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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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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

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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]

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)).

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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.

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

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