SEWARD & KISSEL LLP

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Memorandum to Our Investment Management Clients and Friends

IPO Transactions for Private Funds Managers

In February 2007, Fortress Investment Group, LLC raised more than $634 million in the public equity capital markets, becoming the first alternative investment manager to conduct an initial public offering ("IPO") in the United States. More recently, private equity firm, The Blackstone Group L.P., filed an IPO registration statement with the U.S. Securities and Exchange Commission ("SEC"). Many alternative investment, hedge fund and/or private equity fund (collectively, "private funds") managers are now considering IPOs for themselves.

There are many benefits that a privately-owned private funds manager can achieve by conducting an IPO, including:

- raising substantial equity
- using the liquidity of the public markets to achieve a higher valuation than would be possible in a private company context
- gaining greater visibility in the investment community, leading to distribution opportunities and a greater ability to tap the public capital markets regularly and efficiently
- providing a more valuable currency for acquisitions and future growth
- providing a means for attracting and incentivizing new talent
- institutionalizing operations
- providing principals and employees with a vehicle for estate planning
- monetizing a portion of its equity interests at the more attractive valuation

Going public implicates complex structural, SEC-accounting, tax, investment management, disclosure, regulatory and capital markets-related issues. In particular, the application of SEC legal and accounting principles to an investment management concern requires distinct accounting and legal expertise. As discussed below, not all private funds managers are positioned to conduct a successful IPO, and those that are must carefully weigh the benefits against the costs, both tangible and intangible.

IPOs in the investment management arena are not new, as evidenced by the history of the mutual fund industry in the United States and the offerings of private equity funds on the London Alternative Investment Market and on Euronext. The Fortress and Blackstone offerings are a new twist on an old theme, in that they represent offerings of interests in an investment management vehicle whose performance is tied both to the management and incentive fees that it earns and to the manager's proprietary investments in its portfolio funds.

IPO Considerations

As the recent offerings illustrate, the typical private funds manager does not fit the traditional public company model. While a comprehensive discussion of the issues arising in connection with a public offering are outside the scope of this memorandum, set forth below are a number of the key factors that should be considered when evaluating a potential IPO, both in terms of the IPO transaction itself, as well as the ramifications of operating as a public company after the closing of the IPO.

Tax and Corporate Structure: Most investment management firms are formed as limited liability companies or limited partnerships and are treated as partnerships for U.S. federal income tax purposes, and, as such, their income is not subject to U.S. federal corporate income tax. Under current U.S. federal income tax law, notwithstanding a limited liability company or limited partnership structure, a publicly traded entity may be treated as a "publicly traded partnership" for U.S. federal income tax purposes and be subject to U.S. federal corporate income tax, if it is not able to satisfy the "qualifying income exception". The qualifying income exception is generally available where at least 90% of a publicly traded partnership's gross income during each taxable year in which the partnership was in existence consisted of "qualifying income", which generally includes dividends, interest, capital gains from the sale of securities and certain other investment income (including certain commodities income), but does not include management fees. Some types of incentive fees may be treated as "qualifying income", depending on how they are structured.

Valuation: The success of any public offering depends on the company's initial valuation. Based upon SEC filings, public offerings of investment management companies are being valued primarily on the track record of a firm's portfolio managers, as represented by the historical returns that they generated and, indirectly, the managers' own income. However, while investors are ultimately investing in individual managers, it is unlikely that investors will be willing to accept the risks inherent in a firm whose continued success lies with a single portfolio manager. To be a candidate for a successful IPO, an investment manager will likely be required to have an organization in place. In this regard, one of the principal reasons for conducting an IPO is to provide the means for attracting and retaining key personnel.

Financial Statements: Managers conducting an IPO will generally be required by SEC rules and regulations to include in the prospectus contained in a registration statement historical financial statements for the three most recently completed fiscal years, and selected income statement and balance sheet data for the five most recently completed fiscal years; however, only those financial statements and data for the three most recently completed fiscal years need to be audited. Also, under certain circumstances, the prospectus will need to contain unaudited interim financial data for the most recently completed fiscal quarters for which financial statements exist,

with applicable prior year comparative data. A manager will need to determine whether it can produce the required financial information.

Corporate Governance: While not all public investment management companies will require the large legal and compliance departments that mutual fund complexes have, it will be necessary to have in place the corporate governance and operating structures necessary to comply with the financial and regulatory requirements imposed on a public company. These demands, many of which have been created or expanded by the implementation of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), include:

- *Board Composition and Committees:* Every public company is required to have a board consisting of a majority of "independent" directors and to form an audit committee consisting solely of independent directors. An exception to the independent board requirement is generally available to controlled companies, 50% of more of which are owned by a single person or group, although this exemption does not apply to the audit committee requirements. Many master limited partnerships' ownership structures are designed to take advantage of this exception.

- *Exchange Listing Requirements*: In addition to meeting SEC requirements, a publicly listed company must also meet the minimum listing and corporate governance requirements of the exchange on which it expects to be listed. While the corporate governance standards generally parallel the SEC requirements, a prospective listed company must satisfy certain minimum listing standards, which may include, among other things, a minimum initial public float, a minimum number of public shareholders and a minimum trading price.

- *Section 404 of Sarbanes-Oxley*: Every public company must have in place internal controls over financial reporting necessary to comply with Section 404 of Sarbanes-Oxley, which must be attested to by the company's independent accountants and certified by the chief executive and accounting officer of the company in the company's annual report, although new public companies will not be required to make such attestations or certifications until their second annual report. We note that the Public Company Accounting Oversight Board, a private sector accounting watchdog established by Sarbanes-Oxley, is together with the SEC considering proposals to lessen the burdens placed on public companies by Section 404 of Sarbanes-Oxley.

- *Prohibitions on Loans to Insiders.* Public companies are generally prohibited from making loans to their executive officers and directors.

- *Code of Ethics and Insider Trading Policies:* Every public company must adopt a code of ethics and insider trading policies, which may significantly restrict the ability of insiders to buy and sell the company's equity securities.

- *ERISA:* If the private funds manager is investing ERISA plan assets and relying on the "QPAM" exemption, then becoming a public company imposes an

additional level of monitoring, because the QPAM exemption does not cover transactions with entities related to the QPAM (e.g., an entity that owns 10% of the private finds manager's stock is related under the QPAM exemption).

Registered Investment Adviser: The Investment Advisers Act of 1940 (the "Advisers Act") prohibits any person from holding itself out to the public as an investment adviser, unless it is a registered investment adviser under the Advisers Act. Accordingly, registration under the Advisers Act is likely to be a prerequisite to conducting an IPO. It should be noted that investment adviser registration raises a host of unique regulatory and compliance issues, which are not the subject of this memorandum (please contact any partner in Seward & Kissel's Investment Management Group, for further information about this).

Retaining Key Personnel: In order to assure public investors that the company will have the means to pursue its core business strategy, the company must take measures to retain key portfolio managers and other personnel. This may result in pre-IPO negotiation of employment arrangements and related equity and bonus incentives.

Costs of Being a Public Company

Along with the advantages of being a public company come some financial costs, as well as less tangible costs, that may impact the traditional operation of a private investment management firm, and that can affect the company's trading price. Among these costs are:

- *SEC Reports:* United States public companies are required to register under, and comply with, the provisions of the Securities Exchange Act of 1934 (the "Exchange Act"), which requires, among other things, both annual (e.g., Form 10-K) and quarterly (e.g., Form 10-Q) reports, as well as current reports (e.g., Form 8-K) to disclose certain material events and disclosures on an ongoing basis. Furthermore, holders of more than 5% of a public company's registered class of equity securities are required to file beneficial ownership reports (i.e., on Schedule 13D or 13G) and amendments to them.

- *Sarbanes-Oxley:* As noted above, compliance with Sarbanes-Oxley includes the certification by the chief executive and chief accounting officers as to the Company's internal control procedures and an attestation by the Company's independent accountants, each of which may require the implementation of significant and costly corporate governance procedures and ongoing independent testing procedures.

- *Short Swing Profits Disgorgement:* Under Section 16 of the Exchange Act, all transactions in a public company's listed securities by directors, officers and other deemed "insiders" (*i.e.,* 10% holders) must be reported in SEC filings (*i.e.,* on Forms 3 and 4) and are subject to the "short swing profit" disgorgement rules, which may have the effect of significantly restricting the founders' liquidity in their public company.

- *Disclosure:* A private funds manager that has historically operated outside of public scrutiny will need to acclimate itself to the level of transparency in disclosures required to be made by a public company, both in an initial registration statement for its IPO and on an ongoing basis.

- *Managing Investor Relations:* A public company must have a mechanism for dealing with communications received from security holders, Wall Street analysts, reporters and other members of the public at large, which may be time-consuming and bothersome. In this regard, public companies are subject to and must be mindful of the SEC's "Regulation FD", which generally prohibits a public company from selectively disclosing material information to analysts or others.

- *Control:* The degree of control given to a company's public equity holders may be limited by the structure of the public entity. In many master limited partnerships and analogous structures, such as in Fortress and Blackstone, the public holders have no right to elect the board of the general partner (or managing member), and are limited to the ability to remove the general partner (or managing member) with some supermajority. However, despite the ability of the manager to retain actual control of the company, a public offering will necessarily result in accountability to public investors.

- *Financial Reporting:* Private funds managers often emphasize the long-term natures of their investment strategy, a timetable that may be inconsistent with the quarterly reporting requirements of a public company. The impact of such quarterly reports, and the effect of such reports on the market price of the securities, may make it difficult to adhere to a long-term investment strategy.

The IPO and Going Public

Having determined to go forward with an IPO, the management of the prospective public company must expect to devote a considerable amount of time and resources to the offering process. In addition to the underwriters' discount, which is generally in the range of 6% to 7% of the gross offering proceeds, a prospective public company will also incur expenses, including substantial legal and accounting fees, SEC and stock exchange listing fees, certain underwriters' regulatory fees, printing costs and road show expenses. The time required to complete an IPO will vary greatly from offering to offering, but will typically be four to five months from the start of the registration statement drafting process to the completion of the road show and pricing of the offering. In addition, although the underwriters, lawyers and accountants perform a significant portion of the work throughout the registration process, senior management personnel should expect to dedicate a significant portion of their time to the process.

Conclusion

Private funds managers contemplating an IPO should consider the complex structural, SEC-accounting, tax, investment management, disclosure, regulatory and other capital markets-related issues. The determination of whether an IPO is appropriate for a particular manager requires an analysis of many risks, costs and benefits, and involves close consultation with investment bankers, auditors and attorneys who understand both the capital markets and the particular issues that are unique to private funds managers.

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If you would like to discuss the IPO process further, please feel free to contact any of the partners listed below in Seward & Kissel's Investment Management and Capital Markets Groups at 212-574-1200.

Investment Management Group Partners: John Cleary, Maureen Hurley, Steven Nadel, Patricia Poglinco, Jack Rigney, John Tavss and Robert Van Grover

Capital Markets Group Partners*:* Robert Lustrin and Gary Wolfe

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