

PwC *Alternatives**

insights for the private equity
and hedge fund communities

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*connectedthinking

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Welcome to the first edition of *PwC Alternatives*!

In our continuing efforts to provide value to you and your business, we introduce *PwC Alternatives*—our quarterly publication specifically written for the hedge fund and private equity fund industries. Each issue of *PwC Alternatives* will provide you with insightful, thought-provoking articles on issues affecting the industry—and what that means to fund advisors.

Kicking off the New Year with this publication couldn't be more timely. Our industry is rapidly growing and becoming more complicated with greater accounting, tax and regulatory challenges—and 2005 should prove to be another challenging year. In fact, participants in our recently completed Risk Management and Valuation Practices survey indicated that:

- There will be an increasing demand to improve returns, both on an absolute and risk adjusted basis;
- Many funds will expand into new products and add additional investment strategies;
- Funds will be forced to improve controls and compliance procedures in response to upcoming regulatory demands; and
- Funds will need to strengthen their back office and technology infrastructures to keep pace with pressure from numerous constituencies, including investors, regulators, asset allocators, and let's not forget, the accounting and taxing authorities.

In addition to thought-provoking articles, each issue will contain The PwC Pulse – your opportunity to anonymously tell us your thoughts on emerging issues impacting your business. The survey results will be featured in the next edition of *PwC Alternatives*. Look for The PwC Pulse on page eight to offer us your views.

In addition, the electronic version of this newsletter features a link to PwC's Knowledge Center www.pwc.com/alternatives, where you will find a wealth of industry-specific information, including topical publications, white papers, hot topics and event details.

PricewaterhouseCoopers is committed to consistently bring seminars, newsletters, surveys and other demonstrations of thought leadership to assist you in navigating through the challenging times that will continue to lie ahead. With our global reach and local presence, we believe we are well connected to help you interpret the constant developments that shape your industry. As always, we invite you to contact us with your questions and concerns.

Sincerely,



Anthony Artabane



Mark Casella



Will Taggart

PRICEWATERHOUSECOOPERS 

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PwC's 4th Annual Private Investment Funds Accounting, Tax and Regulatory Seminar Series

A look back & what lies ahead—Are you ready?



On December 2, 2004, PricewaterhouseCoopers kicked off its 4th Annual Private Investment Funds Accounting, Tax and Regulatory Seminar series in New York City. The New York Seminar was the first of seven seminars held throughout the country, with a cumulative registration approaching 1,500 clients and friends. These seminars are designed to provide timely and thought-provoking commentary on the issues we think are most relevant for hedge funds and private equity funds with respect to accounting, tax and regulatory matters.

This year's New York Seminar featured Dan Quayle, the 44th Vice President of the United States and the current Chairman of our client, Cerberus Global Investments, LLC. Mr. Quayle delivered our first keynote address, which included an interesting discussion on the current political environment. In addition, Mr. Quayle provided his views on matters affecting the private investment fund industry.

The entire program provided information on a variety of accounting, tax, and regulatory developments, and our perspectives on how these matters may affect private investment funds. We opened by saying that “the veil had clearly been lifted on an industry that had enjoyed relative anonymity for quite some time.”

We started by looking back on the many challenges you faced in 2004, which included (1) the so-called issue of “institutionalization”; (2) growing concern regarding “retailization”; (3) concerns regarding valuation practices; (4) the challenges of globalization, and; (5) issues surrounding conflicts of interests and the demand for greater transparency. Despite these challenges, we expect the industry to continue to grow at a robust pace and have a dramatic impact upon the broader capital markets.

At the same time, as the private investment fund industry becomes further “institutionalized”, it will need to adapt to new requirements emanating from investors, regulators, accounting and tax rule makers, and the business community. We are convinced that fund managers will have to transition into a new culture—moving from the entrepreneurial environment that many of you created, to a more “corporate style” operating environment. ■

For more information on upcoming events, visit our website at <http://www.pwc.com/alternatives>

Alternative investment funds: Deferred compensation legislative update

Maureen Renick and Tien Bruno

On October 22, 2004, the President signed The American Jobs Creation Act of 2004 ("Act"). While many provisions of the Act affect managers and investors of alternative investment funds, the rules relating to deferred compensation plans are of particular interest. These new provisions apply not only to the fee arrangements between a manager and an offshore fund, but also apply to many other arrangements where services are provided at one time, and compensation is paid at another. While the rules are generally effective for amounts deferred in years after December 31, 2004, there are transition rules, which could result in retroactive application of these new rules.

The transition rules and interim guidance are generally more favorable to the hedge fund industry than had been expected. There are several caveats, however, which create a general unease for taxpayers especially related to the 2005 elections. These caveats are (1) immediate taxation on *vested amounts deferred* if the requirements of the new law are not met, plus an additional 20% tax on the *amounts deferred*, (2) possible interest and penalties, and (3) a significant number of unanswered questions and ambiguities in the new law.

On December 20, 2004, the Treasury issued Notice 2005-1 (the "Notice"), which for the first time, provided guidance in this area. This Notice provides liberal transition relief for 2005 and also a "good faith" exception for addressing the many unanswered questions. Of particular importance in the Notice are:

- An ability to elect out of a deferral election prior to December 31, 2005, if the Act applies to the taxpayer
- Extending the deadline for the deferral election until March 15, 2005, in certain circumstances for taxpayers with plans in place on December 31, 2004
- Limiting the applicability of the Act, by providing it does not apply to management companies that are engaged in the trade or business of providing "substantial services" and, which provide those services to two or more parties who are "unrelated".

Generally, unless the new rules are followed, all vested amounts deferred under a nonqualified deferred compensation plan that are subject to the new law (i.e., deferrals after December 31, 2004) are currently taxable to the service provider, unless the amounts were previously taxable. The Act imposes stringent restrictions on when distributions can be made, and how and when deferral elections are to be completed. These general requirements are as follows:

- Distributions - may only be made at the following times:
 - Separation from service, disability, or death of the service provider; *It is unclear whether these extend to partners of the management company or back-to-back arrangements with employees.*
 - A time or schedule specified in the deferral election or the deferred compensation plan, which must be at a specific time, not based on an event.
 - A "change of control"- *This provision is unlikely to apply as it involves change in control of the payor/fund, not the management company.*
 - Unforeseeable emergencies (Severe financial hardships resulting from an illness or accident or other similar extraordinary event.) Distributions are limited to the amount needed to satisfy the emergency, plus taxes resulting from the distribution. *Practically, it may be difficult to accelerate distributions, since the amounts must first be reduced by insurance proceeds or by liquidation of other assets.*
- Elections
 - Initial elections must be made before the year in which the services are provided (e.g., by December 31, 2004 for a 2005 compensation plan).
 - *In the past, many participants who deferred management fees made quarterly elections. Those elections should now be made on an annual basis.*
 - *For taxpayers who are certain that they are subject to the new law and will be throughout 2005, the 2005 election may be made by March 15, 2005, as long as the deferred fee agreement, between the management company and the offshore fund, is in place prior to December 31, 2004.*

- Elections may be made within 30 days of an employee's eligibility to participate in the plan.
- To the extent that the deferred compensation is based solely on performance for at least 12 months, the election must be made six months prior to the end of the performance period (a plan which provides for deferral of both management and incentive fees may not qualify under this test).
- Subsequent deferral elections (1) must be for a minimum of 5 years (2) must be made more than 12 months prior to the first scheduled payment date under the prior election, and (3) the plan must provide for the ability to re-defer. *We understand that Treasury is contemplating an interpretation of the re-deferral provision, which would only allow pay out at the conclusion of the specified period, and would limit distributions under some of the other statutory events (e.g., if a subsequent election is made, and the employee separates from service during the 5 year additional deferral period, the employee may have to wait until the end of the 5 year period for a distribution).*

One further limitation in the Act is that assets may not be set aside offshore in a trust "or other arrangement determined by the Secretary." For those funds which used an offshore trust mechanism, this limitation presents an issue. For those funds that did not, it is unclear whether the Secretary will determine that the mere retention of the assets supporting the deferral in the offshore fund will trip this limitation. Even more troubling is a technical corrections bill, which was proposed in the last Congress and is expected to be reintroduced. The bill would make this specific limitation retroactive to assets placed in offshore trusts prior to January 1, 2005, unless the parties unwind the trust within a short period of time.

In order to comply with the Act, existing deferral arrangements that do not comply with the above requirements must be amended or terminated by December 31, 2005. Deferrals prior to December 31, 2004, and the earnings thereon, are not subject to the new rules, with one major exception. If a plan was in effect prior to October 3, 2004, and was materially modified on or after that date, then the new rules are applicable. The Notice provides that a modification of a plan is a material modification, if a benefit or a right existing as of October 3, 2004 is enhanced or a new benefit or right is added (e.g., acceleration of vesting or adding a right to a distribution upon an unforeseeable emergency if the plan did not previously provide for such distributions). The amendment of a plan to comply with the Act will not be treated as a material modification to the pre-2005 plan provisions.

The Act further provides reporting requirements where deferred amounts must be reported on Form W-2 or Form 1099 for the year deferred, even if the amounts are not currently includible in income. Such amounts are subject to Federal income tax withholding requirements when includible in income.

The Act has created a considerable amount of concern for hedge fund managers, due to the significant ambiguities, the 20% penalty, and the possibility of creating a retroactive effect. Taxpayers should approach any plan modification very carefully. In addition, all compensation plans, not just the offshore fund fee deferral, should be reexamined to assure compliance with the new rules. Finally, this Act only addresses federal income tax issues. Taxpayers should also consult their attorneys to assure that their plans allow for use of some of the more liberalizing provisions provided by the Treasury (e.g., revocation during 2005). ■



SEC adopts rule on registration of certain hedge fund advisers

Ludmila Mendez

Rule 203(b) (3)-2, which was adopted by the SEC on October 26, 2004, requires most private fund advisers to register with the Commission. Advisers must consider the number of investors in their funds, rather than the number of funds, to determine whether they are eligible for the exemption from registration available to advisers with 14 or fewer clients. Advisers to private funds in which a registered fund invests (i.e. a fund of hedge funds) must go one step further and count the investors in the registered fund as clients. Advisers who are no longer eligible for the exemption will have to register with the SEC by February 1, 2006.

The new registration requirements will give the SEC jurisdiction over many more hedge fund advisers, allowing the SEC greater access to information on advisers' operations. All registered investment advisers ("RIAs") are subject to examinations by SEC staff and must comply with the provisions of the Investment Advisers Act ("the Act"). Following is a summary of major provisions of the rule:

Definition of a "private fund"

The rule defines "private fund" as (1) one that would be an investment company but for the exceptions in Section 3(c) (1) or 3(c) (7) of the Investment Company Act; (2) permits investors to redeem their interests within two years of purchase; and (3) is offered based on the investment advisory skills, ability or expertise of the investment adviser.

The definition specifically exempts advisers to offshore publicly offered funds that (1) have their principal office and place of business outside the U.S.; (2) make a public offering of their securities outside the U.S.; and (3) are regulated as a public investment company under the laws of a country other than the U.S.

The two-year redemption test applies to each interest in the private fund and can be applied on a first in first out, or FIFO, basis. However, this requirement does not apply to interests acquired with reinvested dividends or to private equity and venture capital funds that allow redemptions under extraordinary circumstances.

Effect on performance-based fees

RIAs to private funds may charge performance-based fees to new investors only if they meet the standards of rule 205-3, which allows performance-based fees only for "qualified clients" (investors with a net worth of at least \$1.5 million or at least \$750,000 of assets under management with the adviser). The rule allows existing investors that are not "qualified clients" to retain their interest in that private fund

and to add to that account. However, it does not give them an exemption to open new accounts in that or other hedge funds.

Financial statements and required books and records

RIAs to funds of hedge funds will be able to satisfy their requirement to deliver audited financial statements within 180 days of their fiscal year end, instead of the requirement that they be delivered within 120 days of their fiscal year end.

Rule 204-2, which lists books and records requirements for all RIAs, will be amended to provide an exemption from the performance recordkeeping requirements for newly RIAs to private funds. Such RIAs will be required to retain whatever records they have that support the performance prior to their registration but will be excused from the recordkeeping rule to the extent that the records do not meet the requirements at the time of registration.

Code of ethics and compliance programs

RIAs are subject to rule 204A-1, which requires the adoption of a Code of Ethics tailored to the RIAs' business. The Code should state a standard of business conduct that the RIA requires of its employees and address personal securities trading and the protection of material non-public information.

RIAs are also subject to rule 206-4(7), which require the adoption of comprehensive policies and procedures and the appointment of a Chief Compliance Officer ("CCO"). Effective policies and procedures should be designed to prevent, detect, and correct violations. They should be tailored to the firm and provide for supervisory escalation of unresolved issues. The CCO must be knowledgeable of the federal securities laws

and the products and services offered by the firm. The CCO must also be independent and empowered with full responsibility and authority to develop and enforce a compliance program. SEC examiners will look to the CCO as an ally that will be expected to inform them of significant compliance violations.

Applicability to offshore advisers to private funds

The rule does not require advisers to offshore funds that have U.S. investors to “look through” the fund for any purposes under the Act, other than (1) the anti-fraud provisions and (2) determining the availability of the private adviser exemption. The release included a

reminder that U.S. advisers to private funds should not try to use the exception to evade the requirements of the Act by establishing a shell subsidiary in a foreign country to manage offshore hedge funds. Why? Because, under Section 208(d), advisers are prohibited from doing indirectly that which they cannot do directly.

For more information, please see IA Release No. 2333 (Dec. 2, 2004) available at www.sec.gov/rules/final.shtml. ■

The fair valuation debate continues

William Yip

Years of debate over the fair valuation practices of financial and non-financial assets and liabilities by accountants, valuation specialists, and investment professionals prompted the Financial Accounting Standards Board (the “FASB”) and the American Institute of Certified Public Accountants (the “AICPA”) to release an Exposure Draft, *Fair Value Measurements* (the “Exposure Draft”) and a Practice Aid, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the “Practice Aid”), respectively.

The Exposure Draft provides guidance on how to measure *fair value* for both financial and non-financial assets and liabilities that are measured at fair value under other authoritative accounting pronouncements. The FASB initiated this project, in part, to address the differences in guidance that have created inconsistencies in the measurement of fair value and ultimately added to the complexity of financial reporting in accordance with generally accepted accounting principles. In response, the FASB developed a framework to further refine the fair value measurement objectives and its application under other pronouncements.

Likewise, the Practice Aid, which focuses on the valuation of privately-held-company equity securities, sets objectives which include the identification and encouragement of best practices in valuation. This guidance supplements recently released auditing guidance provided separately by SAS 101.

While the FASB’s response to comments on the Exposure Draft may result in further revisions, the implementation of these pronouncements may ultimately require participants in the alternative investment industry to revisit their policies and procedures with respect to the valuation of privately-held securities.

If adopted, the Exposure Draft and Practice Aid, which are described in greater detail below, could potentially impact or influence the application of securities pricing and the valuation of privately held securities. Upon becoming an official Statement of Financial Accounting Standard, the Exposure Draft will be the authoritative pronouncement on the subject of fair value measurement, while the Practice Aid will provide supplementary guidance on the valuation of privately held securities.

Exposure draft, *Fair Value Measurement*—highlights

The Exposure Draft focuses on the application of fair value measurements and expanded disclosure requirements. The Exposure Draft defines fair value as “the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties.”

If the Exposure Draft is adopted as proposed, it would require:

- “...the fair value of financial instruments traded in active dealer, markets where bid and asked prices are more readily and regularly available than closing prices, be estimated using bid prices for long positions

(assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions.”

- “...the fair value of restricted securities (securities for which sale is legally restricted by governmental or contractual requirements for a specified period) be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction.”
- “...in the absence of quoted prices for identical or similar assets or liabilities, fair value be estimated using multiple valuation techniques consistent with the market approach, income approach, and cost approach, whenever the information necessary to apply those techniques is available without undue cost and effort.”

The Exposure Draft emphasizes the use of relevant market inputs in the valuation techniques and the assumptions that marketplace participants would use in their estimates of fair value. The FASB’s proposed “Fair Value Hierarchy” is summarized as follows:

- **Level 1 estimates**—“Fair value shall be estimated using quoted prices for identical assets or liabilities in active reference markets, whenever that information is available. Quoted prices used for a Level 1 estimate shall not be adjusted.”
- **Level 2 estimates**—“If quoted prices for identical assets or liabilities in active markets are not available, fair value shall be estimated using quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences, whenever that information is available.”
- **Level 3 estimates**—“If quoted prices for identical or similar assets or liabilities in active markets are not available, or if differences between similar assets or liabilities are not objectively determinable, fair value shall be estimated using *multiple valuation techniques* consistent with the market approach, income, approach, and cost approach, whenever the information necessary to apply those techniques is available, without undue cost and effort.”

The objective of the Exposure Draft is to establish a framework for the consistent application of fair value measurement, which would ultimately lead to improved financial reporting. It would also require expanded disclosures regarding the application of fair value measurements and the use of related inputs, in order to assist readers in assessing those measurements used.

If adopted as released, the Exposure Draft would be effective for financial statements issued for fiscal years beginning after June 15, 2005.

AICPA Practice Aid Project, Valuation of Privately-Held-Company Equity Securities Issued as Compensation—highlights

The Practice Aid provides guidance on the valuation of privately-held-company equity securities issued as compensation. Of particular relevance is the establishment of criteria and approaches that could be used to value private securities. The Practice Aid addresses the following four areas:

1. General valuation methodologies
2. Valuation of Preferred vs. Common stock
3. Impact of IPO process on valuation
4. Accounting and disclosures

General valuation methodologies

The Project’s first working group recommends three different approaches to determining fair value:

1. **Market approach** — requires using comparable or “guideline” companies in the valuation process
2. **Income approach** — emphasis is made on the use of the discounted cash flow or “DCF” approach
3. **Asset-based approach** — the value of a company is equal to the fair value of the assets less the fair value of the liabilities

The selection and application of a valuation approach should consider factors such as the “life cycle stage” of a company (i.e., seed, beta, and expansion), milestones achieved by a company, members of management and board of directors, barriers to entry, and other competitive forces.

In the absence of observable market prices for similar investments, the Practice Aid discusses the “Hierarchy of Valuation Alternatives” and

recommends that a contemporaneous (i.e., at or around the grant date for stock-based compensation) valuation, by an unrelated valuation specialist, be made if a determination of fair value is to be made. The Practice Aid refers to this as **Level A**. The Practice Aid also highlights two additional valuation alternatives:

Level B Retrospective valuation by an unrelated valuation specialist

Level C Contemporaneous or retrospective valuation by related-party valuation specialist.

Valuation of Preferred vs. Common stock

The next working group focused on the valuation of preferred vs. Common stock, and discusses the impact of preferred stock rights in the valuation process (i.e., economic rights and control rights) and recommends the use of a Bottom-up and/or Top-down approach for valuing and quantifying various preferred stock rights. The Bottom-up approach utilizes the pricing of recent instruments to derive the value of another class of equity. The Top-down approach requires the valuation specialist to establish fair value, at the enterprise level, and allocate value among the various equity classes.

Impact of IPO process on valuation

The focus of the next working group was to assess the effect of the IPO process on the valuation approaches recommended by the first working group. For example, under a market valuation approach, a discount for lack of marketability is typically applied to adjust for valuation differences between a public company and a private company. Under an income valuation approach, using traditional DCF analysis, the discount rate or weighted average cost of capital must incorporate an appropriate risk adjustment.

Accounting and disclosures

The last working group focused on developing recommendations for disclosure and valuation reporting guidelines for privately held companies, focusing on greater transparency and ultimately encouraging the Level A approach of contemporaneous valuations performed by an unrelated valuation specialist.

The release of the Exposure Draft and the Practice Aid, is a reflection of the increasing focus regulators and investors are placing on the fair valuation of investment portfolios. Fund managers should stay alert to future developments and review their current practices in light of these changes. ■

Sources:

Proposed Statement of Financial Accounting Standards, Fair Value Measurements, 2004, FASB
Valuation of Privately-Held-Company Equity Securities Issued as Compensation, 2004 AICPA

PwC's latest Risk Management and Valuation Survey results are here!

This year's survey includes responses from 68 firms who manage over \$225 billion, range in size from \$50 million to \$10 billion, and encompasses a wide range of investment strategies.

To learn about the different approaches used to address the evolving requirements for consistency and reliability in:

- Governance and organization
- Valuation and financial risk management
- Operational risk management
- Regulatory and legal risk
- Disclosure and reporting

be sure to visit:

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What do you think?
Take the PwC Pulse!

Do you agree with the SEC's decision to register hedge funds?

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Look for results in the next issue of **PwC Alternatives!**

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