these firms may have to consider themselves to be in the same position as officers, directors and employees of operating companies who are restricted from trading securities issued by their company just prior to earnings announcements and other material disclosures regarding corporate finances and operations.

## Compliance issues

What should private equity managers do if they have invested or plan to invest in credit securities of issuers whose equity they privately own? Like all securities market participants, they can best protect the interests of their investors and prevent the misuse of material nonpublic information by establishing information walls between those tasked with trading and executing in public securities and those who may possess nonpublic information as a result of researching or managing investments.

These information walls and related policies and procedures should be tailored to each firm’s conditions and operations. Private equity managers also should establish “need to know” policies to control and limit sharing of information within the firm. Finally, they should use controls around a restricted list and a watch list to restrict or monitor trading in securities of issuers for which the firm holds material nonpublic information.

## Questions private equity managers should be asking

- Do we invest in debt and credit instruments of issuers whose private equity we own?
- If so, do we have material nonpublic information (MNPI) regarding those issuers as a result of our private equity ownership?
- If we have MNPI, what are the basic policies, procedures and controls to ensure that we are not misusing that information in our purchase and sale of debt and credit instruments related to our private equity portfolio companies?
- If we are relying on information walls between the public and private sides of our investment management activities, how do we know those walls are working effectively?

- What controls are in place to enforce restricted lists and watch lists to prohibit or monitor trading in issuers for whom we have MNPI? Have we tested our trading records against those lists?
- Have we fully disclosed to our investors, regulators and the markets our policies and procedures related to MNPI?
- Have we considered and disclosed how we will handle potential conflicts between our clients if one fund owns debt and another fund owns equity of an issuer that becomes distressed or enters bankruptcy?
- Is there adequate training provided to employees on protocol that must be followed if they become privy to MNPI?

Distressed debt, mortgage, bank loan and other credit securities offer an excellent opportunity for private equity managers to diversify their investments in volatile equity markets and benefit from the expertise gained in owning companies. However, given the wide array of holdings included in many private equity portfolios, it is crucial that managers ensure that there is no misuse of material nonpublic information. Establishing appropriate policies, procedures and controls and educating staff will ensure that private equity managers can serve their investors without making improper use of nonpublic information.

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