Fund Terms

Schulte Roth & Zabel

PRIVATE EQUITY FUND CONFERENCE

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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.

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

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

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

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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

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.

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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]

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,

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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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Conrad Axelrod is an associate in the investment management group at Schulte Roth & Zabel LLP, where he focuses on the formation and structuring of private equity and alternative investment funds. In addition to assisting clients with operational issues and management company structuring, Conrad has extensive experience advising on co-investment transactions in the real estate, international credit and E&P sectors. He has also guided investors and sponsors through secondary portfolio transactions and fund restructurings.

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