The Private Equity Review

Eleventh Edition

Editor

Stephen L Ritchie

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THE PRIVATE EQUITY REVIEW

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PREFACE

The 11th edition of *The Private Equity Review* comes on the heels of a record-breaking year for dealmakers in 2021. Despite the continued impact of the global covid-19 pandemic, the volume and value of both US and global buyouts soared to all-time highs in 2021, with more than US$1 trillion of global activity attributed to private equity sponsors – at roughly 25 per cent of global deal value, the highest share ever. Deal activity was propelled by a confluence of factors, including favourable macroeconomic conditions leading to increased confidence in boardrooms, accommodating central bank policies, an abundance of cheap financing, robust stock markets, substantial corporate cash and the pace of innovation across industries. IPO and merger and acquisition activity by special purpose acquisition corporations (SPACs), skyrocketed to unprecedented levels, with more than 300 de-SPAC transactions announced in 2021 for a total of over US$600 billion. Private equity (PE) sponsors also sought out larger public targets in record numbers, with overall take-private value eclipsing that of previous years. In keeping with the theme, sponsor-backed leveraged buyouts above US$1 billion peaked in 2021, as did exits above US$1 billion, in part due to more public exits with higher multiples fuelled by the boom in de-SPAC transactions and IPOs. With continued confidence in the performance of PE as an asset class, fundraising activity remained strong, with PE funds amassing aggregate capital of over US$1.3 trillion raised and record amounts of available capital ('dry powder') (one estimate puts the latter at over US$1.6 trillion).

In 2021, PE's enormous impact and the continuing creativity of PE dealmakers was demonstrated. Given PE funds' success, creativity and available capital, we are confident that PE's role in the global economy will continue to grow, not only in North America and western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa, notwithstanding ongoing and potential political, regulatory and economic challenges.

PE professionals need practical and informed guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. *The Private Equity Review* has been prepared with this need in mind. It contains contributions from leading PE practitioners in 16 different countries, with observations and advice on PE deal-making and fundraising in each.

As PE has grown, it has also faced increased regulatory scrutiny throughout the world. Adding to this complexity, regulation of PE is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

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I want to thank everyone who contributed their time and labour to making this 11th edition of *The Private Equity Review* possible. Each of these contributors is a leader in their respective markets, so I appreciate that they have used their scarce and valuable time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
March 2022

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Part I

Fundraising

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Chapter 15

UNITED STATES

Joseph A Smith, Tarik M Shah and Ruchi Sharma[1]

I GENERAL OVERVIEW

Not only did US private equity (PE) fundraising rebound in 2021, it was in many ways the most successful year for PE fundraising since the financial crisis of 2007–2008. Neither continuing lockdowns due to the covid-19 pandemic, consistently high trading multiples for private companies nor ongoing concerns over the high volume of 'dry powder' within the industry were sufficient to mitigate an influx of fresh capital. Indeed, as fiscal stimulus drove public market shares higher, a 'reverse denominator effect' drove additional commitments into private equity, while institutional investors became increasingly comfortable with 'Zoom diligence'. Meanwhile, the continued growth of general partner-led secondary transactions demonstrated that 'going public' is no longer a presumed exit strategy. It is reported that private equity firms raised US$733 billion in 2021, US$14 billion more than the previous record set in 2019.[2] Moreover, taken together, the illiquid alternative asset classes (i.e., private equity, private debt, hedge funds, real estate, infrastructure and natural resources) together are projected to reach over US$23 trillion in assets under management globally by 2026.[3]

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 a special purpose vehicle to act as the general partner to a fund vehicle, usually structured as a Delaware limited liability company (LLC) or limited

1 Joseph A Smith is a partner and Tarik M Shah and Ruchi Sharma are associates at Schulte Roth & Zabel LLP. The authors would like to thank David M Cohen, Elie Zolty and Kelly Koscuiszka for their contributions to this chapter.
2 Private Equity International 2021 Fundraising Report.
3 Preqin Alternatives in 2022 (October 2021).

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partnership. A separate investment manager or adviser entity is commonly used for a series of funds, which provides ongoing office infrastructure and bears ongoing registration and compliance burdens concomitant with this role (see Section III.iii below). This structure permits the sponsor or key executives to maintain control of investment decisions and operational budgets, while segregating incentive payments and investment income among 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. The consistency in prevailing fund terms is a function of an adverse selection process in which terms are driven by top-quartile fund managers, and the pandemic has only perpetuated this. The strongest managers, aided by the 'flight to quality' (or, as some say, 'flight to the familiar'), are able to maintain their desired terms and consistent comments from limited partners (LPs) belie their acceptance of the classical PE model. First-time and even partially challenged managers with sufficient investor interest are then able to leverage these accepted market terms in their favour, with concessions that can be material but nonetheless maintain the paradigm established by more successful general partners (GPs).

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 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.[4] 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.

4 A number of rules apply for purposes of computing the 2 per cent limit, but discussing them is beyond the scope of this chapter.

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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 take action 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.

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

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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.[5]

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',[6] 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.[7] In addition, issuers relying on Rule 506 of Regulation D[8] must not

5 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).

6 'Accredited investors' are, generally: regulated entities (such as banks, insurance companies or registered investment companies); natural persons (or spouses or spousal equivalent) with (joint) net worth of more than US$1 million (excluding the value of any primary residence) or meeting certain income thresholds; natural persons based on certain professional certification, designations or credentials or other credentials issued by an accredited educational institution; natural persons who are 'knowledgeable employees'; corporations, trusts, partnerships, limited liability companies with assets of more than US$5 million; SEC and state-registered investment advisers, exempt reporting advisers, rural business investment companies and certain employee benefit plans; any entity organised under the laws of foreign countries, that own 'investments,' as defined in Rule 2a51-1(b), in excess of US$5 million and was not formed for the specific purpose of investing in the securities offered; family offices with at least US$5 million in assets under management and their 'family clients'; 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 (see Rule 506 of Regulation D).

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

8 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).

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be subject to any 'disqualifying event' as set forth in the rule.[9] 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[10] provides an exemption for certain offers and sales of securities outside the US, whether conducted by foreign or domestic issuers, in recognition of the underlying policy and objectives of the Securities Act to protect US investors. In general, two basic requirements must be met for an offering to qualify under Regulation S: first, the offer or sale must be made in an 'offshore transaction'; and second, no 'directed selling efforts' may be made in the US by the issuer, a distributor, any of their respective affiliates or any person acting on their behalf in respect of the securities.[11]

Notwithstanding the latter requirement, contemporaneous domestic and offshore offerings may be undertaken in reliance on both Regulations D and 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,[12] 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 (or, in the case of a qualifying venture capital fund,[13] 250 persons).[14] Although this exception is available irrespective of the financial

9 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 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.

10 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.

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

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

13 A qualifying venture capital fund is 'a venture capital fund that has not more than $10,000,000 in aggregate capital contributions and uncalled committed capital, with such dollar amount to be indexed for inflation once every 5 years by the Commission, beginning from a measurement made by the Commission on a date selected by the Commission, rounded to the nearest $1,000,000.' Venture capital fund is defined in Investment Advisers Act Rule 203(l)-1.

14 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 integration framework has been codified in Rule 152.

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sophistication or wealth of the investors (and permits participation by a potentially unlimited number of 'knowledgeable employees'),[15] 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 when an issuer has complied with the requirements of Regulation D or S to avoid registration under the Securities Act (including offerings employing general solicitation under Rule 506(c)).

Second, a further exception is available under Section 3(c)(7) for an 'investment company' if it does not make a public offering of its securities (see above) and the ownership of such securities is limited exclusively to 'qualified purchasers,' which include:[16]

a individuals who own at least US$5 million in investments (including joint or communal property);[17]
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'; and
d companies with at least US$25 million in investments.[18]

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).[19]

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15 '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.

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

17 '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).

18 Those meeting the definition of 'qualified institutional buyer,' which 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 (Rule 144A), are likely to meet the qualified purchaser requirements.

19 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.

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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,[20] which is intended to address the fiduciary nature of the advisory relationship and focuses on the mitigation or disclosure of conflicts of interest inherent in such a relationship.[21]

Investment advisers with more than US$100 million in regulatory assets under management[22] are eligible for SEC registration, although advisers with less than US$150 million in regulatory assets under management can generally remain subject to state-level regulation under similar statutes.[23] 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).[24] 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.[25]

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

20 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 202(a)(11)).

21 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).

22 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).

23 SEC Regulation of Investment Advisers, note 47.

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

25 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.

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year, changes in the adviser's business, and the effectiveness and comprehensiveness of the adviser's policies or procedures.[26] The SEC's Division of Examinations conducts periodic examinations of registered advisers, but may also conduct 'for cause' and sweep examinations under appropriate circumstances (see Section IV.i below).

Specific restrictions also apply to performance-based compensation,[27] which an investment adviser may only charge to sufficiently sophisticated investors, including 3(c)(7) funds (see Section III.ii above) and qualified clients,[28] as well as non-US persons. Registered advisers are generally required to hold client assets through a qualified custodian (such as a bank or registered broker-dealer), but private equity funds holding privately offered securities are eligible for the 'audit exception' from such requirements if certain additional conditions are satisfied.[29]

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 asked 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' include 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

26 While Rule 206(4)-7 itself does not enumerate specific elements of the required policies and procedures, the SEC staff recognises that the application of such policies and procedures may vary widely depending on the size and nature of an adviser's business. In November 2020, the SEC examination staff issued a risk alert regarding examination observations of investment adviser compliance with Rule 206(4)-7 and specifically observed that, 'although the Compliance Rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments.' See also: SEC Release No. IA-2204 (17 December 2003); OCIE Risk Alert, OCIE Observations: Investment Adviser Compliance Programs (Nov. 19, 2020).

27 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.'

28 Rule 205-3: A 'qualified client' includes an investor that has at least US$1.1 million under management with the investment adviser, a net worth of at least US$2.2 million (including joint property, but excluding the value of a natural person's primary residence), qualified purchasers (footnote 38, above), and certain knowledgeable employees of the investment adviser. Under Rule 205-3, the SEC is empowered to update by order the dollar thresholds in the qualified client definition to adjust for inflation. The dollar amounts listed above reflect the June 2021 SEC Order. See SEC Release No. IA-5756 (June 17, 2021).

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

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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;[30] 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 equal or exceed 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.[31]

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 (excluding cash and certain short-term holdings);[32]

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); and

e is not registered under Section 8 of the Investment Company Act and has not elected to be treated as a business development company.[33]

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. 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.[34]

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:

30 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)).

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

32 See Rule 203(l)-1(c)(3) for a list of investments considered a qualifying investment.

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

34 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.

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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.[35]

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,[36] these duties effectively require an investment adviser to act in its clients' best interests. In 2019, the SEC released interpretations on the fiduciary duty to provide clarifications and precedent regarding investment advisers' federal fiduciary duties, which is discussed further below.

In addition, the SEC has adopted 'pay-to-play' rules prohibiting any investment adviser (whether registered or unregistered) from providing advisory services for compensation to a government client for two years after making certain political contributions.[37] 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).

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.[38] Due to the myriad complexities of ERISA and the potentially significant consequences for a fund and its manager if the fund's assets are treated as 'plan assets' for purposes of ERISA of those investors in the fund that are subject to 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.

35 Section 203(b)(3); Section 202(a)(30) of the Advisers Act and Rule 202(a)(30)-1 thereunder.
36 Principally contained in Section 206 of the Advisers Act and rules promulgated thereunder.
37 Rule 206(4)-5; see also SEC Release No. IA-3043 (1 July 2010).
38 In particular, the 'Plan Asset Regulation' issued by the US Department of Labor (29 CFR 2510.3-101).

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Limited participation in the fund by benefit plan investors

If benefit plan investors own less than 25 per cent of each class of equity interests of the fund, then the assets of the fund will not be treated as plan assets for the purposes of ERISA.[39] It should be noted that governmental, church and non-US employee benefit plans are not counted as benefit plan investors for this purpose. One common oversight, however, is that interests in the fund 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 also every time that there is an investor default, a transfer of fund interests, formation of co-investment vehicle or formation of alternative investment vehicles. In the latter two cases, if not all investors participate in such vehicle, that vehicle will be subject to its own 25 per cent test.

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) and it actually exercises those rights each year in the ordinary course with respect to at least one of its qualifying investments.[40] Once again, there are several formal hurdles to surmount 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 meets the under 25 per cent test described above but the fund is designed to permit it to fail the 25 per cent test at the fund's final close and the fund makes its first long-term investment before it is closed to new investors, the fund will want to ensure that its first investment will be a qualifying investment unless, at the time of the first investment, it is willing to give up the possibility of failing the 25 per cent test.

Also, although the 50 per cent test for VCOCs implies that not all long-term investments must be qualifying, the 50 per cent test must be passed on one day during a 90-day valuation period, which typically begins on the anniversary of the first investment.[41] For the purposes of the VCOC rule, operating companies are companies that are, either themselves or through

39 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 plans or pension 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.

40 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).

41 There is an exception to this 50 per cent rule for a VCOC that has elected to declare that it is in its distribution period. This will occur, if at all, towards the end of the life of the fund and is subject to other technical requirements.

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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 available to funds-of-funds and will typically not be available to secondaries funds because the underlying investments are funds and not operating companies. Further, the VCOC exception will not typically be available to credit funds that lend to credit worth borrowers because of the inability to obtain direct contractual management rights from the borrowers, particularly if that fund is not heavily engaged in origination loans. 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.[42] For a real estate investment to qualify for REOC compliance purposes, the REOC must have rights to participate directly in the management or development of the underlying real property. As an obvious corollary to this principle, the real estate must be actively managed or developed. Accordingly, fallow land and triple-net-leased assets are inappropriate for REOC qualification. As is the case with VCOCs, if a REOC's first long-term investment is not a qualifying investment, the entity in question can never qualify as a REOC, and 50 per cent of a REOC's investments, once again measured by historical cost, must be qualifying investments on at least one day during a 90-day annual valuation period. Among other things, a REOC must also actually exercise management rights in the ordinary course with respect to at least one of its qualifying investments in any given year. In sum, although the rules for REOC qualification are also complex and nuanced, they are generally consistent with the investment objectives of most value-added, opportunistic and core real estate private equity funds that seek to create value through active involvement in the management of underlying real estate assets.

42 29 CFR 2510.3-101(e).

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IV REGULATORY DEVELOPMENTS

i The fiduciary duty

In 2019, the SEC issued the Commission Interpretation Regarding the Standard of Conduct for Investment Advisers (the Fiduciary Interpretation). In particular, the SEC provided guidance with respect to the inability of advisers to categorically waive the federal fiduciary duty, the disclosure of potential conflicts of interest that may result in impartial advice being given to a client,[43] contractual limits,[44] the duty of care[45] and allocation policies.[46]

The SEC's interpretation highlights the fact that the actual effectiveness of any given disclosure will be determined in a 'facts and circumstances' review. Part of the goal of the Fiduciary Interpretation was to emphasise the SEC's position that a fiduciary duty exists, that it exists for all categories of clients and that it cannot be categorically waived. An adviser must eliminate or make full and fair disclosure of all conflicts of interest which might incline the adviser, consciously or unconsciously, to render advice which is not disinterested such that a client can provide informed consent to the conflict.[47] An adviser must be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision about whether to provide consent. The SEC has acknowledged that advisers are not required to 'seek to avoid' all conflicts of interest; rather, an adviser may utilise disclosure in lieu of eliminating a conflict, and validate an 'informed consent' concept for conflict of interest disclosures by an adviser.

The SEC further recognises that retail and institutional investors are differently positioned in their ability to assess conflicts. Specifically, institutional clients generally have a greater capacity and more resources than retail clients to analyse and understand complex

43 In addition to stating that disclosure and consent alone cannot satisfy an adviser's duty to act in the client's best interest, the SEC (1) acknowledged that advisers are not required to 'seek to avoid' all conflicts of interests; rather, an adviser may utilise disclosure in lieu of eliminating a conflict; and (2) validated an 'informed consent' concept for conflict of interest disclosures by an adviser. Further, the SEC stressed that an adviser may not state that it 'may' have a conflict when (1) the adviser in fact, generally has a conflict or (2) has such a conflict with respect to some, but not all, of the adviser's clients.

44 While investment adviser's fiduciary duties may vary with the scope of the relationship, the SEC's Fiduciary Interpretation specifically noted that over-broad waivers of the duty will not be permitted.

45 The duty of care obligations run to suitability (and a duty of inquiry to support a reasonable belief that advice is in the best interests of a client), an obligation to seek best execution and a requirement to monitor performance over the course of the relationship.

46 The SEC stressed 'when allocating investment opportunities, an adviser is permitted to consider the nature and objectives of the client and the scope of the relationship. An adviser need not have pro rata allocation policies, or any particular method of allocation, but, as with other conflicts and material facts, the adviser's allocation practices must not prevent it from providing advice that is in the best interest of its clients.' See SEC Release No. IA-5248 (June 5, 2019).

47 Section 206 of the Advisers Act prohibits investment advisers from employing any device, scheme or artifice to defraud any client or prospective client, and from engaging in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client. Advisers Act Rule 206(4)-8 prohibits investment advisers to pooled investment vehicles from (1) making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (2) otherwise engaging in any act, practice, or course of business that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

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conflicts and their ramifications. While the application of the investment adviser's fiduciary duty will vary with the scope of the relationship, the relationship in all cases remains that of a fiduciary to the client. Over-broad waivers, such as the following, are not permitted:

a a contractual provision purporting to waive the adviser's federal fiduciary duty generally;
b a statement that the adviser will not act as a fiduciary;
c a blanket waiver of all conflicts of interest; or
d a waiver of a specific obligation under the Investment Advisers Act.

ii Compliance focus on private fund advisers

In 2020, the then SEC Office of Compliance Inspections and Examinations (OCIE) had identified three general areas of deficiencies for private fund managers. In previous years, the OCIE has found that private fund advisers inadequately disclosed conflicts of interests arising from (among other things):

a allocating investments among clients, including the adviser's largest private fund clients (flagship funds), private funds that invest alongside flagship funds in the same investments (co-investment vehicles), preferentially allocated limited investment opportunities to new clients, higher fee-paying clients, or proprietary accounts or proprietary controlled clients;
b multiple clients investing in the same portfolio company, including when one client owns debt and another client owns equity in a single portfolio company; or
c private fund adviser interests in recommended investments, including when advisers and employees had undisclosed pre-existing ownership interest or other financial interest.

The OCIE staff also observed that private fund investors inaccurately allocated fees and expenses that caused investors to overpay. Examples include, but are not limited to:

a allocating shared expenses in a manner inconsistent with disclosures to investors or policies or procedures which caused certain investors to overpay expenses (e.g., expenses from broken-deal, due diligence, annual meeting, consultants and insurance costs);
b charging funds for expenses that were not permitted by the relevant fund operating agreements (e.g., salaries of adviser personnel, compliance, regulatory filings and office expenses); and
c failing to comply with contractual limits on certain expenses that can be charged to investors (e.g., legal fees or placement agent fees).

Private fund advisers have also been cited for violations under Section 204A of the Advisers Act, including but not limited to failing to establish, maintain and enforce provisions in their code of ethics reasonably designed to prevent the misuse of material non-public information.[48] The OCIE staff observed that advisers failed to enforce requirements in their code of ethics relating to employees' receipt of gifts and entertainment from third parties, and failed to require access persons to submit transactions and holdings reports timely or to submit certain personal securities transactions for pre-clearance.

48 Section 204A requires investment advisers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by the adviser or any of its associated persons. Advisers Act Rule 204A-1 (Code of Ethics Rule) requires a registered investment adviser to adopt and maintain a code of ethics, which must set forth standards of conduct expected of advisory personnel and address conflicts that arise from personal trading by advisory personnel.

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iii The SEC's guidance relating to chief compliance officers

On 19 November 2020, the SEC's examination staff and its director provided unprecedented guidance with respect to the responsibilities of registered investment advisers and their chief compliance officers (CCOs). The SEC provided an overview of its expectations and identified numerous strengths and weaknesses of the compliance programmes of SEC-registered investment advisers. Private fund managers and their CCOs should evaluate their compliance programmes in light of this guidance. Former Director of OCIE Peter Driscoll gave a straightforward assessment concerning compliance resource and support levels: 'empowerment, seniority, and authority' and stated that:

> *We notice when a CCO holds one or more roles in a firm and is inattentive to their compliance responsibilities. We notice when a firm positions a CCO too low in the organization to make meaningful change and have a substantive impact, such as mid-level officer or placed under the CFO function. We notice when CCOs are expected to create policies and procedures, but are not given the resources to hire personnel or engage vendors to provide systems to implement those policies and procedures. We notice when a CCO is replaced because they challenge questionable activities or behaviour. We notice when a CCO is trotted out for an examination or sits silently in the corner in compliance discussions, overshadowed by firm senior officers. We notice when a firm puts responsibility on the CCO for a failure of an employee or an officer to follow a firm policy or procedures.*

In making these statements, the direction to senior management and its implicit warning could not be clearer: CCOs cannot shoulder the compliance responsibilities alone and are not solely responsible for compliance failures.

In connection with the former director's statement, the OCIE released a Risk Alert, 'OCIE Observations: Investment Adviser Compliance Programs', that focuses on examination deficiencies observed by OCIE staff, especially deficiencies that relate to Rule 206(4)-7 (the Compliance Rule). The OCIE instructs that '[e]ach adviser should adopt policies and procedures that take into consideration the nature of that firm's operations. The policies and procedures should be designed to prevent violations from occurring, detect violations that have occurred and correct promptly any violations that have occurred.'

The annual compliance review required under the Compliance Rule should consider:

a compliance matters that arose during the previous year;

b changes in the business activities of the adviser or its affiliates; and

c changes in the Advisers Act or applicable regulations that might suggest a need to revise an adviser's policies or procedures.

In the OCIE risk alert,[49] the SEC emphasised that 'although the Compliance Rule requires only annual reviews, advisers should consider the need for interim reviews in response to significant compliance events, changes in business arrangements, and regulatory developments.' Rote reliance on a single annual compliance review may be seen as problematic by the SEC examination staff, and could be particularly problematic if an actual deficiency contributes to harm to clients or a substantive violation of the federal securities laws.

The SEC also highlighted several issues and concerns relating to inadequate compliance resources, including:

49 OCIE Risk Alert, OCIE Observations: Investment Adviser Compliance Programs (19 November 2020).

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a 'dual-hatted' CCOs who do not appear to have sufficient knowledge of the Investment Advisers Act or of their compliance responsibilities under the Act or who do not appear to devote sufficient time to fulfilling (and who may not in fact be fulfilling) their CCO responsibilities; and

b situations where advisers that 'had significantly grown in size or complexity' have not increased their compliance headcount and have not invested in additional information technology resources, resulting in compliance-related deficiencies and failures.

The OCIE also acknowledged that it observed numerous examples of CCOs who lacked sufficient authority within the adviser to develop and enforce appropriate policies and procedures for the adviser. As support for this shortcoming, the OCIE identified situations where CCOs were restricted from accessing critical compliance information, where senior non-compliance personnel only had limited interaction with the CCO, where CCOs' knowledge about their firms' investment and business operations was unreasonably limited and where CCOs simply were not consulted on matters that potentially had compliance implications.

The SEC staff expect CCOs to be knowledgeable about federal securities laws, and have sufficient resources to implement a compliance programme and are empowered to enforce it. Additionally, like all of an adviser's employees, they are expected to be honest and forthright with the SEC staff during examinations and enforcement actions, and the SEC staff has shown that it is willing to pursue actions when that is not the case.[50]

IV OUTLOOK

Against the backdrop of covid-19, political polarisation and growing geopolitical stress, the outlook for private equity fundraising in the United States continues to be very positive. Fundraising is expected to maintain strength in 2022, although the prospect of higher interest rates and concerns over high trading multiples may finally relieve upward pressure on allocations. Additional regulatory pressures can also be expected. That said, the continuing growth of the industry suggests that private capital is no longer an 'alternative' capital market. Private equity, venture capital and private credit are larger components of the economy than ever before.

50 See: *In the Matter of Meredith A. Simmons, Esq., IA Release No. 5603* (Sept. 30, 2020), available here (in a settled action, a CCO backdated a compliance memorandum, provided it to SEC staff and falsely represented that it had been created at the time of the events it purported to describe).

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Appendix 1

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