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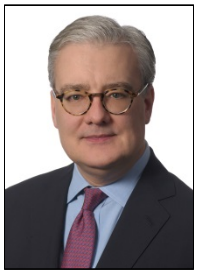
6TH ANNUAL

PRIVATE EQUITY FUND CONFERENCE

TUESDAY, MAY 22, 2018

1. State of the Industry
2. Liquidity and Winding Up Issues
3. Litigation Finance
4. Regulatory and Tax

STATE OF THE INDUSTRY



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

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Stephen L Ritchie

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Chapter 22

UNITED STATES

Joseph A Smith, Conrad Axelrod and Christopher S Avellaneda[1]

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]

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.

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.

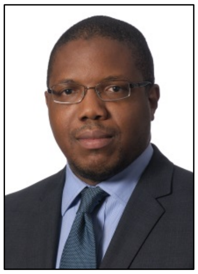
74 Generally, to qualify for the *de minimis* exemption for unregistered funds contained in CFTC Rule 4.13(a)(3), either: the aggregate initial margin and premiums on commodity interest positions do not exceed 5 per cent of the liquidation value of the fund's portfolio (including unrealised gains and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

LIQUIDITY AND WINDING UP ISSUES



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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. He 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. Omoz 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. His 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 US* and he regularly speaks at industry events covering current developments impacting private investment funds. Omoz contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ) and authored the article “Investor Remedies: The Importance of Key-Person Provisions,” published in *Law360*. He was also featured in the article “Ringing the Changes,” published in leading private equity magazine *Private Funds Management*.

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

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

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 US*, *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 the Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She is co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject, and contributed 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." Phyllis has served as a speaker at numerous conference and events discussing topics such as "Investing in Litigation Finance" at SRZ's 27th Annual Private Investment Funds Seminar and "Credit Facilities for Private Equity Funds" at PLI's Eighteenth Annual Private Equity Forum.

Phyllis received her J.D. from Columbia University School of Law and her A.B. from Smith College.

Liquidity and Winding Up Issues

I. Background

A. Liquidity issues are not end-of-life issues for private equity funds.

B. Investors make decisions to invest in private equity funds, in part, based on the perceived liquidity that a fund affords. The absence of redemption or withdrawal rights, often referred to as essentially a "10-year lockup" for private equity funds, creates an emphasis on the lack of liquidity of a private equity fund during marketing.

C. While investors are typically not granted withdrawal rights (other than for regulatory reasons or other adverse events) in a private equity fund, the obligation of a fund to distribute proceeds received from the sale of an investment or as dividends does provide investors with liquidity on their investments and substitutes for withdrawals.

D. Yet, distributions from investment proceeds are unpredictable and do not necessarily satisfy investors' liquidity needs for several reasons.

1. Investors cannot control the timing of a fund's exit from an investment or the timing of dividends or other income paid by portfolio companies.

2. Funds are allowed to recycle investment proceeds with greater latitude. This latitude reflects investors' and the general partner's desire for a fund to invest as much as possible, even though reinvesting presents a tension with investors' liquidity objectives.

3. Recycling occurs under one or more of the following events:

(a) If a fund sold an investment after a relatively short holding period ("quick flip" – previously for a typical private equity fund within 12 months, now possibly within up to 18 or 24 months), the fund will be able to reinvest the amount invested in the investment;

(b) Credit funds, and sometimes real estate funds, now often permit reinvestment at any time during the entire investment period;

(c) Some credit funds also now permit reinvestment of profits (in addition to invested capital);

(d) Funds can use investment proceeds for fund expenses and obligations;

(e) Funds may be given a bucket to reinvest without regard to the timing of the exit; and

(f) A fund may be permitted to reinvest investment proceeds to the extent that the fund had made capital calls for expenses. Reinvesting is generally not permitted after the fund's investment period. There is typically no limit on the use of investment proceeds to cover expenses and obligations of the fund. Venture funds often have even more latitude than buyout funds to reinvest proceeds, but may be subject to limits on the overall cost of investments that are made by the fund.

E. Given the unpredictability of distributions, investors have negotiated for greater controls over the investment period and term of funds through no-fault termination rights. It is thought that shorter investment periods and shorter terms will result in distributions at more quicker intervals.

1. A fund's dissolution date (which is the same as its term ending) does not necessarily result in exits, nor does the date of dissolutions require a fund to have completed its exits.

2. Prior to the development of the secondaries market, GPs' options to address LPs' desire for liquidity when a fund held a substantial amount of assets at or near the end of its term were generally limited to (a) seeking LP consent to extend the fund's term for an additional year or two, (b) making an in-kind distribution of assets to LPs or placing fund assets in a liquidating trust to be managed by the GP or an

affiliate thereof, or (c) selling assets from the fund to a successor fund (or other fund managed by the GP or its affiliate), in which case the consent of the LPACs of both the selling fund and the buying fund would typically be needed.

II. New Options

A. Given the unpredictability of distributions by private equity funds, the sale of limited partnership interests in private equity funds – known as secondary transactions – has been regularly used as a strategy to obtain liquidity.

B. In response to greater investor requests for liquidity, GPs are now leading secondary transactions in several formats that revolve around either (i) the sale of LP interests or (ii) the sale of the fund's assets. GP-led secondaries usually involve an investment banker/broker who is retained to locate a buyer and to structure the transaction. GPs may also lead a secondaries transaction because the GP believes that having the fund hold on to its assets for a few more years (i.e., beyond the end of the fund's term) may lead to a significant increase in value when the assets are ultimately sold, but that not every LP would be willing to consent to a corresponding increase in length of the fund's term. In addition, a GP may also lead a secondaries transaction in order to recapitalize a fund's assets (typically by using a portion of the buyer's purchase price as a capital infusion into the underlying portfolio companies/assets).

C. If assets of the fund are being sold, a new vehicle managed by the GP or its affiliate would typically be set up to acquire such assets. The buyer would become an investor in the new vehicle; the new vehicle would purchase assets from the fund; and the proceeds from the sale would be distributed to the existing investors (to the extent such investors have elected to cash out of the fund).

1. The transfer of the assets to an entity controlled by, and which will make payments to, a GP affiliate requires a conflict approval. Therefore, the benefits afforded to the GP affiliate in the transaction must be carefully disclosed. Investors should also understand the fees and expenses that will be charged to them and that will reduce the proceeds they will receive.

2. Pricing of the secondaries transaction will be subject to scrutiny, and therefore it is best to (a) demonstrate that an auction for the sale was held, and/or (b) obtain a valuation from an independent valuation agent. Certain offers are not necessarily credible, and comparisons of offers may not be as simple as the relative pricing. For instance, a buyer may need to finance the purchase price or may need its own approvals to proceed with the purchase.

3. In light of the pricing issue, a GP may consider offering LPs a "rollover" option, where the LPs, individually, have the right to receive cash or to invest their proceeds from the transaction in the new vehicle. This process is difficult, as the buyer and the GP will negotiate the terms of the new vehicle, following which the LPs must evaluate the attractiveness of the transaction as presented to them. Additionally, some GPs offer existing LPs the right to keep their existing economic terms. The carried interest calculation for the buyer will typically be different than that of existing investors, as generally the buyer's cost basis for purposes of determining return of capital under a distribution waterfall will equal the amount of capital invested by the buyer.

4. Even if LPs are comfortable with the valuation of the fund's assets, LPs may have different assessments about the profitability of holding on to the assets for a longer period. LPs may also have their own internal liquidity needs which may lead them to opt to cash out of their existing investment in the fund.

5. Transferring assets presents challenges, and may require third-party approvals. In particular any fund investments held through joint ventures may be subject to change of control provisions in the applicable joint venture agreement.

6. LP consent is almost always obtained prior to implementing a GP-led secondaries transaction. Even if LPAC approval is technically the only requirement for a sale of fund assets to a new vehicle that will be managed by the GP or its affiliates, typically LPAC members will want all LPs to have a chance to approve

the transaction and may want to be on informed and consulted on (and not formally consent to) the transaction. The buyer may also condition its offer on obtaining a minimum level of consent from investors.

D. If LP interests in a fund are being sold, the buyer would typically enter into a separate purchase and sale agreement with each LP of such fund. Typically, the GP and the buyer (to the extent there is one buyer) attempt to get the LPs to execute the same form of agreement (with the same economic terms).

1. Presumably, it may be more difficult to get each LP to agree with the buyer as to the same agreement or even to sell at the offered price at all. Funds do not typically have a "drag-along" provision, although JV investment vehicles might.

2. If a selling LP does request and agree to more favorable terms with a buyer, the GP must consider whether all LPs should be offered such terms.

3. A buyer may condition its obligation to close based on the number of LPs agreeing to sell.

4. The purchase and sale agreement will typically provide that the LP interests being sold will be sold at a discount to the portion of the net asset value of the fund attributable to such LP interests, measured as of a prior valuation date (typically the calendar quarter-end immediately prior to the date on which the solicitation of potential buyers occurred). In addition, the purchase price for the LP interests is typically adjusted upwards or downwards on a dollar-for-dollar basis to reflect any capital contributions to, or distributions from, the applicable fund made during the period commencing on the valuation date and ending on the closing date of the sale of the LP interests.

5. A GP may agree with a buyer to amend the fund's limited partnership agreement to reflect any special terms agreed to by the buyer, including changes in economic or governance rights. Such amendments may, depending on the amendment provisions set forth in the fund's limited partnership agreement, require consent from the LPs. In some instances, the consent of all LPs may be needed. In addition, in order to persuade LPs to approve the transaction, GPs will often make a number of investor-friendly amendments to the limited partnership agreement of a fund (typically providing LPs with more favorable economic and/or governance rights).

6. Who Are the Buyers?

(a) A major driver in the increase in secondaries transactions in recent years has been the emergence of secondaries funds. Secondaries funds are specialized private investment funds with typical private equity fund terms. The investment program of such funds is to acquire LP interests on the secondaries market. Typically, such funds only acquire interests in mature funds whose investment periods have already expired as it is easier to value the assets of such funds.

(b) Secondaries funds are sophisticated counterparties whose managers employ investment personnel with relevant expertise to relatively quickly (i) perform due diligence on the LPs interests/assets being sold, (ii) value and evaluate such LP interests/assets, (iii) underwrite the potential purchase of the LP interests/assets and (iv) structure the purchase of LP interests/assets in a manner that addresses the relevant commercial, legal and tax concerns. All of the foregoing advantages help minimize execution risk and are of particular importance when the buyer is acquiring a portfolio of LP interests issued by different funds.

(c) Sometimes an existing fund LP is the acquirer of an LP interest. Existing LPs have familiarity with the fund and the manager. They often also have access to the same information regarding the assets of the fund as the selling LP does and are therefore able to make quick decisions regarding the economic terms of the sale without having to go through a lengthy due diligence process. If an LP is selling its interest in a fund to an existing LP in the same fund, GPs are typically more willing to approve the transaction than they might if the buyer is unknown to the GP.

(d) Some individual institutional investors also make investments in the secondaries market for LP interests as a way of getting access to good private equity investments at attractive valuations. These investors (unless they are existing LPs in the funds(s) whose LP interests are being sold) tend to have less ability to quickly execute a transaction as the secondaries funds, particularly if the LPs' interests in many different funds are being sold as part of the transaction.

(e) Some buyers insist on having the side letter rights granted to the selling LP transfer over to the buyer. GPs typically successfully resist such transfer of side letter rights, except in connection with GP-led secondaries transactions where the buyer is purchasing a large chunk of LP interests (or through the establishment of a new GP-managed entity, the assets of the existing fund).

7. Auction Process

(a) Often the first step in commencing a secondaries transaction is to hire an investment bank/broker to seek out prospective purchasers. These banks/brokers will often also conduct a formal or informal auction process whereby information on the underlying assets/LP interests will be provided to potential purchasers who will be asked to indicate interest. Auctions (whether formal or not) have the advantage of increasing the pool of prospective buyers. Sometimes a seller may receive a bid from a potential buyer and then run (or hire an investment bank/broker to run) an auction to validate or potentially improve the price at which the underlying LP interests or assets can be sold. If using an auction, there may be one or two rounds of bidding before the winning bid is selected. In addition to pricing, sellers will also take into account execution risk in selecting the buyer. Note that in LP secondaries transactions, the GPs of any underlying funds will need to consent to the sale of the applicable LP interests. Certain buyers (e.g., existing investors in the same or other funds managed by such GP) may be more likely to be approved.

(b) All offers from prospective bidders are not necessarily credible or equivalent. Also, potential buyers may offer different prices for different amounts. A potential buyer's bid may be subject to getting financing or otherwise raising capital or to obtaining internal approvals.

(c) The price paid in a secondaries transaction is ultimately based on the value of the underlying assets owned by the fund. Since these assets will often be illiquid, many GPs (in the case of GP-led secondaries) obtain a third-party valuation or fairness opinion for the LP interests or the fund's underlying assets to reassure LPs that the valuation is (i) fair and (ii) not self-serving from the GP's perspective.

(d) Typically, in seeking consent for a GP-led restructuring, the material elements of the entire transaction (e.g., pricing, structure, governance and economic terms for existing LPs, GP carried interest, management fees and other material terms of the new fund) are disclosed to LPs in connection with soliciting their consent to the transaction.

8. Rollover Investors

(a) For existing LPs who chose to continue holding interests in a fund following a GP-led secondaries transaction, existing economics and governance terms are often kept in place as such investors are unlikely to agree to new terms (unless such terms are clearly more favorable). Sometimes GPs sweeten the terms of a fund (or the new vehicle being set up to hold the fund's assets) in an effort to persuade existing LPs to vote in favor of the transaction.

(b) In a GP-led secondaries transaction, requiring existing investors to roll over their existing LP interests (or otherwise retain such interest) is generally not practicable or desirable, as in such instances the GP will be unlikely to receive sufficient LP consents to the transaction. LPs may feel coerced and may therefore be more likely to bring claims against the GP alleging that the transaction is unfair.

(c) Buyers will frequently insist that existing LPs be prepared to cash out with respect to a minimum amount of LP interests in the fund (i.e., if too many people opt to roll over there will be no transaction).

III. LP Secondaries

A. GP secondaries do not replace the decision by a single investor to sell its interest in one or more private equity funds without the participation by the GP in its sale process.

B. LP secondaries transactions have increased significantly in recent years, as it has become a means for investors with large private equity fund portfolios to actively restructure such portfolios. These types of transactions also allow LPs to remove from their portfolios interests in funds where most of the assets have been sold (and the proceeds distributed) but there are still a few remaining assets held by a fund which may take a relatively long period of time to liquidate. Investors with large portfolios looking to sell all or a portion of such holdings also frequently hire investment banks/brokers to solicit interest from prospective bidders and possibly conduct an auction. Unlike a GP-led secondaries transaction, the terms of the underlying funds remain the same and GP consent is needed to approve each transfer/assignment of LP interest in an underlying fund.

C. These LP-led transactions are cumbersome for many reasons.

1. The GP of each fund whose interest is being sold will require its own form of NDA (prior to allowing the seller to share information about the applicable fund) that must be approved by each prospective buyer. If LP interests of multiple funds are being sold, this could be a time-consuming process.

2. If LP interests in multiple funds are being sold, the seller and buyer will have to negotiate separate transfer/assignment agreements with the GP of each fund (as each fund will have its preferred form of assignment/transfer agreement). One of the main issues regarding such negotiations tends to be the carve-out to the indemnity given to the GP under such assignment/transfer agreement. In addition, sometimes buyers want the GP to make certain representations regarding the fund, including the completeness and veracity of the financial information and reporting provided by the seller to the buyer. Historically, the indemnity provisions have been broad and have generally covered all losses of the GP and its affiliates relating to the assignment of the applicable LP interests. However, buyers (especially secondaries funds) now often request for such indemnities to (a) apply only to a material breach by the buyer or seller of its representations and warranties set forth in the assignment/transfer agreement or (b) carve out losses relating to the gross negligence, fraud or willful misconduct of the GP and its affiliates.

3. If the seller can locate one buyer, the process of closing the transaction can be somewhat streamlined.

4. Even if the seller locates a single buyer for the LP interests being sold, the limited partnership agreements of the underlying funds may provide that the GP or existing LPs in such fund have a right of first offer with respect to a sale of the applicable LP interests. Such provisions increase the amount of time necessary to close the transaction and also add uncertainty to the transaction (since the buyer has reduced certainty as to which LP interests it will eventually be able to acquire).

IV. Permanent Capital/Long-Dated Funds

A. An alternative approach to addressing the liquidity issues regarding the term of a typical private equity fund is to use a long-dated or permanent capital vehicle structure. These structures typically provide investors with liquidity options beyond the typical 10-year term of a private equity fund, usually by providing for a listing of interests in the fund on a U.S. or non-U.S. stock exchange or providing for a periodic hedge fund style withdrawal right. Permanent capital vehicle and long-dated fund structures generally tend to be practical only with respect to certain types of investment strategies.

1. Credit

   Some credit-oriented investment strategies can be implemented via private or public business development companies ("BDCs"). Often the governing documents of a private BDC will provide the sponsor with the ability to, at some future date, convert the fund to an exchange-listed entity (thereby providing liquidity to investors).

2. Real Estate

   Real estate funds can be structured as REITS (including publicly traded REITS). Real estate funds, and in particular, funds focused on core or core-plus strategies, can be structured as open-ended investment funds which provide for investors to have periodic liquidity rights, subject to the fund having enough cash from rental income, sale proceeds or new subscriptions to fund requests for withdrawals.

3. Infrastructure

   Infrastructure funds are often structured as long-dated funds (e.g., 20- or 25-year term) or exchanged-listed funds. A key feature of this type of structure is that carried interest is often paid based on net cash flows from investments (rather than investment proceeds from sales or re-financings) since infrastructure assets are held by the fund for extremely long periods of time.

4. Investment Manager Staking Funds

   Staking funds (i.e., specialized funds set up for the purpose of acquiring minority stakes in the managers and GPs of private equity funds and hedge funds) typically have unlimited terms. The minority stakes in managers/GPs held by these funds are often structured as gross revenue shares (i.e., with respect to carried interest and management fees). Typically, funds holding these minority stakes need consent from the underlying managers in order to sell all or any portion of a given minority stake in a manager to a third party (and such consent will not be given unless the manager is comfortable with being a partner with the transferee). LPs are less likely to be worried about the underlying liquidity of the investments (i.e., the underlying manager stakes) because, when they underwrite the investment in the staking fund, they are often underwriting such investment by taking into account the projected revenue stream from the fund's revenue shares over a period of time equal to 10 years or more. Any residual value in the revenue share after such time period is often not included in the LP's underwriting process. Notwithstanding the foregoing, the limited partnership agreements of most large-staking funds provide the GP with the ability to list the fund on a non-U.S. stock exchange, thereby providing liquidity to investors.

LITIGATION FINANCE

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Stephanie is co-head of the firm's Investment Management Group and a member of the firm's Executive Committee and Operating Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of private equity funds (including LBO, mezzanine, distressed, real estate and venture) and liquid-securities funds (including hedge funds, hybrid funds, credit funds and activist funds) as well as 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 funds of funds and other institutional investors in connection with their investment activities, including blockchain technology and virtual currency offerings and transactions.

Stephanie is a highly sought-after speaker on fund formation and operation and compliance issues, and she regularly publishes articles on the latest trends in these areas. She co-authored *Private Equity Funds: Formation and Operation* (Practising Law Institute) and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), among others. 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 former member of the Advisory Board of Third Way Capital Markets Initiative, a former member of the Board of Directors and current member 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.

Stephanie has received the highest industry honors. Most recently, she was named to *The Legal 500 US* Hall of Fame. The inaugural list highlights law firm partners who consistently receive high praise from their clients for continued excellence. She is also listed in *Chambers USA: America's Leading Lawyers*, *Chambers Global: The World's Leading Lawyers*, *IFLR1000*, *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 "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 *Who's Who Legal* Awards 2014 and the Euromoney Legal Media Group's "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards.

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

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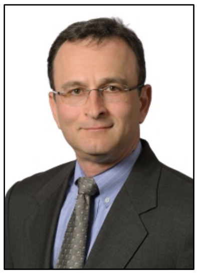
Bill is a founder, managing director and general counsel of Longford Capital, a leading private investment company in the commercial litigation finance industry.

Bill is an experienced trial lawyer with more than 20 years of litigation and trial experience as both a government prosecutor and as a partner in the commercial litigation departments of two prominent national law firms, Neal Gerber Eisenberg and Gardner Carton & Douglas (n/k/a Drinker Biddle & Reath). He has served as the lead attorney in dozens of cases and taken numerous cases through trial and appeal. He has negotiated and structured numerous settlements involving companies of all sizes. As a result of Bill's trial and appellate experience, companies have relied on him for assistance in all aspects of complex commercial disputes, from inception through settlement, trial and appeal. Bill has represented clients in state and federal courts and before arbitration panels and regulatory agencies. His practice has included defense of antitrust claims and investigations, defense of class actions, healthcare litigation, intellectual property and trade secret litigation, First Amendment and defamation cases, consumer and commercial fraud, and a variety of contract and commercial disputes.

Before launching Longford Capital, Bill served as the outside general counsel to several companies and regularly provided advice to clients concerning litigation strategy, claim valuation, risk mitigation and avoidance, acquisitions, corporate structure, corporate governance, contracts, internal policies and other issues. Bill has been awarded the highest possible rating (AV Preeminent 5.0 out of 5.0) by the Martindale Hubbell Peer Review Rating System for legal ability, expertise, experience, integrity and overall professional excellence. Prior to joining private practice, Bill served as a prosecutor in the Criminal Prosecutions Bureau of the Cook County State's Attorney's Office. As a government prosecutor, Bill served as the lead attorney in numerous trials and represented the State of Illinois in several cases before the Illinois Appellate Court. Bill has also been appointed an Illinois Special Assistant Attorney General in connection with the representation of government officials and government agencies.

Bill received his J.D. from University of Notre Dame Law School, where he was a Thomas J. White Scholar, and his B.S. from Indiana University Kelley School of Business.



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Boris is co-head of the firm's Structured Finance & Derivatives Group. With over 20 years of experience across diverse asset classes, Boris focuses on asset-backed securitizations, warehouse facilities, secured financings and commercial paper conduits. His practice encompasses a variety of asset classes, including life settlements, equipment leases, structured settlements, lottery receivables, timeshare loans, litigation advances and cell towers, in addition to other esoteric asset classes such as intellectual property and other cash flow producing assets. He also represents investors, lenders, hedge funds, private equity funds and finance companies in purchases and dispositions of portfolios of assets and financings secured by those portfolios.

Recognized as a leading lawyer in the industry, Boris is ranked in *Chambers USA* and *The Legal 500 US* for his work in structured finance. He serves as outside general counsel to the Institutional Longevity Markets Association (ILMA) and he is a member of the Structured Finance Committee of the New York City Bar Association, the New York State Bar Association, and the Esoteric Assets Committee and Risk Retention Task Force of the Structured Finance Industry Group. A frequent speaker at securitization industry conferences, Boris has conducted various securitization and life settlement seminars in the United States and abroad. His speaking engagements have included "Flash Briefings on Alternative & Emerging Asset Classes — Structured Settlements" at SFIG and IMN Vegas 2018 and "Investing in Litigation Finance" at SRZ's 27th Annual Private Investment Funds Seminar.

Boris earned his J.D. from the New York University School of Law and his B.A., *with honors*, from Oberlin College.

Litigation Finance

I. Introduction

A. What Is litigation funding?

1. The term litigation funding is sometimes used to describe several forms of funding transactions, some of which do not involve the actual funding of a litigation.

2. The opportunity is to invest in an uncorrelated asset that, while complex, is not generally exposed to market volatility.

B. We represent clients that provide litigation funding. These clients generally are structured as private investment vehicles, but we also represent banking and similar institutions that are active in certain categories of litigation finance.

C. Litigation funding raises numerous issues under applicable laws and regulations, including regulations governing attorney conduct.

D. Tax issues vary depending on the party being financed (usually the plaintiff or the law firm), whether the financing will be treated as debt or equity for tax purposes and the presence of any investors who have special concerns, such as offshore investors and tax-exempts.

E. We coordinate with one another in creating vehicles that will provide litigation funding, negotiating transactions in which the funding is to be provided and identifying legal and regulatory issues affecting these transactions.

II. Types of Litigation Financings

A. Pre-Settlements

1. Advancing funds to personal injury litigation plaintiffs, who use the funds to pay medical expenses or for other purposes.

2. Each individual advance is fairly small, so pre-settlement companies originate a large number of fundings (hundreds or thousands).

3. Each advance will earn an accrual based on amount of time outstanding.

4. The risk is binary. The plaintiff is obligated to repay an advance only if there are proceeds from a judgment or settlement.

5. Funder does not have the right to control the litigation. The plaintiff’s lawyer is obligated to do what is best for his or her client, which is the plaintiff.

B. Post-Settlements

1. As the name implies, these fundings are made after a settlement has been finalized and the funded party is awaiting distribution of proceeds.

2. The advances can be made to a plaintiff or to a law firm that’s entitled to a contingency fee to be paid from the settlement proceeds.

3. One example of a type of post-settlement funding business is in the class action sector, such as the NFL concussion settlement. The settlement is final and is currently in the implementation stage.

4. Another example is the Deepwater Horizon BP settlement. The two settlements are good examples of how they can vary.

   (a) The BP settlement requires a more complicated assessment of recovery entitlement.

(b) The NFL settlement is based on a grid.

C. Medical Liens (also known as Letter of Protection Fundings)

1. The advances are made to medical professionals.

2. Such medical professionals provided medical care to the plaintiffs and are entitled to be paid from recoveries under the related litigation.

3. “Letter of Protection” refers to the letter signed by the plaintiff’s attorney acknowledging the entitlement to payment.

D. Loans to Law Firms

1. Can be secured by fees from one case or multiple cases.

2. Can be full recourse, non-recourse or limited recourse.

3. Can be a pre-settlement or a post-settlement.

4. Has often been done in the class action or other personal injury context, but can also be in commercial tort or other types of cases.

E. Investment in Cases

1. One might say this is the purest form of litigation funding.

2. Advancing money to a plaintiff to prosecute the litigation.

3. One well-publicized recent example was Hulk Hogan’s case against Gawker.

4. This type of arrangement can be used in different types of cases (e.g., pharmaceutical, medical devices, patent infringement, matrimonial and others).

5. There is a waterfall for distributing proceeds among the plaintiff, the attorneys and the funder.

6. Some legal issues are usury and champerty.

F. Bankruptcy Litigation Funding

1. Advancing money to debtors-in-possession, creditors’ committees, liquidation/litigation trusts, Chapter 7/11 trustees or liquidation trusts.

2. Types of litigation matters to be funded may include fraud/fraudulent transfer/preference actions, other avoidance or clawback actions and/or monetization of pre-bankruptcy or post-bankruptcy judgments.

3. Funding may be required during pendency of bankruptcy case (e.g., commencement of an adversary proceeding or continued prosecution of pre-bankruptcy litigation), post-confirmation or after consummation of a Chapter 11 plan.

4. Bankruptcy Code requires court approval for debtor or trustee to obtain credit outside ordinary course of business and approval of litigation financing is not a “slam dunk.”

III. Why Do Litigants Seek Funding?

Maximize value of litigation claims for benefit of:

A. War chest;

B. Reduce pressure to settle;

C. Working capital;

D. De-risking; and

E. Refinancing.

IV. Litigation Finance Investment Vehicles

A. Managers

1. The founders of litigation finance investment firms are often litigators or other professionals with trial experience, who may not have previously managed a fund. Some of our clients have directly funded litigation, other than through investment vehicles.
2. The litigation experience of the managers is likely to drive the particular litigation finance strategy.

B. General Structure of Investment Vehicles

1. Litigation finance vehicles are structured with most features used by private equity funds, including management fee and carried interest structures.
2. At least one well-recognized investment vehicle is a publicly registered entity.
3. Privately held litigation finance vehicles are allowed to finance new cases during an "investment period," and have a stated term (both of which are likely to be shorter than a typical five and five year investment/harvest period).
4. Litigation finance vehicles may leverage their investments.
5. Privately held litigation finance vehicles generally do not offer withdrawal rights, as they rely on the settlement or conclusion of the underlying litigation in order to be able to make distributions to investors. When a case settles and the fund receives its proceeds from the case, distributions are made to the investors in the fund, subject to a waterfall.

   The waterfall in the litigation financing vehicle should not be confused with the waterfall in the transaction documents between the funder and a plaintiff. In the transaction documents, proceeds from the case are also divided pursuant to a waterfall.

C. Joint Ventures

1. Litigation funding is a relatively new investment strategy. As a result, managers may not be able to arrange for capital sources on a committed basis, and will form "pledge" or "club" funds that pursue litigation funding.
2. If a club fund is set up to pursue litigation financing transactions, investors have the right to decide whether an underlying case will be financed and are likely to carry out their own diligence of that case.

D. Expenses of Investment Vehicles

In addition to typical fund-related expenses, a litigation funding vehicle will often retain outside experts to assess the strength of a case (even where the managers are also litigators).

E. Drawdowns of Capital From Investors

1. A litigation finance vehicle will draw down capital as needed to cover litigation expenses borne by the plaintiff pursuant to the agreement between the plaintiff and the investment vehicle.
2. If an investment is made at a point when the plaintiff has funded a substantial amount of expenses, the investment vehicle may make a payment to the plaintiff, and hence, a single capital call from investors.
3. As the manager assesses the progress of a case, the manager of the investment vehicle may determine to cease funding that case; in the event that the investment vehicle is set up as a joint venture, investors in the joint venture may have a say in whether the investment vehicle continues to fund the case.

F. Information-Sharing

1. In order to assess the case, the manager will rely on information provided by the plaintiff and its attorneys or that is publicly available. To protect attorney client privilege, such information is likely to be limited.

2. Information provided to investors in a litigation investment vehicle will accordingly be limited.

G. Tax Issues

1. The tax analysis depends on the facts, which can vary dramatically from transaction to transaction. The three principal variables are the identity of the party being funded, the treatment of the investment as debt or equity for tax purposes and the treatment of investors subject to special rules, such as tax-exempt and offshore investors.

2. Transactions structured as loans will generally produce returns characterized as interest or original issue discount, which are treated as ordinary income and taxed at marginal federal rates up to 40.8 percent plus any applicable state or local tax. In some cases, such as equity financings of plaintiffs, it is possible that some of the return could be treated as long-term capital gain, currently taxed at a maximum federal rate of 23.8 percent and state and local rates that vary by jurisdiction.

3. Offshore investors will generally be treated as engaged in a U.S. trade or business and thus will be required to file U.S. federal, and possibly state and local, net income tax returns. To avoid that result, such investors typically invest through "blocker" corporations so that the blocker, rather than the investor himself, files the U.S. tax returns. The good news is that the cost of investing through a blocker has been reduced by 40 percent as the U.S. corporate tax rate was recently reduced from 35 percent to 21 percent.

4. Tax-exempt investors may be subject to the tax on "unrelated business taxable income," depending on the structure of the investment and certain other factors.

5. The tax treatment of the party being financed can also be critical. In general, those parties desire to defer the inclusion of any item of income or gain until the receipt of settlement proceeds that they are entitled to retain.

H. Regulatory Issues

1. Managers may be required to register as investment advisers, depending in part on whether the investments are deemed to be securities

2. Litigation funding vehicles structured using a private equity fund format are unlikely to permit participation by ERISA investors to be 25 percent or more, as these vehicles could not meet the "VCOC" standards.

V. How To Become a Litigation Funder

A. Litigants or their counsel often will market the investment opportunity.

1. Established players in this field.

2. Investment firms interested in alternative investments/opportunities.

3. Attorney referrals.

4. Brokers/investment bankers.

B. In addition to diligence of the litigation, funders should assess additional factors such as:

1. Litigation expenditures (including volume of discovery);

2. Availability of insurance to defendant;

3. Jury vs. bench trials;
4. Likely duration;
5. Probability of one or more appeals;
6. Collection risk;
7. Ability to satisfy judgment;
8. Foreign enforcement risks;
9. Priority encumbrances; and
10. Potential bankruptcy filing.

C. In order to structure, negotiate and document the financing, the following factors should be considered:

1. Percentage recovery of litigation proceeds or multiple of amount invested;
2. Interest rate (if investment is structured as a loan or after some specified period of time);
3. Repayment terms, timing and process;
4. Maturity date, if any;
5. Budget (pre-approval by, or consultation with, funder); and
6. Notifications/updates.

VI. Certain Legal Issues

A. Legality of Transaction

1. Champerty

(a) Champerty is a common law doctrine, which has been codified in some states, aimed at precluding frivolous litigation by preventing the "commercialization of or trading in litigation." *Bluebird Partners v. First Fidelity Bank, N.A.*, 731 N.E.2d, 581, 582 (N.Y. 2000).

(b) New York is one of the states that has codified its prohibition against champerty. *See* New York Judiciary Law § 489(1): "… no corporation … shall solicit, buy or take an assignment of … a bond, promissory note, bill of exchange, book debt, or other thing in action, or any claim or demand, with the intent and for the purpose of bringing an action or proceeding thereon."

(i) New York's champerty statute has a safe harbor exception: New York Judiciary Law § 489(2): 489(1) "shall not apply … if such assignment, purchase or transfer … [has] an aggregate purchase price of at least five hundred thousand dollars … ."

(ii) However, this safe harbor would likely not cover the purchase of all legal claims, but would only exempt claims from Section 489 if they are debt-based claims that meet the threshold value and are "issued by or enforceable against the same obligor." N.Y. Jud. Law § 489(2).

(c) In most jurisdictions, litigation funding agreements are generally not considered champertous if there are limits on the funder's ability to:

(i) Influence/control the litigation and strategy;

(ii) Hire/terminate counsel; and

(iii) Make settlement decisions.

2. Usury

In addition to champerty concerns, litigation funders should be aware of state laws which may set limits on interest rates.

(a) It is not necessarily the case that litigation finance would be subject to usury laws. Some courts have adopted the view that litigation finance arrangements are not loans, since the repayment of the funds is contingent upon the outcome of the underlying lawsuit. *See Hamilton Capital VII LLC, I v. Khorrami, LLP*, 48 Misc.3d 1223(A), at *6 fn. 14 (Sup. Ct. N.Y. Cnty. 2015).

(b) Many states have safe harbors for their usury laws, which protect loans above a certain amount. In New York, loans made over $2.5 million are exempt from usury laws. N.Y. Gen. Oblig. Law § 5-501 (6) (b).

B. Ethical and Privilege Issues

1. Ethical Concerns

(a) Ethical canons in most jurisdictions prohibit attorneys from sharing, or splitting fees, with non-lawyers. Transactions, therefore, should generally be structured so that the plaintiff shares proceeds with the funder, rather than the plaintiff's attorney.

(b) In addition, funders must be mindful to not exert influence over the attorney's professional judgment and impede the party's attorney's ethical duties to his or her client. N.Y.C.B.A. Comm. on Prof'l Ethics, Formal Op. 2011-2 (2011) (discussing third-party litigation financing).

2. Privilege/Work Product/Confidentiality Issues

(a) There is a risk that sharing information with a third-party litigation funder waives attorney client privilege and work product protections.

(b) In addition, privilege concerns may result in a limit on the diligence that the funder can conduct. However, the funder can receive documents that are not privileged, will likely be disclosed to the adversary, and/or have already been disclosed to the adverse party. Funders may receive updates that are publicly available or that have already been disclosed to the adverse party.

C. Increased Regulation

1. As litigation finance becomes more popular, state and federal governments have begun to consider whether the process should be more regulated.

2. Agreement with the N.Y.A.G.

In 2005, the New York Attorney General and nine litigation finance companies entered into an agreement which imposed nine consumer-friendly requirements for future funding agreements, including providing translation into consumers' native languages and providing a disclosure statement. Bureau of Consumer Frauds and Protection, Attorney Gen. of the State of N.Y., Assurance of Discontinuance Pursuant to Executive Law § 63(15) 4-7 (2005). The agreement shows tacit approval of litigation finance arrangements.

REGULATORY AND TAX

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Brian advises hedge, private equity and real estate fund managers on regulatory, compliance and operational matters. He has extensive experience designing and improving compliance processes and organizational systems and helps clients navigate their initial and ongoing regulatory compliance obligations under the rules and regulations of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the National Futures Association. Brian also regularly represents clients in enforcement actions, regulatory examinations, trading inquiries and in seeking no-action or similar relief. Having spent nearly a decade in-house as general counsel and chief compliance officer of several prominent investment management firms, Brian is well-versed in the wide range of legal and business challenges facing investment advisers, commodity pool operators and commodity trading advisers.

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Jason's practice 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 businesses. He advises 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; structures and negotiates seed and strategic investments and relationships and joint ventures; and advises investment managers with respect to regulatory and compliance issues.

Jason has been recognized as a leading lawyer by *Chambers USA*, *The Legal 500 US*, *IFLR1000* and *New York Super Lawyers*. Jason publishes and speaks often on topics of concern to private investment funds. He co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and "Information Security: Obligations and Expectations," an *SRZ White Paper*. A recognized thought leader, Jason was quoted in the articles "Schulte Roth Partners Discuss Hedge Fund Seeding" and "Co-Investments With SRZ's Leading Fund Formation Group," both published in *The Hedge Fund Journal*. Jason was also quoted in the *Financial Times FundFire* article "Hedge Fund Co-Investing Picks Up Steam." Jason's speaking engagements include discussing "Credit Facilities" at SRZ's 5th Annual Private Equity Fund Conference and "Shareholder Activism" at SRZ's 27th Annual Private Investment Funds Seminar. He also presented at the Goldman Sachs Annual Hedge Fund Conference, Financial Executives Alliance's Regulatory Hot Topics for Private Equity Firms Conference and at ALM's 2017 Hedge Fund General Counsel & Compliance Officer Summit.

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Elie focuses his practice on the tax aspects of onshore and offshore investment funds, private equity partnerships, REITs and real estate joint ventures. He represents investment managers in connection with the formation of funds and their ongoing operations, as well as sales of their investment management businesses. He also represents real estate sponsors in connection with operations, restructurings and workouts.

Elie discussed "Tax Considerations for 2018" at SRZ's 27th Annual Private Investment Funds Seminar and "New Partnership Audit Rules" at an SRZ Webinar. A published author, Elie contributed to the "United States Fundraising" chapter in *The Private Equity Review* (Law Business Research), and he co-authored "PATH Act: Recently Enacted Legislation Modifies the FIRPTA and REIT Rules," an *SRZ Client Alert*.

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Regulatory and Tax

I. Recent SEC Enforcement Actions

A. Conflicts of Interest

1. WCAS Management Corporation[1]

(a) The SEC brought an enforcement action against WCAS Management Corporation, a registered investment adviser, alleging that WCAS failed to disclose conflicts of interest between itself and its private equity fund clients and fund investors in connection with an agreement between WCAS and a "group purchasing organization" (the "GPO").

(b) The portfolio companies of the private equity funds advised by WCAS employed the GPO to aggregate the portfolio companies' spending in order to obtain volume discounts. The GPO charged the portfolio companies fees for its services.

(c) However, under the related services agreement, WCAS received 25 percent of the net revenue generated by the portfolio companies' use of the GPO.

(d) The SEC alleged that WCAS failed to disclose the conflicts of interest arising from the receipt of fees from the GPO, which provided incentives for WCAS to encourage the portfolio companies to participate with the GPO. WCAS settled with the SEC without admitting or denying the SEC's findings.

2. Strong Investment Management[2]

(a) SEC Focus

(i) The SEC filed a complaint against Strong Investment Management, a registered investment adviser, and its founder for operating an alleged "cherry picking" scheme that defrauded Strong's clients.

(ii) The complaint also alleged that Strong's CCO carried out his compliance responsibilities in an extremely reckless manner and brought claims against him individually.

(b) Strong traded on behalf of numerous clients through a single omnibus account and then allocated each trade to individual client accounts. The allocation of trades to specific client accounts was allegedly delayed until Strong could determine the securities' intraday performance. Profitable trades were then disproportionately allocated to proprietary accounts, while losing trades were disproportionately allocated to client accounts.

(c) The SEC alleges that Strong's Form ADV misrepresented its trading and allocation practices by stating that trade allocations would be governed by pre-trade allocation statements. In addition, the complaint claims that Strong's CCO failed to oversee the firm's allocation practices and disregarded "red flags" relating to the allocation practices.

B. Valuation

Premium Point Investments[3]

1. The SEC filed a complaint against Premium Point Investments, a registered investment adviser, alleging that it inflated the value of securities held by private funds it advised by hundreds of millions of dollars. According to the SEC's complaint, as the performance of Premium Point's funds began to deteriorate,

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[1] WCAS Management Corporation, Advisers Act Release No. 4896, Admin. Proc. File No. 3-18449 (April 24, 2018).

[2] Complaint, *SEC v. Strong Investment Management, et al.*, Civil Action No. 8:18-cv-00293 (C.D. Cal. filed Feb. 20, 2018).

[3] Complaint, *SEC v. Premium Point Investments, LP et al.*, Civil Action No. 1:18-cv-04145 (S.D.N.Y., May 9. 2018).

Premium Point engaged in two efforts to artificially inflate the value of the securities held by the private funds.

(i) First, Premium Point allegedly obtained inflated price quotes from a friendly broker in exchange for directing securities trades to the broker. These inflated price quotes were used to calculate the funds' valuation in monthly reports sent to investors.

(ii) Second, Premium Point allegedly used "imputed" midpoint prices to calculate valuations for certain illiquid securities, such as securities with one-sided quotes (i.e., a bid or an ask, but not both). Premium Point disclosed that it would, in general, use the midpoint of the bid-ask spread to value securities in the funds' portfolio, but, in these one-sided cases, Premium Point would impute the midpoint prices on the basis of other information, such as the spread between the bid and ask prices of a broad sector of securities. This imputed midpoint practice allegedly did not represent fair value and served to inflate the value of securities in the funds' portfolio. Premium Point did not disclose its practice of using imputed midpoints.

2. Stefan Lumiere[4]

(a) The SEC instituted proceedings to bar Stefan Lumiere from the securities industry following a criminal conviction[5] for his involvement in a scheme to falsely inflate the value of assets in portfolios he managed.

(b) Lumiere was a portfolio manager of a registered investment adviser who focused on distressed assets and "special situations" investing for private funds. Lumiere solicited friendly brokers to provide him with sham quotes for securities held by the funds, which he sent to his employer's back office to override the disclosed valuation methodology that relied on established pricing sources.

(i) As a result of Lumiere overriding the disclosed valuation methods with the sham quotes, the private funds' securities were overvalued. This, in turn, caused the funds to report falsely inflated performance to investors and to overpay management and performance fees.

(ii) Furthermore, the scheme caused the funds to misclassify certain assets as "Level 2" assets, rather than "Level 3" assets, under the Federal Accounting Standard Board's framework for measuring "fair value." These inaccurate classifications were disclosed to investors, who relied on them as a measure of the liquidity of the funds' securities.

C. Lessons From Recent Enforcement Actions

1. The SEC continues to focus on the practices and disclosure surrounding fees and expenses charged by private equity advisers. Advisers to private equity funds should pay particular attention to the disclosure surrounding the receipt of fees from portfolio companies, including any monitoring or service fees.

2. The SEC continues to bring enforcement actions relating to the allocation of investment opportunities. In the private equity context, allocation issues may arise when operating funds at different points in the life cycle or when offering co-investment opportunities. Investment advisers should ensure that their allocation procedures are fulsomely disclosed and that their practices are consistent with the disclosures.

3. The SEC has also increasingly shown an appetite for criticizing managers, individual CCOs and other individual business executives for failing to exercise sufficient oversight over the practices of their firms.

4. The valuation practices of investment advisers are a focus of the SEC. Investment advisers should carefully review their valuation disclosures to ensure they are consistent with practice. In addition, advisers should critically review and question their valuation procedures on a regular basis to ensure they result in "fair value" — even fully disclosed, objective procedures may be problematic if they result

[4] Advisers Act Release No. 4861, Admin Proc. File No. 3-18380 (Feb. 28, 2018).

[5] See *U.S. v. Lumiere*, No. 16 Cr. 483 (S.D.N.Y. filed June 15, 2016).

in consistent overvaluation. Private equity advisers should be especially cognizant of valuation issues due to the lack of liquidity in their portfolios and the lack of availability of public price quotes for securities in their portfolios.

5. Investment advisers should monitor the implementation of their valuation procedures to ensure the practices match their disclosures. Repeated patterns of exceptions to disclosed procedures should be investigated and questioned. Valuation practices require special attention when applied to illiquid investments without publicly available price quotes.

II. Tax Reform

A. Changes to Taxation of Carried Interest

(a) If an "Applicable Partnership Interest" is held by a taxpayer, then the taxpayer's long-term capital gain with respect to such interest necessitates a holding period exceeding three years.

(b) An "Applicable Partnership Interest" is a partnership interest transferred to a taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in an "Applicable Trade or Business."

(c) An "Applicable Trade or Business" is an activity conducted on a regular, continuous and substantial basis which consists of (i) raising or returning capital and (ii) either investing, disposing, identifying or developing "Specified Assets."

(d) "Specified Assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to the foregoing and an interest in a partnership to the extent of the proportionate interest in any of the foregoing.

(e) An Applicable Partnership Interest does not include (i) an interest held by a corporation or (ii) a capital interest which provides the taxpayer with a right to share in partnership capital commensurate with (x) the amount of capital contributed (determined at the time of receipt of such interest) or (y) the value of such interest subject to tax under Section 83 upon the receipt or vesting of such interest.

(f) These changes to the taxation of carried interest apply to tax years beginning after 2017.

B. Sale of Partnership Interests by Foreign Partners

1. The IRS held in a 1991 Revenue Ruling[6] that gain on the sale of a partnership interest by a foreign partner was subject to tax in the United States to the extent of such partner's share of unrealized net gain in any ECI assets held by the partnership.

2. In 2017, the Tax Court held in *Grecian Magnesite*[7] that a foreign partner was not subject to U.S. federal income tax on gain from the sale of a partnership interest in a partnership conducting business in the U.S., except for gain attributable to the partnership's USRPIs. The IRS has appealed the decision of the Tax Court.

3. The Act effectively reverses *Grecian Magnesite* by revising Code Section 864(c) to provide that gain or loss realized by a foreign partner from the sale or exchange of a partnership interest occurring on or after Nov. 27, 2017 is treated as effectively connected with a U.S. trade or business to the extent that the seller of such interest would have had effectively connected gain or loss had the partnership sold all of its assets for their fair market value as of the date of the sale or exchange.

4. The Act adds a new Code Section 1446(f), which requires the buyer of a partnership interest to withhold 10 percent tax on the amount realized by the seller on the sale or exchange of a partnership interest

[6] Rev. Rul. 91-32

[7] *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017).

occurring after Dec. 31, 2017 if any portion of the seller's gain on the sale of the interest would be effectively connected income under revised Code Section 864(c), unless the seller certifies that the seller is non-foreign. In the event the buyer fails to withhold the correct amount of tax, the partnership shall deduct and withhold from distributions to the buyer an amount equal to the tax that the buyer failed to withhold from the seller.

5. The IRS issued Notice 2018-08 on Dec. 29, 2017, which suspends withholding under Code Section 1446(f) on the transfer of any interest in a PTP as defined in Code Section 7704(b) until regulations or other guidance have been issued under Code Section 1446(f).

6. On April 2, 2018, the IRS issued Notice 2018-29, providing interim guidance upon which taxpayers may rely (pending the issuance of regulations or other guidance).

   (a) The Notice outlines methods to certify that Section 1446(f) withholding is not necessary.

      (i) No Section 1446(f) withholding is required if the transferor certifies to non-foreign status. Transferors may use a modified FIRPTA certificate or a W-9 (so long as such W-9 contains the name and TIN of the transferor and is signed and dated under penalties of perjury). A transferee may rely on a previously obtained W-9.

      (ii) No Section 1446(f) withholding is required if the transferor provides a certification that the transfer will not result in gain.

      (iii) No Section 1446(f) withholding is required if, within 30 days prior to a transfer, the transferor provides a certification that transferor's allocable share of "effectively connected taxable income" in each of the three taxable years prior to such transfer was less than 25 percent of its entire allocable share of partnership income in each such year.

      (iv) No Section 1446(f) withholding is required if the partnership provides a certification that a hypothetical sale of all of its assets at fair market value would generate less than 25 percent effectively connected gain (including, for these purposes, FIRPTA gain).

   (b) The Notice suspends withholding under Section 1446(f) for nonrecognition transactions if the transferor provides a notification of a nonrecognition transaction to the transferee, signed under penalties of perjury, containing the transferor's name, TIN, address and a brief description of the transfer and an explanation of why gain or loss is not recognized in such transaction.

   (c) The Notice also suspends withholding in situations in which the partnership would be required to withhold under Section 1446(f) due to a transferee's failure to withhold as required.

C. Deductibility Issues

1. Limitation on Deductibility of Business Interest Expense

   (a) Section 163(j) of the Code limits the deduction of business interest expense attributable to a trade or business generally to the sum of the taxpayer's (x) business interest income and (y) 30 percent of adjusted taxable income relating to a trade or business (calculated by excluding business interest expense and business interest income). For these purposes, business interest expense and business interest income do not include "investment interest" or "investment income," respectively, within the meaning of Section 163(d) of the Code.

   (b) Any business interest expense not deductible pursuant to the foregoing limitation is treated as business interest expense of an eligible taxpayer that carries forward to succeeding taxable years, subject to the same limitation.

   (c) The limitation on the deductibility of business interest expense does not apply to interest attributable to an electing real property trade or business and certain other businesses.

(d) In the case of a partnership, the limitation is determined at the partnership level. To the extent the limitation applies at the partnership level to reduce the business interest expense deductible for a year, such excess shall carry forward to succeeding years and, subject to certain limitations, may be deducted by an eligible partner to the extent the partnership has sufficient excess taxable income that was not offset by business interest expense in such year. Any amount not utilized will form part of the investor's adjusted basis in its interest in the partnership only at the time such investor disposes of its interest.

(e) This limitation is effective for tax years beginning after 2017.

2. Limitation on Deductibility of Excess Business Losses; Changes to Rules on NOLs

(a) Under a new provision (Section 461(l) of the Code) applying to noncorporate taxpayers, if a trade or business activity generates losses in excess of a taxpayer's trade or business income, a maximum of $250,000 ($500,000 if filing a joint return) of the losses can be used to offset investment income for the year.

(i) Any excess business losses that are disallowed by this provision cannot be used to offset tax liability on investment income, but rather will be carried forward as net operating losses ("NOLs") that can be used in subsequent years.

(ii) This provision is not permanent; it applies only for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

(b) For losses arising in taxable years beginning after Dec. 31, 2017, a deduction for NOLs is limited to 80 percent of taxable income.

(i) Any unused NOLs can be carried forward indefinitely.

(ii) NOLs can no longer be carried back (except for certain losses incurred in a farming trade or business).

(iii) NOLs carried forward from taxable years beginning before Jan. 1, 2018 are not subject to this new 80 percent limitation.

3. Suspension of Miscellaneous Itemized Deductions

Miscellaneous itemized deductions for individuals under Section 67 of the Code are suspended for any taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2026.

D. Reduction in Corporate Tax Rate and Limitation on Deductibility of State and Local Taxes

1. The corporate income tax rate is reduced from 35 percent to 21 percent for taxable years beginning after Dec. 31, 2017.

2. For individual taxpayers, the amount of state and local taxes (including income and property taxes) permitted to be deducted is limited to $10,000 (aggregated).

The $10,000 aggregate limitation is scheduled to sunset in 2026; it applies only to tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

E. Deduction for Qualified Business Income of Pass-Thru Entities

1. Twenty percent deduction for taxpayers other than "C" corporations for Qualified Business Income ("QBI") and certain other income.

2. QBI deduction means the sum of the:

(a) Lesser of either the taxpayer's "Combined QBI" amount or 20 percent of the taxpayer's ordinary income (excluding capital gains and qualified cooperative dividends); plus

(b) Lesser of either 20 percent of the taxpayer's qualified cooperative dividends or taxpayer's ordinary income (excluding capital gains).

3. Combined QBI means the sum of the:

(a) Lesser of either taxpayer's QBI from a qualified trade or business, or a combination of a percentage of W-2 wages and/or basis of depreciable property; plus

(b) Twenty percent of the total "qualified REIT dividends" and "qualified PTP income."

4. Investment management and most investing funds are not "qualified trades or businesses." Funds whose trade or business does qualify (e.g., certain lending funds) generally do not pay W-2 wages.

(a) For most investment funds and investment managers, the first clause of Combined QBI will be $0.

(b) Funds can still benefit from the QBI deduction from "qualified REIT dividends" and "qualified PTP income."

5. This deduction is available only for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

F. Controlled Foreign Corporations ("CFCs")

1. Modification of definition of United States Shareholder.

(a) The definition of "United States Shareholder" of a CFC is amended to include U.S. persons that own 10 percent or more of the total value of shares of all classes of stock of a foreign corporation.

(b) In general, a foreign corporation will be a CFC if "United States Shareholders" own more than 50 percent of the total combined voting power of all classes of stock of the corporation entitled to vote or the total value of the stock of such corporation.

(c) Under the new rule, a U.S. person (which for this purpose includes a U.S. partnership, and any U.S. entity treated as a partnership for U.S. federal income tax purposes) generally will be treated as a "United States Shareholder" of a foreign corporation for these purposes if such person owns, directly, indirectly or constructively, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation or 10 percent or more of the total value of all classes of shares of such corporation.

2. Elimination of requirement that corporation must be controlled for 30 days before Subpart F inclusions apply.

Amendment eliminates requirement that 10 percent U.S. shareholders of a foreign corporation must only include their pro rata share of Subpart F income of a foreign corporation that was a CFC for an uninterrupted period of 30 days or more during any taxable year. Ten percent U.S. shareholders must now include their allocable share of Subpart F income if the foreign corporation has been a CFC at any time during any taxable year.

3. Both CFC amendments are effective for taxable years of foreign corporations beginning after Dec. 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

G. Global Intangible Low-Taxed Income ("GILTI")

1. Section 951A requires "United States Shareholders" of CFCs to include currently in their income the "global intangible low-taxed income" attributable to such CFCs, even though they may not receive any distributions from the CFCs during such taxable year.

The new Section 951A of the Code is effective for taxable years of foreign corporations beginning after Dec. 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

2. GILTI is determined at the shareholder level and is generally calculated as the excess of the net GILTI of all CFCs for which the shareholder is a United States Shareholder over a deemed return on tangible assets.

3. GILTI generally includes the gross income of a CFC (other than income effectively connected with a U.S. trade or business, “subpart F income,” income subject to an effective foreign income tax rate greater than 90 percent of the U.S. corporate tax rate, dividends received from a related person and certain foreign oil and gas income) that exceeds 10 percent of the tax basis of “qualified business asset investment” (minus certain interest expenses of the CFC).

4. A deduction is allowed for eligible corporate United States Shareholders on their GILTI. For taxable years through 2025, the allowed deduction equals 50 percent of GILTI (with certain adjustments). For taxable years after 2025, the deduction is reduced to 37.5 percent of GILTI with certain adjustments.

5. Additionally, eligible corporate United States Shareholders are entitled to a tax credit of 80 percent of the foreign taxes paid by their CFCs attributable to their amount of GILTI.

H. New Excise Tax on Certain Private Colleges and Universities; UBTI

1. Excise Tax Based on Investment Income of Private Colleges and Universities

   Net investment income of certain private colleges and universities is subject to a 1.4 percent tax. Such income is calculated in the same manner in which private foundations calculate their net investment income. Effective for taxable years beginning after Dec. 31, 2017.

2. UBTI

   Under a new provision (Section 512(a)(6) of the Code) effective for tax years beginning after 2017, UBTI must be calculated separately with respect to each separate trade or business with losses usable only against the applicable related trade or business and not against all UBTI generally.

I. Accounting Methods — Certain Special Rules for Taxable Year of Inclusion

1. New Section 451(b) provides that accrual basis taxpayers must include certain types of income in gross income when an item of income (or portion thereof) is taken into account as revenue in an “applicable financial statement” of the taxpayer. Does not apply with respect to items of gross income for which a taxpayer uses a “special method of accounting” (other than one in Sections 1271 through 1288). The period for taking into account any Section 481 adjustments with respect to income from a debt instrument with OID is six years.

2. New Section 451(c) provides that accrual method taxpayers can elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income is also deferred for financial statement purposes.

3. Effective for taxable years beginning after Dec. 31, 2017 (Dec. 31, 2018 for instruments with OID).

III. Partnership Audits

A. 2018 is the first taxable year subject to the new partnership audit tax regime created by the Bipartisan Budget Act of 2015. Under the new regime, tax adjustments and collections are made at the partnership level rather than at the partner level, unless the partnership elects to pass adjustments through to its partners.

B. The new partnership audit procedures generally apply to all partnerships.

C. Partnerships with 100 or fewer partners can elect out of the procedures if each of the partners is an individual, a C corporation, a foreign entity that would be treated as a C corporation if it were domestic, an estate of a deceased partner or an S corporation.

1. In the case of a partner that is an S corporation, each S corporation shareholder is counted as a partner in determining whether the partnership has 100 or fewer partners.

2. Partnerships with partners that are other partnerships, trusts, IRAs, pension plans, disregarded entities or nominees cannot elect out.

3. The election to opt out of the new rules must be made each year with a timely filed return for such taxable year, including extensions, and notice thereof needs to be provided to the partners.

4. The election must disclose the name, tax classification and taxpayer ID of each partner of the partnership, including each S corporation shareholder in the case of an S corporation partner.

D. Instead of appointing a tax matters partner, a partnership must designate a partnership representative who will have sole authority to act for and bind the partnership and all its partners in all audit and adjustment proceedings.

1. The partnership representative does not need to be a partner but must have a substantial presence in the United States. This requirement is intended to ensure that the partnership representative will be available to the IRS in the United States when the IRS seeks to communicate or meet with the representative.

2. No notice of an audit needs to be given to the partners. In addition, no appeals process exists if a partner disagrees with the result of an audit.

3. In the absence of a designation of a partnership representative by the partnership, the IRS has the authority to select any person as the partnership representative for a partnership.

E. Following a partnership audit, the IRS will issue a Notice of Proposed Partnership Adjustment setting out the "imputed underpayment" required to be paid by the partnership.

1. An imputed underpayment is determined by netting all adjustments of similar items of income, gain, loss or deduction at the partnership level and multiplying by the highest tax rate for individuals or corporations for the year to which the tax audit rules relate ("reviewed year").

(a) If an adjustment involves reallocation of an item to another partner, only the tax increase, not the net adjustment, enters into the calculation of the imputed underpayment under the statute. This could cause the same income to be taxed twice.

(b) However, under Proposed Regulations issued on June 14, 2017, a determination by the IRS that an item of income should have been allocated differently among the partners may, in certain cases, not result in the partnership incurring an imputed underpayment.

2. The partnership has 270 days to demonstrate to the IRS that its tax rate should be lower and the imputed underpayment should be reduced.

(a) An imputed underpayment may be reduced to the extent that it is allocable to a partner that is a "tax-exempt entity" that would not owe tax on the adjusted income (e.g., the U.S. government, a tax-exempt U.S. organization, a foreign person or entity, etc.), a partner that is a C corporation (in the case of ordinary income) or an individual with capital gains or qualified dividends. In the case of a modification requested with respect to an indirect partner, the IRS may require information related to the pass-through partner through which the indirect partner holds its interest.

(b) If any partner files an amended return for the reviewed year taking into account its allocable share of the adjustments and pays tax thereon, that payment can offset the partnership's imputed underpayment. Modification is allowed to the extent the amended returns are filed and any necessary payments are made within the 270-day time period.

(c) An imputed underpayment may be reduced to the extent that direct and indirect partners adjust their tax attributes and pay the tax that would be due as if they amended their returns. The partners do not actually amend their tax returns but must provide information to the IRS to substantiate that the tax was correctly computed and paid. The partners must make the payment and provide the required information to the IRS within 270 days after the date of notice of proposed partnership adjustment.

F. As an alternative to the partnership paying the imputed underpayment, the partnership may elect, under Section 6226 of the Code, within 45 days following the mailing by the IRS of the notice of final partnership adjustment, to pass the adjustment through to its partners who were partners for the reviewed year.

   1. The adjustment is passed through to the partners by issuing a statement to the reviewed year partners with their share of adjustments. The reviewed year partners are required to take the adjustments into account on their returns in the year when the adjustment takes place ("adjustment year") (rather than amend their returns for the reviewed year).

   2. An imputed underpayment is collected together with the partner's tax due for the adjustment year.

   3. This special election generally removes partnership-level liability for the adjustments but makes the partnership responsible for identifying the reviewed year partners and appropriately allocating the adjustment among those partners.

   4. The cost of making this election is that interest on an imputed underpayment is determined at the partner level at a rate that is 2 percent higher than the normal underpayment rate (i.e., short-term AFR + 5 percent).

   5. A partnership that passes the adjustment through to its non-U.S. partners may still be required to withhold under chapters three and four on any adjustment that would have been subject to withholding in the reviewed year.

   6. The Section 6226 Election may be effected through partnership tiers, whereby each partnership in the chain generally may choose to either pay the tax directly or push it out to its own partners (e.g., from a master fund to its feeder fund, and then to the feeder fund's investors). Each upper-tier partnership would need to make such choice by the extended due date for the tax return for the adjustment year of the partnership that was audited.

G. A partnership can file an administrative adjustment request in the amount of one or more items of income, gain, loss, deduction or credit of the partnership for any partnership taxable year. A partnership has three years from the later of the filing of the partnership return or the due date of the partnership return (excluding extensions) to file an administrative adjustment for that taxable year. However, a partnership may not file an administrative adjustment for a partnership taxable year after the IRS has mailed notice of an administrative proceeding with respect to such taxable year.

   1. Adjustments that result in underpayments will cause tax to be due at the partnership level in the year in which the administrative adjustment is filed as described above, except that certain provisions related to modifications of such underpayment will not apply. In the alternative, such tax may be passed through to the partners under the election discussed above, except that the additional interest does not apply.

   2. Adjustments that result in a refund must be passed through to the partners that were partners during the year to which the adjustment relates.

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