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New Accounting Treatment For FSA-Regulated LLPs *by Peter Draper*

Anyone operating their business through a limited liability partnership (LLP) may have received mailshots recently from the accountancy firms, trade bodies and/or the FSA about the new Statement of Recommended Practice (SORP) – Accounting by Limited Liability Partnerships issued by the Consultative Committee of Accountancy Bodies (CCAB). The previously adopted "partnership" form of accounting has been abandoned in favour of one designed (in the CCAB's words) " to ensure that, so far as possible, LLP's present financial statements that are comparable with those of limited liability companies".

The likely result, especially for LLPs which have members' agreements negotiated at arm's length between the members, will be that the audited accounts for many LLP's will show greatly *increased expenses*, *zero profits*, and *zero fixed capital* for the business. So much for "comparability" with limited companies!

For FSA authorised investment management businesses the effect is likely to be even worse, in that *members' capital* may *not* count towards the business' *regulatory capital* requirement (it will be treated instead as debt) and *allocating profit* to members *may breach* the FSA's *large exposure rules*.

Are the accountants now adopting the politicians and bureaucrats' motto of: "If it ain't broke, try harder"? The new SORP may be logical, but the CCAB can hardly be complimented for their problem solving ability - the new accounting rules risk destroying for investment management businesses much of the utility the LLP form provided.

By contrast, the FSA has adopted a much more pragmatic approach. Although they plan to propose a new rule in their July quarterly consultation paper (which is likely to follow the SORP and make most LLP members' capital ineligible for capital resource requirement purposes), this will at least be a consultation paper on which representations can be made. Better still, the FSA has announced that as a matter of regulatory forbearance firms may under certain conditions continue to include within their capital resources amounts of members' capital which UK GAAP now requires be treated as debt. This "forbearance" will continue until 1 January 2007 for GENPRU LLPs (i.e. those subject to the Capital Requirements Directive) and until the new IPRU (INV) rule comes into effect for other LLPs (estimated 1 April 2007), so long as no repayment of members' capital is permitted where it would be imprudent or breach the FSA capital resources requirement.

Regrettably for the investment manager LLP community, most LLPs will need to review their members' agreements in the light of the interaction of the new SORP with the FSA financial resource requirements and probably make changes, not only to the provisions governing repayment of members' capital, but also in some cases to the profit allocation language or at least their procedures for

allocating profits. The "quick temporary fix", at least for FSA purposes, is for the members to adopt a resolution straight away along the following lines:

"RESOLVED that, notwithstanding any contrary provision of the [members' agreement], no repayment of capital [or other amount due] to any member shall be permitted where the LLP considers it imprudent to do so or that this would cause the [LLP] to breach its FSA capital resources requirement."

This is only a temporary solution. LLPs should consider amending their members' agreements to take account of the new rules. For those LLPs who wish to attempt to influence the form of the FSA's new rule, this review exercise should be started immediately, so that representations can be put to the FSA on its consultation paper. We would recommend all other regulated LLPs to commence this exercise as soon as the FSA has published its proposed new rule in July. Regrettably for the LLPs, this may require a visit to their lawyers. Even though accountants may define what constitutes debt or equity capital, only a lawyer is competent to construe the terms of an LLP agreement to determine whether members' capital is debt or not. If you do not believe your accountant when he tells you black is really red, your lawyer may be able to give you an opposite opinion, or at least a suggestion as to how to return red to black.

Side Pockets – The New Irish Stock Exchange Initiative *by Jim Baird*

Summary

The Irish Stock Exchange (the ISE) last month released a new listing rule which opens the door to the listing of investment funds that invest a portion of their assets in less liquid special situations type assets through so-called "side pockets". For the first time the ISE's rule will make explicit provision for listed shares that provide exposure of both a more liquid asset pool and (by conversion) a pool of less liquid special situations assets.

Background

There has been an increasing trend over the last year or so towards hedge funds seeking additional diversification by investing part of their portfolios in special situations or private equity type investments in addition to more conventional hedge fund assets. However, these assets are typically less liquid and more difficult to value than conventional hedge fund assets. Funds investing in these assets have therefore needed to overcome the difficulties associated with allowing investors to subscribe and redeem their interests in the fund where part of the portfolio is incapable of being accurately valued or easily disposed of. A mechanism that such funds have increasingly been using is to transfer these assets (and the corresponding portion of investors' interests) into a separate class in the fund, often referred to as side pocket classes. The side pocket class would not allow subscription or redemption of interests until such time as the underlying asset became liquid and capable of ready valuation. In this way, such funds could allow investors to subscribe into and redeem their interests in the main pool of assets without the risk of diluting or otherwise prejudicing other investors (due to the uncertainties surrounding valuation and disposal of the illiquid component).

However, until now, funds using side pockets have encountered difficulties in listing all of their shares on the ISE. First, it has not been possible to list "convertible" securities unless the security into which they are to be converted is listed (or certain other conditions as to valuation of the underlying security are satisfied). Secondly, as a new side pocket class is generally created for each illiquid asset, these classes have fallen foul of the ISE's concentration rules limiting investment in any one issuer or exposure to any one counterparty to 20 per cent. of that class' gross assets.

The new rule (which is set out in full below) permits the creation of (and conversion of existing assets into) side pocket classes by a listed fund provided that: (a) no more than 30 per cent. of the fund's gross assets are invested in side pocket, or "S", classes; and (b) the fund does not permit direct investment solely in S classes.

The 20 per cent. concentration rules are applied across both the conventional classes and the "S" classes as a whole. This allows the "S" classes to be listed and thus enables the fund to participate in less liquid investments by conversion of interests into the listed "S" classes.

Future Developments

The new rule presents significant opportunities for fund sponsors wishing to establish a listed product that can take advantage of special situations and private equity type opportunities. We anticipate that over the coming months the ISE will be developing its policy around the new rule and its application.

One question is how the "S" class assets will be valued for the purposes of applying the 30 per cent. exposure limit. The ISE seem likely to require valuations for the "S" classes not less than quarterly (as with other funds). However, it is unlikely that the underlying assets will be capable of accurate valuation on a

regular basis. A quarterly valuation in accordance with a recognised valuation standard (such as IFRS) would be likely to pass muster. Alternatives might be, in the case of private equity assets, to do a valuation in accordance with the International Private Equity and Venture Capital Association Valuation Guidelines or some other valuation methodology. However, the ISE will need to be comfortable with the approach adopted.

The mechanism by which investors may realise their "S" class interests will also need to be considered. On the one hand, funds may permit direct redemption from an "S" class following a liquidity event in respect of the underlying asset. An alternative might be to re-convert "S" class interests into the conventional classes. However, the latter option may be construed as a class which allows no direct redemption and might therefore subject the fund to the Prospectus Directive. Another consideration will be fee structures for the "S" classes. Funds will generally charge management fees based on the fund's net asset value and, in many cases, performance fees based on the profits of the fund. However, in the absence of accurate valuations, it may be difficult to charge fees on the same basis as other funds and alternative methodologies may need to be adopted.

New ISE Rule 2.68

"Where an applicant invests or proposes to invest in special situations or illiquid investments through a separate share class ("S shares"):

a. no more than 30% of the gross assets of the applicant may be invested in such S shares;

b. direct investment solely in S Shares is not permitted by the applicant.

For the avoidance of doubt, the investment restrictions shall apply to the applicant."

Cayman Insolvencies – Whose Law Governs?

Since the Long Term Capital Management collapse of 1998, the US authorities have evinced their unhappiness at the idea that a fund in which US citizens invest might be wound up by someone other than a US court. This is one reason why US-based managers may choose to use onshore US funds for US investors, and offshore Cayman funds for the rest of the world.

Against this trend, the Cayman courts last month rejected an attempt by a US appointed receiver to take over the liquidation of Philadelphia Alternative Asset Fund Limited (PAAF), a Cayman-based hedge fund regulated by the Cayman Islands Monetary Authority. PAAF collapsed in 2005 following huge trading losses that had been hidden from its investors. A US receiver was appointed on the application of the US Commodity Futures Trading Commission in mid–2005, on the discovery of the losses.

The Cayman court based its decision on the fundamental legal principle that when a company incorporated in the Cayman Islands is wound up, Cayman law will apply on the liquidation. Judge Henderson added that investors had a reasonable and legitimate expectation that such a winding up would occur in the Cayman Islands under Cayman Islands law.

The US receiver tried to argue that a liquidation in the Cayman Islands would serve no practical purpose, would mean a duplication of effort, delay and increased costs. It was also argued that any distributions should be made in accordance with US law, which could have meant that offshore investors would have been severely prejudiced.

Judge Henderson held that, whilst there was some English and Cayman Islands case law to support the recognition of receivers in the Cayman Islands, none of it was in point for a foreign appointed receiver of a Cayman Islands domiciled company. Rather it related to receiverships of foreign incorporated companies (or trusts), where the foreign receiver had sought recognition in the Cayman in order to obtain repatriation of assets, which happened to be located in Cayman, to the entry's home jurisdiction.

Walkers, the Cayman law firm, have commented that it would have been open to the judge to make use of a related Cayman law principle, namely that receivers appointed in proceedings brought by foreign governmental agencies to enforce foreign penal laws could not be recognised in the Cayman, even where the receiver was in actual fact only pursuing restitution for investors.

Insider Dealing And Market Abuse – Five Years On *by Duncan Black*

In December 2001, Howard Davies, then the Chairman of the FSA announced a new code of market conduct. He explained that, after a four year gestation period, the new code would "outlaw insider trading and other clearly abusive practices".

Five years on, the results are not encouraging. In March 2006, the FSA published the results of a statistical analysis of share price movements preceding market announcements of FTSE 350 listed companies, relating to take-over bids or trading performance. The period under review ended in 2004. The results showed that 'informed' trading appears to have occurred prior to 28.9% of the takeover announcements and 21.7% of the trading announcements. The FSA Managing Director, Hector Sants, commented that there appeared to have been no improvement in market cleanliness following the introduction of the FSA's new powers in 2001. Why is this?

Mr Sants suggested that the lack of 'visible' enforcement action prior to 2004 may have played a part. In 2004, action was taken against five individuals: their penalties ranged from £1,000 to £18,000. The amounts of profit (or loss avoided) by the insider trades were surprisingly low (considering the consequences) - ranging from £393 to £6,825. No other penalty (such as suspension) was imposed in any of these cases.

Since 2004, the most high profile case has been that of Philippe Jabre, a former GLG trader. He was fined £750,000 (although he is now appealing this). No official figures are available for the amount of profit alleged to have been made in relation to the trades in Sumitomo convertible bonds which prompted the enquiry. It has been observed, however, that Mr Jabre is probably well able to afford the penalty.

It has been commented that the deterrent effect seems to be missing. But this is an over-simplification. It is doubtful whether insider dealers weigh up the size of the fines before deciding to make their unlawful plays. The reputational risk of any enquiry – let alone public penalty – is beyond any price. In addition, the time and expense of dealing with such an enquiry puts an immense strain on those concerned.

It has been said that the risk of being caught – and not the penalty if caught – is the main deterrent to a wrongdoer. But again, one wonders whether insider dealers actually stop to ponder the risk of being detected before dealing. Applying statistical analysis (just like the FSA) to publicly available market data, it is straightforward to identify unusual price movements correlated with relevant events. All those connected with the transactions will then be identified, and it is likely that telephone or e-mail records of their communications around the trades will be preserved and reviewed. Market participants know this.

What is more likely is that those involved simply do not realise that they have over-stepped the mark; or alternatively they see similar conduct occurring around them and are less inclined to recognise it as inherently wrong or a breach of the rules. In some of the cases there does appear to have been a genuine dispute about the implications of the supporting facts; this is hardly surprising since the line between inside information and harmless information can be very fine indeed.

Whilst it may be true that an eye-catching headline might prompt market participants to stop and think, it may be that the most effective course is to continue with raising awareness in helping traders identify situations when dealing would be in breach. Like any process it is a combination of 'carrot' and 'stick'. The stick having manifestly grown bigger and heavier, perhaps it is time to enlarge the carrot. Whilst few would suggest that further compliance training is an especially seductive prospect, reminders – in small doses – to the trading community within firms as to the elements of the offence would probably be worth considering. There is no doubt that the FSA are concerned by the scale of the problem and intend to step up their efforts to stamp it out.

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