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1. Industry Update: Fundraising Environment

2. Credit Facilities

3. Operational Best Practices

Industry Update: Fundraising Environment

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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*, *New York Super 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 legal developments affecting employers, issues related to fund restructuring, regulatory and compliance concerns for co-investments, 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). She was recently featured in *Private Funds Management*'s spotlight article "Ringing the Changes."

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Industry Update: Fundraising Environment

I. Introduction

A. The private equity fundraising market was strong through Q4 2016.

B. Private equity fund documents reflect a highly developed and active industry. These documents are continually evolving given investor demands, management team strengths and regulatory compliance.

II. Economics

A. Generally, there is no significant update regarding carried interest structures, although managers continue to assess alternative arrangements to typical carried interest and management fee structures.

1. One such alternative may involve charging lower management fees in exchange for a higher carried interest. GPs have also discussed a structure whereby a carried interest above 20 percent is paid based on a fund's performance. Those waterfalls are rare, but they occur more frequently in venture capital funds or joint ventures. Separately, there has been greater interest in longer-term private equity funds.

2. There is pressure to reduce the typical preferred return, particularly for real estate (for which the hurdles have been as high as 9 percent or 10 percent), credit and distressed funds. The 8-percent hurdle is more likely to remain in buyout funds; however, managers of funds that hold assets for unexpectedly long periods are seeing the preferred return dwarf their carried interests.

3. GPs and investors are assessing possible changes to tax laws, particularly the effects of changes to the taxation of carried interest.

4. Funds raised with back-ended waterfalls (i.e., European waterfalls where the carried interest is paid after capital and the preferred return are paid) continue to be easier to market; however, a manager is unlikely to switch its successor fund to a back-ended waterfall if the predecessor fund had a deal-by-deal waterfall.

5. Security for clawback payments continues to be a focus for investors, particularly for funds with deal-by-deal waterfalls. While interim clawbacks are common and fund-level escrows are uncommon, we are reminding managers to create their own internal escrow arrangements to manage collectability of clawback obligations from individual investment team members. This is especially important given shifts among management teams in the private equity industry. Collecting clawback payments from former employees is extremely difficult.

B. Management fees do not appear to have deviated materially from standard terms (i.e., 1 percent to 2 percent of committed capital until the end of the investment period, followed by 1 percent to 2 percent of net invested capital). However, investors are increasingly scrutinizing management fees.

1. Scrutiny has been applied to the periods during which fees are paid.

   (a) Commencement of fees: Typically, management fees accrue from the first closing of a fund. Investors may request that the commencement date be delayed until the first closing of an investment. Investors being admitted at later closings may object to being charged management fees for periods prior to their admission (which we see more often as marketing periods have been extended). Other investors may object to being charged interest on

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management fees that were payable for periods prior to their admission. Even if managers wish to accommodate the requests of investors being admitted at later closings, careful attention must be given to "most favored nations" (MFN) rights of other investors.

(b) Step-down of fees to amounts based on net invested capital: Investors have sought to accelerate the step-down date to the earlier of the formation of a successor fund and the termination of the investment period. The step-down calculation is also applicable during a suspension of the investment period for key person events. Attention should be given to the definition of "net invested capital" and the "formation of a successor fund." For instance, clarification of whether proceeds from a refinancing are treated as a reduction of invested capital is a typical LPA provision. A fund should be treated as "formed" when it receives capital commitments from unaffiliated investors (and not when a certificate is filed in Delaware), and the definition of a "successor fund" should be clarified as to size so that an "add-on" or "bridge" fund does not trigger a step-down.

(c) Termination of fees: Management fees typically continue until a fund completes its liquidation, and fees will reduce as net invested capital shrinks. Investors may require that management fees terminate on a date certain, such as the dissolution date of a fund (i.e., the end of its term) or shortly thereafter. The hard-stop date of management fees was intended to discourage managers from hanging on to assets in zombie funds. Investors seem to understand, however, that even zombie funds have to be managed and therefore have been more flexible about insisting on hard stops.

2. Scrutiny has been applied to the size of fees:

(a) The larger the fund, or total funds under management by a single manager, the smaller the fees (i.e., the fee percentage is likely to be less than 2 percent).

(b) Larger investors are requesting smaller fees; however, again, this is likely to be accommodated when the overall fund size is relatively large.

(c) The fee percentage is also likely to drop below 2 percent after the "step-down date," possibly to 1 percent.

(d) The fee may be smaller for certain investors (e.g., investors "re-upping" into successor funds and investors committing at the first closing). We recently saw an investor ask a manager to commit to giving that investor a fee break for a successor fund when committing to the predecessor fund. This raises MFN issues before the successor fund is raised.

(e) The strategy of the fund could drive different fee structures — venture capital funds pay on committed capital with step-down percentages; debt funds pay under 2 percent; real estate funds may pay on the cost of investments (including debt used to acquire the asset).

(f) The calculation of net invested capital should be clarified. Specifically, the partnership agreement should specify whether a disposition has occurred as a result of:

(i) A debt refinancing; or

(ii) The fund's receipt of securities paid in kind for a portfolio company.

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3. Scrutiny is applied to management fee offsets.

   (a) 100-percent offsets to management fees from transaction fees are widely accepted.

   (b) Some anchor investors may negotiate for a piece of the transaction fee that is allocable to co-investors (which would ordinarily have been carved out of the offset), and similarly, some anchor investors believe that any management fees charged to co-investors (which is rarely the case) should be shared with them.

   (c) The SEC has found that monitoring fees should not be accelerated at either the exit or IPO of a portfolio company without LP approval (including LP committee approval).

C. Fund expenses must be given greater attention.

   (a) As a result of SEC guidance and requirement for greater disclosure, generally expense provisions in fund documents are more extensive. These provisions give the appearance that funds are incurring more expenses than they did in prior periods. In fact, funds are likely to be paying for the same expenses they have always incurred. Greater disclosure of expense items may have ironically led to certain confusion in the market place and possibly unintended negotiations between investors and GPs.

   (b) Third-party expenses are subject to more scrutiny, but in certain cases, partnership agreements allow managers of funds to be paid for services normally provided by third parties if the manager is being paid at comparable rates that third parties charge.

   (c) Expense allocation among affiliated funds must be tracked regardless of the disclosure of expense items permitted to be borne by a single fund.

III. Fundraising and Operations

A. Fundraising continues to occur over longer periods.

1. Presentation of track record by a consistent team is key:

   (a) The team must meet attribution rules;

   (b) The team must be in compliance with confidentiality obligations to prior employers; and

   (c) Equalization calculations are applied more frequently (such as assuming all investors are charged 2 percent/20 percent).

2. AIFMD rules limit the ability to raise capital in the EU.

   GPs and regulators have become more skeptical about over-reliance on the “reverse solicitation” exemption. More GPs are looking into registrations under national private placement regimes in key EU jurisdictions, with some of the largest multi-strategy managers opting to form their own AIFMs and funds in the EU. Other solutions, such as third-party EU AIFM platforms, are also available and offer the potential for a wider distribution in Europe, including in countries that do not allow marketing of non-EU funds.

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B. Side letters have added burdens to fundraising and fund operations.

   1. The number of side letters per fundraise often covers almost every institutional investor.

   2. Side letters are highly customized for individual investors, particularly government pension plans. Customized provisions include reporting obligations, investment restrictions, representations, confidentiality rights, use of name limits and co-investment rights.

   3. The customization of side letters has led to the expansion of exceptions to MFN rights, particularly of the customized topics.

   4. In response to the use of "size-based" MFN rights, investors often negotiate for the aggregation of their investment with their affiliates and other co-managed investors.

C. Data Management

   1. In response to the amount of due diligence and reporting obligations created under side letters, managers are tracking data of portfolio investments in anticipation of future marketing.

   2. These tracking sheets are being included in regular investor reports.

   3. Data tracking and presentation is driving up fund costs.

D. Conflicts/LP Committees

   1. Regulators are focused on the fair treatment of investors, and LP committees have the authority to pass on conflict of interest transactions.

   2. LP committee votes are more difficult to obtain for several reasons. First, members of LP committees who are themselves conflicted may be excluded from a vote on the matter. Other members of the LP committee may choose to abstain from voting, fearing liability. As a result, the number of votes needed to obtain LP committee approval is shifting from a majority of the whole committee to a majority of the members attending the meeting.

   3. There is also a trend to move votes away from LP committees to investors, particularly with respect to investment restrictions.

E. Investment restrictions are more specific. Even industry-specific funds have limits on areas within the particular industry (such as limits on pharma investments within a biotech fund).

IV. Winding Up

A. GPs customarily seek extension of a fund's term, but both LPs and GPs may misunderstand the process that is triggered by a fund's dissolution.

   1. A dissolution of a fund allows for an orderly sale and winding up process without a specific date by which all investments must be sold, unless the LPA provides otherwise.

   2. The LPA of a fund typically provides that the GP conducts the winding up of a fund, but occasionally the LPs have the right to substitute a third party for the GP as the liquidator. This would be the case if a fund were terminated following a removal of the GP for "cause," but also may occur if the liquidation does not occur by a date certain.

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3. Other provisions are relevant after the term of a fund expires, such as whether management fees continue to be paid and whether the fund continues to be able to make capital calls.

B. Fund liability to purchasers of assets and may delay the winding up process.

C. Secondary buyers have great opportunities in today's market to buy either assets of the fund or LP interests during the winding up phase.

1. Secondary buyers may be presented with opportunities before the winding up of a fund.

2. The GP should determine whether a discount proposed by a secondary buyer is appropriate before the winding up of a fund.

V. Conclusion

A. The new U.S. administration and Brexit may have an effect on the industry, but there is no view yet on the expected changes.

B. The successful fundraising from 2016 has provided GPs with enormous amounts of dry powder to deploy, perhaps driving up prices of deals.

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Chapter 22

UNITED STATES

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I GENERAL OVERVIEW

A confluence of factors shaped the US private equity fundraising market in 2016. Consistently high trading multiples and ongoing concerns over the high volume of 'dry powder' within the industry were not sufficient to mitigate an influx of fresh capital. Faced with continuing low interest rates and concerns about secular economic growth, institutional investors seeking to satisfy long-term funding obligations had limited options to redeploy a record wave of returning capital.[2] Consequently, these investors were willing to make ever larger allocations to the asset class.

Since the nadir of 2010, when North American-focused funds raised only US$163 billion, fundraising activity recovered to US$312 billion in 2016, significantly outpacing the US$258 billion raised in 2015.[3] Established investors continued to scrutinise management teams and negotiate individual fund terms in particular detail, with fund sponsors marketing their increased transparency and a willingness to accommodate investors' policies and procedures. In addition, a continued wave of bespoke solutions, such as separately managed accounts, continued to augment the classic approach to private equity fundraising. Over one-third of investors now report the use of special accounts in conjunction with traditional commingled funds.[4] Here, in the current environment, managers are searching further afield for sources of capital, with the result that access to formalised club deals and sizeable co-investments are frequently cited by investors as a prerequisite to new blind-pool commitments, especially with new managers.

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1 Joseph A Smith is a partner, Conrad Axelrod is a special counsel and Christopher S Avellaneda 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 Distributions have exceeded capital calls for six consecutive years, with a record US$443 billion distributed in 2015 from private equity funds worldwide against a backdrop of US$226 billion in capital calls. Preqin Private Equity Spotlight, December 2016, p. 3; Preqin Global Private Equity and Venture Capital Report (2017), p. 17.

3 Preqin 2016 Alternative Assets Fundraising Dataset (January 2017) (private capital figures excluding real estate fundraising); Preqin 2015 Alternative Assets Fundraising Dataset (January 2016).

4 According to industry estimates, an additional 28 per cent (US$188 billion) of private capital was raised worldwide in 2016 for deal-by-deal structures, co-investment and managed accounts: *The Triago Quarterly* (December 2016), 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; Preqin Global Private Equity and Venture Capital Report (2017), p. 30 (reporting a 42 per cent participation rate among LPs for co-investments, with 30 per cent participating in separate accounts).

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 increase ticket sizes and concentrate their attention on a finite number of 'best of breed' fund sponsors.[5] 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 by larger household names and emerging managers with an exceptional track record or value proposition. Commentators have also observed that they expect the steadily increasing proportion of capital raised by 'mega-funds' (over US$5 billion) to be offset in part by the declining persistence of top-quartile returns.[6]

New and spin-off managers, however, continued to face particularly high barriers to entry as a result of increased regulatory burdens on marketing and operational activities. These burdens have been 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.[7] Indeed, many believe that the increased regulatory scrutiny since enactment of the Dodd-Frank Act and the focus of the Securities and Exchange Commission (SEC) presence exam initiative on private equity funds (discussed below) has fed investor commentary in this regard.[8]

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'.[9] These fund managers are subject to increasing pressure to specialise and differentiate themselves in an effort to demonstrate their unique potential for adding value

5 The average commitment size of investors in private equity funds has increased 47 per cent in the past five years, to US$50 million. *The Triago Quarterly* (December 2016), p. 2.

6 McKinsey & Company, Private equity: Changing perceptions and new realities (April 2014). Twenty-six per cent of aggregate capital raised worldwide in 2016 was secured by the 10 largest funds, up from 19 per cent in 2014: Preqin Global Private Equity and Venture Capital Report (2017), p. 16.

7 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 30 January 2017).

8 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.

9 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.

– claims that are increasingly substantiated by market research.[10] 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 2016 were Advent Global Private Equity VIII (US$13 billion), TPG Partners VII (US$10.5 billion) and Green Equity Investors VII (US$9.6 billion).[11] Buyout funds comprised by far the largest share of 2016 fundraising activity, with 103 buyout funds raising an aggregate of US$120.2 billion (up from 79 funds and US$81.8 billion in 2015).

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.[12] Infrastructure fundraising surged from US$13 billion in 2015 to nearly US$30 billion in 2016,[13] buoyed by an emerging set of demographic and political trends that foreshadow some relief from the difficulties that have burdened the sector in the past.

Secondary fundraising peaked in 2013, but deal activity remained a vibrant feature of the industry in 2016, 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.[14]

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

10 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, December 2016, p. 5; Preqin Special Report, 'Making the Case for First-Time Funds', November 2016; Preqin Global Private Equity and Venture Capital Report (2017), p. 52.

11 Preqin 2016 Alternative Assets Fundraising Dataset (January 2017).

12 Between 2009 and 2015, private debt fundraising increased more than threefold to US$96 billion (down to US$74 billion in 2016), with US$49.5 billion raised in 2016 in the US: Preqin 2016 Alternative Assets Fundraising Dataset (January 2017).

13 Preqin 2016 Alternative Assets Fundraising Dataset (January 2017); Preqin 2015 Alternative Assets Fundraising Dataset (January 2016). Almost half of PE investors are planning a higher target allocation to infrastructure: Coller Capital, Global Private Equity Barometer, Winter 2016-17, p. 4.

14 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. Almost two thirds of LPs will buy or sell in the secondary market in the next two years: Coller Capital, Global Private Equity Barometer, Winter 2016-17, p. 6.

being based overseas.[15] Venture capital fundraising momentum was largely sustained for the sixth consecutive year, with US$34.2 billion raised across 220 funds (2015: US$31.3 billion raised across 175 funds).[16]

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 2016 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:

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

16 Preqin 2016 Alternative Assets Fundraising Dataset (January 2017). See also: National Venture Capital Association and Thomson Reuters, 2016 National Venture Capital Association Yearbook (March 2017), p. 22, suggesting a slight decline in year-on-year fundraising.

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.[17] 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 result 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.[18] 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.

17 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.

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

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 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.[19] 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),[20] an FFI is generally required to register with the Internal Revenue

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

20 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 type that produce interest or dividends, as well as withholding on certain 'foreign pass-through payments', the meaning of which has

Service (IRS) and, except as discussed below, enter into an FFI agreement with the IRS. Under such 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).[21] Pursuant to Model 1 IGAs, an FFI located in an IGA jurisdiction generally is not subject to withholding under FATCA[22] 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 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 chapter.[23]

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yet to be published by the US Department of the Treasury.

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

22 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.

23 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).

i Securities Act

The sale of interests in a private equity fund is governed by the Securities Act, which requires securities sold in the US to be registered with the 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 provides an exemption for private offerings of securities to US persons who qualify as 'accredited investors',[24] and was amended in 2013 to permit general solicitation (i.e., advertising to the public) in limited 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.[25] In addition, issuers relying on Rule 506 of Regulation D[26] must not be subject to any 'disqualifying event' as set forth in the rule.[27] This requirement effectively prohibits private equity funds and their advisers from raising capital using Regulation D if those persons are subject to certain disciplinary events.

Regulation S[28] 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

24 '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.

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

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 Rule 506(c) (discussed below).

27 17 C.F.R. Section 230.506(d). The 'Bad Actor' rule applies when a 'covered person' is subject to a 'disqualifying event'. The term 'covered person' includes both the issuer itself and the investment adviser to the issuer. 'Disqualifying Events' include certain criminal convictions, certain court injunctions and restraining orders, certain SEC disciplinary and cease-and-desist orders, final orders of certain state and federal regulators, and suspension or expulsion from any self-regulatory organisation, as well as other events enumerated in the rule.

28 Rules 903 and 904 of Regulation S (17 CFR 230.901 et seq.) establish requirements in order for the issuer and any reseller, respectively, 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.

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.[29]

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,[30] 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.[31] 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'),[32] compliance with Regulation D (discussed above) will generally require investors to satisfy the 'accredited investor' test.

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)).

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

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

31 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.

32 '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 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.

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:[33]

a individuals who own at least US$5 million in investments[34] (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'.[35]

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).[36]

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,[37] 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.[38]

Investment advisers with more than US$100 million in regulatory assets under management[39] 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

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

34 '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).

35 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.

36 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 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.

37 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)).

38 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).

39 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).

under similar statutes.[40] 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).[41] 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 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.[42]

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 and address compliance matters that arose during the previous year, changes in the adviser's business, and the effectiveness and comprehensiveness of the adviser's policies or procedures.[43] The SEC's Office of Compliance Inspections and Examinations conducts periodic examinations of registered advisers, 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,[44] which an investment adviser may only charge to sufficiently sophisticated investors, including 3(c)(7) funds (see Section III.ii, *supra*) and qualified clients,[45] as well as non-US persons. Registered advisers are generally required to hold client assets through a qualified custodian (such as a

40 SEC Regulation of Investment Advisers, note 47.

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

42 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.

43 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.

44 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'.

45 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.

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.[46]

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;[47] 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 file for registration as an investment adviser with the SEC.[48]

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'[49] (excluding cash and certain short-term holdings); and

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

47 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)).

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

49 '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).[50]

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.[51] 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.[52]

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.[53]

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,[54] these duties effectively 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

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

51 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).

52 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.

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

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

government client for two years after making certain political contributions.[55] 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).[56]

The Employee Retirement Income Security Act of 1974, as amended (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.[57] 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[58] 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, 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.

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

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

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

58 A 'benefit plan investor' is any of the following: any employee benefit plan (as defined in section 3(3) of ERISA) that is subject to the provisions of title I of ERISA; any plan described in Section 4975(e)(1) of the Code that is subject to the provisions of Section 4975 of the Code; or 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.

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')[59] 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.[60] 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.

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.[61] 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

59 Qualifying investments are either: '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 'derivative investments' that arose from a prior 'venture capital investment': see 29 CFR 2510.3-101(d).

60 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.

61 29 CFR 2510.3-101(e).

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 and SEC enforcement activity

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. 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. In April 2014 the SEC staff 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'.[62] 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).[63]

SEC enforcement actions since 2014 have mirrored the examination programme's focus on conflicts of interest. In 2015, the SEC's Division of Enforcement brought several cases against private equity fund managers alleging breach of fiduciary duty because the manager had not disclosed or taken steps to mitigate certain conflicts of interest. Alleged breaches of fiduciary duty underlying SEC enforcement actions have included:

a Broken deal expenses.[64] The SEC alleged that a private equity fund manager's failure to disclose its practice of not allocating 'broken deal expenses' to co-investors in fund investments was a breach of fiduciary duty. Most of the co-investors involved were internal firm personnel.

b Expense and fee disclosures.[65] The SEC alleged that a private equity fund manager breached its fiduciary duty when the manager did not disclose (i) the manager's ability to accelerate monitoring fees to be paid in the future prior to the submission of capital commitments by limited partners in the funds and (ii) a discount that it received on legal fees provided to the sponsor but not to the funds.

c Personal investments.[66] The SEC alleged that a fund manager breached its fiduciary obligations by failing to disclose that one of the manager's portfolio managers was a general partner of and had a substantial investment in a company that formed a joint venture with one of the fund's portfolio companies.

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62 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 30 January 2017).

63 SEC Office of Compliance Inspections and Examinations—National Exam Program, Examination Priorities For 2016, available at www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf (accessed 30 January 2017); 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 30 January 2017).

64 Investment Advisers Act Release No. 4131 (29 June 2015).

65 Investment Advisers Act Release No. 4219 (7 October 2015).

66 Investment Advisers Act Release No. 4065 (20 April 2015).

The key takeaway from the cases we have summarised here and the trends in SEC enforcement actions is that the SEC is focusing on failures by private equity fund managers to effectively disclose and mitigate conflicts of interest, and to implement compliance programmes able to detect and mitigate these conflicts of interest.

ii Cases brought against individuals

The SEC is increasingly charging individuals, including both business managers and compliance personnel, with failing to adequately supervise personnel and not establishing compliance programmes reasonably designed to prevent violations of the Advisers Act.

In 2016, the SEC charged a senior analyst of an investment manager with failure to reasonably supervise an employee who procured material non-public information from an insider at a public company, on the basis of which the investment adviser subsequently traded.[67] The SEC alleged that the senior analyst in question should have reasonably known to question where his subordinate received the information. The senior analyst was therefore charged with failure to reasonably supervise his subordinate as required by the Advisers Act.

Historically, the SEC generally charged CCOs and other compliance professionals only to the extent they were involved in wrongdoing. However, the SEC recently brought an enforcement action against a CCO for causing his firm's compliance violations by 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.[68] In 2015 the SEC also alleged that a CCO aided and abetted violations of the Custody Rule[69] because the CCO was simply ineffective in persuading management to take actions to remedy the investment adviser's failure to timely distribute audited financial statements to investors.[70]

The SEC's recent enforcement actions demonstrate that the SEC is willing to charge individuals personally for failure to supervise subordinates and establish meaningful compliance programmes, but also that individuals do not necessarily need to be directly responsible for wrongdoing in order to be charged by the SEC. Ensuring compliance with applicable law is therefore not solely the responsibility of compliance professionals, but also of business supervisors.

iii Financial CHOICE Act and Dodd-Frank reform

On 10 September 2016, the House Financial Services Committee approved H.R. 5983, the Financial CHOICE Act of 2016.[71] The Financial CHOICE Act contains various revisions to the Dodd-Frank Act, and several provisions relevant to private equity fund advisers. As of the date of this writing, the Financial CHOICE Act has been reported to the House of Representatives by the Financial Services Committee, but has not been voted upon.

Two provisions relevant to private equity fund advisers are Sections 450 and 452 of the Financial CHOICE Act. Section 450 of the Financial CHOICE Act exempts advisers to private equity funds from the registration and reporting requirements of Section 203 of the

67 Investment Advisers Act Release No. 4550 (13 October 2016).

68 Investment Advisers Act Release No. 4065 (20 April 2015). Specifically, the CCO was held partially responsible for a portfolio manager and the principals of the firm failing to disclose a conflict of interest to the board of directors of a fund and not disclosing other pertinent compliance matters to the fund's board.

69 275 CFR 206(4)-2.

70 Investment Advisers Act Release No. 4273 (19 November 2015).

71 Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. (2016).

Advisers Act. The Financial CHOICE Act also requires the SEC to issue rules that require investment advisers to 'private equity funds' (yet to be defined) to maintain records and provide to the SEC reports that the SEC, taking into account fund size, governance, investment strategy, risk and other factors, determines necessary and appropriate.

Even if private equity fund managers are permitted to deregister as investment advisers, the SEC has authority to increase the reporting obligations of exempt reporting advisers if it views such additional reporting as being in the public interest or for the protection of investors.[72] This authority could result in unregistered private equity fund managers shouldering additional reporting responsibilities relative to exempt reporting advisers.

Section 452 of the Financial CHOICE Act expands the definition of an accredited investor to include natural persons who: are currently licensed or registered as a broker or investment adviser by the SEC, the Financial Industry Regulatory Authority (FINRA), an equivalent self-regulatory organisation (SRO) or a state securities regulator; or the SEC determines by regulation have demonstrable education or job experience to qualify as having professional knowledge of a subject related to a particular investment, and whose education or job experience is verified by FINRA or an equivalent SRO. This revision could significantly expand the field of individuals who are able to invest in private equity funds that are not reliant on Section 3(c)(7) of the Company Act.

We have detailed here the provisions of the Financial CHOICE Act that are directly applicable to private equity fund managers, but the Financial CHOICE Act is a comprehensive reform measure and it contains a variety of changes that may, directly or indirectly, affect private equity fund managers. For example, the Financial CHOICE Act as currently drafted would also repeal the Volcker Rule in its entirety.

iv 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.

72 Section 203(m)(2) of the Advisers Act gives the SEC the authority to require advisers relying on the Private Fund Adviser Exemption 'to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.'

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: 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 the aggregate notional value of such positions does not exceed 100 per cent of the liquidation value of the fund's portfolio (including unrealised gains and losses).

IV OUTLOOK

Against the backdrop of a sustained economic recovery in the US and political turbulence in key international markets, the outlook for US private equity fundraising continues to be positive. Fundraising volumes appear well positioned to maintain strength in 2017, although the prospect of higher interest rates and concerns over high trading multiples may continue to relieve upward pressure on private equity allocations. Nonetheless, recent data continue to show that 90 per cent of investors are looking to maintain or increase their allocations to private equity in coming years,[75] a situation attributable in part to the record return of capital over the past three 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, co-investments and separately managed accounts. Hence, despite uncertainty regarding certain structural economic conditions, increasing concern about the geopolitical environment and uncertainty over the prospects for regulatory change, the US private equity market, we believe, continues to be fundamentally robust.

75 Coller Capital, Global Private Equity Barometer, Winter 2016–2017, p. 9.

Appendix 1

ABOUT THE AUTHORS

JOSEPH A SMITH

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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, as well as secondary investments and funds of funds.

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Conrad Axelrod is a special counsel 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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Christopher S Avellaneda is an associate in the investment management, and regulatory and compliance groups at Schulte Roth & Zabel LLP. He advises hedge funds, private equity funds and funds of funds on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organisation requirements. Chris has extensive experience providing guidance to clients on establishing compliance programmes, registering with the SEC, complying with US securities trading rules and handling SEC examinations.

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Jason concentrates on corporate and securities matters for investment managers and alternative investment funds. He represents institutional and entrepreneurial investment managers, financial services firms and private investment funds in all aspects of their business. Jason's practice focuses on advising managers of private equity, hedge and hybrid funds regarding the structure of their businesses, and on day-to-day operational, securities, corporate and compliance issues; structuring and negotiating seed and strategic investments and relationships and joint ventures; and advising investment managers with respect to regulatory and compliance issues.

Jason has been recognized by both *IFLR1000* and *New York Super Lawyers* as a "Rising Star," and he publishes and speaks often about topics of concern to private investment funds. He is the co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and "Information Security: Obligations and Expectations," an *SRZ White Paper*. He recently addressed "Challenges Terminating Old Funds and Launching New Ones" and "Credit and Hybrid Funds" at SRZ's 26th Annual Private Investment Funds Seminar, and has discussed co-investments, considerations for managers in their first five years of operations, and marketing opportunities and challenges for funds.

Jason received his J.D. from Fordham University School of Law and his B.S. from the University of Michigan.

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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 also advises investment managers on strategic transactions involving alternative asset management businesses. Omoz has extensive experience representing sponsors and investors on funds employing credit, distressed investment, buyout, real estate, special opportunities, structured products, activist, multi-strategy and quantitative strategies. Omoz has advised clients on spin-out transactions, acquisitions of minority stakes in hedge fund and private equity firms, joint ventures between investment management firms and strategic transactions involving a change of management of private investment funds. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and advises sponsors of private equity firms and hedge fund 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 he most recently addressed "Financing for Funds and Managers" at SRZ's 26th Annual Private Investment Funds Seminar. Additional speaking engagements have focused on 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).

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Credit Facilities

I. Capital Call Lines/Subscription Facilities

A. General

1. These are non-amortizing senior secured facilities that private equity funds use as cash management tools. Capital call lines are often used to bridge an investment to be made by a private equity fund prior to receipt of proceeds of capital calls and also occasionally to fund working capital needs of a private equity fund (e.g., to pay fund expenses, including management fees) or manage capital call defaults by LPs. They are also increasingly being used as more conventional longer-term financing for investments. A subscription facility may also be used to provide standby letters of credit. In certain types of facilities, drawdowns are required to be repaid within a short period (e.g., between 90 days and 180 days). This may be required to meet tax structuring needs (such as where the fund has UBTI-sensitive investors) or may be a credit criterion imposed by the lender. In other cases, drawdowns will not be required to be repaid until final maturity.

2. The current low interest rate environment has made using capital call lines more attractive to GPs (and fund LPs) and has in part led to an increase in the use of these facilities as a means of longer-term financing enabling GPs to juice up fund returns. In addition, unlike asset-based financing where the amount of credit extended and the rates charged for such credit are based on the quality of the assets serving as collateral, for subscription facilities, the amount of credit extended and the rates charged by the lender are based on the creditworthiness of the fund's investors. For a fund with highly rated institutional investors, a subscription facility may actually be cheaper than a more conventional asset-based financing.

3. Sometimes, funds prefer to draw down funds under a subscription facility rather than call capital directly from the fund's investors because, in many instances, the preferred return on an investor's capital contribution to a fund only starts ticking when the capital contribution is actually made. If the interest rate at which the fund can borrow from a lender is low compared to the preferred return rate, GPs may prefer to keep money drawn down by a fund under a subscription line facility outstanding (and unpaid) for a longer period of time than would otherwise be the case.

4. The practical effect of delaying the fund calling capital from LPs to repay amounts outstanding under a subscription facility is that the IRRs on investments that have been financed using the subscription facility will be higher than they otherwise would have been if the fund had drawn down cash from LPs at the time the investment was made. Theoretically, if a fund used cash drawn down from a subscription facility to fund an investment and sold that investment without having ever actually called capital from LPs in connection with such investment, the IRR on such investment would be astronomical.

5. Typically, if leverage is a critical part of the investment strategy of a fund, this is disclosed in the description of the fund's investment program set forth in its private placement memorandum. Given the increased use of subscription facilities as a means of longer-term financing of fund investment, GPs need to consider whether their PPMs and other offering materials contain adequate disclosure of the potential use of a subscription facility as a means of longer-term financing investments and that this may also result in higher IRRs for the fund.

6. Typically, when funds obtain subscription facilities, instead of granting a security interest on portfolio assets to the lender, the GP pledges its right to call capital from commitments to the

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lender, and limited partners agree (usually pursuant to the partnership agreement of the fund and sometimes through the execution of separate confirmation letters) that their unfunded capital commitments can be called directly by the lender to repay amounts drawn under the facility. Thus, the loan facility is secured by unfunded capital commitments of the limited partners (as well as the collection account for capital contributions). Occasionally, in situations where the fund is near the end of its investment period and unfunded capital is relatively low, the lender may also take a security interest in fund assets.

B. Obligations of Limited Partners

Limited partners are usually required under the fund's partnership agreement to provide financial information about themselves so that the lender can assess individual limited partners' credit. Some limited partners (e.g., certain pension funds or foundations) enter into side letters with a fund pursuant to which they agree only to provide publicly available financial information about themselves. In addition, certain tax-exempt limited partners who want minimal UBTI risk will enter into side letters with the fund that provide that they will be given the chance to pre-fund (usually on notice shorter than the notice required for capital calls) their share of any drawdown from a subscription facility and such limited partners usually also request that no portion of the interest expense charged on the fund's drawdown from the subscription facility will be allocable to a limited partner that has pre-funded its share of such drawdown from the subscription facility. Private equity funds also frequently agree with limited partners to side letter provisions that limit the subscription facility documentation required by a lender to be executed by such limited partners to "customary" documentation and/or documentation "reasonably satisfactory" to such limited partners.

C. Terms of Borrowing

1. The borrowing base (i.e., the amount of funds that can be drawn down under a subscription facility) is typically equal to a percentage of the unfunded capital commitments of eligible (or "included") limited partners. Limited partners that do not provide sufficient financial information about themselves, or whose credit the lender deems insufficient, are typically excluded from the borrowing base. The default or bankruptcy of a single eligible limited partner should not result in default if outstanding loans are less than the amount of borrowing base. However, if the facility is provided to a "fund of one," a default or bankruptcy event affecting the investor would result in all loans becoming due and an inability to borrow going forward, because the borrowing base will be zero. Note that even though some investors are not included in the borrowing base because the lender is not sufficiently satisfied with their creditworthiness, the GP would still be pledging its right to call capital from such investors.

2. The advance rate on drawdowns may be a blended rate that takes into account different advance rates for different limited partners in the borrowing base (e.g., limited partners with higher ratings effectively get to borrow a higher percentage of their collateral). In addition to interest on amounts drawn down from the subscription facility, lenders may also charge a facility fee payable at closing, as well as an unused commitment fee.

3. Because lenders are primarily relying on the capital commitments rather than on the value of the borrower's assets, a subscription facility should include fewer restrictions and controls over a fund's business (which restrictions and controls may be typical in a more typical corporate credit facility). A subscription facility, however, will include many provisions relating to the investors (such as restrictions on transfers and withdrawals by investors or excusing an investor's obligation to fund; limitations on who may become an investor and restrictions on amendments to the partnership agreement; or entering into new side letters). Usually, the restrictions are tighter for the investors

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included in the borrowing base, although, since all investor commitments are pledged, the lender may still insist on some control over certain actions relating to excluded investors.

D. LPA/Side Letter Issues

1. In order to successfully obtain a subscription facility, fund partnership agreements should expressly permit the use of a subscription facility and provide that the GP's right to call capital can be pledged to a lender. The typical subscription facility provision in a fund partnership agreement should also put LPs on notice that they may be required to provide financial information about themselves as well as investor letters/opinions confirming their capital commitments. To the extent that a GP knows which lender it is going to obtain a subscription facility from ahead of time (i.e., before closing the fund), the GP should, to the extent possible, find out from such lenders what specific requirements they have for investors (e.g., the form of confirmation letter the lender prefers to use) and bake those requirements into the partnership agreement and subscription agreements for the fund.

2. Some lenders may require that the provisions set forth in a fund's partnership agreement permitting subscription facilities should also explicitly permit joint and several liability (for such subscription facility borrowings) between the fund, on the one hand, and alternative investment vehicles and parallel funds, on the other hand. Lenders also want partnership agreements to provide clarity on the purposes for which funds drawn on a subscription facility can be used as well as permit cash to be called from LPs to repay borrowings under the subscription facility.

3. Subscription facility lenders will typically want to review all investor side letters prior to finalizing the subscription facility. They will often also want notification and/or consent of any transfers by investors of their LP interests, as this can affect the quality of their collateral. Finally, lenders will want to be notified of any amendments to the fund partnership agreement.

II. Leveraged Co-Investment Arrangements

A. General

1. Investors in private equity funds usually want the fund's investment team to be aligned with investors by having "skin in the game" and will, therefore, often require investment team members (either individually or collectively) to make capital commitments to the private equity fund. A manager may also want the investment team for a particular fund to participate in the fund's P&L through an actual investment (i.e., capital commitment) in the fund.

2. Leveraged co-investment arrangements provide a means for a manager to facilitate loans from a lender to the employees and principals of a private equity fund manager to fund capital commitments to be made by such employees and principals to a private equity fund. Managers with sufficient internal capital may loan money to employees to fund employees' capital commitments under a similar arrangement. More typically, a manager will arrange for a lender to provide loans to employees to make capital commitments. Private banks and the private banking units of larger banks are typically the types of lenders who offer leveraged co-investment arrangements.

B. Terms of Borrowing

Loan advances are typically made each time the private equity fund makes a capital call and an employee's partnership interest in the private equity fund is usually pledged as collateral to the manager, who then guarantees repayment of the loan to the lender. The manager, in turn, then typically pledges to the lender its right to receive management fees. A more manager-friendly option is for the

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employees to pledge their interest in the private equity fund directly to the lender. Proceeds from any distribution (other than distributions subject to reinvestment) are usually paid directly to the lender to repay principal on the loan, and the lender often requires employees participating in the leveraged co-investment to maintain bank accounts with the lender.

C. Structure

1. Instead of having employees invest directly in the fund, sometimes the manager will establish solely for employees:

   (a) A parallel fund in which the loan advances will be invested, which parallel fund will invest alongside the main private equity fund; or

   (b) A feeder fund in which loan advances will be invested and which will, in turn, invest substantially all of its capital into the main private equity fund.

2. The parallel fund option may not necessarily be economically efficient because it would necessitate allocating investments across funds, which entails additional operational costs that are not incurred with a feeder fund structure.

D. Regulatory Requirements

For securities law purposes, employees will need to be accredited investors under Regulation D, and because many private equity funds rely on the Section 3(c)(7) exemption to the Investment Company Act, employees also typically need to be "qualified purchasers" or "knowledgeable employees."

III. Management Company Facilities

A. Management companies sometimes borrow money from lenders in order to meet their working capital needs, which may include paying employee salaries and bonuses. In some instances, the manager/GP of a fund may have significant unrealized carried interest or incentive allocations in the fund which, upon realization, could help pay employee compensation. In such instances, it may be inconvenient or impractical to sell investments in order to have cash to pay compensation, and the manager may instead choose to borrow funds to compensate employees.

B. Management company borrowings are usually secured by granting the lender a security interest in management fees. This kind of secured borrowing by the management company can create concerns for investors who may be worried that if the management company defaulted on such borrowings and the lender started receiving the management fees that the management company would otherwise have been entitled to receive, the management company would not be able to cover its ordinary operating expenses (e.g., salaries, rent, utilities, etc.) and perform its core function as investment adviser to the applicable fund. This is one reason why management company borrowings are often for relatively small amounts.

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Operational Best Practices

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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 and venture) and liquid-securities funds (hedge funds, hybrid funds), and providing regulatory advice to investment managers. 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 serving as 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 former member of the board of directors of 100 Women in Finance, 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. Featured in *Private Funds Management*'s recent spotlight article "Ringing the Changes," 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).

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A member of the American Bar Association's Business and Litigation Sections and the Hedge Funds Subcommittee of the Committee on Federal Securities Regulation, Marc is a frequent speaker at hedge fund industry conferences and seminars. He recently addressed "Regulatory Outlook" at SRZ's 26th Annual Private Investment Funds Seminar and has addressed regulations impacting investment management, as well as SEC inspections and examinations of private equity and hedge funds. Marc co-authors the "Protecting Firms Through Policies and Procedures, Training, and Testing" chapter in the *Insider Trading Law and Compliance Answer Book* (Practising Law Institute). In addition, he co-authors the "Market Manipulation" chapter in the leading treatise *Federal Securities Exchange Act of 1934* (Matthew Bender), and wrote the chapter on "The Legal Basis of Investment Management in the U.S." for the Oxford University Press book *The Law of Investment Management*.

Marc received his J.D. from New York University School of Law and his B.A., with honors, from Wesleyan University.

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Operational Best Practices

I. Recent Enforcement Actions Against Private Equity Managers

A. *In the Matter of Apollo Management V, L.P. et al*., Release No. 4493 (Aug. 23, 2016).

1. The SEC alleged that Apollo breached its fiduciary duties by:

    (a) Failing to adequately disclose that it accelerated monitoring fees to portfolio companies after the monitoring agreements terminated; and

    (b) Failing to disclose that accrued interest in connection with a loan agreement between funds and their GP would be allocated solely to the capital account of the GP.

2. In the same settled enforcement action, the SEC alleged that a former senior partner improperly charged personal items and services to client funds and portfolio companies of those funds. The SEC found the firm's policies and procedures in the areas of monitoring fee disclosures and employee expense reimbursement to be deficient.

B. *In the Matter of WL Ross & Co., LLC*, Release No. 4494 (Aug. 24, 2016).

1. The SEC alleged that private equity fund adviser WL Ross failed to disclose its fee allocation practices to certain private equity funds and their investors, resulting in the funds paying higher management fees. Specifically, the focus was on the offset of transaction fees against management fees.

2. The SEC alleged that the methodology used by the firm to offset transaction fees favored the firm and that the firm failed to disclose this. The way that fees were offset was based on the funds' relative ownership percentage of the portfolio company, but the firm retained the portion of the transaction fees based on the relative ownership percentages of the portfolio companies attributable to co-investors.

C. *In the Matter of Blackstreet Capital Management LLC*, Release No. 77959 (June 1, 2016).

1. The SEC charged a private equity fund adviser and its principal with:

    (a) Receipt of transaction-based compensation for the provision of brokerage services in connection with the acquisition and disposition of portfolio companies while not being registered as a broker;

    (b) Receipt of unauthorized and inadequately disclosed fees;

    (c) Unauthorized use of fund assets;

    (d) Unauthorized purchase of portfolio company interests; and

    (e) Improper purchase of limited partnership interests.

2. The activity the SEC viewed as unlicensed brokerage consisted of soliciting deals, identifying buyers and sellers, negotiating and structuring transactions, arranging financing and executing transactions.

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3. Notably, the funds' limited partnership agreements expressly permitted the adviser to charge transaction or brokerage fees.

D. *In the Matter of SLRA, Inc.*, Release No. 4641 (Feb. 7, 2017).

1. The SEC alleged that the principal of a private equity firm directed more than $20 million from the funds' accounts to the investment adviser's accounts. The principal claimed the amounts were properly paid as fees for services by affiliates of the adviser, including for the acquisition, disposition, financing, refinancing, workout and recapitalization of certain investments.

2. The SEC charged the adviser and the principal with violations of 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

II. Recent Areas of Examination Focus

A. The role of advisory boards and committees.

1. Which LPs are on the LPAC?

2. What issues are raised with the LPAC?

B. Allocation of investment and co-investment opportunities.

C. Valuation of investments.

1. Third-party valuation providers — SEC skepticism.

2. Use of interim valuations in marketing.

D. Side letter compliance.

E. Transaction fee sharing.

F. Outsourcing of employees to become consultants.

G. Sales of portfolio companies from one fund to another.

H. Subscription lines and impact on IRRs.

I. Cybersecurity expectations.

J. Conflicts disclosure — the "may" word.

K. Zombie funds.

L. Expenses, expenses, expenses.

III. Examination Preparation Highlights

A. Considerations for introduction call with examination staff — who should be on it, what topics are typically covered, use of slide deck.

B. Preparation for responding to requests about joint ventures, co-investments and other arrangements.

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C. Preparation of onsite portion of the examination — first day meetings, agendas and interviews.

D. Written “additional requests” during the course of the exam have taken the place of a lot of dialogue.

E. Identification of key issues up front and strategize to address them effectively.

IV. Regulatory Reform

A. Potential JOBS Act relief on advertising and general solicitation.

B. Continued uncertainty on carried interest legislation and tax rates.

C. Proposed registration relief for private equity advisers.

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Managing conflicts

As fund formation becomes ever more complex, two partners from Schulte Roth & Zabel tell *pfm* how the regulator views conflicts of interest and how best to deal with them

Q As partners with your respective specialties and focus areas, how do you work together to advise private equity fund managers?

Joseph A Smith: Marc and I provide the yin and yang to advising clients on regulatory compliance matters, and I think it's imperative to have a team looking at it from two perspectives. The regulator is frequently examining clients, and it's critically important to have a partner like Marc, who is outward-facing toward the regulator and keeps his finger on the pulse of changes in enforcement practices. But similarly, I think it's critical for clients to be represented by counsel who is fully familiar with the folkways and history of private equity. Bringing history, industry knowledge and intimacy with business practices to bear when you're talking to the regulator is of paramount importance in representing clients effectively.

We used to call ourselves fund formation lawyers. Now we're also fund operations lawyers, because so many legal issues come up during the life of a fund, in the course of transactions. Fund lawyers need to continually be involved in a client's business.

Q What has the SEC done so far with conflicts of interest in private equity?

Marc Elovitz: We find the regulators are working to get up to speed to try to understand the industry. There have always been some private equity managers who were registered as investment advisors, but before the Dodd-Frank [Wall Street

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Reform and Consumer Protection] Act, most weren't. So, the SEC didn't have years of experience getting to know the firms and how the business works.

One thing Joe and I have found very effective in representing our clients is to provide that perspective, background, the folkways, so the SEC can understand that and can incorporate it into its regulatory oversight program.

It has also often been helpful for the SEC to hear from limited partners about their knowledge and understanding of the industry, because disclosure is the centerpiece of the securities laws.

JS: The SEC's concern has been that LPs might not understand completely how the industry works and how general partners allocate opportunities, expenses, etc. Therefore, the SEC's request has been that PPMs be more explicit about these mechanisms. The regulator's basic concern is that the methodologies with which the GP exercises discretion need to be laid out for LPs to make educated investment decisions.

ME: The SEC staff have done outreach to different stakeholders in the industry to try to understand what their concerns are, and see what issues are bubbling up. When the SEC is looking at a particular issue, we have facilitated communication between LPs and the SEC staff to help educate the staff to say, 'look, the LPs understand this the way this is structured and this is what they want.'

Q Could you expand on how you've advised GP and LP clients on conflicts of interest?

JS: Again, it's critically important for the SEC to hear LPs say, 'yes, we understood this.' We, as fund counsel, could include an entire encyclopedia of how underlying businesses are operated as part of the PPM, but no one's going to read all of that. Ergo, what we try to do when we craft a PPM is to make sure we're specific enough that anybody who reads it understands exactly what the underlying business model is, exactly what the objectives of the fund are, and exactly how the fund will seek to create value. But it must be short enough to read! So much of what we do is translate.

Counsel for GPs and counsel for LPs negotiate, every day, the terms and conditions of a document that the parties believe will align interests, and these documents already provide mechanisms for LP consents. Hence, the issue becomes whether the potential conflicts that might appropriately give rise to the need for consents have been adequately described.

ME: It's not always obvious where to draw the lines for sufficient disclosure around conflicts. Enforcement actions are posted on the SEC website, and should be carefully studied, but you've really got to be seeing what's coming through the examination program to get more color on how the SEC is viewing these types of disclosures.

Q How are conflicts of interest viewed in the industry?

ME: There are a lot of situations where the LPs are happy to accept a business model including what could be viewed as potential conflicts of interest because they determine that it's in their interest.

JS: Conflicts occur all the time. The issue is how they're disclosed and how they are resolved. The classic conflict of interest everybody recognizes as such would be for two funds managed by the same manager to transact with one another. For example, one fund is investing in equity and another fund is investing in debt. That was Forstmann Little's classic business model – all disclosed, all well-understood.

In rare circumstances, you'll have a situation in which a fund managed by a given GP sells an asset to a fund managed by the same GP. That raises a host of valuation issues. Believe it or not, there are certain circumstances in which those valuation issues are adequately understood, passed by LPs, consented to and the sale occurs.

I think it is important to recognize that conflicts are part of life, and that managers sometimes have to weigh conflicting considerations relevant to even just their own interests, no less those of the LPs. Private equity is a business. The legal environment had long recognized this. For example, the VCOC exemption under the Plan Asset Regulation, as well as the exception of private equity funds from the definition of an 'Investment Company' under the '40 Act, are designed to permit parties to govern themselves under commercial, contractual arrangements and Delaware principles that recognize the role of business judgment, rather than stricter standards. The policy thinking was that this enhances capital formation and, ultimately, economic returns to investors. This is a history we should be proud of. That said, it is now clear that greater elucidation will be necessary going forward. A thorough understanding of the business is therefore a predicate to compliance.

Smith: much of what we do is translate

Elovitz: disclosure lines not always clear

Q How do you think conflicts of interest are best dealt with?

JS: I always thought the rules were awfully clear that you're not supposed to defraud people, and therefore the practice was to draft with the expectation that something was an institutional offering. Professionals come to the table with embedded training as to business practices. Now, the industry has been asked to be more explicit and I think the industry's doing an admirable job responding to that requirement.

It would sadden me if the regulatory approach were something not principles-based, simply because the creativity of our clients demands it. You'd be drafting new regulations everyday as types of deals evolved. So, I think it needs to be principles-based and I'm hoping it remains so. Any alternative approach I believe would stymie capital formation.

ME: There's nothing in the law that specifies what words you need to use in your disclosures. It's not in the Investment Advisers Act of 1940 or Dodd-Frank, and it's not in the regulations promulgated by the SEC or in the SEC guidance. You need to be familiar enough with both the business that's being regulated and the approach of the regulators. In an area where there are not a lot of specific technical requirements, it's principles-based.

JS: So, it's very important to have a cross-pollination of ideas between people who are advising the industry and regulatory authorities in order to make sure they understand each other, every step of the way. And I think that's the philosophy Marc and I try to bring to the practice. ■

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