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Chapter 16

UNITED STATES

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I OVERVIEW

The US private equity fundraising landscape for 2013 was dominated by concerns over increased regulatory scrutiny combined with the perception of a significant but less-than-robust economic recovery. Although fiscal debates and political brinkmanship generated broader discussions on asset allocation paradigms, the private equity market continued to show resilience in the wake of the financial crisis: fundraising volumes steadily increased. Since the nadir of 2010, when North American-focused funds raised only US\$160.7 billion, fundraising activity gradually recovered to US\$266 billion in 2013.²

Established investors in the market demonstrated their continued commitment to the private equity sector, well aware that the balance of negotiating power had shifted since the fundraising peaks of 2007–2008. They are now using this balance to scrutinise management teams and negotiate individual fund terms in particular detail, with fund sponsors in turn realising the marketing benefits of increased transparency and demonstrable compliance with investors' policies and procedures. In addition, a new wave of bespoke solutions such as separately managed accounts augmented the classic commingled approach to private equity fundraising, with a reported five-fold increase in volume in the first 10 months of 2013.³

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2 Preqin 2013 Private Equity Fundraising (January 2014), p1. In 2012, North American-focused private equity funds raised US\$200 billion.

3 *PEI Alternative Insight*, 'US Institutions moving towards separate accounts,' 11 December 2013.

This increased sophistication and attention to detail has come at a cost for both sponsors and investors. As a result of the time and effort involved in conducting pre-commitment due diligence (which may include multiple meetings and on-site visits), investors have tended to concentrate their attention on a finite number of ‘best of breed’ fund sponsors. In some instances this has led to competition for allocations in the face of scale-backs, rebalancing to a degree the negotiation position of sponsor and investor at the top of the market. This focus on established fund managers has also contributed to the ongoing bifurcation of the fundraising market. Together with increased regulatory burdens on marketing and operational activities, new and spin-off managers now face particularly high barriers to entry. This trend is exacerbated by lengthening fundraising periods,⁴ which tend to be less disruptive to established operating teams able to rely on 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 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.

Mid-market managers continue to receive strong support from an investor base looking to diversify away from ‘mega-funds’, with over half of all investors currently viewing small to mid-market buyout funds as presenting the best opportunities.⁵ Nevertheless, these fund managers are subject to increasing pressure to specialise and differentiate themselves in an effort to demonstrate their unique potential for adding value. 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 funds raised in 2013 were Apollo Investment Fund VIII (US\$18.3 billion), Carlyle Partners VI (US\$13 billion) and Warburg Pincus Private Equity XI (US\$11.2 billion).⁶ The proportion of capital raised by ‘mega-funds’ (over US\$5 billion) increased to 36.8 per cent during this period, from 23.2 per cent in 2012.⁷

4 The average fundraising period for funds achieving a final close in 2013 was 18.2 months, representing a new record and the third increase in succession; see footnote 9 below.

5 Preqin Investor Outlook: Alternative Assets, H2 2013, p12.

6 Preqin 2013 Private Equity Fundraising (January 2014), p2; PEI Media Research (January 2014).

7 PEI Media Research (January 2014).

Buyout funds comprised by far the largest share of 2013 fundraising activity, with 78 buyout funds raising an aggregate of US\$73.4 billion. This represents a significant increase on 2012 fundraising activity, when US\$45.3 billion was raised across 65 buyout funds. Although average fund sizes in the North American market remained steady at around US\$540 million, the average buyout fund increased from US\$700 million (2012) to US\$940 million (2013).⁸

Length of fundraising

In keeping with the trend of recent years, 2013 has seen the average fundraising period lengthen to 18.2 months, from 17.9 months in 2012.⁹ Strongly favoured funds are continuing to reach (and often exceed) their targets in under 12 months. Investors, acutely aware of the impact of their own expanded diligence protocols, have demonstrated that they understand these circumstances by generally approving requests to extend fundraising periods by a further three to six months.

Types of funds

In general, the fundraising landscape in 2013 has been more favourable for certain types of private equity funds. In contrast to the traditional buyout funds discussed above, secondary funds continue to enjoy historic levels of investor appetite and deal flow, with fund manager-led secondary transactions reaching an all-time high in both value and number.¹⁰ This reflects an increasing desire on the part of both primary and secondary (or strategic) investors to actively manage their private equity portfolios in terms of return profile and liquidity considerations. In particular, banking and insurance companies worldwide have been confronted with more stringent capital adequacy rules and other prohibitions such as the Volcker Rule (see Section IV.v, *infra*), which will continue to drive secondary deal flow in the coming years. Specialised funds in this category may also present an exit opportunity for investors faced with an otherwise drawn out liquidation process.

Fund managers operating in the US real estate, natural resources, and renewable energy sectors have also benefited from macroeconomic trends, with real estate fundraising increasing by 40 per cent (to US\$50.7 billion) and natural resources fundraising increasing by 90 per cent (to US\$25.3 billion).¹¹

Debt funds are also becoming increasingly specialised by sector, tranche and geography, and remain popular among investors with appropriate risk appetites,

8 Preqin 2012 Private Equity Fundraising (January 2013), p2; Preqin 2013 Private Equity Fundraising (January 2014), p2.

9 Preqin 2013 Private Equity Fundraising (January 2014), p2.

10 Preqin Investor Outlook: Alternative Assets, H2 2013, p12; Preqin 2012 Private Equity Fundraising (January 2013), p2.

11 Preqin 2012 Private Equity Fundraising (January 2013), p2; Preqin 2013 Private Equity Fundraising (January 2014), p2.

evidenced by strong increases in mezzanine and distressed private equity fundraising.¹² Industry estimates reveal that around 47 per cent of investors in alternative assets currently have an exposure to private debt, with many more considering future investment in this asset class.¹³

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 27 per cent of investors interested in this market segment being based overseas.¹⁴ 2013 represented another strong year for venture capital fundraising, with US\$19.9 billion raised across 119 funds (2012: US\$19.2 billion across 78 funds).¹⁵

In contrast, funds of funds have continued their recent decline in size and prevalence.¹⁶ Many industry participants attribute this trend to three factors: first, the reluctance of many investors to pay for an additional level of fees in the face of pressure to reduce costs across the board; second, the growing sophistication of institutional investors (with increasing ability and desire to hand-pick their sectoral and geographical allocations, as well as the opportunity to participate in co-investments); and third, the growth of mega-funds and the concomitant decrease in the incidence of reductions to the requested size of investor commitments. Nevertheless, funds of funds continue to play a very important role as a platform for investors seeking no-frills diversification and access to larger funds.

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, in particular, may 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.

12 In 2013, fundraising activity for mezzanine funds increased by 63 per cent (to US\$13.6 billion), while distressed private equity funds increased by 36 per cent (to US\$27.4 billion): Preqin 2012 Private Equity Fundraising (January 2013), p2; Preqin 2013 Private Equity Fundraising (January 2014), p2.

13 Preqin Investor Outlook, Alternative Assets, H2 2013, p12.

14 Preqin Special Report, ‘US Venture Capital Industry, October 2013’, p2.

15 Preqin 2012 Private Equity Fundraising (January 2013), p2; Preqin 2013 Private Equity Fundraising (January 2014), p2.

16 Ibid.

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 subsection iv, *infra*). One important aspect of this structure is that it permits the sponsor or key executives to maintain control of investment decisions and operational budgets, while segregating incentive payments and, potentially, 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 2013 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 that attract sufficient investor interest are then able to leverage these generally accepted market terms, with some additional concessions.

Two notable exceptions to this stasis are representative of the shift in bargaining positions since the global financial crisis of 2008–2009. A conceptual focus on greater alignment of interests between sponsors and investors has resulted in material changes in the areas of fee offsets and the timing of carried interest distributions:

First, fee offsets have gradually evolved from a historic zero offset, through an intermediate 50 per cent offset, to an 80 per cent or sometimes 100 per cent offset.¹⁷ 100 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, hence the 100 per cent offset deprives the general partner and its affiliates of their proportionate share of fee income attributable to their own invested capital.

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 the traditional deal-by-deal distribution waterfall, thereby aligning interests over the life of the fund.

The most significant challenge to the traditional ‘2 and 20’ commingled blind-pool model lies in the advent of bespoke solutions such as separately managed accounts, including the ‘fund of one’. Investors with significant capital to invest are increasingly

¹⁷ The mean offset percentage for buyout funds has steadily increased from 69 per cent for 2006 vintage funds to 87 per cent for 2012/2013 vintage funds: The 2013 Preqin Private Equity Fund Terms Advisor, p41.

seeking individualised arrangements that permit customised asset allocation paradigms, with fees and control mechanisms tailored to each investor's specific requirements. Fee structures are inherently more flexible under this style of management mandate, with base fees sometimes only being charged in respect of invested capital rather than committed capital (particularly in the context of pledge funds, where the investor is able to decide whether to participate in each deal during the life of the fund). In order to allay the concerns of their regular investor base, sponsors offering these platforms have been required to devote significant resources to develop policies that address disclosure to other investors, deal flow allocation and other inherent potential conflicts of interest.

iii Taxation of the fund and its investors

There are a number of important tax considerations for a private equity fund and its investors that will determine the way in which the fund is structured.

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 for 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.

Taxation of the 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

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.

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 US persons invested in FFIs.¹⁹ Beginning 1 July 2014, 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 will

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

20 Beginning no earlier than 1 January 2017, 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

generally be required to register with the Internal Revenue Service (IRS) and, except as discussed below, enter into an 'FFI agreement' with the IRS. Under that agreement, the FFI must agree, among other things, to perform certain due diligence functions in order to identify its US investors and report specific financial information about certain of its investors to the IRS. Investors who do not provide an FFI with sufficient information about their US or FATCA status to satisfy the FFI's due diligence requirements generally will be 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, the Cayman Islands and the Isle of Man) have signed intergovernmental agreements with the US (IGAs).²¹ Pursuant to Model 1 IGAs, an FFI located in an IGA jurisdiction generally will not be subject to withholding under FATCA²² so long as it registers with the IRS and complies with the FATCA enabling legislation promulgated by the IGA jurisdiction. While each IGA jurisdiction will enact enabling rules specific to its own legal system, it is expected that the due diligence and reporting requirements under these rules will be substantially similar to the due diligence and reporting requirements provided in the FFI agreement with the IRS; accordingly, the requirement to withhold on investors who fail to provide sufficient information about their US or FATCA status will likely be suspended.

III REGULATORY FRAMEWORK

The operation of private equity funds in the US is governed principally by federal statutes, although fund entities, if formed in the US, are formed pursuant to state legislation, which can also play a significant role in the contexts of placement agent activities and governmental pension plans (which represent a significant proportion of domestic capital for many private funds). A detailed discussion of applicable legislation is beyond the scope of this article; however, as a practical matter, any fund sponsor engaging a placement agent should ensure that the placement agent is registered as a broker-dealer under the Securities Exchange Act of 1934, as amended (the Exchange Act)²³ and complies with any lobbyist registration requirements imposed by the states

type that produce interest or dividends, as well as withholding on certain 'foreign passthru payments' the meaning of which has yet to be published by the US Department of the Treasury.

21 For a complete list of countries that have concluded IGAs, 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

in which fundraising activity will be undertaken. The potentially draconian penalties applicable under state legislation (ranging from forfeiture of two years' management fee and carried interest to complete repayment of invested capital with interest) have caused some private funds to shy away from accepting commitments from these investors unless compliance with such regulations can be assured.

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 in further detail below.

i Securities Act

The sale of limited partnership interests in a private equity fund is governed by the Securities Act, which requires securities sold in the US to be registered with the Securities and Exchange Commission (SEC) unless an exemption is available. To avoid the burdensome registration and disclosure requirements under the Securities Act, most funds structure their offerings in a manner that qualifies for one or both of the 'safe harbours' promulgated by the SEC. These safe harbours operate within the scope of a general statutory exemption for private placements under Section 4(a)(2) of the Securities Act and have been affected by recent regulatory developments (discussed below). 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 limit the manner in which an investor may transfer its interest.

Regulation D²⁴ provides an exemption for private offerings of securities to US persons who qualify as 'accredited investors',²⁵ and was amended with effect from 23

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).

24 Rule 506 of Regulation D (17 CFR 230.501 et seq.) sets out the requirements with which an issuer must comply in order to benefit from the 'safe harbour' assurance that its offering falls within the private offering exemption contained in Section 4(a)(2) of the Securities Act. An offering that fails to satisfy the requirements of Regulation D can nevertheless qualify for exemption under Section 4(a)(2) of the Securities Act, unless general solicitation has taken place pursuant to the new Rule 506(c) (discussed below).

25 '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.

September 2013 to permit general solicitation (i.e., advertising to the public) in limited circumstances and subject to additional restrictions. Issuers relying on Regulation D are nevertheless 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.²⁶

Regulation S²⁷ 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’;²⁸ 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

A private equity 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 issuers 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

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

27 Rules 903 and 904 of Regulation S (17 CFR 230.901 et seq.) set out the requirements with which the issuer and any reseller, respectively, must comply in order to benefit from the ‘safe harbour’ assurance that its non-US sale or resale is exempted from the registration requirements contained in Section 5 of the Securities Act.

28 See further: Rule 902(h) of Regulation S.

29 See further: Rule 902(c) 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.

(and permits an unlimited number of ‘knowledgeable employees’),³² compliance with Regulation D (discussed above) will generally require investors to satisfy the ‘accredited investor’ test.

This exception 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)).

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. Note, however, that non-US persons do not always count towards the 100 beneficial owner test.³³

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’ (defined below). This exception is favoured by larger funds due to the higher qualification standard and lack of 100-investor limitation. For offshore funds, the 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).³⁴

‘Qualified purchasers’ include:³⁵

- a* individuals who own at least US\$5 million in investments³⁶ (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’;

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) or 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.

33 Touche Remnant & Co, SEC No-Action Letter (27 August 1984).

34 Goodwin, Procter & Hoar, SEC No-Action Letter (28 February 1997).

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

36 ‘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).

- d* companies with at least US\$25 million in investments; and
- e* 'qualified institutional buyers'.³⁷

In addition, Section 3(c)(5)(C) of the Investment Company Act excludes certain real estate funds from the definition of an 'investment company' and is referred to colloquially as the 'REIT exception' because real estate investment trusts generally must have at least 100 shareholders to maintain their tax status. In practice, the strict distinction drawn by the SEC between interests in real estate (which qualify under this provision) and securities (such as investment contracts, which do not qualify) limits the applicability of this exception,³⁸ with the result that the majority of real estate funds tend to structure their offering in compliance with one of the exceptions described above.

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,³⁹ 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.⁴⁰ Investment advisers with more than US\$100 million in regulatory assets under management⁴¹ are eligible for SEC registration, although advisers with less than US\$150 million in regulatory assets under management can generally remain subject to state-

37 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.

38 There is little legislative history on Section 3(c)(5)(C), which predates the existing Section 3(c)(7) exception discussed above. SEC no-action letters have predominantly informed industry practice in this respect. For further discussion, see: SEC Release No. IC-29778 (31 August 2011).

39 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)).

40 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.

41 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).

level regulation under similar statutes.⁴² 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 (including potential conflicts of interest).

The SEC mandates comprehensive Form ADV disclosures that are accessible to the public, and must be updated by the investment adviser at least annually (or more promptly in the event of certain material changes).⁴³ 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.⁴⁴

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 is required to be undertaken, which should consider any compliance matters that arose during the previous year, any changes in the adviser's business and any changes in the Advisers Act or applicable regulations that might suggest a need to revise the policies or procedures.⁴⁵ The SEC's Office of Compliance Inspections and Examinations conducts periodic examinations of registered advisers roughly every three to four years, but may also conduct 'for cause' and sweep examinations under appropriate circumstances (see Section IV.ii, *infra*).

42 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, Note 47. (SEC Regulation of Investment Advisers.)

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

44 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.

45 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.

Specific restrictions also apply to performance-based compensation,⁴⁶ which an investment adviser may only charge to sufficiently sophisticated investors, including 3(c)(7) funds (see III.i, *supra*) and qualified clients,⁴⁷ 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.⁴⁸

Multiple managers, advisers and general partners

Private funds are frequently structured with the general partner and investment adviser as distinct entities in order to permit adequate insulation of liabilities. Established fund managers may operate several generations of funds concurrently, each with its own general partner and (in some cases) separate management or advisory vehicles. Alternative investment vehicles established within a single fund structure may also utilise separate general partners.

In this context, SEC guidance informs market practice as to whether affiliated entities are required to register separately with the SEC. In a series of no-action letters,⁴⁹ the SEC has confirmed that general partners and managing members affiliated with, and formed by, a registered investment adviser (the filing adviser) may, subject to certain conditions, rely on SEC filings made by the filing adviser and thus avoid separate registration. Similar considerations apply to commonly-controlled or operationally integrated groups of investment advisers.⁵⁰ Such relationships must be disclosed in Part 1A, Schedule D of the filing adviser’s Form ADV.

However, non-US investment advisers are precluded from relying on these policy positions unless the filing adviser is a US-based investment adviser. Instead they are required to either: qualify independently for one of the exemptions outlined above; or structure their activities in accordance with the Unibanco line of no-action letters issued by the SEC.⁵¹ Reorganising an advisory structure artificially into separate entities is not

46 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’.

47 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 35, *supra*), and certain knowledgeable employees of the investment adviser.

48 Rule 206(4)-2; see also SEC Release No. IA-2968 (30 December 2009).

49 American Bar Association, Business Law Section, SEC No-Action Letter (18 January 2012); American Bar Association, Subcommittee on Private Investment Entities, SEC No-Action Letter (8 December 2005).

50 SEC Regulation of Investment Advisers, p. 17. See footnote 42, *supra*.

51 SEC Staff No-Action Letters: Royal Bank of Canada, et al. (3 June 1998); ABN AMRO Bank NV (1 July 1997); Mercury Asset Management Plc (16 April 1993); Uniao de Banco de Brasileiros SA (28 July 1992); Richard Ellis, Inc (17 September 1981). Although acknowledging

permitted in this context, nor can related entities rely on both the private fund adviser and venture capital adviser exemptions simultaneously to avoid registration.

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,⁵² but remain subject to the anti-fraud provisions contained in Section 206 of the Advisers Act and may be requested to provide access to books and records in connection with 'for cause' examinations. These 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 Section 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 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;⁵³ and
- c* the value of such private fund assets under management in the US must be reviewed annually by the private fund adviser. A private fund adviser whose assets under management in the US equals or exceeds US\$150 million has 90 days from the date of its annual update filing to register with the SEC.⁵⁴

the ongoing application of the Unibanco line of no-action letters under the Dodd-Frank Wall Street Reform and Consumer Protection Act (21 July 2010) (Dodd-Frank Act), SEC staff have noted that they expect to provide further guidance in the context of the foreign private adviser and private fund adviser exemptions (SEC Release No. IA-3222, at p128).

52 Exempt reporting advisers are required to complete the following items on Part 1A of Form ADV, which must be updated annually within 90 days after the end of each fiscal year: Items 1 (Identifying Information), 2.A and 2.B (SEC Reporting by Exempt Reporting Advisers), 3 (Form of Organisation), 6 (Other Business Activities), 7 (Financial Industry Affiliations and Private Fund Reporting), 10 (Control Persons), 11 (Disciplinary Disclosure), and the corresponding sections of Schedules A, B, C and D. See www.sec.gov/about/forms/formadv-instructions.pdf.

53 For these purposes, 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)).

54 Rule 203(m)-1(c), SEC Regulation of Investment Advisers, p. 15. See footnote 42, *supra*.

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'⁵⁵ (excluding cash and certain short-term holdings); and
- 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).⁵⁶

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.⁵⁷ 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.⁵⁸

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;

55 '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 42, *supra*).

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

57 As of 2 January 2014, there were 2,594 exempt reporting advisers registered with the SEC, of which approximately 43 per cent maintained their principal office outside the US (source: SEC FOIA Documents).

58 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.

- 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.⁵⁹

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 between an investment adviser and its client. Interpreted by courts in tandem with the anti-fraud provisions of the Advisers Act,⁶⁰ 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 government client for two years after making certain political contributions.⁶¹ 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 approximately US\$19.5 trillion in retirement assets available for investment within this sector (up from US\$14.2 trillion just five years ago).⁶² The Employee Retirement Income Security Act of 1974 (ERISA) and extensive rules and regulations promulgated by the US Department of Labor thereunder govern the obligations of fiduciaries responsible for managing pension plans in private industry.⁶³ Conveniently for private equity fund managers, governmental and church pension funds are not subject to ERISA. 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. Moreover, ERISA investors frequently request that fund counsel issue a legal opinion confirming

59 Investment Company Act, Sections 203(b)(3) and 202(a)(30).

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

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

62 As at 31 December 2012. Source: 2013 Investment Company Fact Book, Figure 7.4, Investment Company Institute (53rd Edition).

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

the fund's status under ERISA or the issuance of periodic compliance certificates from fund managers.

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 investors⁶⁴ 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 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 subscription closings but over the duration of the fund. Hence, fund managers must monitor for compliance in the context of investor defaults, transfers of interest, the formation of alternative investment vehicles, etc.

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 (such investments are referred to as 'qualifying investments')⁶⁵ 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 tricks 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 (i.e., an investment other than in liquid investments such as cash equivalents pending long-term

64 A 'benefit plan investor' is any of the following: (1) any employee benefit plan (as defined in section 3(3) of ERISA) that is subject to the provisions of title I of ERISA; (2) any plan described in Section 4975(e)(1) of the Code that is subject to the provisions of Section 4975 of the Code; or (3) any entity whose underlying assets include plan assets by reason of an employee benefit plan's or plan's investment in the entity: see Section 3(42) of ERISA. An employee benefit plan or pension plan of a US state or local government, a church plan and an employee benefit plan or pension plan of a non-US entity are not 'benefit plan investors' under ERISA.

65 Qualifying investments are either: (1) 'venture capital investments' with respect to which the fund has obtained certain management rights permitting the fund 'to substantially participate in, or substantially influence the conduct of, the management of the operating company'; or (2) 'derivative investments' that arose from a prior 'venture capital investment': see 29 CFR 2510.3-101(d).

investment). Hence, if a fund's first long-term investment is not a qualifying investment (i.e., an investment in an operating company in respect of which it has direct contractual management rights), 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 and it is not known whether, once the fund raise has been completed, it will continue to pass the significant participation test, it may be appropriate for the fund to seek to ensure that its first investment will be a qualifying investment for VCOC purposes. 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.⁶⁶ 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.⁶⁷ 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 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 add, opportunistic and core real estate private equity funds that seek to create value through active involvement in the management of underlying real estate assets.

66 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.

67 29 CFR 2510.3-101(e).

IV REGULATORY DEVELOPMENTS

i Regulatory authorities

As outlined above, the marketing and operation of a private equity fund in the United States fall within the regulatory purview of the SEC. Since the implementation of the Dodd-Frank Act in 2012, fund sponsors have been required to register with the SEC as investment advisers unless subject to one of three remaining exemptions (see above).⁶⁸ The following discussion summarises certain recent regulatory developments in the US.

ii National exam programme

As a result of the large number of newly-registered investment advisers, the SEC is in the process of conducting presence exams over the next year with the stated goals of: (1) familiarising newly-registered investment advisers with their duties under the Advisers Act; (2) examining those advisers to promote compliance with the Advisers Act; and (3) upon completion of the initiative, reporting to the SEC and the public on findings arising from the presence exams.⁶⁹ This initiative has required a resource-intensive legal response that should focus not just on demonstrations of formalistic ‘black letter’ compliance, but of practical compliance across the board.

iii General solicitation rules

By far the greatest ideological shift in the US regulatory landscape in 2013 was the elimination of the SEC’s long-standing prohibition against general solicitation and advertising in private placement offerings. Mandated by Section 201(a) of the JOBS Act,⁷⁰ amendments to Rule 506 of Regulation D were implemented with effect from 23 September 2013 in order to permit public advertising and general solicitation by issuers of their private placement offerings, subject to certain conditions. As a consequence of initial opposition by the SEC to the changes, additional amendments designed to improve investor protection were adopted simultaneously to other aspects of Regulation D, Form D (the principal filing for a securities offering under Regulation D) and Rule 156 (relating to investment company sales literature).

Although issuers of unregistered securities are now legally able to avail themselves of general solicitation and public advertising, the additional compliance burdens, together with strong mandatory sanctions for even slight or accidental transgressions, has meant that few issuers are currently taking advantage of the new rules in practice. To address the SEC’s perception of the increased risks associated with untargeted marketing activities, issuers relying on Rule 506(c) are required to carry out enhanced verification procedures to ensure that their investors meet the ‘accredited investor’ standard, in a stark reversal of the long-standing practice that allowed reasonable reliance on an investor’s

68 Changes to the Advisers Act contained in the Dodd-Frank Act eliminated the private adviser exemption as from 21 July 2011, although existing advisers were permitted to continue to rely on the exemption until 30 March 2012 following an extension of the compliance date.

69 www.sec.gov/about/offices/ocie/letter-presence-exams.pdf (accessed 21 October 2013).

70 The Jumpstart Our Business Startups Act (5 April 2012).

asserted qualifications. Importantly, and in contrast to regular private placements under the existing Rule 506(b), an offering that fails to qualify for safe harbour treatment under Rule 506(c) will not be able to satisfy the fallback position under Section 4(a)(2) of the Securities Act if general solicitation has taken place.

Industry participants have suggested that the cost–benefit analysis of engaging in general solicitation does not make this a panacea for private funds, especially given the traditional role played by informal recommendations and introductions in the private equity industry. This notwithstanding, some of the SEC’s other amendments apply to issuers across the board, regardless of whether they engage in general solicitation or advertising activities.

iv Bad actor rules

Additional amendments to Regulation D, known as the ‘bad actor’ rules, now require private funds issuing unregistered interests in reliance on Regulation D to certify that they are not disqualified from relying on Regulation D ‘for one of the reasons stated in Rule 505(b)(2)(iii) or Rule 506(d).’⁷¹

An issuer is now disqualified from relying on the Regulation D safe harbours under Rules 505 and 506 if the issuer or any of its predecessors, affiliated issuers, directors, executive officers, other officers participating in the offering, general partner or managing member, beneficial owners of 20 per cent or more of the issuer’s outstanding voting equity securities, promoters, investment managers, placement agents (or any other persons remunerated for solicitation of purchasers) and, in respect of investment managers and placement agents, their general partners, managing members and the respective directors, executive officers or other officers thereof participating in the offering:

- a* has been convicted of certain felonies or misdemeanors relevant to the investment management industry within a 10-year period before the sale (or five years in the case of issuers, their predecessors and affiliated issuers);
- b* is subject to any court order or judgment entered into within five years before the sale that restrains them from engaging in practices within the investment management industry;
- c* is subject to certain orders of the SEC, a state securities commission or banking regulator, the Commodity Futures Trading Commission, the National Credit Union Administration or the United States Postal Service, in some instances entered into as long as 10 years before such sale; or
- d* is suspended or expelled from a registered national securities exchange or securities association for certain acts inconsistent with just and equitable principles of trade.⁷²

71 The ‘bad actor’ rules were mandated by Section 926 of the Dodd-Frank Act: see SEC Release No. 33-9414. Additional changes to Form D have been proposed in SEC Release No. 33-9416.

72 This list is a summarised, non-exhaustive extract of the ‘bad actor’ provisions contained in 17 CFR 230.506(d).

Any such circumstances, to the extent prevailing at 23 September 2013, must be disclosed to each purchaser of unregistered securities a reasonable time prior to sale, and will not preclude an issuer from relying on the Regulation D safe harbour. However, the scope of factual inquiry necessary to ensure that an issuer can in fact make such representations (going back 10 years in certain respects) has required extensive administrative and compliance efforts on the part of private funds and their business partners in recent months. As a result of these changes, additional care is necessary in situations where an investor holds more than 20 per cent of the interests issued in a fund vehicle.

v Volcker Rule

The US agencies responsible for implementing the Volcker Rule agreed on 10 December 2013 to a final version of the long-awaited regulations governing the proprietary trading and private investment fund activities of US banking entities.⁷³ The final rule allows banking entities until 21 July 2015 to comply with the restrictions, although further extensions are possible.

The final rule applies to ‘banking entities’, covering both US banks and their affiliates, as well as foreign banks with a branch or agency office in the US and their affiliates. The restrictions are largely similar to the proposed rule issued in 2011 (with some important modifications), and will prevent, subject to limited exemptions, a banking entity from holding an investment as principal in a private equity fund⁷⁴ or sponsoring a private equity fund.⁷⁵ A banking entity may, nevertheless, continue to invest in private equity funds to which it acts as an investment adviser, distributor, broker or sponsor,⁷⁶ subject to a ‘per fund cap’ of 3 per cent of the total outstanding ownership interests in each covered fund and an ‘aggregate cap’ of 3 per cent of the banking entity’s Tier-1 capital. A ‘seeding exception’ further permits a banking entity to own up to 100 per cent of the covered fund for at least one year post-establishment while external investors are sought. Sponsorship of a private equity fund by a banking entity is subject to further detailed restrictions, including in respect of ownership by employees, naming conventions, disclosure and self-dealing transactions.

73 Section 619 of the Dodd-Frank Act, commonly known as the ‘Volcker Rule’, mandated collective rulemaking by the Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, Office of the Comptroller of the Currency and Securities and Exchange Commission.

74 The final rule applies to ‘covered funds’, which includes an issuer relying exclusively on the exemptions contained in Sections 3(c)(1) and/or 3(c)(7) of the Investment Company Act (discussed above), as well as any foreign fund that would, if it were subject to US securities laws, rely exclusively on such exemptions: see paragraph 10(b) of the final rule.

75 See further: Schulte Roth & Zabel LLP, ‘Summary of Final Volcker Rule Regulation – Fund Activities’, 23 December 2013.

76 Acting as a ‘sponsor’ includes (1) serving as a general partner, managing member, commodity pool operator or as a trustee with investment discretion; (2) selecting or controlling a majority of the directors, trustees or management; or (3) sharing the same name (or a variation thereof) with a covered fund: Section 10(d)(9).

vi **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)⁷⁷ now means that fund managers are effectively limited to a *de minimis* exemption for such activities in practice,⁷⁸ and face CFTC registration as a commodity pool operator unless another exemption is available.

IV OUTLOOK

The market outlook for fundraising continues to be positive, and we expect fundraising volumes to maintain the upward trend exhibited since 2010. Recent data show that nearly half of all investors are below their target allocation to private equity, with only one-quarter reporting over-allocation to the asset class.⁷⁹ 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 pledge funds and separately managed accounts.

This positive outlook is nonetheless tempered by still-resonant memories of the financial crisis, uncertainty regarding certain structural economic conditions and an overriding sense of ‘reform fatigue’, as the volume of recent regulatory changes is slowly absorbed into the folkways of the industry.

77 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.

78 Generally, to qualify for the *de minimis* exemption for unregistered funds contained in CFTC Rule 4.13(a)(3), either: (1) the aggregate initial margin and premiums on commodity interest positions does not exceed 5 per cent of the liquidation value of the fund’s portfolio (including unrealised gains and losses); or (2) the aggregate notional value of such positions does not exceed 100 percent of the liquidation value of the fund’s portfolio (including unrealised gains and losses).

79 Preqin Investor Outlook: Alternative Assets, H2 2013, p3.

Appendix 1

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