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PRIVATE EQUITY FUND CONFERENCE

MAY 19, 2016

1. Regulatory and Enforcement
2. Life Cycle of a Fund Manager
3. Fund Terms

Regulatory and Enforcement

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Stephanie is co-head of SRZ's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (LBO, mezzanine, distressed, real estate, venture) and liquid-securities funds (hedge funds, hybrid funds), as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed-capital investments in fund managers and acquisitions of interests in investment management businesses, and she represents funds of funds and other institutional investors in connection with their investment activities.

Recently named chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a member of the board of directors of 100 Women in Hedge Funds, a member of the Board of Visitors of Columbia Law School and a member of the board of directors of the Girl Scouts of Greater New York. She is listed in *Chambers USA*, *Chambers Global*, *IFLR1000*, *The Legal 500 United States*, *Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *Who's Who Legal: The International Who's Who of Private Funds Lawyers* (which ranked her at the top of the world's 2014 "Most Highly Regarded Individuals" list), *Expert Guide to the Best of the Best USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *Expert Guide to the World's Leading Women in Business Law* and *PLC Cross-border Private Equity Handbook*, among other leading directories. Stephanie was named the "Private Funds Lawyer of the Year" at the 2014 Who's Who Legal Awards and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also recognized as one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and was named one of the 2012 Women of Distinction by the Girl Scouts of Greater New York. She is a much sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. Stephanie co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute) and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), contributed a chapter on "Hedge Fund Investment in Private Equity" for inclusion in *PLC Cross-border Private Equity Handbook 2005/06* (Practical Law Company) and a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" for *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute), and wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* (West) and *New York Limited Liability Companies: A Guide to Law and Practice* (West).

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

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Brad focuses his practice on counseling hedge funds and private equity funds on operational, regulatory and compliance matters. He represents clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the United Kingdom with respect to regulatory, compliance, trading and operations. Prior to joining SRZ, he served for 12 years in various in-house roles, including as general counsel and chief compliance officer of investment advisers ranging from multibillion-dollar funds to start-ups, and as a member in the asset management group of a leading investment bank.

A frequent speaker and writer on the topics of fund operations and regulatory compliance, Brad most recently presented on SEC examination priorities for hedge funds; FinCEN's new proposed anti-money laundering rule; market terms and regulatory issues for co-investments; regulatory changes to Form ADV and recordkeeping requirements; and other compliance topics for private investment funds. He also contributed to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-authored "The New AML Rules: Implications for Private Fund Managers" and "JOBS Act Update: CFTC Relief Removes Impediment to General Solicitation," which were published in *The Hedge Fund Journal*.

Brad received his J.D., *cum laude*, from Boston College Law School and his B.A., *magna cum laude*, from Georgetown University.

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Charles represents financial institutions, public companies and accounting firms, and their senior executives, in securities-related enforcement proceedings before the SEC, DOJ, FINRA, PCAOB, and other federal and state law enforcement and regulatory authorities. In particular, he counsels hedge funds, private equity firms, venture capital funds and other asset managers through regulatory scrutiny, including in routine and risk-based inspections and examinations and in enforcement proceedings. He defends investigations involving a broad spectrum of issues, including accounting and disclosure fraud, insider trading, foreign corruption, offering fraud, market manipulation, breach of fiduciary duty and conflicts of interest. In addition, Charles represents boards of directors and associated committees in internal investigations, and he provides guidance on corporate governance and trading practices for public companies and private funds. Prior to entering private practice, Charles served for nine years in the SEC's Division of Enforcement, most recently as assistant director supervising the investigation and prosecution of some of the SEC's most significant matters, including its investigation of Enron Corporation.

A frequent speaker and panelist, Charles has addressed a wide variety of topics of interest to the white collar defense community, including, most recently, examination priorities and enforcement risk for hedge funds, the Wells settlement process at the SEC, and short-selling violations under Rule 105. He recently co-authored "Rule 105 Update: New Round of Enforcement Highlights SEC Approach on Short-Selling Violations" in *The Hedge Fund Journal*, and he wrote the "Use of Paid Consultants" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). Charles also serves as a resource for numerous media publications, including *Bloomberg News*, *The Wall Street Journal* and *The Washington Post.*

Charles holds a J.D. from the New York University School of Law and a B.A., with high distinction, from the University of Virginia.

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Regulatory and Enforcement

I. SEC Exams Update

A. Inter-relation Between Exams and Enforcement

1. The examination staff and the enforcement division are converging. In addition to inviting enforcement into the exam process or referring deficiencies to enforcement for more investigation, the Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") itself has adopted investigative tools and potential sanctions that usually were reserved for enforcement.

2. For example, OCIE has begun to require funds to provide affirmative narratives as to why certain conduct is not a violation, similar to a mini-Wells submission during the exam process. These narratives are forcing firms to accept an affirmative burden to disprove a negative.

3. In terms of corrective measures, OCIE has begun imposing more significant sanctions formulated as voluntary remedial steps. These enforcement-like corrective measures include disgorgement and reimbursement of fees and expenses, hiring of third-party compliance consultants and monitors, drafting new policies and procedures, and implementing new systems to safeguard against potential compliance violations.

B. Enhanced Examination Capabilities

1. OCIE has adopted tools and hired personnel that allow OCIE to more efficiently uncover violations of the Advisers Act during exams.

2. OCIE has hired new personnel over the past several years that have significant private sector experience working in the private funds industry. OCIE has hired experts with industry experience in particular areas including in private equity, cybersecurity, pricing, valuation and audits.

3. Note that the director of OCIE and the head of OCIE's private funds unit are industry experts, formerly with hedge funds and private equity funds.

4. As a result, OCIE is now more familiar with the industry and is in a better position to understand the operations of most private equity fund managers, investments and risks.

C. Different Types of Exams

1. Full/comprehensive exam. SEC request list with 60+ requests (all investments, fund documents, marketing materials, custody, valuation, expenses, co-investments, side letters).

2. Never-before-examined initiative.

3. Focused exams. SEC focusing on particular issues (fees and expenses, valuation, co-investments).

4. Recidivist exams. SEC specifically mentioned as a priority for 2016, that if an adviser has been examined and had significant deficiencies, the adviser should expect the SEC to be back within a year or two.

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D. Length of an SEC Exam

1. All depends on the adviser and the strength of the adviser's compliance program.

2. If the adviser is prepared and demonstrates that it has a strong compliance infrastructure, exams could last only a week or two with a few additional requests, resulting in either a few deficiencies or a clean bill of health (most firms receive some deficiencies).

3. If the SEC finds serious weaknesses in the adviser's compliance program, exams can last much longer (months to a year), with many additional requests, resulting in serious deficiencies, monetary penalties to the adviser and risk of enforcement.

II. Common Examination Focus Areas for Private Equity

A. Fees and Expenses

1. OCIE is focused on fees and expenses in examinations of private equity sponsors.

2. SEC staff have recently confirmed what we've been seeing in exams of PE managers, which is that the exam staff believes there to be significant compliance issues to address, particularly in connection with fees and expenses. After examining more than 150 private equity fund managers, the exam staff reported that when they reviewed fees and expenses, they found more than 50 percent of managers to have violated the law or to have material internal control weaknesses. The former head of the exam staff called this a "remarkable statistic" and the message is clear: if you haven't yet been examined, you should be reviewing these matters to make sure you are in compliance.

3. The SEC's list of examination priorities for 2016 reflects that this will be a continued area of focus for exams of all private equity fund managers. Common deficiencies that relate to expense allocation include:

   (a) Over-allocation of expenses to one investor, as opposed to other investors;

   (b) Improperly allocating "mixed use" expenses between the manager and its investors; and

   (c) Charging to investors expenses that are not adequately disclosed to investors.

4. Disclosure

   (a) In examination, OCIE exam staff are auditing fee and expense disclosures very closely. The SEC's expectations in terms of the specificity of disclosures has changed from two years, one year or even six months ago. The SEC expects clear and specific disclosures with respect to fees and expenses being charged to investors.

   (b) Advisers should be mapping fees and expenses billed to investors to specific disclosures included in fund PPMs, LPAs and LLCAs, and Form ADV.

5. Fee and Expense Focus Areas for Private Equity

   (a) Fees

      (i) Fees paid to joint venture partners;

(ii) Transaction fees and whether these fees reduce management fees;

(iii) Monitoring fees, including accelerated monitoring fees; and

(iv) Consulting, advisory and director fees.

(b) Expenses

(i) Reasonableness, rationale and records of expense allocation methodologies. Very important to be able to back up expense allocation rationale to show it is reasonable and to keep contemporaneous records showing how the adviser made the allocation decision and why.

(ii) Expenses at the fund level versus portfolio company level. OCIE staff will review expenses allocated by the adviser at both the fund level and expenses billed by the adviser directly to the portfolio company.

(iii) Overhead expenses. Any billing of adviser overhead expenses to investors will be closely scrutinized.

(iv) Marketing expenses versus investment expenses. OCIE staff will scrutinize travel expenses, conferences, specific systems, etc., to determine whether they are for investment purposes or marketing purposes.

(v) Co-investments. Focus on how dead deal costs are being allocated across funds and co-investors. Will depend on whether co-invest capital is committed or not. Many new private equity funds are adding disclosures.

(vi) Proprietary investments. Focus on whether expenses are being allocated fairly to proprietary investments or whether those proprietary accounts are getting a "free ride."

B. Co-Investments

1. Allocation. PE managers are considering additional disclosures on co-investments in terms of who gets co-investments and expense allocation between funds and co-investors.

2. If the fund has concrete guidelines/caps on investing only a certain percentage in any one deal, then it is more objective and straightforward to justify allocations to the fund versus co-investment vehicles. If there are no hard guidelines, it is more subjective and advisers need to be prepared to justify why the fund was allocated X and co-investors were allocated Y.

3. It is very important that disclosures be consistent across PPMs, LLCAs or LPAs, Form ADV — and side letters, RFPs, DDQs and marketing materials.

4. Dead deal costs continue to be a focus area in SEC exams. Many new private equity funds are adding clarifying disclosures if a fund is paying for all dead deal expenses.

C. Valuation

1. OCIE often focuses its examinations on valuation processes and, in particular, on any gaps between the valuation procedures as disclosed to investors and as carried out in practice.

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2. OCIE has focused on situations where managers have changed their valuation methodologies and have either:

   (a) Not properly disclosed the change in the valuation methodologies to investors; or

   (b) Failed to effectively adhere to the disclosed valuation methodology.

3. OCIE will examine closely quarterly valuation committee meeting materials and when an adviser has committed to have quarterly meetings, the Staff will expect that the adviser is keeping minutes/notes for those meetings and a record of what was discussed and decided.

4. Other Valuation Issues

   (a) Role of independent valuation experts;

   (b) Effect of sale of minority positions;

   (c) Backup for marks on unrealized investments;

   (d) Inflated reported returns due to non-consideration of fee discounts, waivers and fees outside commitments; and

   (e) Performance attribution to split teams — who has track record after split.

D. Marketing

1. Marketing materials. Marketing materials have long been an area of focus during exams. In an exam, the SEC will request your pitch books, DDQs, versions of your website and any other “advertisements,” including materials included on investor portals. The SEC will closely scrutinize these materials to make sure these materials are overall fair and balanced, comply with the specific SEC advertising rules, and are all consistent.

2. Cherry-picking. Often private equity managers would like to highlight the performance of particular investments or portfolio companies, perhaps in case studies. The general rule is that selected case studies that do not include performance data are acceptable if they are chosen on an objective non-performance basis, but if you are providing performance information for some investments, you should provide the same information for all investments (even if you are not necessarily providing case studies for all investments).

3. Net IRRs vs. Gross IRRs. The SEC always wants to see net IRRs. Gross IRRs are acceptable alongside net IRR data shown with equal prominence. There may be instances where it may difficult to prepare net IRRs (e.g., for proprietary capital investments or in situations where the fund pays out carried interest only after return of all contributed capital). This should not, however, mean that fund-wide net IRRs should not be disclosed, as these can be calculated using exit prices and/or current portfolio company valuations. Net IRRs can also be calculated for unrealized investments (with the appropriate footnotes that make it clear that the net IRR calculation assumes that unrealized investments have been sold at their most recent fair value).

4. Projections. The SEC has consistently highlighted projections and hypothetical performance as focus areas. If a private equity fund manager is going to show projections, the adviser must make it clear these are projections — not actual performance. An adviser should be able to back up any

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projections to show that the assumptions are reasonable. Also, FINRA rules are even more restrictive here and prohibit showing projections.

E. Custody

1. The SEC has continued to focus on compliance by advisers with the Custody Rule (Rule 206(4)-2).

2. Registered investment advisers are generally required to maintain client funds and securities to which they have access with a "qualified custodian" (such as a bank) in segregated client accounts. There is an exception to this requirement in the case of "privately offered securities" held by a client that is a "pooled investment vehicle" (such as a typical PE fund). To qualify under this exception, among other things, the pooled investment vehicle must comply with the Pooled Vehicle Annual Audit Exception such that: (a) the fund is subject to an annual audit by an independent public accountant registered with the Public Company Accounting Oversight Board; and (b) its audited financials must be prepared in accordance with US GAAP and delivered to investors within 120 days after the vehicle's fiscal year-end.

3. Under Rule 206(4)-2, "privately offered securities" must be acquired in transactions not involving a public offering, must be uncertificated (such that ownership is only recorded on the books of the issuer) and the transfer must be subject to the consent of the issuer or other investors. The SEC staff clarified in a Guidance Update that partnership agreements, subscription agreements and LLC agreements are not "certificates" for purposes of the custody rule. The SEC staff also indicated that even if a security is certificated, it can be held by the adviser itself if: (a) the fund is complying with the Pooled Vehicle Annual Audit Exception; and (b) the stock certificate is issued in the name of the vehicle is appropriately legended, and can be replaced upon loss or destruction.

4. Some managers were unclear as to the treatment of special purpose vehicles ("SPVs") (such as alternative investment vehicles and pooling vehicles used in connection with co-investments) that are often interposed between a fund complex and its underlying portfolio investments for tax, regulatory or similar reasons. As to the use of SPVs, the SEC staff clarified that whether the vehicle is used for one or more underlying investments, so long as it is exclusively owned by one or more pooled investment vehicle clients of the registered adviser, and/or the adviser itself and/or its related persons, and the assets of the special purpose vehicle are considered within the scope of the pooled investment vehicle's financial statement audit, the SPV need not be separately audited as an individual client. If, however, the SPV is an "investment advisory client," which will depend on the facts and circumstances, and the SPV is used to acquire an investment not exclusively on behalf of pooled investment vehicle client(s), but also on behalf of one or more third parties that are not clients of the adviser, then the SPV itself may need to be treated as a separate client, and may require a separate audit.

5. As to the use of escrows in M&A transactions, the SEC indicated that it will not object if, in the aftermath of a negotiated M&A transaction, an adviser maintains client funds in an escrow with other client and non-client assets, provided that the client is a pooled investment vehicle that relies on the Pooled Vehicle Annual Audit Exception, and includes the portion of the escrow attributable to the pooled investment vehicle in its financial statements, and, among other things, a designated seller's representative is required to make prompt distributions upon resolution of the escrow.

F. Insider Trading

1. As in prior years, OCIE often closely scrutinizes relationships between the investment adviser and any outside consultants or expert networks. In addition, OCIE has focused on relationships between

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different buy-side firms, as well as information sharing with investors and the receipt of confidential information at certain industry conferences.

2. Examination staff have taken the position in many recent examinations that advisers should keep logs of meetings with company management.

G. Secondary Transactions

1. Potential conflicts regarding fees. The issue is the amount charged to secondary buyers and whether any preference is given to fee-paying buyers.

2. Potential conflicts regarding valuations. The issue is whether low valuations and limited access to information force sales to the sponsor and friends of the sponsor.

3. Asset sale vs. tender. Need to consider issues raised by active sponsor involvement in the process.

H. Advisory Committee Conflicts

Need to consider potential conflicts or appearance of conflict between large investors on the adviser committee and small investors.

I. Compliance Program

1. OCIE frequently scrutinizes the compliance program an investment adviser employs, including whether adequate resources are dedicated to the compliance function and whether the firm has a "culture of compliance."

2. Deficiency letters have identified perceived deficiencies in the knowledge and qualifications of chief compliance officers ("CCOs") in some cases.

J. Internal/Operational Controls

1. Registered advisers (and unregistered advisers, including Exempt Reporting Advisers). The SEC is focused on operational controls and is bringing enforcement actions where there is a breakdown of those controls.

2. Private equity fund managers should conduct a risk analysis of their internal/operational controls, including with respect to the following areas: fund and portfolio company accounts, wire authorizations, and verification of payees and wires. Any weaknesses discovered need to be addressed and internal procedures/safeguards strengthened.

3. Private equity fund managers should review internal procedures, and all expenses, accounts and wires should run through the CFO, rather than separate processes for corporate expenses versus expenses billed to portfolio companies.

III. Enforcement Update — New Focus on Internal Controls

A. The SEC pursued enforcement actions against several noteworthy private equity firms based on various types of violations, but one type of violation appeared repeatedly, regardless of the specific facts: failure to adopt and implement adequate policies and procedures.

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B. On May 12, 2016, Andrew Ceresney, Director of the Securities and Exchange Commission's Division of Enforcement, gave a speech in which he emphasized the SEC's focus on private equity firms (Andrew Ceresney, Director Division of Enforcement, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (May 12, 2016)). Earlier this year, Director Ceresney emphasized that the SEC has brought charges for pure internal controls violations, or in other words, pursued enforcement actions against entities that failed to maintain adequate controls and procedures, even absent underlying fraud charges. While this speech was in the context of public company reporting, a similar sentiment applies to the SEC's scrutiny of private equity fund managers (Andrew Ceresney, Director Division of Enforcement, Directors Forum 2016 Keynote Address (Jan. 25, 2016)).

C. Specific Enforcement Actions

1. *SEC v. Caspersen and Irving Place III SPV, LLC*, 1:16-cv-02249 (S.D.N.Y. Mar. 28, 2016); *United States v. Caspersen* (S.D.N.Y. Mar. 28, 2016)

(a) The SEC and DOJ recently charged an individual in parallel civil and criminal proceedings with allegedly using false and misleading statements to solicit and secure large investments from institutional investors under the illusion that the investments would be secured by assets of a private equity fund, Irving Place Capital Partners III SPV. In fact, the promissory notes are alleged to have been issued by a shell company, operating under an almost identical name as the legitimate private equity fund (Irving Place III SPV LLC) and controlled by the Defendant. As alleged by the SEC, when the Defendant received a $25 million investment, he took control of the funds for his personal use. The SEC charged Caspersen with violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The DOJ charged Caspersen with the same violations as well as a violation of 18 U.S.C. §§ 1343 and 2 (wire fraud).

(b) Caspersen is alleged to have falsely represented that he had authority from his employer, Park Hill Group (a firm that provides alternative asset advisory and fundraising services for private equity firms and hedge funds), to conduct deals on behalf of Park Hill Group with another private equity fund. Park Hill Group fired Caspersen the week before the government's complaints were filed.

2. *In the Matter of Fenway Partners, LLC, et al.* (Nov. 3, 2015)

(a) The SEC alleged that Fenway Partners LLC ("Fenway") and four of its executives failed to disclose conflicts of interest when fund and portfolio assets were used for payments to former firm employees and an affiliated entity. Fenway and the four involved executives are alleged to have caused certain portfolio companies to terminate their payment obligations under their existing Management Services Agreements and replaced those payment obligations with payment obligations under new Consulting Agreements with an entity affiliated with Fenway and the four executives. The use of the consulting agreements allegedly precluded the portfolio companies from offsetting their monitoring fees with the fund advisory fee, resulting in a greater advisory fee for Fenway. Fenway also allegedly failed to adequately disclose other conflicts of interest, including that an affiliate would receive $1 million out of funds requested from investors in connection with a potential investment and that certain executives were part of a portfolio company's cash incentive plan through which they received $15 million in proceeds from the sale of that company, thereby reducing the fund's return on its investment in that same company.

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(b) Ceresney: "Private equity advisers must be particularly vigilant about conflicts of interest and disclosure when entering into arrangements with affiliates that benefit them at the expense of their fund clients or when receiving payments from portfolio companies."

(c) Fenway agreed to pay $7,892,000 in disgorgement, $824,471.10 in prejudgment interest, and a $1,000,000 penalty to settle the matter. Three of the involved executives paid penalties of $150,000 each and one executive paid a penalty of $75,000 to resolve the claims against them.

3. *In the Matter of Blackstone Management Partners L.L.C., et al.* (Oct. 7, 2015)

(a) The SEC alleged that Blackstone Management Partners LLC ("Blackstone") and certain of its affiliates breached their fiduciary duty to clients by inadequately disclosing certain information to funds and limited partners. Specifically, Blackstone allegedly failed to disclose a discount it received on legal fees being provided to the advisory entities, but not to the funds. In addition, the SEC alleged that Blackstone failed to disclose its ability to accelerate monitoring fees to be paid in the future prior to the submission of capital commitments. The SEC alleged that these accelerating fees had the effect of reducing the value of the portfolio companies prior to their sale. In doing so, the SEC alleged that Blackstone violated Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

(b) The SEC further alleged that Blackstone violated Section 206(4) and Rule 206(4)-7 for inadequate written policies and procedures reasonably designed to prevent conflicts of interest and failure to disclose information regarding monitoring fees.

(c) To settle the matter, Blackstone agreed to pay $26,225,203 in disgorgement, $2,686,553 in prejudgment interest and a $10-million civil penalty.

4. *In the Matter of Kohlberg Kravis Roberts & Co. L.P.* (June 29, 2015)

(a) The SEC alleged that Kohlberg Kravis Roberts & Co. LP ("KKR") breached its fiduciary duty to clients by misallocating expenses. KKR incurred $338 million in expenses, including diligence, research, travel and professional fees, related to potential investment opportunities that ultimately were unsuccessful or went unexecuted. As alleged by the SEC, these broken deal expenses were permitted to be reimbursed through fee-sharing arrangements with KKR's funds and co-investors. The SEC alleged that KKR improperly allocated these expenses by failing to allocate any of them to its co-investors (many of whom were internal firm personnel) and additionally failed to disclose in limited partnership agreements or otherwise that it did not allocate any broken deal expense to its co-investors. By doing so, KKR allegedly breached its fiduciary duty as an investment adviser and Section 206(2) of the Advisers Act.

(b) The SEC also charged KKR with failing to adopt and implement a written compliance policy or procedure regarding its fund expense allocation practices in violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The SEC discovered these violations through a 2013 OCIE Compliance Examination.

(c) KKR agreed to pay over $28 million in total to settle the action.

5. *SEC v. Ahmed*, Case 3:15-cv-00675-JBA (D. Conn., May 6, 2015)

(a) The SEC alleged that an individual employed by Oak Investment Partners, a venture capital firm, committed fraud and self-dealing in violation of Section 17(a) of the Securities Act and

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Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Specifically, the SEC's complaint, filed in the District of Connecticut, alleged that the Defendant illegally transferred approximately $27.5 million from fund accounts into accounts under his control, had funds managed by Oak Investment Partners pay inflated prices for certain investments, and failed to disclose his beneficial interest in a company with which the fund transacted.

(b) In connection with the SEC's complaint, the SEC received a temporary restraining order and asset freeze order freezing up to over $55 million in assets.

(c) A month earlier, on April 2, 2015, the SEC filed a complaint against the individual and his friend for their alleged perpetration of an illegal insider trading scheme. The friend allegedly obtained the material non-public information regarding an upcoming acquisition from his wife, the then-general counsel of one of the companies involved in the transaction, and then passed the information to the individual. The individual is also alleged to have subsequently paid the friend $220,000 for the tip. *SEC v. Kanodia and Ahmed*, Case 3:15-cv-00479 (D. Conn., Apr. 2, 2015).

6. *In the Matter of Lincolnshire Management, Inc.* (Sept. 22, 2014)

(a) The SEC alleged that Lincolnshire Management Inc. ("Lincolnshire") breached its fiduciary duty to two of its private equity funds by improperly sharing expenses between different companies in each of the funds' portfolios in a way that benefited one fund over the other.

(b) The SEC also charged Lincolnshire with violating 206(4) of the Advisers Act and Rule 206(4)-7 by failing to adopt and implement written policies and procedures reasonably designed to prevent violations arising from the integration of the two portfolio companies.

(c) Lincolnshire agreed to pay $1.5 million in disgorgement, $358,112 in prejudgment interest, and a $450,000 civil penalty to settle the matter.

IV. Personal/Individual Liability

A. Recent SEC Enforcement Actions Against Individuals

1. The SEC has more frequently been bringing enforcement actions against CCOs of investment advisory firms.

2. In terms of actual enforcement actions, the SEC has come down on both sides of the CCO liability front in 2015.

(a) In *Pekin Singer Strauss Asset Management, Inc. et al.* (June 23, 2015), the SEC alleged that an investment manager had widespread and significant compliance failures, but the CCO was not responsible for them and was not charged by the SEC. To the contrary, the CCO had repeatedly informed upper management that the firm needed to strengthen its compliance program and needed more resources dedicated to compliance. SEC officials have cited this case as an example of a competent CCO not being held liable for the compliance failures of his or her company.

(b) In *BlackRock Advisors, LLC*, the CCO agreed to pay a $60,000 civil penalty for causing his firm's alleged compliance-related violations: failing to adopt and implement written compliance policies and procedures reasonably designed to monitor and disclose conflicts related to outside business activities of firm employees. Specifically, the CCO was held

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partially responsible for a portfolio manager and the principals of the firm failing to disclose a conflict of interest to its funds. Additionally, the CCO was charged with causing some of the adviser's funds to violate Rule 38a-1(a) by not disclosing a "material compliance matter to the funds" boards.

(c) In *SFX Financial Advisory Management Enterprises, Inc. and Eugene S. Mason* (June 15, 2015), a CCO was charged with causing his firm's alleged failure to implement compliance policies, as well as failure to conduct an annual compliance review, and causing a material misstatement in a Form ADV filing, all of which were related to firm principals allegedly misappropriating client funds through their unilateral signatory power over client bank accounts. Notably, the CCO was held responsible for not implementing policies and procedures reasonably designed to prevent this misappropriation, and for failing to adequately implement the existing policies. The CCO was charged regardless of the fact that when he learned that the misappropriation had occurred, he conducted an internal investigation that resulted in the firing of the individual who misappropriated funds and a referral to criminal authorities. In addition, the CCO was charged with not conducting an annual review in the midst of the internal investigation.

(d) In *Sands Brothers Asset Management et al.* (Nov. 19, 2015), the SEC settled charges with an adviser who allegedly failed to properly distribute audited financial statements to investors in violation of Rule 206(4)-2 ("the Custody Rule"). The CCO was charged with aiding and abetting the alleged violation and failing to implement adequate policies and procedures reasonably designed to prevent these types of violations. In this case, however, the CCO raised these issues directly with management but was ineffective in persuading management to take actions to remedy deficiencies pointed out by the SEC staff.

3. A recent public memorandum by Deputy Attorney General Sally Yates, the second-highest ranking member of the Department of Justice ("DOJ"), announced that the DOJ was formalizing in writing steps intended to strengthen its pursuit of individual corporate wrongdoing, which necessarily includes violations by investment advisers and their employees. Among other things, Yates' memorandum states that in order for an entity to receive credit for cooperating with a government investigation, it must provide all relevant facts relating to the individuals responsible for the misconduct, and all criminal and civil investigations should focus on individuals and their potential liability from the inception of the investigation. Other government regulators, including the SEC and the CFTC, have expressed similar views.

4. All employees — not just CCOs — have a personal interest in preventing compliance failures. Principals and portfolio managers and analysts alike must take personal responsibility for ensuring that the investment adviser is complying with its fiduciary obligations, and that its compliance policies and procedures are properly crafted to address any emerging risks.

5. In a speech in October 2015, Andrew J. Donohue, the SEC's chief of staff, outlined a number of areas that CCOs should focus on in performing their duties:

   (a) The various laws and regulations that govern the manager and its business;

   (b) The manager's compliance policies and procedures and how they are applied and monitored;

   (c) How the manager identifies conflicts of interest, the frequency of any conflicts review, and how conflicts are disclosed, mitigated or resolved;

   (d) The manager's internal operations, supervisory regime, and structure and interdependencies;

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(e) The power and limitations of the manager's compliance and other technology platforms;

(f) The manager's clients, the offering in which they are invested, and their investment objectives;

(g) The types of investment products and strategies in the manager's portfolio;

(h) The practices and regulations in the various markets in which the firm operates; and

(i) The manager's performance across its various products, and how that compares with the corresponding advertising and marketing efforts and materials.

6. Donohue's speech provides a useful guidepost for CCOs attempting to perform their jobs consistently with the SEC's expectations and ensuring that the investment adviser is complying with its fiduciary obligations, including that its compliance policies and procedures are properly crafted to address any emerging risks.

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ALLOCATION OF EXPENSES

Barbash, Breslow and Rozenblit Discuss Hedge Fund Allocations, Restructurings and Advisory Boards

By Vincent Pitaro

Liquidity and performance presentation are only two of the myriad issues facing hedge fund managers. See "*Liquidity and Performance Representations Present Potential Pitfalls for Hedge Fund Managers*" (Mar. 31, 2016). Hedge fund and private equity managers must also be wary of numerous issues that can trigger conflicts of interest or anti-fraud violations, including expense allocations, restructuring and the use of advisory boards. See "*Full Disclosure of Portfolio Company Fee and Payment Arrangements May Reduce Risk of Conflicts and Enforcement Action"* (Nov. 12, 2015).

During the "Issues of the Day for Alternative Asset Managers" program at the Practising Law Institute's recent 2016 Investment Management Institute, panelists discussed these and other topics. Barry P. Barbash, a former Director of the SEC Division of Investment Management and now a partner at Willkie Farr & Gallagher, moderated the program, which featured Stephanie R. Breslow, a partner at Schulte Roth & Zabel; and Igor Rozenblit, co-leader of the Private Funds Unit of the SEC Office of Compliance Inspections and Examinations. This article summarizes the panelists' discussion of these issues.

For additional commentary from Breslow, see "*Schulte Partner Stephanie Breslow Discusses Tools for Managing Hedge Fund Crises Caused by Liquidity Problems, Poor Performance or Regulatory Issues*" (Jan. 9, 2014). For further insight from Rozenblit, see "*SEC's Rozenblit and Law Firm Partners Explain the SEC's Enforcement Priorities and Offer Tips on How Hedge Fund and Private Equity Managers Can Avoid Enforcement Action (Part Three of Four)*" (Jan. 15, 2015).

Overview of the Private Funds Unit

As is customary, Rozenblit cautioned that the views expressed were his own and not those of the SEC or any of its Commissioners. Rozenblit explained that the Private Funds Unit (PFU) is a small team of about 20 individuals within the Office of Compliance Inspections and Examinations that focuses solely on hedge funds and private equity (PE). Its examiners have developed the skills to identify issues more quickly. Its examinations are more focused, and may be "more detailed and more thorough" than other SEC exams. They may also be faster, when the PFU does not spot an issue it is focusing on. For more on the PFU, see "*Current and Former Regulators Advise Hedge Fund Managers on How to Prepare for SEC Exams*" (Feb. 18, 2016).

The PFU looks at incentives that drive manager behavior and takes a thematic approach to examinations. It spends time with industry professionals to conduct "top down, bottom up" analyses, focusing on the overall market at the "top," and individual managers at the "bottom." Rozenblit explained the SEC's National Exam Analytics Tool enables PFU personnel to analyze trade blotters to spot cross trades, valuation changes and other potential red flags.

The PFU has noticed less talk among managers about capital raising and more about "keeping the clients that they have," said Rozenblit. It also sees continuing pressure on management and performance fees. This year is shaping up to be no better than 2015, he added, with particular pressure on credit strategies and funds of funds.

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Poor manager performance, a "glut" of hedge funds, capital draw-downs and decreasing demand for hedge funds are viewed by the PFU as key drivers of hedge fund manager behavior. On the PE side, the PFU has found a bifurcation between PE managers that have no trouble raising capital and those that have "serious problems." It expects the latter category to face the most pressure. Finally, the unit is seeing significant pressure in the high-yield market.

Expense Shifting

Expense shifting is more of an issue for PE funds than for hedge funds, said Rozenblit. See "*Current and Former SEC, DOJ and NY State Attorney General Practitioners Discuss Regulatory and Enforcement Priorities*" (Jan. 14, 2016). In the hedge fund context, one fund may generate all of a manager's soft dollars, but the manager uses those dollars to benefit other funds.

Breslow said that conflicts concerning expenses arise between fund and manager; between fund and fund; and even between classes of the same fund. See "*RCA Compliance, Risk and Enforcement Symposium Examines Ways for Hedge Fund Managers to Mitigate Conflicts of Interest*" (Jan. 21, 2016). A traditional expense disclosure, she said, was that the manager bore its own overhead and that the fund bore all other expenses, "including, but not limited to" a list of specific types of expenses. In response to SEC concerns, that list has become much more detailed over time.

When a manager desires to change its expense practices, Breslow explained, it must first determine whether it requires investor consent. If an expense is a type that an investor would expect to be included in the list provided in existing disclosures, the manager can simply add the expense to the list. If the expense is something that investors would not have expected, the manager must follow the fund's process for obtaining consent. In some cases, managers will notify investors of the proposed change before a redemption date passes, thereby giving them an opportunity to "vote with their feet." See our series on "*How Should Hedge Fund Managers Approach the Allocation of Expenses Among Their Firms and Their Funds?": Part One* (May 2, 2013); and *Part Two* (May 9, 2013).

Managers should also consider the reasonableness of specified expenses, said Breslow, even in funds that pass through all expenses. Rozenblit noted that a "manager-pays-everything" scenario is the easiest situation to evaluate, because there can be no harm to the fund.

Fully passing through expenses raises red flags due to the temptation to put things "that don't belong" into expense buckets. Rozenblit explained that the PFU would certainly take a close look at a fund that paid the cost of the manager's apartment; on the other hand, it might not spend much time considering whether a Bloomberg terminal is used solely by the fund that pays for it. See "*ACA Compliance Report Facilitates Benchmarking of Private Fund Manager Compliance Practices (Part Two of Two)*" (Oct. 11, 2013).

Fund Restructurings

Fund restructurings often occur when a manager is no longer able to raise new capital, said Rozenblit. Managers may offer investors an opportunity to be bought out at a discount, while seeking capital for new investments. These transactions create significant conflicts of interest because without them, the manager is out of business.

One way to effect these transactions is for the manager to sell all of the assets of one fund to a new fund. Another is for limited partners of one fund to sell to other limited partners. An even more difficult situation, said Rozenblit, is when the manager itself buys fund assets, which raises valuation issues and issues under Section 206(3) of the Investment Advisers Act of 1940 (which prohibits principal transactions).

Asset sales are "even more treacherous waters" than tender offers, said Rozenblit, and raise numerous fiduciary duty issues. Such sales are used less frequently. See our two-part series on asset manager M&A transactions: "*Initiating and Structuring M&A*

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Transactions" (May 7, 2015); and "*Taxation, Regulatory and Business Integration Issues*" (May 14, 2015).

Managers have an incentive to keep valuations in restructurings as low as possible, said Rozenblit. Selling investors are often willing to sell at par, and buyers have a great deal of transparency into the portfolio and can more easily value their purchase. A buyer who is getting a "great deal" on assets may be more willing to give the manager a higher fee or more capital to invest.

Breslow tries to ensure that buyers and sellers have access to the same information. A competing concern is that managers may not want to hurt their portfolios by revealing too much information about them. Other concerns, said Rozenblit, include a manager charging a fee on its own restructuring; misrepresentations regarding the health of the portfolio, valuations or the circumstances of the sale; and manipulation of advisory boards.

Advisory Boards

Because a restructuring creates conflicts of interest, a manager may have to seek advisory board approval. See our series on "*How Can Hedge Fund Managers Use Advisory Committees to Manage Conflicts of Interest and Mitigate Operational Risks": Part One* (Apr. 11, 2013); and *Part Two* (Apr. 25, 2013).

One "troubling" situation, said Rozenblit, is when the composition of an advisory board changes prior to the transaction in order to facilitate approval. Breslow noted that, while some managers may try to stack a board with sympathetic people, restructurings may also cause some board members to "flee," because they do not want to be involved in the process.

Rozenblit concurred that pension funds often do not want "to take the liability of making hard decisions." Breslow noted that pensions like the idea of participating in advisory boards because they get a better handle on what is going on at the fund, but they may not want to stay "when things get ugly."

Advisory board composition is a contractual issue, not a regulatory one, said Breslow. Fund documents usually provide that advisory board members may act in their own interests and are not liable to the fund except for bad faith acts.

A board is not usually composed of the manager's "friends and family"; its members tend to be representatives of a fund's largest investors, which often insist on a seat. In Breslow's view, this is a way that "real investors with real skin in the game get to face the manager and deal with conflicts."

The interests of large investors may not be aligned with those of smaller investors, Rozenblit cautioned. Large investors may be seeking other opportunities with the manager – such as co-investments or mezzanine lending – which might make them more willing to approve a new expense pass-through (or other matters) than other investors.

Over-Disclosure and Form ADV

The PFU has noted some "over-disclosure" by PE firms on Form ADV, said Rozenblit. Many funds make disclosures, apparently on the advice of their counsel, as to practices in which they do not engage and have no intention of engaging.

Other issues concern Item 2 of Form ADV Part 2, which is disclosure of material changes. Some firms make changes to their brochure without disclosing the change in that Item. Others move Item 2 with bad news all the way to the back of Part 2.

Enforcement Actions vs. Guidance

In recent years, Breslow noted, SEC enforcement actions have been brought not only against firms that intentionally engaged in illegal behavior, but also against legitimate firms that did not believe that anything they were doing was improper at the time they were doing it. She said industry participants were "wistful" for a time when "the rule would come first and the enforcement [would] come later."

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Rozenblit defended recent SEC actions, arguing that many addressed longstanding industry practices that were never properly disclosed to investors. Enforcement cases, he said, have pushed discussion of "uncomfortable" issues, such as acceleration of monitoring fees, to the forefront. Breslow observed that if the SEC simply provided guidance on some of these issues, it could have had the same impact, without leaving any managers "hanging in the public square." Rozenblit said he would defer to the Division of Enforcement on that issue.

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Life Cycle of a Fund Manager

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Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, structured products, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and he advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees. Omoz's recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz is recognized as a leading lawyer by *The Legal 500 United States*. He regularly addresses investment managers about current developments relating to private investment funds, and his recent speaking engagements have addressed trends in fund governance and economics; structures, terms and fiduciary duties regarding co-investments; market terms and regulatory issues surrounding co-investments; market updates for private equity funds; and trading compliance. He is a contributor to the *Fund Formation and Incentives Report* (SRZ in association with Private Equity International).

Omoz received his J.D. from University of Michigan Law School and his B.A., with highest honors, from Michigan State University.

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Phyllis focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning and the creation of internal investment and co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of investment funds. Phyllis also advises private equity funds in connection with their investments in, and disposition of, portfolio companies.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 United States*, *The Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed regulatory and compliance concerns for co-investments; conflicts of interest; and other ethics issues for private equity fund managers. Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject, and she contributed to *Fund Formation and Incentives Report* (SRZ in association with Private Equity International) as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" to *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute).

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Life Cycle of a Fund Manager

I. Introduction

A. Private equity managers consist of two principal entities: (1) the general partner of the private equity fund (the "GP"); and (2) the investment adviser or management company (the "management company"). Usually, a new GP is formed for each fund (or group of parallel or related funds), whereas it is customary for a private equity firm to form a single management company that provides investment advice across multiple funds.

B. The life cycle of managers encompasses three stages: (1) formation; (2) ongoing operations and relationships; and (3) winding up. Planning for these stages requires coordination and balancing between the requirements and concerns of fund investors and the GP's internal objectives.

C. Investors conduct extensive due diligence on both the fund and the GP/management company and require "key person" provisions as part of their decisions to invest.

D. Changes to the GP team have become commonplace. Best practice is to anticipate changes to the team in both fund documents and governing documents for the GP and management company.

II. Formation of General Partners and Investment Managers

A. The GP and the management company are, like the fund, flow-through entities (such as LLCs or limited partnerships), whose owners have economic and governance rights.

1. Owners of the GP typically consist of a broader group than the owners of the management company. Recent trends show that all or some of the general counsel, chief compliance officer, chief operating officer and chief financial officer may be admitted to the general partner. In addition, senior and mid-level investment professionals often share in carried interest through an ownership interest (which ownership interest may have limited governance rights) in the GP. Larger organizations may utilize "carry plans" or other arrangements to provide payments based on performance of the fund. Those payments may actually be made out of management fees and therefore would be taxable at ordinary income rates. Some GPs use assignment agreements, where the employee has an economic interest in the carry and receives K-1s as if a member of the GP, but is not actually admitted to the LLC for Delaware purposes.

2. Ownership of the management company generally consists only of the senior managers and founders of a private equity firm. That ownership may be associated with the right to receive fee income, but since fees are usually paid out as salaries and bonuses, there may be little or no residual net income available to distribute to the equity owners of the management company.

   (a) Occasionally, the management company's governing documents contemplate liquidity events, such as an IPO or sale of the company, in which case, the proceeds from such an event may be specially allocated to the owners of the management company. Typically in these situations, the entities acting as GPs in the structure are included in the IPO or sale and a GP holding company may be established to hold all GP entities. Alternatively, in some situations (e.g., IPOs), a single holding company may be established to own interests in both the management company and the various GP entities.

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(b) Investors may care about ownership of the management company being a mirror of ownership of the GP. Governance of the management company and the GP are often alike.

3. Estate planning vehicles are often awarded a percentage of the carried interest and should be included in documents at the earliest possible time, preferably at the time of formation.

B. Third-Party Investors in GP and Management Company

1. A third-party investor (e.g., an institutional investor) may acquire a minority ownership interest in the GP and management company. Consideration for the ownership interests may be a cash investment in the management company (and sometimes, additionally, an anchor investment in Fund I or a subsequent fund).

2. A third-party investor often has a limited (or no) role in decision making regarding fund investments as fund investors often want to know that the fund's investment team (and not the third-party investor) is responsible for making, managing and exiting investments.

3. A third-party investor will typically have limited governance rights, including approval rights over certain material actions not related to management of fund investments (e.g., borrowing by the management company, replacement of senior members of investment team, sale of all or a portion of business, etc.).

4. A third-party investor's stake in the GP and management company will not be subject to any vesting. In addition, the GP and management company agreements will also typically provide economic protections to the third-party investor (e.g., anti-dilution provisions, rights of first offer/refusal on a sale of ownership interests in the GP and management company, tag-along rights, etc.).

5. Third-party investors and the managing members of the GP and management company may also negotiate put and/or call rights with respect to the third-party investor's ownership interests in the GP and management company providing each party with the right to buy and/or sell such ownership interests on or after the expiration of a pre-determined period.

6. The ownership interests in a management company and GP acquired by a third-party investor may be structured as a true equity interest (entitling the third-party investor to a fixed share of profits, i.e., management fees and carried interest after deduction for expenses) or a revenue share (where the third-party investor is entitled to a fixed percentage of management fees and carried interest on a gross basis, without any deduction of expenses).

C. "Skin in the Game"

1. The owners of the GP and management company represent the selection by investors of a team that has generated a successful track record. Investors seek to retain and incentivize that team and to make sure the team is aligned with the interest of investors by awarding economics to the team associated with profitable investments.

(a) Investors also expect the investment professionals to have substantial capital at risk. The amounts vary from 1-3 percent of capital to 10-15 percent of capital. What is ultimately important is that the capital invested by the senior members of the team should represent a significant amount to such individuals.

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(b) Investors are increasingly more attentive to the source of capital for the team's investment in the fund. They will inquire about whether each GP member has a stake in the fund or whether the "house" is putting up the capital for the team.

D. Key Person Provisions

1. Key person events are triggered by one of several events:

(a) The failure of named individuals to remain actively involved in the fund, usually based on a "substantially all" time commitment, whether by reason of departure, death or retirement.

(i) LP committees usually have the right to approve a replacement key person. The GP should make as many members of its team known to LPs, as such familiarity will make such approval easier to obtain.

(ii) As part of planning for retirement, senior members of the team usually are not subject to a "substantially all" time commitment to the fund.

(iii) In practice, whether a key person has satisfied his or her time commitment to a fund can be difficult to measure, particularly when multiple funds are under single management.

(b) The failure of the key persons and other members of the management team to own a minimum amount of the carried interest and/or capital in the GP and interests in the management company.

(c) A change of control of the GP or the manager.

Both of the minimum ownership and control tests have limited internal GP and management company transfers and third-party financings of the GP or management company.

2. The remedy for key person events is commonly a termination of the fund's investment period. Key person events can also trigger dissolution rights and, rarely, removal rights.

Removal rights are typically provided when a key person engages in misconduct.

3. The LPA may include multiple tiers of key persons, such as a senior executive team and a support investment professional team. Instead of naming individuals within the second support tier of the key person group, investors may permit the GP to include a requirement that there be a minimum number of investment professionals comprising that group.

When a fund only has two key persons from its origination, the departure of each usually triggers a key person event.

4. Key person clauses need to be reviewed at the time of hiring, departure and promotion of an individual to the decision-making or "control" group of persons.

5. Consider requesting an amendment to the fund's LPA to include additional key persons before an actual key person event occurs to avoid a crisis vote.

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E. Vesting

1. Just as key person provisions are designed to protect investors from the departure of the investment team, vesting is utilized internally by GPs to incentivize professionals to stay with the firm. Vesting also gives the employer points to apportion to a replacement professional and to reward professionals for contributing to the value of investments while employed.

2. There is no "market" for vesting schedules; many GPs use different vesting schedules for different individuals in the same company; the same individual may have different vesting schedules for different deals.

   (a) Vesting is more common for GP-carried interests; whereas, an individual who is not a founder is unlikely to retain an interest in the management company after departure.

   (b) Investors are requesting information on vesting schedules as part of their diligence and in some instances have requested that GPs lengthen or otherwise modify vesting schedules.

   (c) Estate planning vehicles should be subject to vesting in the same manner as the individual for whom such estate vehicle is related to.

3. Vesting provisions apply to the carried interest — and rarely the capital invested in a fund — whereby the carried interest paid after a person leaves is reduced to that person's vested carried interest.

   (a) It is rare to apply vesting to carried interest earned while the individual is still employed.

   (b) The GP agreement addresses who receives the forfeited carried interest or allows the senior principal to decide how to reallocate forfeited carried interest.

   (c) For tax purposes, unallocated carried interest still needs to be owned by some person (typically the founders).

4. A fund's investment strategy often drives the GP's vesting schedule. Venture funds have generally had the longest schedules. Strategies where the bulk of the investment management work is done in evaluating, selecting and closing an investment (rather than in managing the investment once acquired) may have shorter vesting schedules.

5. Vesting may also occur on a fund-wide basis (e.g., from the start of the fund's investment period with respect to all fund investments) or on a deal-by-deal basis (i.e., for each individual investment commencing at the time of closing of such investment).

6. Vesting has become more restrictive, as managers now recognize getting to an exit after a departure does not justify generous vesting.

   (a) Competitive activity by the departed individual may result in complete forfeiture of such individual's right to receive carried interest distributions.

   (b) Vesting may be capped at an amount that is less than 100 percent.

   (c) Vesting may be tied to the receipt of points in a successor fund.

   (d) Junior professionals may never vest in their carried interest when they leave.

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III. Ongoing Operations and Relationships

A. Manager operations are designed around decision-making authority and sharing of economics.

B. Decision-Making

C. Economic Sharing: (i) Carried Interest; and (ii) Fees

1. The group that participates in the carried interest and investments in the fund continues to expand from the most senior/founding members to more junior professionals (including the individuals identified in the second tier of key persons).

2. This expansion has resulted in complicated structures for apportioning the carried interest; managers should be extremely cautious in documenting grants of carried interest points.

3. A firm may also wish to expand its overall growth potential by adding a partner who has a selective industry expertise.

4. Employment offer letters that refer to carried interest grants should be qualified by reference to the separate documentation that will be entered into for such purpose. Similarly, carried interest plan awards should be reviewed with counsel for compliance and consistency with the GP's LLC agreement and fund documents.

5. The carry can be paid out in several ways, typically deal-by-deal or on all deals (i.e., on a fund-wide basis).

   (a) Most GP documents exclude a former employee/partner/member from participating in investments made after the individual's departure.

   (b) Deal-by-deal tracking is neutralized by clawback obligations.

D. Hiring

1. Dilution issues arise from the grant of carried interest points to new employees in existing investments.

2. Managers may establish a "reserve" or "unallocated" portion of the carried interest to allocate in the future or to create a bonus system. GP agreements may also provide for "floors" on the amount to which an individual's carried interest can be diluted or provide for protection from dilution for a fixed period of time.

3. Tax counsel should address implications of unrealized gains as there can be issues with granting carried interest with respect to unrealized investments which have appreciated in value.

4. Multijurisdictional managers have to take into account local taxation issues with respect to the carried interest.

5. Escrows should be utilized within the GP to ensure collectability of the clawback.

6. Other key hiring events include non-disclosure/non-compete agreements, agreement on specific disclosure, and attribution of track record.

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E. Spin-Outs

1. A team of investment professionals managing a specific fund or funds focused on a specific investment strategy may wish to leave the larger firm and establish a separate management company owned by the team.

2. The team spinning out is required under the Investment Advisers Act of 1940 to obtain approvals for the spin-out from investors in each fund that will be managed by the new firm.

3. The team will have to negotiate with the management of existing firm regarding the terms of their departure, including how to communicate the proposed spin-out transaction to investors and what happens to ownership interests in the existing management company held by the members of the team spinning out.

4. A spin-out transaction may be structured as a management buyout where the team is buying out the existing firm's ownership of the business that is being spun out.

5. Existing firms may sometimes retain a minority stake in the new firm.

6. The team spinning out will need to establish new governance and economic sharing arrangements for the new firm (addressing many of the items discussed in Section II above in the governing agreements of the GP and management company).

IV. Winding-Up of the General Partner and Management Company

A. Succession Planning

1. The unplanned departure of individuals may cause not only a key person event, but also the absence of decision makers.

   GP and management company agreements should include provisions for replacement decision makers, including "springing" decision makers when there is a single managing member.

2. A member (including a managing member and founder) who leaves the firm should cease to have management rights.

3. Transfers to family planning vehicles should be permitted only if the transferor retains decision-making authority.

4. Transfers by operation of law, such as in death or divorce, should be explicitly limited to economic transfers and should not pass on rights to participate in decision-making to spouses, ex-spouses or estates.

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Fund Terms

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Kevin joined DuPont Capital in 2010 and manages the investment team responsible for partnership selection and portfolio management. Prior to joining DuPont Capital, Mr. Campbell was a partner with Montagu Newhall Associates, Inc., where he was responsible for investments in private equity partnerships, secondary transactions, co-investments, raising capital from prospective investors, and the operations of the business. Prior to joining Montagu Newhall Associates, Kevin worked as a financial consultant for R.M. Vredenburg & Company, a consulting firm for both public and private institutions, where he specialized in financial management and logistics. Kevin joined the financial services industry in 2001.

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Joe represents private equity fund sponsors and institutional investors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, he advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive experience with all alternative asset classes, including venture capital and later-stage growth equity investments, leveraged buyouts, mezzanine investments, real estate ventures and opportunity funds, secondary investments, funds of funds and hedge funds. Joe has also represented many fund managers in connection with spinoffs and consolidations. In addition to domestic representations, he has advised private equity clients in connection with the acquisition and structuring of portfolio company investments throughout Europe, Latin America and Asia. Joe's representation of asset managers in the real estate sector includes advice concerning REIT offerings and privatizations, partnership roll-ups and cross-border investments. His clients include Arcis Group, Coller Capital, DRA Advisors, DuPont Capital Management, GE Asset Management, Harbert Management Corporation, Hemisfério Sul Investimentos, Intel, Kotak Mahindra Group, LCN Capital Partners, The Praedium Group, Ram Realty Services, REAL Infrastructure Partners, Royalton Partners, Top Tier Capital Partners, Value4Capital, VCFA Group and Westport Capital Partners.

Joe has been recognized as a leading practitioner by *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers*, *The Legal 500 United States* and *New York Super Lawyers*. His recent speaking engagements have addressed topics such as current terms for private equity funds, negotiating and understanding co-investment deals, and limited partner concerns. Joe is co-author of the "United States Fundraising" chapter in *The Private Equity Review* (Law Business Research Ltd.) and a contributor to *Fund Formation and Incentives Report* (SRZ in association with Private Equity International).

Joe received his J.D. from New York University School of Law and his A.B. from Columbia University.

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Fund Terms

I. Recent Trends

A. Flight to Quality

1. Market consolidation as number of managers decrease

2. Number of zombie funds increased

3. Size of funds increasing

B. LP Focus on Re-Ups with Successful Managers

1. Many LPs seek to reduce number of GP relationships

2. Limited look at new GP relationships

C. Co-Investment Opportunities

1. Many LPs favor funds that offer co-investment opportunities

2. LP appetite for direct access to deal flow at reduced fees

D. Single-product firms to multi-product firms

II. Disclosure

A. Fee and Expense Allocations — Heightened Scrutiny

1. Co-investment fees and expenses

(a) Increased LP desire for co-investments creates potential for conflicts

E.g., allocation of dead deal costs

(b) Solution: disclosure, disclosure, disclosure

Not only is more specificity required, LPs are requesting it

2. Allocation of investment opportunities

(a) Conflicts arise with increasing size of fund platforms

(b) From single-product firms to multi-product firms

More product offerings across large base of investors creates complexity

(c) Solution: disclosure, disclosure, disclosure

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III. Management Fees

A. Downward Pressure on Fees Continues

1. 2 percent → 1.5 – 2 percent not uncommon

2. Fee breaks for first closers, large commitments and loyal LPs

3. LPs focusing on timing of fee accrual (i.e., upon closing vs. first deal) and step-downs for prior funds

4. LPs more aggressively looking at management company operating budgets

B. Management Fee Offsets

1. Trending up: 50 percent pre-2008 → 80 – 100 percent now

2. LPs increasingly reviewing the types of fees counted toward the offset (e.g., what about fees for services provided by GP affiliates?)

3. How are fees allocated among the fund and co-invest vehicles?

IV. Expenses

A. Heightened Regulatory Scrutiny

Similar to fees, increased regulatory focus on GP disclosure and allocation policies regarding fund expenses

B. Allocation Issues Arise Due to Increased Use of Co-Investment Funds and Multi-Product Firms

C. LPs Asking for More Specificity During Diligence

1. Fund's use of consultants, affiliates, partners

2. Broken-deal expense allocation

3. How to allocate management company expenses accrued as a result of complying with increased regulatory requirements

V. Distribution Waterfall and Clawback

A. Distribution Waterfall Economics

1. European style more common

2. Preferred return trending down in some cases

   (a) Majority still at 8 percent

   (b) Potential rationale: recent interest rate environment and European-style waterfall

3. LPs continue to negotiate distribution economics with more frequency

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B. Clawback

1. More guarantees, less escrows

2. More interim clawbacks → more frequent test dates

VI. Fund Governance

A. LPs Becoming More Sophisticated on Governance Issues as a Result of Increased Complexity of Multi-Product Firms and Continued Regulatory Scrutiny

B. LPs Spending More Time Reviewing and Negotiating the Following Provisions:

1. No-fault remedies (e.g., GP removal, termination/suspension of commitment period, dissolution)

2. Key person (time commitment, succession planning disclosure)

3. Role of LPAC (LPs seeking more proactive behavior regarding conflict approvals, valuations)

4. Contractual modification of GP fiduciary duties

VII. Looking Ahead

A. Zombie Funds

1. LPs increasingly focused on how to deal with funds in their portfolios that are continuing to operate solely to collect fees and avoid clawbacks

2. Looking for liquidity solutions

B. Focus on Multi-Product Firms

1. Reviewing time and attention standards, restrictive covenants on forming new funds, affiliate transaction provisions

2. Increasing conflicts of interest

   (a) Investment and fee/expense allocations

   (b) Personnel and resources overlap

   (c) Overlapping investment mandates

3. Role of LPAC in addressing conflicts

C. Seven Years into a Recovery

D. Chinese Slowdown

E. Weak Oil Prices

F. Upcoming Presidential Election

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Chapter 21

UNITED STATES

Joseph A Smith and Conrad Axelrod[1]

I GENERAL OVERVIEW

The US private equity fundraising landscape in 2015 showed signs of continuing consolidation and was sustained by robust deal flow that returned significant capital to investors, which in turn maintained a healthy investor appetite to commit capital. A period of record distributions over the last two years has instilled confidence among both returning investors and first-time market entrants,[2] but this has been tempered by concerns over the volume of 'dry powder' and the multiples to earnings at which portfolio companies are trading. Since the nadir of 2010, when North American-focused funds raised only US$163 billion, fundraising activity gradually recovered to US$282 billion in 2014, but was down to US$258 billion in 2015.[3]

Hence, established investors in the market demonstrated their continued commitment to the private equity sector, but did so with a keen awareness that the balance of negotiating power had shifted since the fundraising peaks of 2007–2008. They are now using this balance to scrutinise management teams and negotiate individual fund terms in particular detail, with fund sponsors in turn realising the marketing benefits of increased transparency and demonstrable compliance with investors' policies and procedures. In addition, a wave of bespoke solutions, such as separately managed

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1 Joseph A Smith is a partner and Conrad Axelrod is an associate at Schulte Roth & Zabel LLP. The authors would like to thank David M Cohen and Elie Zolty for their contributions to this chapter.

2 Cambridge Associates, US PE / VC Benchmark Commentary (Quarter Ending June 30, 2015), p. 3; Preqin Quarterly Update: Private Equity, Q3 2015 (October 2015), p. 2, p. 12.

3 Preqin 2015 Alternative Assets Fundraising Dataset (January 2016) (private capital figures excl. real estate fundraising); Preqin Private Equity Spotlight (December 2014), p. 3.

accounts, has continued to augment the classic approach to private equity fundraising, with over one-third of investors now reporting the use of special accounts in conjunction with traditional commingled funds.[4]

This increased sophistication and attention to detail has come at a cost for both sponsors and investors. As a result of the time and effort involved in conducting pre-commitment due diligence (which may include multiple meetings and on-site visits), investors have tended to concentrate their attention on a finite number of 'best of breed' fund sponsors. In some instances, this has led to competition for allocations in the face of scale-backs, rebalancing to a degree the negotiation position of sponsor and investor at the top of the market. This focus on established fund managers has contributed to the ongoing bifurcation of the fundraising market, resulting in a perceived 'barbell' distribution of successful fundraises, with the steadily increasing proportion of capital raised by 'mega-funds' (over US$5 billion) offset in part by the declining persistence of top-quartile returns.[5]

New and spin-off managers, however, face particularly high barriers to entry as a result of increased regulatory burdens on marketing and operational activities. These burdens are exacerbated by lengthier fundraising periods for first-timers, which tend to be less disruptive to established sponsors with dedicated investor relations units.

Larger fund managers, buoyed by the 'flight to quality' and their ability to leverage existing institutional relationships and operational infrastructure, have sought to diversify their product palette by offering new investment platforms. These new platforms frequently exhibit investment strategies complementary to the fund manager's existing vehicles, or further specialised variants thereof, and can be tailored to the individual requirements of larger investors. Unsurprisingly, such structures have been the subject of intense investor and regulatory scrutiny in terms of deal flow allocation and potential conflicts of interest, underscoring the need for fund managers to have in place effective and articulable policies and procedures to alleviate such concerns.[6] Indeed, many believe

4 According to industry estimates, an additional 26 per cent (US$161 billion) of private capital was raised worldwide in 2015 for deal-by-deal structures, co-investment and managed accounts: The Triago Quarterly (November 2015), p. 2. See also: Coller Capital, Global Private Equity Barometer, Winter 2015–2016, p. 6; PERE Research & Analytics, 'Notable Separate Account Commitments,' 30 September 2014; PEI Alternative Insight, 'US Institutions moving towards separate accounts,' 11 December 2013.

5 McKinsey & Company, Private equity: Changing perceptions and new realities (April 2014). 'Mega-funds' of more than US$5 billion attracted 36.8 per cent of aggregate North American fundraising capital during 2013, up from 23.2 per cent in 2012: PEI Media Research (January 2014).

6 See, e.g.; Riewe, JM, Conflicts, Conflicts Everywhere, Remarks to the 17th Annual IA Watch Compliance Conference (2015), available at www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html, and Bowden, AJ, Spreading Sunshine in Private Equity ('Industry Trends'), delivered at the PEI Private Fund Compliance Forum (2014); available at www.sec.gov/news/speech/2014--spch05062014ab.html (accessed 21 January 2016).

that the increased regulatory scrutiny since enactment of the Dodd-Frank Act and the focus of the SEC presence exam initiative on private equity funds (discussed below) has fed investor commentary and concern in this regard.[7]

Notwithstanding these trends, mid-market managers with top-quartile performance continue to receive strong support from an investor base looking to diversify away from 'mega-funds'.[8] These fund managers are subject to increasing pressure to specialise and differentiate themselves in an effort to demonstrate their unique potential for adding value – claims that are increasingly substantiated by market research.[9] New managers entering the industry, as well as established teams spinning off from financial institutions or larger fund platforms, almost inevitably boast of their focus on a niche speciality in order to attract investment capital.

i Market trends

Fund sizes

The largest North American-focused private equity funds raised in 2015 were Blackstone Capital Partners VII (US$18 billion), Warburg Pincus Private Equity XII (US$12 billion) and Lexington Capital Partners VIII (US$10.1 billion).[10]

Buyout funds comprised by far the largest share of 2015 fundraising activity, with 79 buyout funds raising an aggregate of US$81.8 billion. This represents a decline from 2014 fundraising activity, when US$109.5 billion was raised across 95 buyout funds. Although average fund sizes in the North American market increased by 6 per cent to US$575 million, the average buyout fund decreased by around 10 per cent to US$1.04 billion.[11]

Length of fundraising

The average fundraising period remained steady in 2015 at 16.6 months, down from 18.2 months in 2013.[12] Strongly favoured funds are continuing to reach (and often exceed) their targets in under 12 months. Investors, acutely aware of the impact of their own expanded diligence protocols, have generally exhibited patience by approving

7 Note, however, that the SEC's recent actions are not viewed uniformly among investors: see, e.g., PEI Alternative Insight, PERE CFO and COO Compendium (2015), 'LPs on the SEC', pp. 17-19.

8 Three quarters of North American investors have invested in first-time funds since the financial crisis: Coller Capital, Global Private Equity Barometer, Summer 2015, p. 5.

9 Ibid., p. 5: 91 per cent of first-time fund investments have equalled or outperformed other private equity investments in LP portfolios. See also: Preqin Private Equity Spotlight, June 2015, p. 3.

10 Preqin 2015 Alternative Assets Fundraising Dataset (January 2016).

11 Preqin Q4 2014 Private Equity Fundraising (January 2015), p. 3.

12 Preqin 2015 Alternative Assets Fundraising Dataset (January 2016); Preqin Q4 2014 Private Equity Fundraising (January 2016), p. 2.

requests to extend fundraising periods by up to six months. Accordingly, contractual caps on organisational costs to be borne by funds have generally not decreased and have sometimes actually increased.[13]

Types of funds

In general, the fundraising landscape in 2015 has been more favourable for certain types of private equity funds. Although traditional buyout funds appear to have lost some ground, secondary funds are enjoying historic levels of investor appetite and deal flow, while debt funds have grown rapidly to fill the lending gap created by the retreat of banking activity worldwide. Debt funds have become increasingly specialised by sector, tranche and geography, and remain popular among investors with appropriate risk appetites, evidenced by strong increases in mezzanine and distressed private equity fundraising.[14]

Secondary fundraising peaked in 2013 but deal activity remained a vibrant feature of the industry in 2015,[15] reflecting an ongoing desire on the part of both primary and strategic investors to actively manage their private equity portfolios in terms of return profile and liquidity considerations. Banking and insurance companies worldwide have been confronted with more stringent capital adequacy rules and other prohibitions such as the Volcker Rule (see Section IV.iv, *infra*), which, when combined with the broader appetite and sophistication of secondary managers, will continue to drive secondary deal flow in the coming years. Specialised funds in this category, combined with the increasing incidence of end-of-life recapitalisation transactions, often present an attractive exit opportunity for investors faced with an otherwise drawn-out liquidation process.

Despite mixed success internationally, venture capital funds historically have held a very significant role in the US fundraising market and continue to feature in the allocation priorities of international investors, with a significant proportion of investors in this segment being based overseas.[16] Resurgent growth in venture capital fundraising was sustained in 2015, with US$33 billion raised across 175 funds (2014: US$28.6 billion raised across 155 funds).[17] These are figures not seen since 2007, undoubtedly owing much to the persistence of deep and broad exit channels, including public offerings and M&A activity.[18]

13 See, e.g.: The 2015 Preqin Private Equity Fund Terms Advisor, pp. 60-61.

14 Between 2009 and 2015, private debt fundraising increased more than threefold (to US$84.6 billion), with US$49.2 billion raised in 2015 in the US: Preqin 2015 Alternative Assets Fundraising Dataset (January 2016).

15 Dow Jones Private Equity Analyst, Guide to the Secondary Market (2015 Edition), p. 6; Private Equity International, 'Secondaries fundraising falls in 2015,' 18 January 2016; Thomson Reuters PE Hub, 'Secondary volume goes through the roof,' 22 January 2015.

16 Preqin Special Report, 'US Venture Capital Industry, October 2013', p. 2.

17 Preqin 2015 Alternative Assets Fundraising Dataset (January 2016); Preqin Q4 2014 Private Equity Fundraising (January 2015), p. 3.

18 National Venture Capital Association and Thomson Reuters, 2015 National Venture Capital Association Yearbook (March 2015), p. 75; VC Fundraising Stats for Q4 2015, Press Release

II LEGAL FRAMEWORK FOR FUNDRAISING

i Fund structures

Private equity funds investing in the United States are predominantly structured as limited partnerships, with the jurisdictions of choice being Delaware and the Cayman Islands. The limited partnership statute and specialised corporate judicature of Delaware are widely recognised as providing a flexible and reliable legal framework for private funds. Onshore structures are typically preferred by domestic investors. Foreign investors frequently have tax considerations associated with investing in US-based private funds (including state and federal filing obligations, financial reporting and concerns over 'effectively connected income', discussed below) that favour investment through an offshore 'blocker' entity, established as either a parallel or feeder vehicle to the main fund.

Fund sponsors generally establish special purpose vehicles to act as investment manager and general partner to the fund vehicles, with a Delaware limited liability company (LLC) or limited partnership being the entities of choice in this respect. The investment manager or adviser entity is commonly used for a series of funds, which can be particularly beneficial in light of the ongoing registration and compliance burdens concomitant with this role (see Section IV.iii, *infra*). This structure permits the sponsor or key executives to maintain control of investment decisions and operational budgets, while segregating incentive payments and investment income between funds and executives on a tax-neutral basis.

ii Fund terms

From a commercial standpoint, very few changes have been witnessed in the headline terms for US funds in recent years, with 2015 being no exception. The consistency in prevalent fund terms is a function of the adverse selection process that permits survival of only the top-quartile fund managers. These preferred managers, aided by the global 'flight to quality', are able to negotiate balanced terms on an even footing with experienced investors. Successor funds with a solid investor base have been able to raise funds in recent years with minimal adjustment to prior terms, and the same requests consistently made by investors belie their acceptance of the underlying model. First-time funds with sufficient investor interest are then able to leverage these generally accepted market terms, with some additional concessions.

Two notable exceptions to this stasis are representative of the shift in bargaining positions since the global financial crisis of 2008–2009. A conceptual focus on greater alignment of interests between sponsors and investors has resulted in material changes in the areas of fee offsets and the timing of carried interest distributions:

First, fee offsets have gradually evolved from a historic zero offset, through an intermediate 50 per cent offset, to an 80 per cent and most recently 100 per cent offset.[19]

(12 January 2016), and VC Fundraising Stats for Q4 2014, Press Release (12 January 2015).

19 The mean offset percentage for buyout funds peaked at 92 per cent for 2012 vintage funds and has since declined to 72 per cent, suggesting some fluctuation in the GP/LP power balance: The 2014 Preqin Private Equity Fund Terms Advisor, p. 42.

Although 100 per cent offsets can be viewed as excessively generous to investors (since the general partner and its affiliates do not customarily pay management fees themselves, the offset deprives the general partner and its affiliates of their proportionate share of fee income attributable to their own invested capital), they can also be viewed as a confluence of economic and regulatory pressures in light of recent SEC scrutiny of private equity fee models, discussed below.

Second, distribution waterfalls have migrated slightly towards the European model, with a full return-of-cost waterfall (otherwise known as 'fund-as-a-whole') becoming more common, particularly in connection with first-time funds. Interim clawbacks are increasingly used to create a hybrid of both models, as investors seek to mitigate the impact of traditional deal-by-deal distribution waterfalls and thereby further align interests over the life of the fund.

iii Taxation of the fund and its investors

Taxation of the fund

Typically, the fund is organised as a limited partnership or a limited liability company, which is a 'pass through' entity for federal tax purposes, and is thus generally not subject to federal income taxes at the fund level. Instead, the income is passed through to its investors and they are taxed on their appropriate share at the investor level.

A partnership may, however, be subject to taxation at the level of the fund (as distinct from any additional federal income tax that is imposed on investors) if the partnership is publicly traded. A 'publicly traded partnership' (PTP) is a foreign or domestic partnership whose interests are 'traded on an established securities market' or are 'readily tradable on a secondary market or the substantial equivalent thereof'. Private equity funds are rarely traded on an established securities market; however, transfers of interests in private equity funds may arguably cause a fund to be deemed to be readily tradable on the 'substantial equivalent' of a secondary market. While these concepts are not well defined, US Treasury Regulations provide a number of 'safe harbours' that a fund can rely on to avoid PTP status. If the fund falls within a safe harbour, interests in the fund will not be deemed to be readily tradable on a secondary market or the substantial equivalent thereof. Typically, the fund will rely on the 'limited trading' safe harbour and the 'block transfer' safe harbour. The limited trading safe harbour, often referred to as the 2 per cent safe harbour, applies if the fund does not permit transfers of more than 2 per cent of the total interests in a partnership's capital or profits in any fiscal year.[20] The block transfer safe harbour allows the fund to disregard transfers of more than 2 per cent of total interests in the partnership's capital or profits.

Taxation of fund investors

As noted above, most private equity funds are structured so that the fund itself is not subject to tax. Instead, the fund's income passes through to its investors, who then pay tax on their proportionate share of such income. It is worth noting that private equity

20 A number of rules apply for purposes of computing the 2 per cent limit but their discussion is beyond the scope of this chapter.

funds typically raise a significant proportion of their capital from entities that are US tax-exempt institutions (such as university endowments and pension funds) or non-US entities (such as pension funds or sovereign wealth funds). As a general rule, each of these types of investor is not subject to US tax on its share of income generated by a private equity fund. There are important exceptions to this general rule, which are described below.

Under Section 512(b) of the Internal Revenue Code (the Code), US tax-exempt organisations are exempt from federal income tax on passive income such as interest, dividends and capital gains. Nonetheless, these organisations are subject to federal income tax on their 'unrelated business taxable income' (UBTI). There are two sources of UBTI: income derived from an unrelated trade or business and debt-financed income. The former type of income is typically generated when a fund invests in an operating business that is itself structured as a pass-through for tax purposes. The latter type of income is generated when the fund itself borrows money to make investments. In order to maximise their after-tax return, US tax-exempt investors often require the fund to undertake to minimise UBTI.

In general, non-US investors are exempt from federal income tax on their share of capital gains generated by a private equity fund. Non-US investors that are engaged in a trade or business in the United States are taxed on their income that is 'effectively connected' with that business, often referred to as 'effectively connected income' (ECI). Additionally, if a non-US investor has ECI or is a member of a partnership that is engaged in a trade or business in the United States, the investor is required to file a US federal income tax return. Typically, ECI is generated from two sources: income from a business that is itself organised as a pass-through entity, and any gain from the disposition of United States real property interests (USRPI). A USRPI will generally consist of interests in land, buildings and in any US corporation for which 50 per cent or more of the fair market value of its real estate and trade or business assets consists of USRPIs. Non-US investors will also typically wish to maximise their after-tax returns and will do so by requiring the fund to undertake to minimise ECI.

iv FATCA

In addition to the income tax framework described above, the US has enacted the Foreign Account Tax Compliance Act (FATCA), which is a supplementary 30 per cent withholding regime with respect to certain non-US entities, including foreign financial institutions (FFIs) (which term includes most private equity funds and hedge funds organised as non-US entities), and certain persons invested in FFIs.[21] In order to avoid being subject to this 30 per cent withholding tax on certain payments of US-source income such as interest or dividends (withholdable payments),[22] an FFI is generally

21 FATCA also imposes a 30 per cent withholding tax on certain nonfinancial foreign entities, unless such nonfinancial foreign entities comply with certain requirements, including the need to provide certain information about its substantial US owners, if any.

22 Beginning no earlier than 1 January 2019, the definition of withholdable payment will extend to 30 per cent withholding on the gross proceeds from the sale of US source securities of a

required to register with the Internal Revenue Service (IRS) and, except as discussed below, enter into an 'FFI agreement' with the IRS. Under that agreement, the FFI must agree, among other things, to perform certain due diligence functions in order to identify its direct US investors (and certain indirect US investors) and to determine the FATCA-compliant status of its non-US entity investors, and to report specific financial information about certain of its investors annually to the IRS. Investors who do not provide an FFI with sufficient information about their US or FATCA-compliant status to satisfy the FFI's due diligence requirements or who have a non-compliant status generally are subject to 30 per cent withholding on any withholdable payments earned through the FFI or distributed to such investors by the FFI.

To facilitate information reporting under FATCA and minimise the need for FATCA withholding, certain jurisdictions (including the United Kingdom, Ireland, Jersey, Guernsey and the Cayman Islands) have signed intergovernmental agreements with the US (IGAs).[23] Pursuant to Model 1 IGAs, an FFI located in an IGA jurisdiction generally is not subject to withholding under FATCA[24] as long as it registers with the IRS and complies with the FATCA enabling legislation promulgated by the IGA jurisdiction. While each IGA jurisdiction has enacted, or will enact, enabling rules specific to its own legal system, the due diligence and reporting requirements under these rules are, or are expected to be, substantially similar to the due diligence and reporting requirements provided in the FFI agreement with the IRS. Notably, the requirement to withhold on investors who fail to provide sufficient information about their US status has been suspended. However, the imposition of withholding remains in place for FFI investors who do not have, or certify to, a FATCA-compliant status.

III REGULATORY FRAMEWORK

Private equity funds in the US are regulated principally by federal statutes, although fund entities, if formed in the US, are formed and governed pursuant to state law.

The primary federal statutes, namely, the Securities Act of 1933, as amended (the Securities Act), the Investment Company Act of 1940, as amended (the Investment Company Act), the Investment Advisers Act of 1940, as amended (the Advisers Act), and the Employment Retirement Income Security Act of 1974, as amended (ERISA), are discussed briefly below. The Securities Exchange Act of 1934, as amended (the Exchange

type that produce interest or dividends, as well as withholding on certain 'foreign passthru payments' the meaning of which has yet to be published by the US Department of the Treasury.

23 For a complete list of countries, see www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.

24 Amounts may still be withheld from payments to such FFIs if that FFI is acting as nominee for the payments on behalf of a beneficial owner that does not certify that it has a FATCA-compliant status.

Act), and state legislation also play a significant role in the contexts of placement agent activities and governmental pension plans, although a detailed discussion of their application is beyond the scope of this article.[25]

i Securities Act

The sale of limited partnership interests in a private equity fund is governed by the Securities Act, which requires securities sold in the US to be registered with the Securities and Exchange Commission (SEC) unless an exemption is available. To avoid the burdensome registration and disclosure requirements under the Securities Act, most funds structure their offerings in a manner that qualifies for one or both of the 'safe harbours' promulgated by the SEC. These safe harbours operate within the scope of a general statutory exemption for private placements under Section 4(a)(2) of the Securities Act. Importantly, the Securities Act also applies to any resale of limited partnership interests in the secondary market, so the governing documents of a fund generally restrict the manner in which an investor may transfer its interest.

Regulation D[26] provides an exemption for private offerings of securities to US persons who qualify as 'accredited investors',[27] and was amended with effect from September 2013 to permit general solicitation (i.e., advertising to the public) in limited

25 The Exchange Act imposes significant additional restrictions on an issuer with more than US$10 million in assets where 2,000 or more persons hold any class of the issuer's equity securities (Section 12(g) and Rule 12g-1). General anti-fraud provisions of the Exchange Act nevertheless operate to attach civil liability to material misstatements and omissions of material fact in connection with any offering of securities (Section 10(b) and Rule 10b-5). These obligations, among others, form the basis for the best practice 'side-by-side' disclosure of gross and net return figures for private funds in placement memoranda; see also JP Morgan Investment Management, Inc, SEC No-Action Letter (7 May 1996).

26 Rule 506 of Regulation D (17 CFR 230.501 et seq.) sets out the requirements with which an issuer must comply in order to benefit from the 'safe harbour' assurance that its offering falls within the private offering exemption contained in Section 4(a)(2) of the Securities Act. An offering that fails to satisfy the requirements of Regulation D can nevertheless qualify for exemption under Section 4(a)(2) of the Securities Act, unless general solicitation has taken place pursuant to the new Rule 506(c) (discussed below).

27 'Accredited investors' are, generally: regulated entities (such as banks, insurance companies or registered investment companies); natural persons (or spouses) with (joint) net worth of more than US$1 million (excluding the value of any primary residence) or meeting certain income thresholds; corporations, trusts, partnerships and certain employee benefit plans with assets of more than US$5 million; and directors, executive officers or general partners of the issuer selling the securities (see Rule 501 of Regulation D). Securities can be sold to 35 other sophisticated purchasers (who are not accredited investors) without losing the benefit of the Regulation D safe harbour.

circumstances. Issuers relying on Regulation D are required to file Form D with the SEC providing brief details of the offering within 15 calendar days of the date of first sale, and to update such details on an annual basis in respect of an ongoing offering.[28]

Regulation S[29] provides an exemption for certain offers and sales of securities outside the US, whether conducted by foreign or domestic issuers, in recognition of the underlying policy and objectives of the Securities Act to protect US investors. In general, two basic requirements must be met for an offering to qualify under Regulation S: first, the offer or sale must be made in an 'offshore transaction'; and second, no 'directed selling efforts' may be made in the US by the issuer, a distributor, any of their respective affiliates, or any person acting on their behalf in respect of the securities.[30]

Notwithstanding the latter requirement, contemporaneous domestic and offshore offerings may be undertaken in reliance on both Regulation D and Regulation S.

ii Investment Company Act

An investment fund (as distinct from any manager or adviser thereof) is generally subject to regulation by the SEC as an 'investment company' unless an exception from the Investment Company Act applies. Although the term 'investment company' broadly encompasses any entity that is engaged primarily in the business of investing, reinvesting or trading in securities,[31] in practice private equity funds make use of two key exceptions from this definition.

First, under Section 3(c)(1), an entity that would otherwise qualify as an investment company is exempt from registration if it does not make a public offering of its securities and does not have more than 100 beneficial owners.[32] Although this exception is available irrespective of the financial sophistication or wealth of the investors (and permits participation by a potentially unlimited number of 'knowledgeable employees'),[33] compliance with Regulation D (discussed above) will generally require investors to satisfy the 'accredited investor' test.

28 See further: www.sec.gov/about/forms/formd.pdf.

29 Rules 903 and 904 of Regulation S (17 CFR 230.901 et seq.) set out the requirements with which the issuer and any reseller, respectively, must comply in order to benefit from the 'safe harbour' assurance that its non-US sale or resale is exempted from the registration requirements contained in Section 5 of the Securities Act.

30 See further: Rules 902(c) and (h) of Regulation S.

31 Investment Company Act, Section 3(a)(1).

32 The SEC has developed guidance on 'integration' (primarily in the form of no-action letters) indicating when parallel offerings will be combined for purposes of calculating the 100 beneficial owner threshold: e.g., side-by-side onshore and offshore offerings to facilitate efficient tax treatment of different classes of investors are typically not subject to integration (Shoreline Fund, LP, SEC No-Action Letter, April 11, 1994). The doctrine extends to integration of offerings under the Securities Act, where the SEC's five-factor approach has been codified in Rule 502(a) of Regulation D.

33 'Knowledgeable employees' for this purpose are defined in detail by Rule 3c-5(a)(4), and include executive officers, directors and trustees of a company that would be an 'investment

In addition, beneficial ownership is determined on a 'look-through' basis for any entity:

a that has been 'formed for the purpose' of investing in the fund;

b that holds more than 10 per cent of the outstanding securities of the fund and itself relies on an exception pursuant to Section 3(c)(1) or 3(c)(7); or

c whose investors retain investment discretion in respect of their participation in the entity's individual investments.

This exception also requires that no public offering of the securities be made in the US, which will normally be the case where an issuer has complied with the requirements of Regulation D or Regulation S to avoid registration under the Securities Act (including offerings employing general solicitation under Rule 506(c)).

Second, a further exception is available under Section 3(c)(7) for an 'investment company' if it does not make a public offering of its securities (see above) and the ownership of such securities is limited exclusively to 'qualified purchasers', which include:[34]

a individuals who own at least US$5 million in investments[35] (including joint or communal property);

b family companies with at least US$5 million in investments;

c trusts not formed for the specific purpose of acquiring the securities in question, provided that the trustee or discretionary manager is otherwise a 'qualified purchaser';

d companies with at least US$25 million in investments; and

e 'qualified institutional buyers'.[36]

This exception is favoured by larger funds due to the higher qualification standard and lack of 100-investor limitation. For investors in offshore funds, these qualification criteria apply only to US persons who are admitted into the fund (in keeping with the SEC's jurisdictional policies focused on protecting domestic investors).[37]

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company' but for the exclusions contained in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, as well as employees who have participated in the investment activities of such company (or substantially similar functions or duties for another company) for at least the preceding 12 months. Issuers must nevertheless take care to observe applicable requirements such as those under tax regulations and the Exchange Act.

34 Section 2(a)(51)(A) of the Investment Company Act.

35 'Investments' for this purpose are defined in detail by Rule 2a51-1, and exclude real estate property that serves as an individual's principal residence for tax purposes (Section 280A of the Code).

36 A 'qualified institutional buyer' includes certain types of registered insurance companies, investment companies, investment advisers and employee benefit plans that in the aggregate own and invest on a discretionary basis at least US$100 million in unaffiliated securities.

37 Touche Remnant & Co, SEC No-Action Letter (27 August 1984); Goodwin, Procter & Hoar, SEC No-Action Letter (28 February 1997). See also: Exemptions for Advisers to

iii Investment Advisers Act

In addition to the private fund itself, the investment adviser or manager of a fund is generally subject to registration and regulation under the Advisers Act,[38] which is intended to address the fiduciary nature of the advisory relationship and focuses on the minimisation or disclosure of conflicts of interest inherent in such a relationship.[39]

Investment advisers with more than US$100 million in regulatory assets under management[40] are eligible for SEC registration, although advisers with less than US$150 million in regulatory assets under management can generally remain subject to state-level regulation under similar statutes.[41] No specific qualifications or exams are required to register as an investment adviser, although detailed disclosures are required about the advisory business, services and fees, background of principals, and applicable policies and procedures.

The SEC mandates comprehensive Form ADV disclosures that are accessible to the public, which must be updated by the investment adviser at least annually (or more promptly in the event of certain material changes).[42] Registered advisers are required to provide each client or prospective client with a 'brochure' containing all the information in Part 2 of Form ADV before or at the time of entering into an investment advisory contract and, although not strictly required, will frequently provide this information to each investor in the private funds they manage. Investment advisers that manage private

Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act, SEC Release No. IA-3222 (22 June 2011), note 294.

38 An 'investment adviser' is any individual or entity that, 'for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities' (Advisers Act, Section 2(a)(11)).

39 See, e.g., SEC Staff of the Investment Adviser Regulation Office, Division of Investment Management: 'Regulation of Investment Advisers by the US Securities and Exchange Commission', March 2013 (*SEC Regulation of Investment Advisers*).

40 An investment adviser's 'regulatory assets under management' is calculated by determining the market value of the securities portfolios to which the adviser provides continuous and regular supervisory or management services, or the fair value of such assets where market value is unavailable (see also Schulte Roth & Zabel LLP, Client Memorandum, 'Final Rules for the Private Fund Investment Advisers Registration Act of 2010,' 8 August 2011). The revised definition includes uncalled capital commitments, proprietary and family accounts, accounts managed or advised without compensation, and accounts of clients who are not US persons (see also Breslow, SR & Schwartz, PA, Private Equity Funds: Formation and Operation, Section 10:2).

41 SEC Regulation of Investment Advisers, note 47.

42 Annual updating amendments are required to be filed within 90 days of the registered adviser's fiscal year end: Rule 204-1.

fund assets of at least US$150 million are also required to report certain information to the SEC on Form PF, typically on an annual basis within 120 days of the adviser's fiscal year end.[43]

Compliance obligations of investment advisers

In addition to recent regulatory developments discussed further below, registered investment advisers are subject to numerous recordkeeping obligations and requirements to maintain up-to-date policies and procedures reasonably designed to detect and prevent violations of, *inter alia*, the Advisers Act, including a code of ethics and the appointment of a chief compliance officer responsible for administering those policies. An annual review must be undertaken to consider any compliance matters that arose during the previous year, any changes in the adviser's business, and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures.[44] The SEC's Office of Compliance Inspections and Examinations conducts periodic examinations of registered advisers roughly every three to four years, but may also conduct 'for cause' and sweep examinations under appropriate circumstances (see Section IV.i, *infra*).

Specific restrictions also apply to performance-based compensation,[45] which an investment adviser may only charge to sufficiently sophisticated investors, including 3(c)(7) funds (see Section III.ii, *supra*) and qualified clients,[46] as well as non-US persons. Registered advisers are generally required to hold client assets through a qualified custodian (such as a bank or registered broker-dealer), but private equity funds holding privately offered securities are eligible for the 'audit exception' from such requirements if certain additional conditions are satisfied.[47]

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43 Rule 204(b)-1 was adopted by the SEC and CFTC in order to assist the Financial Stability Oversight Council (FSOC) in monitoring systemic risk in the US financial system, as mandated by the Dodd-Frank Act.

44 Rule 206(4)-7 does not enumerate specific elements of the required policies and procedures, and the SEC recognises that the application of such policies and procedures may vary widely depending on the size and nature of the advisory business. See also: SEC Release No. IA-2204 (17 December 2003); and Schulte Roth & Zabel, '2014 Annual Compliance Checklist for Private Fund Managers,' www.srz.com/files/upload/private/SRZ_2014_Annual_Compliance_Checklist_Private_Fund_Managers.pdf.

45 Section 205(a) of the Advisers Act restricts the scope of persons from whom investment advisers may receive 'compensation on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client'.

46 Rule 205-3: A 'qualified client' includes an investor that has at least US$1 million under management with the investment adviser, a net worth of at least US$2 million (including joint property but excluding the value of a natural person's primary residence), qualified purchasers (footnote 38, *supra*), and certain knowledgeable employees of the investment adviser.

47 Rule 206(4)-2; see also SEC Release No. IA-2968 (30 December 2009) and SEC IM Guidance Update No. 2013-04 (August 2013).

Exempt reporting advisers

Notwithstanding certain registration and reporting requirements, advisers qualifying as either a 'private fund adviser' or 'venture capital adviser' are exempt from comprehensive regulation under the Advisers Act, but remain subject to the anti-fraud provisions contained in Section 206 of the Advisers Act. These 'exempt reporting advisers' are required to file an abridged Form ADV; and may be requested to provide access to books and records in connection with 'for cause' examinations. The two exemptions are summarised as follows.

Private fund advisers are investment advisers with less than US$150 million in assets under management in the US and which exclusively advise clients that are private funds (regardless of the size or number of such funds), whereby:

a a 'private fund' is an issuer that would be an investment company but for the exceptions provided for in Sections 3(c)(1) and 3(c)(7) of the Investment Company Act;

b 'assets under management in the US' includes the gross market value (or fair value, if the market value is unavailable) of those assets attributable to any US place of business, including undrawn capital commitments. Proprietary assets (i.e., any sponsor's and affiliates' commitments) may not be excluded for this purpose, but an adviser with its principal office and place of business outside the US may exclude consideration of its non-US clients for this purpose;[48] and

c the value of such private fund assets under management in the US must be reviewed annually by the private fund adviser. A private fund adviser whose assets under management in the US equals or exceeds US$150 million has 90 days from the date of its annual update filing to register with the SEC.[49]

Venture capital advisers are investment advisers that exclusively advise one or more venture capital funds, regardless of the amount of assets under management. A 'venture capital fund' is a 'private fund' (see above) that:

a represents to investors that the fund pursues a venture capital strategy;

b does not provide investors with redemption rights;

c holds no more than 20 per cent of the fund's assets in 'non-qualifying investments'[50] (excluding cash and certain short-term holdings); and

48 An investment adviser's 'principal office and place of business' is the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control and coordinate the activities of the investment adviser (Rule 203A-3(c)).

49 Rule 203(m)-1(c), SEC Regulation of Investment Advisers, p. 15; footnote 39, *supra*.

50 'Qualifying investment' means, generally, directly acquired investments in equity securities of private companies (generally, companies that at the time of investment have not made a public offering) and that do not incur leverage or borrow in connection with the venture capital fund investment and distribute proceeds of such borrowing to the fund (i.e., have not been acquired in a leveraged buy-out transaction). SEC Regulation of Investment Advisers, p. 16 (see footnote 39, *supra*).

d does not borrow (or otherwise incur leverage amounting to) more than 15 per cent of the fund's assets, and then only on a short-term basis (i.e., for no more than 120 days).[51]

In practice, many foreign advisers with no significant US presence qualify as 'private fund advisers' and are required to file with the SEC as exempt reporting advisers, even if their assets under management exceed US$150 million on a worldwide basis.[52] Importantly, exempt reporting advisers are not automatically exempted from state registration, so careful analysis is required when maintaining an office, employing personnel or conducting substantial activities in any US state. While relieving non-US fund managers from the most rigorous compliance standards imposed on registered investment advisers, the SEC uses the Form ADV reporting requirements to gather a significant amount of information on the international fund manager community, much of which is publicly available online via the Investment Adviser Registration Depository (IARD). Fund managers that are required to complete SEC filings as exempt reporting advisers should seek local advice on the IARD registration process and aim to complete this well in advance of any necessary filings.[53]

Foreign private advisers

Although there is no general exemption for non-US advisers, a foreign investment adviser with no place of business in the US and a *de minimis* US investor base may be exempt from registration as a 'foreign private adviser' if it:

a has, in total, fewer than 15 clients in the US and investors in the US in private funds advised by the adviser;

b has aggregate assets under management attributable to these clients and investors of less than US$25 million; and

c does not hold itself out generally to the public in the US as an investment adviser, which does not preclude participation by an adviser in a non-public offering conducted pursuant to Regulation D.[54]

Obligations applicable to registered and unregistered advisers

Regardless of their registration status, investment advisers are subject to statutory and common law fiduciary duties towards their clients, including duties of care and loyalty commonly associated with the underlying agency relationship. Interpreted by courts in tandem with the anti-fraud provisions of the Advisers Act,[55] these duties effectively

51 Rule 203(l)-1(a).

52 As of 4 January 2016, there were 3,138 exempt reporting advisers registered with the SEC, of which approximately 39 per cent maintained their principal office outside the US (source: SEC FOIA documents).

53 An investment adviser that qualifies as a private fund adviser must file Form ADV within 60 days of relying on the exemption: Rule 204-2.

54 Section 203(b)(3) of the Advisers Act and Rule 202(a)(30)-1 thereunder.

55 Principally contained in Section 206 of the Advisers Act and rules promulgated thereunder.

require an investment adviser to act in good faith in its clients' best interests, in particular with respect to the disclosure of potential conflicts of interest that may result in impartial advice being given to a client.

In addition, the SEC has adopted 'pay-to-play' rules prohibiting any investment adviser (whether registered or unregistered) from providing advisory services for compensation to a government client for two years after making certain political contributions.[56] The same rules prohibit remuneration of a placement agent to solicit business from a government entity, unless the placement agent is registered as an investment adviser or broker-dealer (and thus subject to pay-to-play restrictions itself).

iv ERISA

US employee benefit plans continue to represent an important source of capital for private equity funds, with almost US$25 trillion in retirement assets available for investment within this sector (up from US$14.2 trillion just seven years ago).[57]

The Employee Retirement Income Security Act of 1974 (ERISA) and extensive rules and regulations promulgated thereunder by the US Department of Labor govern the obligations of fiduciaries responsible for managing pension plans in private industry.[58] Due to the myriad complexities of ERISA and the potentially significant consequences for a fund treated as 'plan assets' under ERISA (including, among other things, heightened fiduciary standards, rules governing the receipt of carried interest and prohibited transaction rules), specialist expertise should always be sought if a private equity fund anticipates accepting commitments from such investors.

In practice, private equity funds generally seek to avoid being classified as holding plan assets by relying on one of the following exemptions, each of which can only be described very generally here.

Significant participation test

If benefit plan investors[59] own less than 25 per cent of each class of equity interests of the fund, then their participation is not deemed to be 'significant' for the purposes of the Plan Asset Regulation. Since the passage of the Pension Protection Act of 2006, governmental,

56 Rule 206(4)-5: see also SEC Release No. IA-3043 (1 July 2010).

57 As at 31 December 2014. Source: 2015 Investment Company Fact Book, Figure 7.5, Investment Company Institute (55th Edition).

58 In particular the 'Plan Asset Regulation' issued by the US Department of Labor (29 CFR 2510.3-101).

59 A 'benefit plan investor' is any of the following: (1) any employee benefit plan (as defined in section 3(3) of ERISA) that is subject to the provisions of title I of ERISA; (2) any plan described in Section 4975(e)(1) of the Code that is subject to the provisions of Section 4975 of the Code; or (3) any entity whose underlying assets include plan assets by reason of an employee benefit plan's or plan's investment in the entity: see Section 3(42) of ERISA. An employee benefit plan or pension plan of a US state or local government, a church plan and an employee benefit plan or pension plan of a non-US entity are not 'benefit plan investors' under ERISA.

church and non-US benefit plans are not counted as 'benefit plan investors' for this purpose. One common oversight, however, is that interests held by the fund manager and its affiliates (other than interests held by individual retirement accounts of such affiliates) must be excluded from both the numerator and the denominator for the purposes of this calculation. In addition, the test must be performed not just at each closing but over the duration of the fund. Hence, fund managers must monitor compliance on an ongoing basis, particularly in situations such as investor defaults, transfers of interest, and formation of co-investment or alternative investment vehicles.

VCOC exception

A private equity fund may qualify as a venture capital operating company (VCOC) if, among other things, it invests at least 50 per cent of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at historical cost, in operating companies as to which it obtains direct contractual management rights ('qualifying investments')[60] and it actually exercises those rights in the ordinary course with respect to at least one of its qualifying investments each year. Once again, there are several formalistic hurdles to obtain and maintain VCOC status. Among other things, the 50 per cent test described above must be met at the time the fund makes its first long-term investment. Hence, if a fund's first long-term investment is not a 'qualifying investment', the fund can never qualify as a VCOC. Because of this strict requirement, if a fund initially qualifies under the significant participation test (discussed above) but contemplates making its first long-term investment before it is closed to new investors, the fund may wish to ensure that its first investment will be a 'qualifying investment'. Also, although the 50 per cent test for VCOCs implies that not all long-term investments must be qualifying, the 50 per cent test generally must be passed once, annually, during a 90-day valuation period.[61] For the purposes of these rules, 'operating companies' are companies that are, either themselves or through majority-owned subsidiaries, actively engaged in the production of goods and services but also include real estate operating companies, which are discussed below. Thus, the VCOC exception is not appropriate for funds-of-funds and most secondaries funds. Notwithstanding that they are so cumbersome, however, the VCOC requirements are generally consistent with the basic business objective of most standard private equity funds: active involvement with the management of underlying portfolio companies in pursuit of value creation on behalf of fund investors.

60 Qualifying investments are either: (1) 'venture capital investments' with respect to which the fund has obtained certain management rights permitting the fund 'to substantially participate in, or substantially influence the conduct of, the management of the operating company'; or (2) 'derivative investments' that arose from a prior 'venture capital investment': see 29 CFR 2510.3-101(d).

61 There is an exception to this rule for a VCOC that has elected to declare that it is in its distribution period, which is subject to other technical requirements.

REOC exception

The real estate operating company (REOC) exception is similar to the VCOC exception and is used by many real estate funds or by the underlying real estate ventures in which a fund that itself qualifies as a VCOC may invest.[62] For a real estate investment to qualify for REOC compliance purposes, the REOC must have rights to participate directly in the management or development of the underlying real property. As an obvious corollary to this principle, the real estate must be actively managed or developed. Accordingly, fallow land and triple-net-leased assets are inappropriate for REOC qualification. As is the case with VCOCs, if a REOC's first long-term investment is not a qualifying investment, the entity in question can never qualify as a REOC, and 50 per cent of a REOC's investments, once again measured by historical cost, must be qualifying investments on at least one day during a 90-day annual valuation period. Among other things, a REOC must also actually exercise management rights in the ordinary course with respect to at least one of its qualifying investments in any given year. In sum, although the rules for REOC qualification are also complex and nuanced, they are generally consistent with the investment objectives of most value added, opportunistic and core real estate private equity funds that seek to create value through active involvement in the management of underlying real estate assets.

IV REGULATORY DEVELOPMENTS

i National exam programme

As a result of the large number of new investment adviser registrations in 2012 following the enactment of the Dodd-Frank Act, the SEC undertook to conduct presence exams of at least 25 per cent of these new registrants, with the stated goals of: (1) familiarising newly registered investment advisers with their duties under the Advisers Act; (2) examining those advisers to promote compliance with the Advisers Act; and (3) upon completion of the initiative, reporting to the SEC and the public on findings arising from the presence exams.[63] This initiative prompted a resource-intense response that focused not just on demonstrations of formalistic 'black letter' compliance, but of practical compliance across the board. The industry was put on notice in April 2014 when the SEC presented the initial findings of the presence exam initiative, revealing that over half of such exams had discovered what the SEC believes are 'violations of law or material weaknesses in controls'.[64] Areas of particular concern and ongoing focus for the SEC have centred on conflicts of interest, expense allocations (concomitant with documented policies, verifiable procedures and investor disclosures), hidden fees, and marketing and valuation issues (specifically track records).[65] As the SEC seeks to educate itself in the

62 29 CFR 2510.3-101(e).

63 www.sec.gov/about/offices/ocie/letter-presence-exams.pdf (accessed 26 January 2016).

64 Bowden, AJ, Spreading Sunshine in Private Equity ('Industry Trends'), delivered at the PEI Private Fund Compliance Forum (2014); available at www.sec.gov/news/speech/2014--spch05062014ab.html (accessed 22 January 2016).

65 SEC Office of Compliance Inspections and Examinations—National Exam Program, Examination Priorities For 2016, available at www.sec.gov/about/offices/ocie/

intricacies of an industry that historically has been averse to undue public scrutiny, even established investment advisers with sophisticated compliance staff and ample resources have succumbed to the regulator's increasingly assertive behaviour. Widely publicised settlement orders in 2015 against household names in connection with 'accelerated monitoring fees' and the allocation of 'broken deal expenses' have served as a clarion call to the broader private equity industry.[66]

ii General solicitation rules

Amendments to Rule 506 of Regulation D were implemented in 2013 to permit public advertising and general solicitation by issuers of their private placement offerings, subject to certain conditions. Amidst growing political and media interest in 'crowdfunding', issuers of unregistered securities are now legally able to avail themselves of additional distribution pathways, although the compliance burdens and mandatory sanctions for even slight or accidental transgressions have resulted in few issuers taking advantage of the new rules. To address perceived risks associated with untargeted marketing activities, issuers relying on Rule 506(c) are required to carry out enhanced verification procedures to ensure that their investors meet the 'accredited investor' standard, a stark reversal of the long-standing practice that allowed reasonable reliance on an investor's asserted qualifications. Importantly, and in contrast to regular private placements under the existing Rule 506(b), an offering that fails to qualify for safe harbour treatment under Rule 506(c) will not be able to satisfy the fallback position under Section 4(a)(2) of the Securities Act if general solicitation has taken place.

iii Bad actor rules

The 'bad actor' rules require private funds issuing unregistered interests in reliance on Regulation D to certify that they are not disqualified from relying on Regulation D 'for one of the reasons stated in Rule 505(b)(2)(iii) or Rule 506(d)'.[67]

An issuer is disqualified from relying on the Regulation D safe harbours under Rules 505 and 506 if the issuer or any of a wide range of the issuer's affiliated entities, individuals, agents and 20 per cent beneficial owners has been convicted of certain felonies or misdemeanours, or is or has been subject to certain orders, judgments or suspensions, which in some cases requires a look-back as far as 10 years before the sale.

Any such circumstances, to the extent prevailing at 23 September 2013, must be disclosed to each purchaser of unregistered securities a reasonable time prior to sale, and will not preclude an issuer from relying on the Regulation D safe harbour. However,

national-examination-program-priorities-2016.pdf (accessed 22 January 2016); PEI Private Equity International, 'Fees: no surprises, please,' 3 July 2014; *The Wall Street Journal*, 'KKR Refunds Some Fees to Investors,' 21 January 2015, available at: www.wsj.com/articles/kkr-refunds-some-fees-to-investors-1421882828 (accessed 22 January 2016).

66 SEC Release No. 4219 (October 7, 2015); SEC Release No. 4131 (June 29, 2015).

67 The 'bad actor' rules were mandated by Section 926 of the Dodd-Frank Act: see SEC Release No. 33-9414 (10 July 2013). Additional changes to Form D have been proposed in SEC Release No. 33-9416 (10 July 2013).

the scope of factual inquiry necessary to ensure that an issuer can in fact make such representations has required extensive administrative and compliance efforts on the part of private funds and their business partners. As a result of these changes, additional care is necessary in situations where an investor holds more than 20 per cent of the interests issued in a fund vehicle.

iv Volcker Rule

The US agencies responsible for implementing the Volcker Rule agreed in December 2013 to a final version of regulations governing the proprietary trading and private investment fund activities of US banking entities.[68] The implementing agencies provided welcome guidance in February 2015 clarifying the application of the rule with respect to non-US banking entities,[69] while the Federal Reserve Board has extended the deadline for banking entities to comply with the private investment fund restrictions until 21 July 2017, provided the investment or relationship was in place as of 31 December 2013.[70]

The final rule applies to 'banking entities', covering both US banks and their affiliates, as well as foreign banks with a branch or agency office in the US and their affiliates. The restrictions are largely similar to the proposed rule issued in 2011 (with some important modifications), and will prevent, subject to limited exemptions, a banking entity from holding an investment as principal in a private equity fund or sponsoring a private equity fund.[71] A banking entity may, nevertheless, continue to invest in private equity funds to which it acts as an investment adviser, distributer, broker or sponsor,[72] subject to a 'per fund cap' of 3 per cent of the total outstanding ownership

68 Section 619 of the Dodd-Frank Act, commonly known as the 'Volcker Rule', mandated collective rulemaking by the Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, Office of the Comptroller of the Currency and Securities and Exchange Commission.

69 Schulte Roth & Zabel LLP, Client Alert, 'Volcker Rule Update: Agencies Clarify Ability of Non-U.S. Banks to Invest in Third-Party Funds', 2 March 2015.

70 Federal Reserve Board Press Release and Approving Order available at: www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm (accessed 22 January 2016). See further: Schulte Roth & Zabel LLP, Client Alert, 'Volcker Rule Deadline Extended to July 21, 2017 for pre-2014 Fund Activity', 19 December 2014.

71 The final rule applies to 'covered funds', which includes an issuer relying exclusively on the exemptions contained in Sections 3(c)(1) and/or 3(c)(7) of the Investment Company Act (discussed above), as well as any foreign fund that would, if it were subject to US securities laws, rely exclusively on such exemptions: see paragraph 10(b) of the final rule. See further: Schulte Roth & Zabel LLP, 'Summary of Final Volcker Rule Regulation – Fund Activities', 23 December 2013.

72 Acting as a 'sponsor' includes (1) serving as a general partner, managing member, commodity pool operator or as a trustee with investment discretion; (2) selecting or controlling a majority of the directors, trustees or management; or (3) sharing the same name (or a variation thereof) with a covered fund: Section 10(d)(9).

interests in each covered fund and an 'aggregate cap' of 3 per cent of the banking entity's Tier-1 capital. A 'seeding exception' further permits a banking entity to own up to 100 per cent of the covered fund for at least one year post-establishment while external investors are sought. Sponsorship of a private equity fund by a banking entity is subject to further detailed restrictions, including in respect of ownership by employees, naming conventions, disclosure and self-dealing transactions.

v Commodity and futures regulation

The expansion of commodity trading oversight by the CFTC effective at the beginning of 2013 has added another layer of compliance for certain fund sponsors engaging in currency or interest rate hedging activities. The rescission of a central regulatory exemption for private fund advisers (including non-US advisers)[73] effectively limited fund managers to a *de minimis* exemption for such activities[74] and mandated CFTC registration as a commodity pool operator unless another exemption is available.

V OUTLOOK

Against the backdrop of a sustained economic recovery and recent turbulence in public markets, the outlook for US private equity fundraising continues to be positive. Fundraising volumes appear well positioned to maintain their strength in 2016, although we do not expect the upward trend exhibited since 2010 to be eclipsed. Recent data show that 90 per cent of investors are looking to maintain or increase their allocations to private equity in 2016,[75] a situation attributable in part to the record return flows of funds over the past two years. In this context, we also expect to see continued activity in the emergence of tailored solutions for sophisticated institutional investors, with a renewed focus on the economic flexibility afforded by direct and indirect secondary transactions,

73 CFTC Rule 4.13(a)(4), which was adopted in 2003, generally exempted from CFTC registration CPOs of funds whose natural person investors are qualified eligible persons (QEPs) within the meaning of CFTC Rule 4.7(a)(2) (a category that includes 'qualified purchaser' investors in funds offered pursuant to Section 3(c)(7) of the Investment Company Act) and whose non-natural person investors are either QEPs or 'accredited investors' as defined in SEC Regulation D. See also Schulte Roth & Zabel LLP, Client Alert, 'CFTC Staff Issues New FAQ Guidance for CPO, CTA Registration and the '*De Minimis*' Exemption', 24 August 2012.

74 Generally, to qualify for the *de minimis* exemption for unregistered funds contained in CFTC Rule 4.13(a)(3), either: (1) the aggregate initial margin and premiums on commodity interest positions do not exceed 5 per cent of the liquidation value of the fund's portfolio (including unrealised gains and losses); or (2) the aggregate notional value of such positions does not exceed 100 percent of the liquidation value of the fund's portfolio (including unrealised gains and losses).

75 Coller Capital, Global Private Equity Barometer, Winter 2015–2016, p. 4; 2015 Preqin Global Private Equity & Venture Capital Report, p. 8.

co-investments and separately managed accounts. In particular, the growing volume and sophistication of co-investment and secondary activity in the US belies a maturing investor base deeply committed to the success of the private equity industry.

This outlook is tempered by still-resonant memories of the financial crisis, uncertainty regarding certain structural economic conditions and increasing concern about the geopolitical environment. We also expect the industry to continue to be marked by an overriding sense of caution as the volume of recent regulatory changes is absorbed into its folkways.

Appendix 1

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Joseph A Smith is a partner in the investment management group at Schulte Roth & Zabel LLP. Joe's practice focuses on the formation and operation of private equity funds, as well as private equity transactions, real estate capital markets and REITs. He represents US and international private equity fund sponsors and institutional investors in connection with fund formation, the acquisition and disposition of portfolio investments and the implementation of exit strategies. In this capacity, he advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. Joe has extensive experience with all alternative asset classes, including venture capital and later-stage growth equity investments, leveraged buyouts, mezzanine investments, real estate ventures and opportunity funds, secondary investments, funds of funds and hedge funds.

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