Private Equity Report

WHAT'S INSIDE

"Look, we've got to improve our voter-tracking algorithms if we want to make more accurate wild-ass guesses."

Tax Reform on the Horizon

Republican leaders in Congress are eager for significant tax reform and believe the election results provide an opportunity for legislation. We expect that the starting point will be a policy paper (called the Blueprint) issued by House Republicans last June. The key takeaway is that the Blueprint upends many of the fundamental principles under which businesses have operated for decades (*e.g.*, by **denying interest deductions to businesses, permitting all business investment to be expensed and exempting foreign earnings**). President-elect Trump also issued a high-level outline of his tax reform plan during his campaign. Many of Mr. Trump's plans are consistent with the Blueprint. The Blueprint and Mr. Trump's plan are both preliminary, however, and any tax reform bill that emerges from the legislative process undoubtedly will be different from the Blueprint and Mr. Trump's plan in many respects.

Individuals

- The top **individual** rate on ordinary income will be 33% instead of 39.6%. The individual alternative minimum tax will be repealed.
- The top individual rate on **capital gain, dividends** and **interest** will be **16.5%**. The 3.8% Medicare tax on passive income will be repealed.

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Jonathan R. Tuttle (Washington, D.C.)
Bruce E. Yannett

Private Equity Group members are based in New York unless otherwise indicated. Please address inquiries regarding topics covered in this publication to the authors or any other member of the Practice Group.

Comment: Interest is included in the category of income subject to the maximum 16.5% rate. This will reduce the tax benefit of holding municipal debt.

- **Carried interest** is not mentioned in the Blueprint. However, Mr. Trump's plan calls for **carried interest to be taxed at ordinary rates** (*i.e.*, carry will not enjoy the reduced rate of 16.5%).
- All **itemized deductions** will be **eliminated** other than those for mortgage interest and charitable donations.

Comment: The elimination of the deduction for state and local income and property taxes will disproportionately affect taxpayers living in jurisdictions with high state and local tax rates (*e.g.*, New York and California). Taxpayers will effectively pay federal tax on state and local tax.

- The **estate tax** will be **eliminated**. The fate of the gift tax and the basis step up upon death is unclear. Mr. Trump's plan indicates that the gift tax will be repealed and that capital gains will be taxed upon death, with an exemption of $5 million ($10 million for married couples).

Businesses

- The corporate tax rate will be a flat **20%** (15% under Mr. Trump's plan). The corporate alternative minimum tax will be repealed.
- "**Small business**" income earned by proprietorships or through pass-through entities (partnerships, LLCs and S corporations) will be taxed at a maximum rate of **25%**. It is unclear what constitutes a small business. Proprietorships and pass-through entities will pay or will be treated as having paid **reasonable compensation** to their owner-operators. This compensation will be deductible by the small business and includible by its owner-operators.

Comment: The requirement to pay reasonable compensation to owner operators (even in the case of a proprietorship) will reduce the benefit of the 25% rate on small business income, if the owner-operators are taxed at the 33% rate.

> "Carried interest is not mentioned in the Blueprint. However, Mr. Trump's plan calls for carried interest to be taxed at ordinary rates (*i.e.*, carry will not enjoy the reduced rate of 16.5%)."

- All **business investment** (including buildings, tangible and intangible personal property, but not including land) will be **expensed** (written off entirely in the year of acquisition).

Comment: The 13-point rate differential between the 33% individual and 20% corporate tax rates could encourage some large businesses held in pass-through form to incorporate. However, for corporations that distribute most of their profits, the effect of the 20% corporate rate and the 16.5% individual rate on dividends will bring the overall effective rate in both the pass-through and corporate scenarios close to the same figure (about 33%). Furthermore, the possibility of offering purchasers of unincorporated businesses an immediate write-off of the purchase price will encourage many large businesses to choose the pass-through form where possible. The same may be true for small businesses. (The Trump plan allows pass-through owners to elect to be taxed in a manner similar to corporate shareholders, eliminating the incentive to incorporate.)

- **Interest expense** will be **non-deductible**, except against interest income. Unspecified special rules will apply to financial services companies such as banks, insurance companies and leasing companies.

Comment: The disallowance of interest expense might encourage alternative forms of financing such as leasing, if rental expense is deductible. However, leased property cannot be expensed (in contrast to purchased property).

- **Net operating losses** will be carried forward indefinitely (but not carried back) and increased by an interest factor. A net operating loss carryforward may offset only 90% of taxable income determined before the carryforward.

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- Tax **deductions and credits** applicable to "special interests" will be repealed, other than a credit for research and development conducted in the U.S.
- Existing **offshore earnings** held in cash and cash equivalents will be subject to an immediate **8.75%** tax, and earnings held in other forms will taxed at a **3.5%** rate (which can be paid over an 8-year term).

  Comment: Presumably there will be rules denying the 3.5% rate and extension of the payment period in the case of the conversion of cash and cash equivalents into other property in anticipation of the change in law. The Blueprint estimates that U.S. multinationals have over $2 trillion of offshore earnings. Even if all of the $2 trillion were taxed at only 3.5%, the one-time tax revenue from the proposal would be $70 billion.
- Prospectively, the U.S. will apply a "**territorial system**," meaning that distributions from foreign subsidiaries and income earned through foreign branches will be exempt from U.S. tax and that foreign tax credits will be disallowed.
- As part of the territorial system, the U.S. will adopt a "**destination-based tax system**" under which products, services and intangibles that are exported outside of the U.S. will not be subject to U.S. tax, regardless of where they are produced. Under this approach, products, services and intangibles that are imported into the U.S. will be subject to U.S. tax regardless of where they are produced. The Blueprint is vague on the details of the export/import regime and its legality under WTO commitments.

Comment: Although the details of the controversial destination-based tax proposal are unclear, its effect would be to encourage both U.S. and foreign companies to locate business activity in the U.S. so that goods and services do not have to be imported and output can be exported without U.S. tax. Allowing a U.S. business to derive tax-free profits from exports would be a major departure from existing tax rules and could incentivize trading partners to retaliate.

- The CFC anti-deferral rules will be streamlined to apply only to passive income.

Change Ahead

As noted above, the Blueprint and Mr. Trump's plan are both preliminary, and will be subject to extensive debate, lobbying and controversy. Any tax reform bill that emerges from the legislative process undoubtedly will differ from the Blueprint and Mr. Trump's plan in many respects, and likely will include extensive transition rules.

Gary M. Friedman
gmfriedman@debevoise.com

Peter A. Furci
pafurci@debevoise.com

Vadim Mahmoudov
vmahmoud@debevoise.comm

Matthew D. Saronson
mdsaronson@debevoise.com

Peter F.G. Schuur
pfgschuur@debevoise.com

Financial Regulatory Reform Under President Trump

"[Under the CHOICE Act, investment] advisers to 'private equity funds' would be exempt from registration and reporting requirements under the Investment Advisers Act of 1940, but required to maintain records and provide to the SEC annual or other reports as the SEC determines by rule."

We expect that Donald Trump's inauguration as U.S. president and the election of Republican majorities in both houses of the U.S. Congress will result in a revised financial regulatory framework. Preliminary indications from the Trump transition team have signaled that substantial changes may be in the offing, although the exact contours of these changes remain unclear. In this article we address several key proposed changes, including those affecting private equity fund advisers, the banking industry (including the Volcker Rule and systemic risk oversight), current leveraged lending guidance, capital markets activity and U.S. Securities and Exchange Commission (SEC) enforcement authority.

Potential Legislative Changes

Is Congress likely to repeal the Dodd-Frank Act?

- Although we believe a wholesale repeal of the Dodd-Frank Act is unlikely to occur, we think that substantial changes to the Dodd-Frank Act are likely.
- Bi-partisan support for "technical" revisions to the Dodd-Frank Act has long existed, in principle, but efforts to implement technical fixes have been stymied by the Obama Administration, which sought to avoid "opening a Pandora's box." With the new Administration, these efforts appear likely to gain steam. Further, the new Administration and Republican leaders in Congress have signaled that they will not stop there, but will also seek broader and more comprehensive revisions to Dodd-Frank, including to various provisions that they believe are misguided and create needless regulatory burdens without commensurate benefits.

What are alternatives to full repeal of the Dodd-Frank Act?

One alternative to a full repeal is the Financial CHOICE Act of 2016 (the CHOICE Act), sponsored by Rep. Jeb Hensarling (R-TX). The CHOICE Act provides a blueprint for the types of reforms that a Republican controlled House and Senate may pursue.

- That bill, which was introduced last year, would: repeal several key provisions of the Dodd-Frank Act, such as the Volcker Rule and Orderly Liquidation Authority; weaken the authorities of the Financial Stability Oversight Council (the FSOC); and restructure the Consumer Financial Protection Bureau (the CFPB). The CHOICE Act has received Republican support thus far and passed committee largely on party lines without Democratic participation or amendment.[1]

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1. Donna Borak, *House Financial Services Committee Passes Bill to Overhaul Dodd-Frank Law*, The Wall Street Journal (Sept. 13, 2016, 5:24 PM), http://www.wsj.com/articles/house-financial-services-committee-passes-bill-to-overhaul-dodd-frank-law-1473787619. Democrats on the Committee disparaged the bill as the "wrong choice act."

- Rep. Hensarling has stated that the CHOICE Act is in the process of being rewritten. The "2.0" version may step back from some of the CHOICE Act's more controversial proposals in order to receive broader support.[2] Although the bill, even without modification, may be expected to pass the House, substantive revision may be necessary to garner enough support to pass in the Senate, where procedural measures can be used by Senate Democrats to hold up legislation.

What are some of the key provisions of the CHOICE Act, as currently drafted?

We are tracking the status of the CHOICE Act and anticipate many updates over the coming weeks and months. For now, we highlight some key provisions of the CHOICE Act as written:

- An "off-ramp" offering relief from capital and liquidity standards under the Dodd-Frank Act and Basel III for financial institutions that reach a 10% non risk weighted leverage ratio threshold;
- A repeal of FSOC authority (1) to designate non-bank financial companies for enhanced supervision and (2) to recommend enhanced prudential standards for large, interconnected bank holding companies (BHCs);
- A renaming and restructuring of the CFPB as a "Consumer Financial Opportunity Commission" (CFOC) subject to congressional appropriations and oversight;
- An increase to the asset threshold for CFOC supervision from $10 billion to $50 billion;
- Repeal of the Volcker Rule, which, among other things, severely limited the ability of banks to sponsor and invest in private equity and hedge funds; and
- Amendments to the Federal Reserve's power, processes and authorities.

> "Unless Congress acted specifically to repeal the interagency guidance on leveraged lending, it is likely that it would remain in place, even if the Dodd-Frank Act were repealed, until new leadership at the federal banking agencies decided to re-visit the guidance."

Will all CHOICE Act changes be "de-regulatory"?

The majority of the changes likely will be de-regulatory in nature. Some of the de-regulatory changes will focus on process. For example, Title VI of the CHOICE Act requires approval processes for new rules, mandates congressional approvals for all "major" rules and subjects all rules to cost-benefit analyses. (See "Procedural Implications" below.)

- It is not clear, however, whether all of the CHOICE Act's changes will be uniformly de-regulatory and whether all industry participants will benefit equally from any de-regulatory revisions. For example, the CHOICE Act's "off-ramp" provisions – as currently drafted – would benefit smaller banking organizations, but not necessarily larger ones.
- One reason any bill that emerges from Congress could have re-regulatory elements is the populist streak that runs through both the Democratic and Republican parties. For example, one plank of the platform presented at the Republican convention called for the reinstatement of the Glass-Steagall Act. This is a policy agenda with which left-leaning Democrats, such as Bernie Sanders, agree.
- Whether these sentiments prevail and form part of a larger scheme to impose new restrictions on big banks remains to be seen. Some restrictions on so-called "Wall

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2. Rep. Hensarling has stated that his staff and committee welcome "advice and counsel" as they begin to redraft "a 2.0 version." Philip G. Feigen, *Chairman Hensarling Open to Revised Financial CHOICE Act*, The National Law Review (Nov. 22, 2016), http://www.natlawreview.com/article/chairman-hensarling-open-to-revised-financial-choice-act.

Street" banks could be added to any legislative effort to garner broader congressional support and to fit within the populist rhetoric that dominated this campaign season.

Does revision or repeal of the Dodd-Frank Act mean that post-crisis reforms will be reversed?

- Even a full repeal of the Dodd-Frank Act, in and of itself, would not necessarily mean a repeal of all post-crisis reforms. Although the Dodd-Frank Act required the Federal Reserve and federal banking agencies to take certain actions (*e.g.*, establish enhanced prudential standards), the federal banking agencies have broad authority to establish prudential and supervisory requirements for banking organizations separate from the Dodd-Frank Act.
- For example, when the Federal Reserve adopted the enhanced prudential standards for large, interconnected BHCs required by the Dodd-Frank Act Section 165, the agency cited a broad range of statutory authorities. As a result, repeal of Section 165 would not necessarily nullify these standards. To use another example, the Federal Reserve's capital planning (or CCAR) requirements were adopted outside of the Dodd-Frank Act Section 165 rulemaking process and repeal of the Dodd-Frank Act would not, on its own, nullify CCAR.
- The regulatory implications of new legislation may require a granular review and analysis of the authorities under which existing rules were adopted and the way in which any statutory changes affect those authorities and rules.

Substantive Implications of Regulatory Proposals

What would be the impact on private equity?

- Investment advisers to "private equity funds" would be exempt from registration and reporting requirements under the Investment Advisers Act of 1940, but required to maintain records and provide to the SEC annual or other reports as the SEC determines by rule.

  Comment: The SEC is mandated to define the term "private equity fund." Other types of private fund advisers (*e.g.*, hedge fund managers) would continue to be required to be registered unless otherwise exempt.

  Comment: Investors in private equity funds, particularly investors that are subject to their own fiduciary duties (such as pension plans), may raise questions about (*e.g.*, object to) private equity fund advisers taking advantage of this provision.

- Unless Congress acted specifically to repeal the interagency guidance on leveraged lending, it is likely that it would remain in place, even if the Dodd-Frank Act were repealed, until new leadership at the federal banking agencies decided to re-visit the guidance.
- Changes to Regulation D discussed below would be useful in certain private fund offerings and management equity offerings.

What are the implications for capital raising?

- Registrants with at least one class of common equity securities listed on a national exchange would be eligible to use Form S-3, regardless of public float.

  Comment: This provision would significantly increase the number of companies eligible to use short-form registration on Form S-3. Note that the provision does not expand eligibility for Form F-3 used by foreign private issuers.

- Securities Act Rule 436(g), previously repealed by the Dodd-Frank Act, would be reinstated, allowing the inclusion of security credit ratings within an issuer's registration statement without the consent of the credit rating agency.
- A definition of accredited investor would be added to the Securities Exchange Act that would (1) use a $1 million asset test indexed for inflation every five years, (2) use an annual income test of $200,000 ($300,000 jointly with spouse) not indexed for inflation every five years and (3) include any individual who is licensed or registered as a broker or investment adviser and any

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individual that the SEC determines to have demonstrable education or job experience to qualify such person as having professional knowledge of a subject related to a particular investment.

- Regulation D would be revised to provide that a "knowledgeable employee" of a private fund or the fund's investment adviser would be an accredited investor for the purpose of a Rule 506 offering of such private fund.

> "Even a full repeal of the Dodd-Frank Act, in and of itself, would not necessarily mean a repeal of all post-crisis reforms."

- The SEC would not be permitted to require issuers to submit written general solicitation materials used in a Rule 506(c) offering, except in connection with certain investigations and enforcement actions, and would not be permitted to extend the requirements for sales literature used by registered investment companies to the sales literature used by private funds.
- Regulation D would be changed to permit presentations and communications made by or on behalf of an issuer at specified so-called "investor days" or "demo days," so long as certain restrictions, including on referring to specific offerings or providing investment advice, are observed.

What would be the impact on executive compensation rules and disclosure requirements?

- Clawbacks of incentive compensation under Section 10D of the Securities Exchange Act (mandated by the Dodd-Frank Act) would be limited to situations "where such executive officer had control or authority over the financial reporting that resulted in the accounting restatement."

Comment: The SEC's September 2015 proposed Rule 10D-1 uses a "no fault" standard in determining whether executive officers must return compensation. "Control or authority" is not defined in the CHOICE Act but would have meaningful implications.

- "Say on Pay" votes would be limited to years in which there has been a material change in executive compensation – rather than the current standard of not less frequently than every three years.

Comment: Investors and proxy advisors strongly favor annual Say on Pay votes and may advocate for current practice to continue, even if not statutorily required.

- Pay-ratio disclosure, slated to go into effect for an issuer's first fiscal year beginning on or after January 1, 2017, would be repealed.

Comment: We recommend, nonetheless, that registrants continue preparing for pay-ratio disclosure given the uncertainty around CHOICE Act provisions.

- Mandatory disclosure of hedging policies applicable to employees and directors, mandated by the Dodd-Frank Act and for which the SEC proposed rules in February 2015, would be repealed.
- Limits on incentive compensation at financial institutions mandated by the Dodd-Frank Act and rules proposed in May 2016 would be repealed.

What disclosure requirements mandated by the Dodd-Frank Act may be repealed?

- Conflict minerals reporting, mine safety disclosure, disclosure of payments by resource extraction

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3. A "major rule" is any rule that has or is likely to result in (1) "an annual effect on the economy of $100 million or more," (2) "a major increase in costs or prices for consumers, individual industries, federal, state or local government agencies, or geographic regions," or (3) "significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic and export markets." (Sec. 634)

issuers and disclosure of an issuer's leadership structure (including whether and why it has chosen to combine the CEO and chairman position) mandated by the Dodd-Frank Act would be repealed.

Comment: We recommend, nonetheless, that registrants continue preparing required conflict minerals reports given the uncertainty around CHOICE Act provisions.

Procedural Implications of Regulatory Proposals

How would increased congressional oversight change SEC rulemaking authority and process?

- The SEC would be required to submit to Congress a complete cost-benefit analysis for any rule, including an analysis of jobs added or lost, and a report containing certain specified information, including: classification of the rule as "major" or "nonmajor," including an explanation of the classification specifically addressing each criterion for a major rule classification.[3]
- A major rule generally would not take effect unless Congress adopts a joint resolution of approval within 70 session or legislative days after the required reports were received by Congress.
- In contrast, a nonmajor rule would not require congressional approval. Instead, Congress has the authority to disapprove nonmajor rules if it adopts a joint resolution of disapproval within 60 session or legislative days after the required reports were received by Congress.

Comment: Congress could effectively veto a major rule by inaction and veto a nonmajor rule by timely joint resolution. These provisions likely would hinder SEC rulemaking.

> "A major rule generally would not take effect unless Congress adopts a joint resolution of approval within 70 session or legislative days after the required reports were received by Congress."

What would be the impact on SEC enforcement authority?

- Any person who is a party to a proceeding brought by the SEC, and against whom an order imposing a cease and desist order and a penalty may be issued, could require the SEC to terminate the proceeding. The SEC could then bring a civil action against that person seeking the same remedy.

Comment: This provision is designed to allow respondents to move cases out of administrative proceedings and into federal court.

- In order to impose a civil money penalty on an issuer for violation of the securities laws, the SEC would be required to publish findings of whether (1) the alleged violation resulted in direct economic benefit to the issuer, and (2) the penalty would harm the shareholders of the issuer.
- SEC authority to bar individuals from serving as officers or directors would be repealed.
- Many "bad actors" would no longer be automatically disqualified (e.g., under Rule 506(d) of the Securities Act of 1934) from using exemption or registration provisions as a result of their bad acts, without the SEC first making a determination, after notice and an opportunity for hearing, of such disqualification.
- Significant increases to monetary penalties for controlling persons in connection with insider trading and securities law violations are proposed.
- Other proposed changes to the SEC enforcement process include: limitations on the duration and renewal of subpoenas; a process for closing investigations and notifying the subjects of the investigation; the creation of an Enforcement Ombudsman to act as a liaison between the SEC and persons who

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are the subject of investigation; and the requirement for the SEC staff to hold an in-person meeting with any recipient of a Wells notice.

How would the CHOICE Act affect the so-called Fiduciary Rule?

The so-called Fiduciary Rule issued by the Department of Labor would have no force or effect.

What happens to the CFPB?

With the new Republican Administration, as well as Republican majorities in the House and Senate, the CFPB is in for some significant changes. However, Trump has not provided any meaningful statements regarding his stance with respect to the CFPB, and the CFPB's mission somewhat aligns with his populist campaign. It is therefore difficult to predict exactly what these changes will be. Although the CFPB is unlikely to be dismantled completely, post-election, the CFPB could see changes to its structure, as well as significant adjustments to its rulemaking, enforcement and supervision priorities. These points are discussed below.

"Although the CFPB is unlikely to be dismantled completely, post-election, the CFPB could see changes to its structure, as well as significant adjustments to its rulemaking, enforcement and supervision priorities."

- *Structural.* Republicans have long advocated for changes to the CFPB's single-director structure, and even before the election, the D.C. Circuit's decision in the *PHH* case made those changes more likely. Under that holding, the court found the CFPB's single-director structure, with the director removable only for cause by the President, unconstitutional, and voided the for-cause requirement, making the director removable by the President for any reason. The decision is stayed pending appeal, which the CFPB has filed with the D.C. Circuit en banc. If the ruling is upheld, it is possible that Trump will replace Director Cordray with his own appointee. However, even if the ruling is reversed, Republicans are likely to continue attacking the CFPB; the CHOICE Act would replace the single-director structure with a bipartisan five-member commission subject to congressional oversight and appropriations and would change the name of the agency to the "Consumer Financial Opportunity Commission."
- *Rulemaking.* The CFPB's rulemaking may also be impacted, particularly those that are not in the final rule stage. The contentious rulemakings on arbitration and payday lending, which have not been finalized, likely could be softened or eliminated altogether. However, rules that have been finalized but that are not yet effective, such as the prepaid card rule, face a higher procedural hurdle to be reversed—the CFPB would need to go through another notice-and-comment process to change them.
- *Supervision and Enforcement.* In the longer term, the CFPB's supervision program could be downsized, particularly if the agency becomes subject to congressional appropriations and its budget is cut. On the enforcement side, the CFPB may be less likely to pursue disparate impact claims and other claims of a similarly subjective nature.

What happens to the Financial Stability Oversight Council?

- Perhaps the FSOC's most prominent authority is the ability to designate nonbank financial companies for Federal Reserve supervision.

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- The CHOICE Act would significantly weaken the FSOC's authority, though it would not eliminate the FSOC altogether. For example, under the CHOICE Act, the FSOC no longer would have the authority to designate nonbank financial companies or financial market utilities as systemically important—doing away with its main binding authority. The FSOC would continue to serve as an interagency forum for monitoring market developments, facilitating information-sharing and regulatory coordination and reporting to Congress on potential threats to financial stability. It would appear to have a somewhat overlapping function with the Working Group on Financial Markets, established by President Reagan.
- Further, an FSOC chaired by a Republican Treasury Secretary may have a very different focus than the FSOC has had under the Obama Administration. For example, rather than focusing on enhancing the regulatory framework, the FSOC could focus on the need for cost-benefit analysis, the role and accountability of international standard-setting bodies and other de-regulatory initiatives.
- It is also notable that Alex Pollock has been named as leading the Trump transition's "landing team" for FSOC. He has been critical of the way in which FSOC has exercised its authority and accused it of being improperly influenced by politics. Thus, his role could indicate a sharp change in the FSOC's role going forward, even absent any legislative changes to the FSOC's authority.[4]

"[U]nder the CHOICE Act, the FSOC no longer would have the authority to designate nonbank financial companies or financial market utilities as systemically important—doing away with its main binding authority."

International Implications

What are the implications for Basel IV and the Basel Committee more generally?

- The Basel Committee on Banking Supervision (the Basel Committee) is the primary global standard-setter for the prudential regulation of banking organizations and provides an international forum for cooperation on supervisory matters. Although the Basel Committee's recommendations are not binding on its member jurisdictions, its recommendations represent some degree of consensus by national supervisors as to "best practices" and are often adopted in some form by its member jurisdictions' legislatures. Following the financial crisis, the Basel Committee undertook to update its capital adequacy and liquidity frameworks through an initiative it referred to as "Basel III." Having finalized Basel III, the Basel Committee currently is undertaking a review of the Basel III package of reforms (this effort is referred to colloquially as Basel IV), including re-calibrations and additional refinements that ultimately may result in additional burdens for banking organizations if adopted by member jurisdictions. As mentioned above, changes recommended by the Basel Committee would not have binding effect in the United States. Any

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4. Pollock has long been critical of FSOC's effectiveness as an independent regulatory agency. He believes that FSOC's failure to designate Fannie Mae and Freddie Mac as systemically important underscores the agency's undue ties to the government, saying "it is indeed unfortunate if a supposedly technocratic risk committee is governed by politics." Alex J. Pollock, *Fannie and Freddie are Obviously SIFIs*, AMERICAN BANKER (Apr. 21, 2014), http://www.americanbanker.com/bankthink/fannie-and-freddie-are-obviously-sifis-1066993-1.html.

changes that come out of Basel IV would have to be adopted by the appropriate federal banking agency.

- Absent additional legislative action, repealing the Dodd-Frank Act likely would not have any direct effect on the capital and liquidity adequacy requirements promulgated by the federal banking agencies since the financial crisis, and would not necessarily affect the federal banking agencies' evaluation of the Basel IV package of reforms.
- However, the CHOICE Act would require U.S. public comment processes before federal financial regulatory agencies could participate in international standard-setting processes, such as the Basel Committee. This would require a shift in how the U.S. agencies participate in the Basel Committee today, which is largely done without any public consultation, and could diminish the extent to which the U.S. is able to fully participate in such international standard-setting forums.

What are the implications for international agreements generally?

See "The Outlook for International Law Under President Trump" elsewhere in this issue.

Matthew E. Kaplan
mekaplan@debevoise.com

Satish M. Kini
smkini@debevoise.com

David L. Portilla
dlportilla@debevoise.com

Guest Column: Howard Marks, Co-Chairman of Oaktree Capital Management

Go Figure!

"Thus two key observations can be made based on November's developments:

- First, no one really knows what events are going to transpire.
- And second, no one knows what the market's reaction to those events will be.

These observations reinforce my belief that it's a mistake to base investment decisions on macro forecasts."

Think back to just before the U.S. elections. What did we know?

- The polls were almost unanimous in saying Hillary Clinton would win the popular vote by about 3%.
- FiveThirtyEight, an analytical website whose forecasts had proved quite accurate in the two prior presidential elections, gave Clinton a 71% probability of winning, and almost everyone else was between 80% and 90%.
- Clinton was favored in most of the "swing states" that would make the difference in the Electoral College. Thus she was expected to win more than 290 electoral votes, leaving just 250 or so for Donald Trump.
- Clinton was the obvious choice of the people who move the markets. This could be seen in the fact that the markets went up when Clinton's odds improved in late October (recovering from some unpleasant Wikileaks disclosures), and then they fell after the FBI's James Comey announced the discovery of an additional cache of Clinton emails on October 28, lifting Trump's chances.
- Thus there was a near-universal belief that a Trump victory — as unlikely as it was — would be bad for the markets.

So what happened? **First Clinton didn't win.** There's much soul-searching, particularly among the forecasting fraternity. Everyone knew intellectually that Trump had a non-zero chance of winning, but few people thought it could actually happen.

And second, right after the election, the U.S. stock market had its best week since 2014! The Dow Jones Industrials rose almost 5% for the week, taking them to a new all-time high. The Dow was up every day last week. It rose on Monday and Tuesday, when Clinton was expected to win. And then it rose Wednesday, Thursday and Friday, after she had lost.

That behavior calls to mind my January 2016 memo, "On the Couch," on the subject of the market's irrationality. Clearly, the election was the biggest event the week of November 7, so it must have been the main influence behind the changes in stock prices. But how could the expectation of a Clinton victory make stock prices rise, and then the reality of her defeat make them rise further?

In that memo, I included a cartoon showing a newscaster saying, "Everything that was good for the market yesterday was no good for it today." In the case

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of the election, it might have been, "Whatever was good for the market yesterday, its polar opposite was good for it today." It just doesn't make sense.

While people search the market's behavior for logic, there really doesn't have to be any. In "On the Couch," I mentioned that sometimes the market interprets everything positively, and sometimes it interprets everything negatively. The market often fails to act rationally in the short run, primarily because of the role played by people in determining its course.

Thus two key observations can be made based on November's developments:

- First, no one really knows what events are going to transpire.
- And second, no one knows what the market's reaction to those events will be.

These observations reinforce my belief that it's a mistake to base investment decisions on macro forecasts. But you knew that.

Impact on the Markets

Of course there's logic to the market's rise post-election, just a logic different from that which would have made it go up if Clinton had won. The reasons one might cite are these:

- **As a businessman, Trump doubtless intends to be a pro-business president.** In fact, he'll probably make more of an effort to nurture business than Clinton would have (especially when being pushed to the left by Bernie Sanders and Elizabeth Warren), and more than I think characterized the Obama administration.
- Trump's campaign promises have included tax reform; reduced income tax rates on corporations and big earners; some form of tax holiday to enable corporations to bring in profits stranded abroad; a reduction of business regulation (Carl Icahn tells me this will be huge); a big infrastructure program ($1 trillion announced); an end to bank-bashing; less pressure on pharmaceutical and health care companies to cut prices; and an end to the estate tax. That's quite a pro-business agenda.
- The populist power of Senator Warren will be reduced.
- Businessmen and Wall Streeters will be welcome to serve in the administration, not verboten as in recent years.

At the bottom line — if everything works as promised — there will be massive fiscal stimulus; big increases in GDP growth, corporate profits and jobs; higher inflation than otherwise would have been the case; a big increase in the national debt; and more of everything for everybody.

Writing in the *Financial Times*, Anthony Scaramucci, a member of Trump's economic advisory council, said the president-elect would finance the new spending plan with "historically-cheap debt and public-private partnerships" and said it would cut deficits by stimulating economic growth. "Economies around the world are fighting deflation largely because of a post-crisis move toward fiscal austerity. We can close the wealth gap in America by replacing emergency-level interest rates with fiscal stimulus." (*Financial Times*, November 12-13, 2016)

No austerity here!

Trump's statements regarding business and the economy contain some real positives and are the best part of his platform . . . if he and his administration are up to the task of putting them into practice.

However, some of his promises may test the limits of what can be accomplished under the limitations imposed by economic reality.

And there are negatives, including:

- Trump's expressed disdain for Janet Yellen, and the resulting possibility that Fed independence will be reduced,
- his stance on international trade pacts (an area in which a president has unusually broad power to take unilateral action), his threat of imposing import duties on goods made in China and Mexico, and the resulting possibility of trade wars, and
- the possibility that this plus his unconventional positions on things such as climate change and defense treaties bode ill for international relations in general.

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That brings us to the outlook for bonds. Just as the U.S. stock market has celebrated Trump's election, the bond markets have been discouraged. Interest rates rose very rapidly following Trump's election, bringing big losses to bond holders. The FT wrote the following, citing Henry Kaufman, the Salomon Brothers chief economist who correctly called the bond bear market in the 1970s:

> "It's a tectonic shift"… the end of a three-decade bond bull market, because of the likelihood of unfunded tax cuts, infrastructure spending and a radically reshaped Federal Reserve. "I would say the secular trend is going to be upwards now," he told the FT. "Secular swings are hard to forecast, but the secular sweep downwards in interest rates is over, and we are about to have a gentle swing upwards."

I always feel it takes a degree of innate optimism to be a devotee of stocks (with their reliance on conjectural returns awarded by the market) as opposed to bonds (which bring contractual returns guaranteed by their issuers). Thus U.S. equity investors have exhibited an optimism regarding the Trump administration that virtually no one foresaw just before the election.

Equity investors like inflation because it pumps up profits. Bond investors dislike it because it raises interest rates, reducing the value of the bonds they hold. But the two can't go in opposite directions forever. At some distant point, higher interest rates can cause bonds to offer stiffer competition against highly appreciated stocks.

Finally on the subject of the market outlook, I'll pass on some observations from Stanley Druckenmiller — the owner of one of the very best investment records in history, and certainly not someone congenitally biased to optimism (or anything else):

> Billionaire investor Stanley Druckenmiller told CNBC on [November 10th] he's "quite, quite optimistic" about the U.S. economy following the election of Donald Trump.
>
> "I sold all my gold on the night of the election," the founder and former chairman of Duquesne Capital said in a "Squawk Box" interview.
>
> He said he's betting on growth by shorting bonds globally, and he likes stocks that respond to growth. He also likes prospects for the dollar, especially against the euro.
>
> This rosier outlook is in sharp contrast to what Druckenmiller said at the Sohn Investment Conference in New York in May. At the time, he told attendees they should sell their stock holdings. He also had said gold was his "largest currency allocation."
>
> Despite Druckenmiller's past negativity, he said Thursday: "It's as hopeful as I've been in a long time." He added, "I would not be surprised if we're not looking at the peak of the divisiveness."
>
> "[But] I hope economic policy is deferred to Mike Pence and Paul Ryan," he said, referring to the vice president-elect and the speaker of the House. He pointed out he did not support Hillary Clinton.
>
> (Druckenmiller had supported John Kasich for the Republican nomination and said he's philosophically in favor of Ryan's economic policies.)
>
> "I don't think Donald Trump is Ronald Reagan," he added.
>
> Since Republicans maintained control of the House and Senate while winning the White House, Druckenmiller said "this is the greatest chance" to get tax reform and deregulation passed.

"A combined shortfall of just 113,000 votes in Pennsylvania, Wisconsin and Michigan made Clinton the loser. If she had won just 57,000 of those votes (or 0.4% of the 13.6 million total votes cast there), she would be the president-elect."

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> "If it wasn't for the messy conflict of rates rising with the stronger economic growth through [fiscal] policy, I would think there's so much low-hanging fruit in terms of deregulation and tax reform, we could get a jolt of 4 percent [growth] for about 18 months," he said.
>
> "I do think interest rates could cut that back into the high 2s, low 3s [percent]," he continued, adding markets are pointing to the cost of borrowing money going up a lot. "I think the market is going to force this. The market is going to push them to raise interest rates if my hopeful scenario turns out to be right." (CNBC on-line)

I usually inveigh against macro forecasting and macro investing, but Stan is the exception who proves I'm far from 100% right. I supply his words unabridged. No one should ignore them.

Why Were the Forecasters So Wrong?

Trump won in 30 states, whereas Clinton won in 20 states and the District of Columbia. Trump won in three states that were expected to go for Clinton plus the two largest of the three states rated "toss¬ups," while Clinton didn't upset Trump in any of the states people expected him to win. Trump won vastly more counties than Clinton (although not the most populated, obviously), including those populated by voters with both below-average and above-average incomes. Many of these things came as surprises.

The amalgamation of Trump voters that I described in my recent memo to Oaktree's clients, "Implications of the Election," came together as expected, but in greater quantity than expected. His supporters were moved by great fervor, and while they may not have admitted to the pollsters that they favored the candidate derided by most of the media and intelligentsia, they voted for him in surprising numbers. The surprises included some college-educated whites, people with higher incomes, and even Hispanics, the vast majority of whom were expected to vote for Clinton.

And in the end, the "enthusiasm deficit" people had talked about all campaign came home to haunt Clinton. While more people had told pollsters they would vote for her than for Trump, many of them were probably motivated by aversion to Trump rather than any great love of Clinton. In the end, her voters' lack of enthusiasm seems to have kept enough from the polls to make the difference. Turnout was below expectations in Florida, Michigan, Pennsylvania and Wisconsin, and the results in these states were largely responsible for the election surprise.

The *Financial Times* of November 12-13 made a telling observation:

> In Michigan and Wisconsin, the two states that arguably swung the election, [Mrs. Clinton] received roughly 300,000 fewer votes than Mr. Obama did, suggesting his supporters either stayed home, or cast their votes for Mr. Trump or a third-party candidate.

The bottom line is that Trump won virtually all the counties that Romney won in 2016 plus a fair number of the ones Obama won. Clinton lost Pennsylvania by 1.4%, whereas less than two weeks before the election she was thought to be ahead by double digits; Wisconsin by 1.5%, a state she was expected to win; and Michigan by 0.3%, a state Obama carried in 2012.

Obama's supporters were passionate, often because of his stirring oratory and/or his potential to be/remain the first black president. Despite the possibility of her being the first woman in the White House, Clinton ran into trouble relating to her difficulty connecting with the "common man," in addition to the controversies relating to her private email server and the Clinton Foundation. Finally, she never picked up some of the Democrats, especially young ones, who had coalesced behind Bernie Sanders's more liberal agenda. Thus her vote count fell short of expectations.

A combined shortfall of just 113,000 votes in Pennsylvania, Wisconsin and Michigan made Clinton the loser. If she had won just 57,000 of those votes (or 0.4% of the 13.6 million total votes cast there), she would be the president-elect.

For whatever reason, Trump, who almost everyone thought had no significant chance, was the surprise winner. After this and the Brexit vote — which also ran counter to forecasts — prognosticators are likely to be followed less assiduously in the future than in the past.

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I keep saying "almost everyone" thought Clinton would win. That's because there was one prominent exception: the USC Dornslife/Los Angeles Times Presidential Election Poll consistently predicted a Trump victory in the popular vote. They had him up by 3% at the end.

Now the USC poll's Arie Kapteyn is being lauded for having gotten the outcome right, and Bloomberg reports that he employed "what experts called a unique and more complex weighting model." Does his success redeem the forecasting profession?

Not really. Trump didn't win the popular vote as USC predicted; he lost it (by just under half a percent). Thus you can't say USC had it right. They were wrong. Or rather, they were right about a Trump victory, but for the wrong reason. (How often do we see that in the investment world?) In the end, who was more right: USC (which said he would win the popular vote) or the others (who were correct in saying Clinton would win it — only to see her lose the election)? That's what I would call a Talebian question.

The bottom line is that popular vote polls get headlines, but the presidency is determined in the Electoral College. The latter made Trump the winner — as USC had said, but not for the reason it had predicted. (More on the Electoral College later.)

Outlook for the Trump Presidency

I was in Australia on Election Day, and right away I was asked what the future holds. First, I said, there's far too much we don't know to permit any conclusions. Here are a few of the key open questions:

- How much of what Trump said while campaigning did he mean?
- How much of what he actually meant will he try to implement?
- And how much of what he tries to implement will he be able to effect?
- Will he seek advice? (While campaigning he gave the impression he thinks he knows best.)
- Will he appoint expert, experienced advisors?
- Will he heed their advice?

Second, I'd look for some initial signs.

- Would his acceptance speech be conciliatory or vindictive? Certainly it was the former.
- Will his first appointments be constructive or less so? Will they primarily reward loyalty or expertise and experience?
  - — We can take some encouragement from the mainstream choice of Mike Pence to head his transition team.
  - — Less cheering is his appointment of Myron Ebell, an outspoken climate change denier, to lead the transition at the Environmental Protection Agency.
  - — I had thought that Trump's selection of his chief of staff would be somewhat telling, given the rumored choice between the controversial campaign adviser Steve Bannon, formerly head of the alt-right Breitbart News, and Republican National Committee Chair Reince Priebus, who is respected in Washington and has an insider's understanding of how it works. The appointment of Priebus as chief of staff and Bannon as chief strategist/senior counselor leaves the question unanswered and suggests there's room in the Trump administration for both traditionalists and outsiders.
  - — One of the things we have yet to see is whether experienced and respected veterans of government will join an unpredictable and potentially controversial administration. [Note: These observations were written on November 14, 2016.]
- Will Trump's early behavior indicate that the man we saw on the stump was the real Trump, or that the fiery populist and outside-the-box persona was exaggerated for effect?

Third, it will be interesting to see the extent to which Trump is supported in Congress. Republicans lost a net of six seats in the House of Representatives, but they still enjoy a solid majority of 45 seats out of the 435 there.

But they lost some ground in the Senate and thus now hold only a bare majority of the 100 seats. Here are some of the key considerations there:

- The Senate has a special role, as its approval is required for treaties (a two-thirds majority) and for

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appointments such as those of cabinet members, ambassadors, and judges of the Supreme Court.

- Certainly some candidates ran for the Senate this year — and won — explicitly rejecting Trump and saying they would vote for Clinton. Thus not all of the Republican senators are sure to support Trump's initiatives; his majority isn't bulletproof.
- Further, the tradition of filibuster in the Senate allows a member to prevent action on a bill (other than a budget) unless the filibuster is lifted through the invocation of "cloture" Cloture requires support from 3/5 of the senators voting (usually 60), with the very new exception of certain executive and judicial appointments (but not Supreme Court nominees), when a simple majority is sufficient. Thus the Republicans' small majority isn't enough to ensure smooth sailing in most cases.

For all these reasons, even though Republicans control both houses of Congress, I don't think Trump necessarily has a blank check. Hopefully circumstances in the Senate will push him toward moderation.

I felt during the campaign that, as opposed to Hillary Clinton, the range of possible actions and outcomes in a Trump administration was far too broad to be predicted. I'm still convinced that's the only thing we know for certain.

Majority Doesn't Rule

In my "The Implications of the Election" memo, I talked about the shortcomings of the Electoral College. Now they have been made clear. As mentioned earlier, even though Hillary Clinton won the popular vote by about 0.5%, Donald Trump is projected to win in the Electoral College by a big margin, 306 to 232, when it votes officially next month. Thus his 47.3% of the popular vote (Clinton got 47.8%, and 4.9% voted for the candidates of so-called "third parties") translated into 57.9% of the Electoral votes.

This alchemy is attributable primarily to the fact that all of the states other than Maine and Nebraska allocate their electoral votes not in proportion to the candidates' popular votes in the state, but rather on a winner-take-all basis.

Clinton won a few big states by huge margins — like New York's 29 electoral votes by 58% to 37%, and the top prize, California with its 55 electoral votes, by 62% to 33%. But since all the electoral votes go to the person with the most popular votes, anything in excess of a simple majority is "wasted." In these two states combined, with 15.2 million votes cast, Clinton got 9.6 million, which was 2 million more than she needed to win. Those extra votes padded her popular vote total, but they could do nothing to help her win the presidency.

Trump, on the other hand, won a larger number of states — many of them small to mid-sized — and in six cases by less than 5%. But, as I said above, 51/49 produces the same outcome as 70/30. So even though Trump received fewer popular votes in total than Clinton, he used them much more efficiently (meaning his average margin of victory was smaller). He got 5.1 electoral votes per million popular votes, whereas Clinton got only 3.8. Of course that's basically undemocratic.

This process translates into outcomes that can deny the election to the candidate for whom more people voted. Last week's election was the fourth time that has happened in our nation's history, but also the second time in the last 16 years.

Here's what CBS reports one astute observer to have said about this arrangement in 2012:

> The phoney [sic] electoral college made a laughing stock out of our nation. The loser one [sic]!
>
> He lost the popular vote by a lot and won the election. We should have a revolution in this country!

That observer was Donald Trump, responding erroneously to Obama's 2012 reelection (Obama actually won the popular vote). For some odd reason, those tweets have now been taken down.

There have been unsuccessful efforts to change the process so that future presidents will be chosen on the basis of the national popular vote, including one as recently as 1969. Another is currently underway, but the road is long and arduous. I hope

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the situation will be revised… and that I live to see it.

But in the meantime, the vote in the Electoral College is the vote that counts. Thus candidates allocate their time, effort and resources to maximize those votes, rather than popular votes. Although I'd prefer a different system, it's the one we've got, and complaints about the legitimacy of a victory that isn't accompanied by a popular vote majority don't resonate with me.

The Outlook for the Parties Revisited

In "The Implications of the Election," I mentioned the uncertain future of the Republican party — with a schism possible between Trump's followers and the unsupportive party establishment. (Now that Trump has won, it's possible all will be forgiven.)

Now I want to point out the possibility of a schism among Democrats.

> "[Even] though Trump received fewer popular votes in total than Clinton, he used them much more efficiently... He got 5.1 electoral votes per million popular votes, whereas Clinton got only 3.8. Of course that's basically undemocratic."

As an aside, a very similar phenomenon impacted the battle for this year's Republican nomination. A few years ago, the party changed the system to winner-take-all in the early primary races. The purpose was to quickly winnow the field to focus the contest on candidates capable of garnering significant support.

Thus when Trump was up against 16 other candidates in the primaries, he distinguished himself from the others and was able to win 100% of the delegates at stake with vote percentages generally in the twenties. This enabled him to take a commanding lead before the Republican establishment was able to respond to his insurgent candidacy. Here too, winner-take-all voting may come under examination.

- There was a clear divide during the primaries between Clinton's centrist supporters and Bernie Sanders's considerably more liberal backers.
- Many of the latter became disgruntled when Clinton received the nomination, and some are likely to have abstained from voting in the general election.
- It's possible some will attribute Clinton's loss to an easily-beatable Republican candidate to her less liberal agenda and membership in the party's old guard. This may cause the liberal faction to try to exert more effort next time to ensure that their kind of candidate is nominated.

Thus I think the 2016 presidential election — and Trump's catalyzing role in it — will have implications on both sides of our political process for years to come. These too, however, are unpredictable.

This is the last memo on politics for a while, I hope (as may you).

Legal Information and Disclosures

Self-Reporting Violations to the SEC: Little Measurable Credit for a Near-Certain Negative Outcome

"Because a self-report almost guarantees an enforcement action (and certainly guarantees at least an investigation), rational firms struggle mightily over the self-reporting question..."

The private equity industry has increasingly felt the bite of U.S. Securities and Exchange Commission (SEC) regulators in recent years amidst a steady string of enforcement actions. This enduring regulatory focus has caused many private equity firms to consider what action, if any, should be taken if they discover that they may have run afoul of their obligations. Given that the SEC today vigorously prosecutes all violations as potential enforcement cases, no matter how they come to the agency's attention, should private equity firms proactively self-report any misconduct or violations of the federal securities laws to the SEC?

First, Fix the Problem

As a threshold matter, firms must immediately get their hands around any possible misconduct or violations that they discover: the scope, materiality (whether quantitative, qualitative, or both), responsible employees, if any, and client or investor harm. If the conduct or violation is ongoing, end it. If clients or investors were harmed or disadvantaged, inform them and remediate. If there is a board, alert the board. If personnel actions are necessary, take them. If there is a whistleblower, do everything possible to ensure that his or her concerns are vetted and resolved as appropriate.

Next, Report the Problem?

The next question – whether a private equity firm should self-report to the SEC – is a complex decision that involves a weighing of real and significant risks with uncertain benefits. In a bygone era, self-reporting was frequently an easier decision: a firm would discover an issue, inform the Division of Investment Management of what it found and the steps it took to remediate, and that would often be the end of the matter. Now, however, with a Division of Enforcement staff – including the Asset Management Unit staff in particular – that is aggressive, has sophisticated knowledge of the asset management space, and is in constant contact and coordination with the Division of Investment Management and examination staff, firms must assume that self-reporting will result in an enforcement action.

It is of course perfectly rational for the SEC, as a law enforcement agency, to aggressively pursue all potential violations of the federal securities laws, no matter how those potential violations come to its attention. After all, the SEC

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is not running a "catch-and-release," or even "self-report-and-release," program. The consequence, however, is that self-reporting carries with it a nearly 100% chance of the self-reporting firm being investigated and made the subject of an enforcement action based on its own self-report.

Given that reality, the reward-risk calculation that informs whether a private equity firm should self-report violations of the federal securities laws to the SEC is now entirely skewed in one direction.

The SEC's View. On the one hand, in terms of reward, the SEC urges firms to self-report violations of the federal securities laws by touting the benefits from doing so. Those benefits include reduced penalties or, less tangibly, a more benign recitation of the misconduct in an order, or perhaps a sentence noting the firm's cooperation, or an "administrative summary" instead of a press release. From the SEC's perspective, these benefits are real, and demonstrate that the SEC actively takes self-reporting into account when determining what remedies are appropriate in the resulting enforcement case.

A Different View of the "Benefits" of Self-Reporting. But there is a fundamental disconnect. Credit in the form of a reduced penalty is simply not meaningful and is entirely unmeasurable by firms, investors, and the public – even though the SEC sees the reduced penalty as meaningful and measurable. Private equity firms care about one thing: avoiding an enforcement action. Because a self-report almost guarantees an enforcement action (and certainly guarantees at least an investigation), rational firms struggle mightily over the self-reporting question when doing so means subjecting themselves and their business to what may be an intrusive, years-long, expensive investigation and then enforcement action. A penalty reduction, or more input on a settlement order, or an administrative summary when the press is going to report on the action regardless, is an insufficient carrot to encourage self-reporting when considering the real stick of reputational damage that would be inflicted by an enforcement action.

"A penalty reduction, or more input on a settlement order, or an administrative summary when the press is going to report on the action regardless, is an insufficient carrot to encourage self-reporting when considering the real stick of reputational damage that would be inflicted by an enforcement action."

The Risks of Self-Reporting. On the risk side of the ledger, there are no aggravating factors for failing to self-report, because self-reporting generally is not required. Rather, private equity firms act in good faith by (1) investigating what occurred and why (and, of course, ending the practice if it is ongoing), (2) making any necessary adjustments to ensure that the violation does not recur, (3) assessing whether any remedial steps are prudent, (4) creating a record of the efforts in this regard, and then (5) simply moving forward. If the issue later comes to light (if, for example, through a whistleblower or by examination staff discovering it), the manager will be prepared to demonstrate that it resolved the issue in good faith, and for the benefit of investors, which, after all, is the SEC's primary interest. If the issue never comes to light, the firm will have responsibly spared its funds and investors a time-consuming and expensive investigation and a reputation-damaging enforcement action (and potentially parallel private civil actions and/or other collateral consequences).

A Different Calculus. It should be noted that firms in certain circumstances may need to think differently about the self-reporting calculus. Those situations might include:

- potential violations of the Foreign Corrupt Practices Act,

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- obligations imposed on publicly traded companies, or their subsidiaries,
- if the discovered conduct is otherwise of such a magnitude that the issue is almost certainly going to come to light,
- if a firm discovers an issue during the course of an SEC examination,
- if a firm has other regulators and/or regulatory obligations, such as Bank Secrecy Act reporting requirements, and
- if a firm has a commercial reason for wanting to self-report, regardless of the consequences.

Meaningful Incentives Would Benefit Everyone

It is to the SEC's detriment that there is no meaningful carrot that encourages advisers (or really anyone) to self-report. This is because each time a firm decides not to self-report an issue it has discovered, the SEC is deprived of critical information concerning a problematic practice or issue that might be widespread. The result is a serious information gap; solving it would enable the SEC to better protect investors.

Today, however, the SEC vigorously prosecutes all violations as potential enforcement cases, no matter how they come to the agency's attention. This is a rational approach to enforcing the federal securities laws and is entirely consistent with the agency's investor protection mandate. As a consequence, however, counsel are forced to advise their private equity clients on a difficult, and uncomfortable, handicapping: namely, what is the likelihood that an issue the firm discovers (and remediates) will be found by the examination staff or a whistleblower? Often that calculation must lead rational private fund advisers and other asset managers to choose not to self-report except in the most extenuating circumstances. Although this might not be an ideal outcome from a regulatory policy perspective, it is, unfortunately, the reality of a system that affords little measurable credit for self-reporting but guarantees a negative outcome in the form of an enforcement proceeding. Unless and until the SEC's approach changes, defense lawyers vigorously representing their clients need to think long and hard before counseling investment advisers to self-report.

Julie M. Riewe
jriewe@debevoise.com

De-Risking Workout Transactions

"[The cases spawning TIA litigation and the other Caesars transactions] demonstrate the current litigious environment surrounding out-of-court restructurings, and together they have created uncertainty that increases both execution risk and litigation risk in workouts."

When a private equity portfolio company faces distress, private equity firms and restructuring professionals work together to identify strategic alternatives. These may include asset sales, internal restructurings, refinancings, debt exchanges and other types of workouts that are intended to create enough time and liquidity to support a turnaround effort. In the last several years, however, that work has become more challenging, particularly in light of some recent court activity that makes out-of-court restructurings more difficult and, in some instances, presents liability risks for directors, officers and private equity sponsors.

Does this mean that out-of-court restructuring is no longer a viable option for distressed portfolio companies? Of course not. Many factors can come into play in any deal, and the consummation of an out-of-court workout may be business-optimal and the right thing to do. Moreover, private equity firms and their professionals can reduce execution risk and mitigate the risk of liability when pursuing out-of-court restructurings by: understanding the potential risks in a given transaction; employing commercially practical strategies in light of such risks; and adhering to smart and careful corporate governance principles. This article seeks to provide a road map for improved execution of workout transactions by briefly summarizing the recent court activity relating to out-of-court restructurings and pointing out some key best-practices in light of recent developments.

Current Court Activity Relating to Workout Transactions

In 2015, decisions issued by the U.S. District Court for the Southern District of New York in cases involving transactions by Education Management Corporation[1] and Caesars Entertainment Corporation[2] broadly interpreted minority bondholder protections under Section 316(b) of the Trust Indenture Act of 1939 (the TIA) and, as a result, cast doubt on out-of-court debt restructurings previously thought to be allowed under that statute.

Section 316(b) provides that the right of any holder to receive payment of principal and interest and to institute suit for enforcement of such payment "shall not be impaired or affected without the consent of such holder." Restructuring professionals, and the broader lending community, traditionally understood this provision to stand for the non-controversial concept that "core terms" like principal, interest rate, and maturity cannot be changed

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1. *Marblegate Asset Mgmt., LLC v. Education Mgmt. Corp.*, 111 F. Supp. 3d 542 (S.D.N.Y. 2015).

2. *BOKF, N.A. v. Caesars Entertainment Corp.*, 144 F. Supp. 3d 459 (S.D.N.Y. 2015); *MeehanCombs Global Credit Opportunities Funds, LP v. Caesars Entertainment Corp.*, 80 F. Supp. 3d 507 (S.D.N.Y. 2015).

without 100% bondholder consent. The Education Management and Caesars decisions, however, imply a broader view that would require 100% consent from bondholders even for amendments that leave these core terms *legally* intact but impair the *practical* likelihood that the debt will be repaid. In those cases, transactions that were otherwise permitted under the terms of the applicable indentures, such as the release of affiliate or parent guarantees and the transfer of assets to a newly formed entity, were found to violate Section 316(b).

Since the *Education Management* and *Caesars* decisions (which are currently on appeal), minority bondholders have filed several copycat class action lawsuits in the Southern District of New York attacking exchange offers by financially challenged companies, particularly when the offer was only open to qualified institutional buyers (QIBs) and not retail investors. Recently, the U.S. District Court for the Southern District of New York dismissed one such lawsuit against Cliffs Natural Resources Inc. by distinguishing the *Education Management* and *Caesars* cases, noting that the transaction at issue (an offer for QIBSs to exchange unsecured bonds for secured bonds) did not dispose of any assets, amend any terms of the indenture, or modify or remove any guaranty.[3] This ruling, while comforting, likely will not be the last on the subject, and litigation involving Section 316(b) will likely continue to develop.

In addition to TIA litigation, an important cautionary note was sounded this past spring when an examiner appointed in the Caesars bankruptcy cases issued an 1,800 page report analyzing several complex restructuring transactions consummated by Caesars Entertainment Operating Company and certain of its affiliates in the years before their bankruptcy, identifying numerous weaknesses in the execution of those transactions and flagging many areas of potential liability for the parties involved. The Caesars transactions had extended maturities, amended credit agreements, reduced debt and transferred assets to affiliates either directly or indirectly controlled by their parent company and/or its private equity sponsors. With respect to some of these actions, the examiner's report concluded not only that the company likely could unwind the transaction, but that there were likely actionable claims against several parties, including the parent company and its directors and sponsors, for (1) actual or constructive fraudulent transfers, (2) breach of fiduciary duty and (3) aiding and abetting breach of fiduciary duty. Those parties disputed the examiner's conclusions and subsequently entered into a settlement in connection with Caesars' chapter 11 plan of reorganization, which remains subject to bankruptcy court approval.

Each of these scenarios – the cases spawning TIA litigation and the other Caesars transactions – involved unique factual circumstances that may not be directly replicated. Nonetheless, they demonstrate the current litigious environment surrounding out-of-court restructurings, and together they have created uncertainty that increases both execution risk and litigation risk in workouts.

Best Practices for De-Risking Workout Transactions

In light of the recent developments, private equity firms and their professionals should consider employing the following practices (among others) to help determine the correct structure for pending workout transactions, and ultimately help insulate those transactions from challenge:

Establishing a Robust Decision-Making Process. When considering a restructuring transaction, parties should create a thorough record that documents in detail both

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3. Waxman v. Cliffs Natural Res., No. 16 Civ. 1899, 2016 U.S. Dist. Lexis 168933, at *18 (S.D.N.Y. Dec. 6, 2016)

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management's and the board's deliberations and the business rationale for the deal, including the impact of the transaction on each applicable entity (as well as that entity's creditors, if it is insolvent). Conflicts of interest should be fully disclosed and considered and, where appropriate, transactions should be approved by disinterested, independent directors or special committees. Boards of directors should consider, and seek advice from professionals regarding, whether private transactions should be subject to a market check in which other parties have an opportunity to participate.

Understanding and Carefully Evaluating Insolvency. It is critical that parties truly understand whether a company is solvent at the time a restructuring is consummated, as solvency may implicate both director duties and the practical ability to close the deal. A company must pass three tests to be considered solvent: (1) does the fair value of its assets exceed its debts (the "balance sheet test"), (2) can it pay its debts as they become due in the ordinary course of business (the "cash flow test") and (3) does it have adequate capital for the business that it operates (the "capital adequacy test"). All three tests must be passed, and parties should be careful to avoid alternative rationales, such as equating solvency with a lack of a "going concern" qualification in a borrower's financials.

Avoiding Mistaken Identity of Interest. In order to follow correct board process and create a record that will demonstrate, even in hindsight, that directors acted appropriately, the transaction must be considered on an entity-by-entity basis and must be approved using appropriate corporate process for each entity that will participate. Where a parent corporation and its subsidiary are solvent, there is generally an identity of interest because actions that benefit the subsidiary also benefit the parent through improved enterprise value. In that case, a streamlined approval mechanism and combined board record can often be used. However, if the subsidiary becomes insolvent, this identity of interest disappears. The directors and officers of the insolvent subsidiary still owe their primary fiduciary duties to the subsidiary, but the *creditors* of the insolvent subsidiary, not the parent or its shareholders, are the residual stakeholders, and such creditors may assert derivative claims on behalf of the subsidiary for breach of fiduciary duty. The interests of the insolvent subsidiary's creditors may not always be aligned with the interests of the solvent parent and its shareholders, and the board records should reflect that these considerations were taken into account.

Avoiding Over-Reliance on Fairness Opinions. Boards should obtain professional advice when analyzing restructuring transactions, including consideration of the fairness of the deal, viable alternatives, potential risks, and the likelihood of achieving the desired result. However, parties should recognize that formal "fairness opinions" or "solvency opinions," in and of themselves, may not insulate transferees of assets from liability, or directors and officers if the "entire fairness" standard applies to review of the decision-making process (*i.e.*, directors and officers are found to be conflicted, thus requiring scrutiny beyond the normal business judgment rule). In any event, fairness or solvency opinions should be prepared by fully informed advisors and then tested to confirm they are based upon reasonable projections and methodologies.

Remaining Mindful of TIA Compliance Opinion Issues. Decision-makers evaluating a transaction should act early to identify and resolve any roadblocks that may occur, such as difficulty in obtaining legal opinions needed for closing. The recent TIA decisions have unsettled practitioners'

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4. Debevoise & Plimpton LLP is among the law firms that authored the TIA white paper and was involved at all stages of its negotiation and drafting.

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prevailing understanding of Section 316(b) of the TIA and, in some cases, caused hesitation among law firms to provide certain legal opinions that are necessary in debt exchanges. To address this issue, 28 law firms published a collaborative white paper in April 2016 intended to provide guidance for opinion givers.[4] Pursuant to the white paper, absent unusual circumstances, a law firm should be able to give a clean legal opinion to a trustee in connection with proposed amendments to one or more "non-core" terms (*i.e.*, not payment terms) of an indenture, including amendments to material covenants, either: (1) outside the context of a "debt restructuring" or (2) in the context of a debt restructuring where the opinion givers have receive satisfactory evidence that the issuer will likely be able to make all future payments of principal and interest to non-consenting noteholders when due after the proposed transaction. What exactly constitutes a "debt restructuring" and what factual evidence can support an issuer's ability to make payments when due may vary from case to case, but as evidenced by *Education Management* and *Caesars*, opinion givers will pay particular attention to transactions that involve the release of material guarantees or substantial collateral, or transfer of significant assets to entities that will not provide ongoing credit support to dissenting bondholders.

Workouts continue to present difficult challenges for private equity sponsors and their portfolio companies seeking solutions to financial distress. And yet such transactions are often preferable to more costly and protracted in-court alternatives. Given the current legal landscape, private equity firms and their portfolio companies should actively consult their professional advisors to help them proactively mitigate risks and see the deal through.

M. Natasha Labovitz
nlabovitz@debevoise.com

Craig A. Bruens
cabruens@debevoise.com

Evolving Deal Practices: Conditionality in Going-Private Transactions

"Reviewing the terms of going-private deals from the mid-to-late 1990s, one finds private equity firms…prevailing on the inclusion of a broad scope of conditions that would meet an icy reception from public targets today."

The custom and practice in the terms of private equity-led going-private deals has evolved significantly in the last 20 years. In response to various judicial decisions, economic downturns and no doubt some number of sobering "lessons learned" from bad experiences, M&A lawyers over this period have moved to tighten provisions and sharpen language throughout merger agreements. Nowhere is this tightening more evident than in the closing conditions governing a buyer's obligation to close. Reviewing the terms of going-private deals from the mid-to-late 1990s, one finds private equity firms (who were occasionally the actual "parent" party to a merger agreement) prevailing on the inclusion of a broad scope of conditions that would meet an icy reception from public targets today.

Representation Bring-Downs, Then and Now

Twenty years ago, it was not uncommon for a buyer's closing obligations to be conditioned on a target bringing down its representations "in all material respects." The underlying representations themselves were often qualified only by materiality rather than a defined material adverse effect standard. This approach obviously placed significant risk on the target given the months-long process of closing a going-private deal with a traditional merger structure.

Even in deals that did give the target the benefit of a "material adverse effect" bring down of representations, the phrase was often defined without any qualifications or carve-outs as to what would not constitute a "material adverse effect." Over the last 20 years, this element of deal conditionality has undergone perhaps the most evolution. In 2001, the *In re IBP Shareholders Litigation* decision came down, finding no MAC had occurred—notwithstanding the absence of any pro-seller qualifications or carve outs—and asserting the need for a "durationally significant" impact on the target. That same year, the events of 9/11 were followed by sellers seeking to expressly allocate to buyers the assumption of terrorism and financial market risk. Thereafter, the MAC qualifications continued to grow and the ability to claim a loss of business "prospects" fell out of many MAC definitions. 2008's *Hexion Specialty Chemicals Inc. v. Huntsman Corp*. reinforced the rationale of *IBP*, declining to find a MAC even without considering the qualifications in a definition.

Private equity firms (as well as strategic buyers) have continued to negotiate MAC clauses anyway. And over the years some pro-buyer definitional expansions (such as "would reasonably be expected to have" language) and limitations on the exceptions (including if certain excepted events

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"disproportionately impact" the target) have crept into practice. **Even if the weight of judicial decisions to date would suggest otherwise, the ongoing presence of MAC clauses in the majority of merger agreements suggests that bidders continue to think they have value.** This certainly could be the case if pushing for a price renegotiation following signing if the target business goes into decline.

"The evolution of the approach to address financing conditionality in going-private transactions over the past two decades represents a significant shift from a broad buyer-favorable closing condition to a construct that provides much tighter conditionality risk from the seller's perspective ."

Financing Outs, Then and Now

In the mid-to-late 1990s, it was typical for private equity-led going-private transactions to contain a "financing out" closing condition that permitted a buyer to walk away from the deal if it was unable to obtain debt financing on terms set forth in the agreement or on terms reasonably satisfactory to the buyer.

However, by the mid-2000s, many private equity firms found themselves competing for target companies with strategic buyers who, in many cases, had cash on hand or existing credit facilities that could be drawn upon for deals and thus did not require sellers to assume any financing-related conditionality risk. To improve their standing in these competitive processes, private equity firms began to forego the pure financing out closing condition, instead offering sellers a "reverse termination fee" (or RTF) proposal that contained the following key characteristics: (1) an obligation for the buyer to use efforts to obtain the financing on terms at least as favorable as those set forth in a commitment letter delivered by the lenders prior to signing and (2) a fixed RTF (often in the range of 3% to 4% of the equity value) payable in the event of the buyer's failure to close when required or other significant breach, which payment would generally serve as the seller's sole monetary recourse against the buyer. Under this RTF construct, the buyer could not be forced to close unless the debt financing were available. Furthermore, in the early days of this deal technology, many merger agreements did not allow the seller to specifically enforce any of the buyer's merger agreement obligations (even if the financing were available), thus creating what could be viewed as a pure option for the buyer at the amount of the RTF.

The financial crisis in 2007-2009 resulted in the collapse of many deals due to a financing failure or simply as a result of buyer's remorse. Some sellers were surprised to learn that their negotiated RTF constructs in merger agreements had the effect of providing the buyer with the ability to pay the reverse termination fee and terminate the deal without expending any efforts to consummate the transaction. In *United Rentals, Inc. v. RAM Holdings, Inc, et al.*, the Delaware court refused to require the buyer, a fund affiliated with Cerberus Capital Management, to close on its contemplated $4 billion acquisition of United Rentals despite the absence of any "material adverse effect" on United Rental's business and United Rental's claim that the agreement's specific performance provision permitted it to force the buyer to consummate the transaction. Instead, the court found the merger agreement to be ambiguous as to whether United Rentals could specifically enforce the buyer's obligation and Cerberus was able to walk away from the deal by paying the $100 million reverse termination fee.

In the aftermath of the *United Rentals* decision and other failed transactions during that period, sellers and their counsel focused intently on the nuances of the RTF construct and a buyer's commitment to take necessary action to complete the deal in the absence of a true financing failure. The result was a modified "conditional specific performance" construct that explicitly permitted a seller to specifically enforce (1) the buyer's obligation to use its efforts to obtain the debt financing (in some cases, including by suing its lenders if

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necessary) and (2) in the event that the debt financing could be obtained using appropriate efforts, to force the buyer to close.[1] Over the past several years, that approach has become the dominant market practice to address financing conditionality in private equity-led leveraged acquisitions.

The evolution of the approach to address financing conditionality in going-private transactions over the past two decades represents a significant shift from a broad buyer-favorable closing condition to a construct that provides much tighter conditionality risk from the seller's perspective. In a few situations in recent years, some private equity buyers have sought to further distinguish themselves on the issue of financing conditionality — for example, by committing to fund the full purchase price (through a fund level revolver or otherwise) irrespective of the ability to receive debt financing,[2] although this approach is still relatively rare in the market.

Employment Conditions, Then and Now

The success of private-equity led going-private deals is, of course, often dependent on the private equity firm structuring an economic partnership with management that incentivizes the management team to remain with and grow the target business post-closing. The risk of not coming to terms with management was placed on the target company in a number of deals in the mid-to-late 1990s. Closing conditions tied to one or more managers having entered into an employment agreement and/or invested in the acquisition vehicle were not unusual (sometimes without even the benefit of an underlying term sheet). Targets were therefore not only taking on the risk of a manager and private equity firm not reaching terms, but also the risk of the manager's death or disability. Today, although a target will commit to continue to employ management during the pre-closing period, the negotiations with management regarding their post-closing roles, terms of employment and equity arrangements occur outside of the merger agreement, with private equity firms entering into whatever agreements or understandings with management prior to signing that the firms consider necessary. **In a review of over 40 private equity-led going-private deals between 2014 and mid-2016, we found no employment-related conditions.**

What's Ahead?

What will private equity commentators in 2036 say about the evolution in closing conditionality since 2016? Perhaps bidders will have had some judicial wins in support of the effectiveness of MAC conditions. Perhaps the RTF concept will have endured, or private equity firms will have been pushed to find alternative back-up sources of financing to provide additional comfort and assurance to targets. Perhaps buyers will increasingly insist on conditions tied to a maximum number of shares seeking appraisal rights in light of the recent decision in *In re Appraisal of Dell Inc.*, in which the Delaware court determined that the fair price of Dell Inc.'s shares at the time of its merger was 28% higher than the negotiated merger price in its 2013 take private transaction with Michael Dell and Silver Lake Partners (despite the fact that Dell Inc. conducted a pre-signing auction and post-signing go-shop process that the court determined "would easily sail through" a fiduciary duty challenge). Perhaps closing tax opinions, so recently at issue in *The Williams Companies Inc. v. Energy Transfer Equity, L.P.*, will have become signing tax legal opinions (with very limited right to withdraw for change in law). And perhaps the meaning of "materiality" will have become defined with specificity as a matter of course, although that seems perhaps the most unlikely evolution of all.

Kevin M. Schmidt
kmschmidt@debevoise.com

Uri Herzberg
uherzberg@debevoise.com

1. The increased attention to the RTF construct and its impact on deal conditionality also led to more difficult negotiations regarding the size of the RTF, resulting in a higher average RTF amount (often over 5% of equity value) and, occasionally, the introduction of two-tier RTFs with different amounts payable depending on the nature of the contract breach that triggered the RTF payment.

2. *See*, for example, Vector Capital's acquisition of Saba Software in early 2015.

The Outlook for International Law Under President Trump

> "Under the U.S. Constitution, Mr. Trump will be vested as President with broad power to act in the sphere of foreign affairs. But that Executive power is not absolute."

The election of Donald J. Trump as President of the United States raises significant questions for the future of international law and policy in the United States. While the President-elect has not detailed concrete policy proposals in the arena of international diplomacy and foreign affairs, he has made broad statements on international trade agreements, international arrangements to combat global climate change and the Iran Nuclear Deal (officially known as the Joint Comprehensive Plan of Action or JCPOA). In particular, Mr. Trump has vowed to renegotiate existing trade agreements such as the North American Free Trade Agreement (NAFTA) and pull out of nascent deals such as the Trans-Pacific Partnership (TPP), a trade deal among twelve Pacific Rim countries. His public commentary has been contradictory, but Mr. Trump has stated at varying times that he will cancel the Paris Agreement, stop payments by the United States to the United Nations Climate Fund and either dismantle or renegotiate the JCPOA.

The President's Power to Effect U.S. Withdrawal from International Agreements Is Not Absolute

Of course, once in office and faced with the realities of governing, Mr. Trump may reconsider. If he does not, the extent of Mr. Trump's power as President to carry out promises of wholesale U.S. withdrawal becomes highly relevant. Under the U.S. Constitution, Mr. Trump will be vested as President with broad power to act in the sphere of foreign affairs. But that Executive power is not absolute. As President, he will not be able to act unilaterally on all matters affecting treaties or international arrangements, particularly with respect to ratified treaties that received the Senate's advice and consent and where Congress has passed implementing legislation.

At times, therefore, Mr. Trump will need to work with Congress, with all of the compromise that usually entails. Although the President-elect will have Republican majorities in both the House of Representatives and the Senate, not all Congressional Republicans share Mr. Trump's views on international law and foreign policy, particularly the hostility to international trade agreements like NAFTA.

Whether the U.S. can withdraw from, denounce or terminate an international treaty is not just a domestic issue. It is also a question governed by international law, which requires either compliance with a specific withdrawal procedure set out in that treaty or satisfaction of a limited set of exceptions.

Looking forward, many questions remain unanswered as to the outlook for international law. But the approach to international law and international

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arrangements likely will shift under the Trump Administration. It remains to be seen whether that shift will be of seismic proportions, and what the consequences will be, including for companies operating internationally.

Unilateral Executive Withdrawal is a Question of Both U.S. Domestic Law and International Law

Not all international arrangements are created equal, including with respect to the steps required to withdraw. Under U.S. law, international agreements fall into three basic categories: treaties, congressional executive agreements and sole executive agreements.

- *Treaties* are international agreements whose entry into force, as laid out by the Constitution, requires the advice and consent of two-thirds of the Senate.
- *Congressional executive agreements* are approved and implemented into U.S. law by an act of Congress, requiring a simple majority of both the House and Senate.
- *Executive agreements* can be entered into solely by the President under certain circumstances by relying on existing Congressional legislation, a pre-existing Senate advice-and-consent treaty, or the President's own Constitutional powers.

In most circumstances, the President can withdraw unilaterally from sole executive agreements or political arrangements. However, the U.S. Supreme Court has not settled the question of whether the President can unilaterally withdraw from treaties or congressional executive agreements.

This is not a new question, but the answer is still unsettled. In 1979, President Jimmy Carter unilaterally withdrew from the Sino-American Mutual Defense Treaty with Taiwan upon recognizing the Beijing government as the sole government of China. The U.S. Supreme Court addressed that act in *Goldwater v. Carter*. More recently, President George W. Bush withdrew from the Anti-Ballistic Missile Treaty (ABM) in 2002, which reached the District Court for the District of Columbia in *Kucinich v. Bush*. Both courts held that the question of Executive power to unilaterally withdraw from a treaty was a non-justiciable "political question," meaning the courts do not have the competence to answer that question.

But the view of Congress towards any Presidential withdrawal is key. The U.S. Supreme Court made clear in *Goldwater* that if Congress had formally opposed President Carter's actions, the legislative and executive branches would have been at a constitutional impasse, and the question would have been justiciable; that is, the question could have been decided by the Court.

In addition, failure to comply with international law renders a purported U.S. withdrawal without legal effect in the international community. Under customary international law (*i.e.*, universally binding international law) embodied in the 1969 Vienna Convention on the Law of Treaties, a country may only withdraw from, or terminate, a treaty if the treaty itself provides for it or if all parties to the treaty agree to it. Absent an express or implied withdrawal or termination clause, the treaty is presumed to continue indefinitely. Withdrawal clauses vary widely from treaty to treaty, with many specifying a fixed term of years and/or notice period.

North American Free Trade Agreement

Mr. Trump has placed much of the blame for the decline of U.S. manufacturing and the loss of American jobs on what he has called unbalanced trade relationships and faulty international trade agreements. He has alternatingly called NAFTA the "worst trade deal in history" and the TPP the "death blow for American manufacturing." Mr. Trump's "Seven Point Plan to Rebuild the American Economy by Fighting for Free Trade" involves three key action items:

- To "withdraw from the Trans-Pacific Partnership, which has not yet been ratified";
- To "direct the Secretary of Commerce to identify every violation of trade agreements a foreign country is currently using to harm our workers, and also direct all appropriate agencies to use every tool under American and international law to end these abuses;" and

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- To "tell NAFTA partners that we intend to immediately renegotiate the terms of that agreement to get a better deal for our workers. If they don't agree to a renegotiation, we will submit notice that the U.S. intends to withdraw from the deal."

It is unclear from his statements what the precise scope of any "renegotiation" would be, including whether it would encompass the investor-state arbitration provisions in Chapter 11 that have led to numerous cases over the past two decades.

"Under U.S. law, however, it is unclear whether Mr. Trump could withdraw from NAFTA without the support of Congress."

NAFTA Withdrawal. As a matter of international law, Article 2205 of NAFTA explicitly allows the United States to withdraw from the agreement, provided that it gives a six-month advance and written notice of withdrawal to the other parties. Under U.S. law, however, **it is unclear whether Mr. Trump could withdraw from NAFTA without the support of Congress**. Unlike the Taiwan or ABM treaties, NAFTA is a congressional-executive agreement and was implemented by Congress through the NAFTA Implementation Act, which is silent on termination. Mr. Trump's withdrawal from NAFTA would not automatically terminate the NAFTA Implementation Act. As the Supreme Court held in *INS v. Chadha*, proposals to amend or repeal statutes must be presented to and considered by both the House and Senate. And of course, again unlike the Taiwan or ABM treaty contexts, Congress could formally oppose withdrawal from NAFTA. Such a response would likely leave it to the Supreme Court to decide the question over the course of the next few years.

WTO Withdrawal. While less of a focus, Mr. Trump has also suggested that he would withdraw from the World Trade Organization (WTO). The WTO regime comprises a number of separate multilateral trade agreements, including the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS). Like NAFTA, the Agreement establishing the WTO provides that countries who are party may withdraw from the WTO (and all other WTO trade agreements) six months after notifying the Director-General in writing. The WTO treaties were congressional-executive agreements approved and implemented by Congress through the Uruguay Round Agreements Act of 1994, such that **unilateral attempts to withdraw would be subject to the same Constitutional challenge described above**.

Impacts of Withdrawal from NAFTA or the WTO. Constitutional concerns aside, withdrawal from NAFTA or the WTO, as well as other trade or investment agreements, would significantly affect U.S. companies' ability to access foreign markets by impacting customs, duties, tariffs and recognition of regulatory standards. Companies' ability to challenge expropriatory or other unfair actions taken by foreign sovereigns against U.S. companies before impartial international tribunals would also be impacted. Moreover, withdrawal without an alternative regime in place, which inevitably would be time-intensive and politically costly, could expose U.S. businesses to a legal vacuum and ensuing commercial uncertainty.

Trans-Pacific Partnership

The Trans-Pacific Partnership (TPP), the largest regional trade accord in history, is a multinational agreement between the United States, Japan, Australia, Peru, Malaysia, Vietnam, New Zealand, Chile, Singapore, Canada, Mexico and Brunei Darussalam, representing roughly one-third of world trade. Proponents point out that the TPP would substantially cut tariffs for U.S. exports to member states and have welcomed the TPP's coverage of issues such as environmental protection, workers' rights, intellectual property and reduction of non-tariff barriers to trade. Detractors point to the lack of transparency in the negotiations process, fear of

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reductions in U.S. tariffs leading to a flood of cheap imports into the U.S. market, and the failure of any growth in exports under the deal to offset the new imports, amplifying the U.S. trade deficit. Mr. Trump has proclaimed his intention to "withdraw" from the TPP on Day One of his administration, labeling it a "job-killing" trade policy. He has been especially critical of the TPP's lack of provisions dealing with currency manipulation, particularly by China, which is not a member of the TPP at present, but may join in the future.

"Any attempt by Mr. Trump to withdraw from the Paris Agreement should have no effect until November 2020—the time of the next U.S. Presidential election—at the earliest."

The TPP was signed on February 4, 2016 by President Obama and the other country signatories, but has not entered into force. The TPP requires Congressional approval, but the Senate majority leader (Sen. McConnell, R-Ky.) stated that the TPP would not be taken up in the lame-duck Congress, leaving the trade pact essentially dead.

Mr. Trump can "un-sign" the TPP as a matter of unilateral Executive power. This would be the death knell for the trade pact not only in the United States, but also for the other signatories. The TPP can only enter into force if at least six of the original signatories comprising 85% or more of the gross GDP ratify the treaty. Due to the size of the U.S. economy, the failure of the United States to ratify the agreement would effectively block its entry into force for all countries involved.

Paris Agreement (Paris Climate Accord)

The conclusion of the Paris Agreement in December 2015 was heralded as a landmark moment in the fight against climate change. The Paris Agreement was adopted under the auspices of the United Nations Framework Convention on Climate Change (UNFCCC), a 1992 treaty ratified by the United States with the advice and consent of the Senate. That treaty requires the United States to "stabilize greenhouse gas concentrations in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system." The Paris Agreement defines how countries will implement their UNFCCC commitments after 2020.

U.S. Secretary of State John Kerry signed the Paris Agreement on Earth Day, April 22, 2016. It sets goals for countries around the world to cap and reduce emissions, with the central aim to combat climate change by keeping the increase in the global average temperature to "well below 2 degrees Celsius above pre-industrial levels and to pursue efforts to limit the temperature increase even further to 1.5 degrees Celsius." The President, deriving authority from the UNFCCC treaty, the Clean Air Act and his own Constitutional powers, signed the Paris Agreement as a sole executive agreement. However, since it was signed without the approval of Congress, it could not establish binding emission targets and new binding financial commitments. Nevertheless, the Paris Agreement does establish a set of binding procedural commitments, including the requirement to prepare and maintain successive nationally determined contributions (NDC) where each successive NDC needs to "represent a progression beyond the Party's then current [NDC]," and the obligation to "pursue domestic mitigation measures." The Paris Agreement has been formally joined by 110 of the 193 signatory countries, including the United States, China and India.

Despite the overwhelming scientific consensus on the evidence, Mr. Trump has been skeptical that the world's climate is changing, going so far as to state that "the concept of global warming was created by and for the Chinese in order to make U.S. manufacturing non-competitive." In May 2016, he released an "America First Energy Plan" on his campaign website, which stated: "We're going to cancel the Paris Climate Agreement and stop all payments of U.S. tax dollars to U.N. global warming programs." Recently, in an interview with the *New York Times*, Mr. Trump

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stated that he would keep an "open mind" with respect to climate change more generally.

The Paris Agreement already has enough signatories to take effect, and it entered into force on November 4, 2016. It precludes countries from withdrawing within the first three years of its entry into force. Once three years have elapsed, a country may give notice of its intention to withdraw, but withdrawal will not take effect until one year after receipt of the notification. **This means that any attempt by Mr. Trump to withdraw from the Paris Agreement should have no effect until November 2020—the time of the next U.S. Presidential election—at the earliest**. While there has been some conjecture that Mr. Trump would try to circumvent the four-year moratorium on withdrawal by withdrawing from the underlying UNFCCC treaty, such a move would be subject to the same Constitutional obstacles described above.

As a result, Mr. Trump will have a hard time extricating the United States from the deal, at least immediately. And the deal itself is likely to continue, particularly where other countries—including China and India—have said they intend to go ahead with the plan on their own. There is also good reason to believe that the 29 states, District of Columbia and three U.S. territories that have adopted carbon reduction goals or renewable energy investments will continue to lead efforts that can meet the overarching goal of the Agreement. Since President Obama took office, the United States has added more than 35,000 MW of wind power and solar generation has increased more than thirtyfold, while coal production has dropped by 36 percent. As a result, while much remains to be seen, including whether the Trump Administration will try to unravel the state rules through contrary federal regulation, the United States may have already passed a critical point of investment in renewables that can set the stage for further progress towards climate change goals.

Joint Comprehensive Plan of Action (Iran Nuclear Deal)

On July 14, 2015, the United States, the United Kingdom, Germany, France, Russia, China, the European Union and Iran agreed on the JCPOA to ensure that Iran could not proceed towards building a nuclear weapon in exchange for sanctions relief. The arrangement came into effect in October 2015 and was implemented on January 16, 2016. The International Atomic Energy Agency verified Iran's compliance with strict restrictions on enriched uranium and centrifuges, abandonment of plutonium and intensive international monitoring of nuclear facilities. In return, the United States and EU lifted nuclear-related sanctions as agreed. If Iran at any time fails to fulfill its commitments, these sanctions will snap back into place.

Mr. Trump's statements on Iran and the JCPOA have been contradictory, ranging from promising U.S. business access to the Iran market to suggestions that he will tear up the deal as "the worst deal ever negotiated," where ending it would be his "number one priority," or renegotiate its terms.

The JCPOA is, as indicated by its name and confirmed by the State Department, a "political commitment," not a legally binding agreement. The State Department has stated that the success of the JCPOA does not depend on whether it is legally binding or signed, but on the verification measures put in place and the capacity of the U.S. government to reinstate or ramp up sanctions if Iran does not meet its commitments. President Obama met U.S. obligations under the JCPOA through a series of waivers and Executive Orders granted under existing legislation, such as the Iran Sanctions Act of 1996. **As such, Mr. Trump as President can unilaterally and immediately withdraw Washington's commitments under the deal.**

While governments may agree on joint statements of policy or intention that do not establish legal obligations, the distinction between an agreement that results in a binding commitment under international law and one that does not is not always clear. Much of the language of the JCPOA is precatory, but there are elements that appear to assert binding obligations, such as the dispute resolution mechanism contained in the agreement and UN Security Council obligations.

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Most recently, Iran has stated that if Washington decides to renew sanctions, Iran will regard that "as grounds to cease performing [Iran's] obligations under the JCPOA." But a U.S. withdrawal would not automatically unravel the deal, as the other countries and the EU could keep the JCPOA in force if they can use their own threat of sanctions to pressure Iran to reconsider. Notably, under the JCPOA, the EU and other countries lifted nearly all significant sanctions, but the United States lifted only a narrower subset of secondary, "nuclear-related" sanctions directed at non-U.S. companies, leaving in place other sanctions, including what are called "primary" sanctions on U.S. companies doing business with Iran. So while Mr. Trump could decide to unilaterally or in conjunction with Congress impose (or reimpose) sanctions, lifting of these U.S. sanctions was only part of the JCPOA deal. Sanctions targeting U.S. companies (and their foreign subsidiaries) would not directly affect foreign companies, and attempting to penalize those companies could risk major disputes with China and France as they have deepened economic ties with Iran. In short, there would still be significant economic incentives for Iran to stay in.

> "Mr. Trump as President can unilaterally and immediately withdraw Washington's commitments under the deal."

The ultimate fate of the JCPOA remains unclear, though the likelihood of passage of some U.S. package of sanctions is material. The risk of disruption for non-U.S. companies and non-U.S. subsidiaries of U.S. companies that may have re-initiated trade is high.

As more information comes to light about the Trump Administration's international law agenda and key appointments, the outlook will become clearer. The Public International Law Group at Debevoise will be monitoring developments.

Catherine Amifar
camirfar@debevoise.com

Donald Francis Donovan
dfdonovan@debevoise.com

Natalie L. Reid
nlreid@debevoise.com

David W. Rivkin
dwrivkin@debevoise.com

Peter H. Goldsmith
phgoldsmith@debevoise.com

Employer Alert: SEC Settles Another Whistleblower Action

"[Recent] enforcement actions represent an important reminder for employers to review all agreements that they have with current and former employees to ensure that the confidentiality provisions do not explicitly or implicitly prohibit protected whistleblowing activities."

In the last two years, the U.S. Securities and Exchange Commission (SEC) announced several major enforcement actions against employers for using contracts with employees that seek to impede the employees from engaging in protected whistleblowing activity. Under rules that went into effect five years ago pursuant to the Dodd-Frank Act, such employment contracts are prohibited. These enforcement actions represent an important reminder for employers to review all agreements that they have with current and former employees to ensure that the confidentiality provisions do not explicitly or implicitly prohibit protected whistleblowing activities.

The BlueLinx Enforcement Action

Last summer, the SEC announced its second major enforcement action concerning agreements with employees that limit the ability of employees to blow the whistle. In an August 2016 settlement order, the SEC faulted BlueLinx Holdings, Inc., an Atlanta-based building supply distributor, for various severance agreements that it had used over the preceding five years, which could have the effect of limiting the whistleblowing activities of its former employees.[1] In particular, earlier versions of the agreements prohibited disclosure of BlueLinx confidential information or trade secrets except as required by law and only following written disclosure to the BlueLinx Legal Department. Subsequent versions permitted disclosure to certain regulators, including the Equal Employment Opportunity Commission, the National Labor Relations Board, the Occupational Safety and Health Administration, and the SEC, but required the employee to agree to "waive the right to any monetary recovery in connection with any such complaint or charge that the Employee may file with an administrative agency."[2]

Section 21F of the Securities Exchange Act, a provision adopted in the Dodd-Frank Act, provides for various whistleblower protections and incentives, including a bounty program for individuals that report original information to the SEC. Exchange Act Rule 21F-17, which the SEC adopted implementing the provision, prohibits "any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement."[3] In its order, the SEC argued that the BlueLinx severance agreements "undermine the purpose of Section 21F, which is to 'encourage individuals to report to the Commission' and violate Rule 21F-17(a) by impeding individuals from communicating directly with the Commission staff about possible securities law violations."

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1. *In re BlueLinx Holdings, Inc.*, Exchange Act Release No. 78528 (Aug. 10, 2016).
2. *Id.*
3. 17 C.F.R. § 240.21F-17(a).

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Subsequent to the BlueLinx action, the SEC has brought three additional cases involving unduly restrictive provisions in contracts with employees,[4] and the SEC's Office of Compliance Inspections and Examinations has issued an alert notifying registered investment advisers—including advisers to private equity funds—that the SEC Exam Staff is reviewing advisers for compliance with the whistleblower provisions.[5]

The KBR Enforcement Action

In 2015, following several public statements by the SEC warning against employee contracts or other measures that seek to limit employees' ability to report wrongdoing to the SEC,[6] the SEC brought its first case against an employer for a confidentiality agreement that it claimed did just that. In that enforcement action, KBR, a technology and engineering firm, settled SEC allegations that confidentiality agreements it used in internal investigation interviews might be interpreted to limit employees' ability to report wrongdoing to regulators, including the SEC.[7] As part of settling the matter, KBR agreed to a $130,000 penalty and to amend its confidentiality agreement language.

The BlueLinx Settlement

The $265,000 penalty for BlueLinx, more than double that for KBR, likely reflects the egregiousness of its violation. Whereas the confidentiality agreement in KBR contained a blanket prohibition on disclosing the substance of internal investigation interviews without prior approval of the KBR legal department, some of the BlueLinx severance agreements explicitly discouraged whistleblowing to regulators by requiring employees that did so to waive potential monetary recoveries.

In addition to the monetary penalty, BlueLinx agreed to amend its severance agreement to allow employees to report to regulators with impunity and agreed to contact former employees that had signed the old agreements, notifying them of their right to do the same.

A Reminder to Portfolio Companies and Other Employers

The KBR, BlueLinx and other recently announced enforcement actions serve as important reminders for employers to review all agreements that they have with current and former employees to ensure that the confidentiality provisions do not explicitly or implicitly prohibit or improperly impede protected whistleblowing activities, particularly reporting to the SEC and the Department of Justice. Although employers may wish to retain language providing that employees waive the right to receive monetary relief in connection with proceedings before the Equal Employment Opportunity Commission, they should ensure that such language does not, explicitly or implicitly, limit employees' right to participate in the Dodd-Frank bounty program. To the extent that past agreements contain prohibited language, the employer should consult with counsel about whether and how to address the matter.

Jyotin Hamid
jhamid@debevoise.com

Mary Beth Hogan
mbhogan@debevoise.com

Jonathan R. Tuttle
jrtuttle@debevoise.com

Ada Fernandez Johnson
afjohnson@debevoise.com

Arian M. June
ajune@debevoise.com

Ryan M. Kusmin
rmkusmin@debevoise.com

4. *See In re Health Net, Inc.*, Exchange Act Release No. 78590 (Aug. 16, 2016); *In re Anheuser-Busch Inbev SA/NV*, Exchange Act Release No. 78957 (Sept. 28, 2016); *In re SanrdRidge Energy, Inc.*, Exchange Act Release No. 79607 (Dec. 20, 2016).

5. *See* Debevoise & Plimpton LLP, Client Update: SEC Exams Focus on Whistleblower Compliance by Investment Advisers and Brokers (Oct. 26, 2016), *available at* http://www.debevoise.com/insights/publications/2016/10/sec-exams-focus-on-whistleblower-compliance.

6. *See* Debevoise & Plimpton LLP, Client Update: Head of SEC Whistleblower Office Warns against Interference with Potential Whistleblowers (Apr. 24, 2014), *available at* http://www.debevoise.com/insights/publications/2014/04/head-of-sec-whistleblower-office-warns-against-i__ (The SEC was "actively looking for examples of confidentiality agreements, separation agreements, [and] employee agreements" that condition certain benefits on not reporting activities to regulators, including the SEC.).

7. *See* Debevoise & Plimpton LLP, Client Update: SEC Brings First-of-Its-Kind Action for Confidentiality Agreement that Discourages Whistleblowing (Apr. 6, 2015), *available at* http://www.debevoise.com/insights/publications/2015/04/sec-brings-first-of-its-kind.

Still in the Waiting Room: Outlook for the Healthcare Industry Under President Trump

"The 2016 election will have important consequences for the U.S. healthcare industry. However, the absence of any detailed policy proposals by President-elect Trump, together with the uncertainties of the political process generally, make it difficult to discern exactly how things will play out in Washington. That said, we won't let the uncertainty deter us from trying to read the tea leaves."

The 2016 election will have important consequences for the U.S. healthcare industry. However, the absence of any detailed policy proposals by President-elect Trump, together with the uncertainties of the political process generally, make it difficult to discern exactly how things will play out in Washington. That said, we won't let the uncertainty deter us from trying to read the tea leaves.

Here's what we know. Mr. Trump talked a lot during the campaign about repealing the Affordable Care Act (ACA) and about deregulation generally. The Trump campaign also issued a short seven-point policy statement regarding healthcare reform, and the Trump transition team released an even briefer 310-word outline after the election. Mr. Trump will have Republican majorities in both the House and the Senate, but the slim Senate majority is not filibuster-proof. Moreover, not all Congressional Republicans share Mr. Trump's perspective on all healthcare issues. And Mr. Trump himself is still refining his views. For example, after his first meeting with President Obama, Mr. Trump expressed support for retaining certain aspects of the ACA. Finally, Mr. Trump will appoint at least one Supreme Court justice and will fill a number of seats on lower federal courts.

We also know that changes are not likely to be experienced immediately, or all at once. Changes to treaties, statutes and regulations all require time – and often compromise – to take final effect. Changes effected through judicial decisions, particularly at the Supreme Court level, often take even longer to be felt. In addition, the new enforcement and regulatory priorities of various agencies depend not only on filling the top positions in those agencies, but on filling the second and third levels of command as well.

Different sectors within the healthcare industry will be impacted in different ways, as the stock markets have already recognized. In the immediate aftermath of the election, pharmaceutical stock prices rose, largely in line with the S&P 500, presumably on the view that Mr. Trump would exercise a more free-market, less regulation-heavy philosophy that would benefit pharma companies. On the other hand, the stocks of hospitals and other providers fell significantly, likely reflecting investor concerns that a repeal of the ACA could leave millions of Americans uninsured, which would impact hospitals particularly hard since in many cases they treat patients regardless of their ability to pay.

What is certain is that the healthcare industry will continue to evolve in the new political environment, likely in ways that present opportunities and risks for operators and investors in this space.

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Affordable Care Act

Significant change to the ACA is inevitable, but the precise shape of that change is less clear than one might think based on Mr. Trump's campaign rhetoric around repeal. Indeed, since the election, Mr. Trump has already proposed retaining both the law's guarantee that consumers cannot be refused coverage due to pre-existing conditions and the provision permitting adult children to be covered under their parents' policies through age 26.

Congress' 2015 Repeal of the ACA May Offer a Guide. The bill repealing the ACA that Congress passed (and President Obama vetoed) in 2015 may offer some clues as to what a "repeal" of the ACA might look like this time around. The 2015 measure would have eliminated:

- the individual mandate, which was a penalty assessed on certain people who did not purchase health insurance,
- subsidies available to low- and middle-income consumers to purchase health insurance,
- the "Cadillac tax" on high-cost health insurance plans,
- the excise tax on medical devices and
- taxes on high earners, which were designed in part to fund the program.

The 2015 measure did not seek to repeal the ACA's prohibition against insurers discriminating on the basis of preexisting conditions, and it retained the strict limits on insurers' ability to charge higher premiums based on health status. Both of these provisions are highly popular and are likely to receive continued bipartisan support. In addition, while the 2015 measure (which covered subsidies and taxes) was passed through the filibuster-proof budget reconciliation process, many provisions relating to insurance reform likely cannot be altered through the budget reconciliation process because they do not impact federal spending.

> "It is also possible that Medicaid may be redesigned. Some Republicans (including Mr. Trump) have proposed curbing the expansion of Medicaid costs at the federal level through the use of Medicaid block grants…"

The Future of Medicaid Expansion Is in Doubt. Another big question surrounding the ACA is the future of the provisions that expanded Medicaid to include all adults who earn less than 138% of the federal poverty level. The Supreme Court ruled that, while the ACA made the expansion a condition of participating in the Medicaid program, states could opt out without losing their Medicaid funds. Republican-led states split in their response: some, like Ohio and Indiana, accepted the federal aid to expand Medicaid in their state, while others, like Texas and Florida, refused.

It is also possible that Medicaid may be redesigned. Some Republicans (including Mr. Trump) have proposed curbing the expansion of Medicaid costs at the federal level through the use of Medicaid block grants, whereby the federal government would provide each state with a block grant of federal funds (*i.e.*, an annual fixed sum) to finance that state's Medicaid program. If the state's costs exceeded the block grant, the state would be responsible for financing those costs or would need to cut coverage. Currently, the federal government has an open-ended commitment to help states cover their Medicaid costs but, in exchange, requires those states to cover certain groups of people. Other Republicans have alternatively proposed allowing each state to choose between block grants and a per capita allotment, whereby states would be given a set amount of money per enrollee (which would increase each year).

An important real-world reminder is that when Congress "repealed" the ACA last year, members could vote for the repeal knowing that it was certain to be vetoed. It is unclear whether there is enough support and fortitude to pass the same repeal (or move to a system of block grants or per capital allotments), knowing it will have actual consequences,

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including for many of Mr. Trump's supporters. Several Republican senators from states with large populations of Medicaid beneficiaries were opposed to the repeal of the Medicaid expansion. With a narrow Republican majority, it is therefore uncertain if there are enough votes to roll back the expansion or alter Medicaid funding.

Trump Has Identified a Few Key Features of an ACA Replacement. Mr. Trump's post-election 310-word outline on healthcare identified a few priorities that his administration might include in an ACA replacement, including:

- making premiums tax-deductible,
- expanding the availability of Health Savings Accounts, which allow people to set aside pre-tax dollars for health expenses and
- permitting the purchase of insurance plans across state lines.

It is unclear how the last proposal would work in practice as most managed care plans feature local networks of providers, so an insured in one state might need to go to out-of-network providers, or travel to in-network providers, for all of her health care if the plan were based in another state. Mr. Trump has also proposed working with high-risk pools to cover individuals with pre-existing conditions who have not maintained continuous coverage previously. However, if all of the ACA's insurance market reforms remain intact, it is not clear whether and for what group high-risk pools would be needed.

What Is the Bottom Line? Any changes to the ACA will have significant and varied implications for different sectors within the healthcare industry:

- For medical device manufacturers, a repeal of the excise tax would be an outright win.
- The balance of bargaining power between insurers and providers may change if the ACA is dramatically altered, although we do not know yet which side will benefit from that development.
- Tax deductions for premiums and increased usage of Health Spending Accounts may increase consumption of healthcare products and services by middle- and upper-income consumers, which would benefit hospitals and other providers.
- Non-partisan experts estimate that an ACA repeal similar to the 2015 bill passed by Congress would lead to more lower-income people being uninsured, particularly if the Medicaid expansion is rolled back. Hospitals, which have benefitted from reduced levels of bad debt and charity care write-offs as the ACA has reduced the uninsured population, may see those gains eliminated in whole or in part.
- The pharmaceutical industry may similarly lose out on drug purchases by people who formerly received free or subsidized insurance but can no longer afford it.

Prescription Drug Pricing

Conventional wisdom is that Mr. Trump's election and the continued Republican majorities in Congress will benefit the pharmaceutical industry relative to the alternative because Hillary Clinton and Congressional Democrats had actively called for controlling prescription drug prices. In addition, the pharmaceutical industry scored a major victory in defeating Proposition 61, a California ballot initiative that would have prohibited California state agencies from buying prescription drugs at prices higher than those paid by the U.S. Department of Veterans Affairs.

While Mr. Trump is regarded as business-friendly and did not make prescription drug pricing a major issue in his platform, he has expressed support for introducing more competition into the healthcare marketplace. And a couple of his campaign proposals, if implemented, could have the effect of depressing prescription drug prices:

- *Permitting the Centers for Medicare & Medicaid Services (CMS) to Negotiate Drug Prices.* Currently, CMS is prohibited from negotiating prescription drug prices. Earlier in his campaign, Mr. Trump took the position (one shared by many Democrats) that this prohibition should be lifted so that CMS could use its enormous purchasing power to negotiate significant discounts to the prices of drugs covered by Medicare Part D. However, repeal of this prohibition seems unlikely as

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the prohibition has strong support among Congressional Republicans and Mr. Trump stopped raising this issue as a major campaign point over the summer.

- *Allowing the Importation of Cheaper Foreign Drugs.* Mr. Trump and certain members of Congress have supported lifting the ban on American consumers purchasing prescription drugs overseas (where drugs are in some cases cheaper, due to price controls or otherwise) and importing them into the U.S. However, there is strong Congressional opposition to lifting this ban, in part due to safety and quality issues if unregulated drug importation were legalized. In any event, Mr. Trump's 310-word healthcare plan does not include this policy point, so it is not clear whether Mr. Trump continues to view this as a priority.

"[T]he pharmaceutical industry should be alert to Mr. Trump using public remarks and Twitter to accomplish his objectives."

Even if the Trump administration does not pursue these proposals, the pharmaceutical industry may remain subject to intense public scrutiny and a relatively hostile political environment. As evidenced by the aftermath of the January 11 press conference, the pharmaceutical industry should be alert to Mr. Trump using public remarks and Twitter to accomplish his objectives. In response to media reporting about a particular high-priced drug or significant drug price increase, Mr. Trump may issue a tweet condemning the drug company at issue. That in turn may cause the drug company's stock price to fall and trigger investigations by some combination of the Department of Justice, Congress or state attorneys general.

Pricing of Medical Services

As part of the Trump campaign's stated aim of creating consumer-focused healthcare, Mr. Trump has argued that hospitals and other healthcare providers should promote greater pricing transparency, allowing individuals to shop to find the best prices for medical examinations and procedures. However, aside from elective cosmetic procedures, most medical procedures are not priced like simple commodities. Instead, hospitals determine rates through negotiation with insurers – the results of which are kept confidential – and typically offer discounts to uninsured patients. At a minimum, we would expect that hospital pricing may be subject to significant political scrutiny.
In addition, it is likely that medical providers will continue to experience a shift from volume-based to value-based payment models, particularly as this shift has received bipartisan support in Congress.

Tax Reform

The current U.S. tax regime of high corporate tax rates and penalties for repatriating foreign earnings incentivizes U.S. healthcare companies with foreign operations to divert profits offshore and keep them permanently reinvested there. Some have taken a step further and have become subsidiaries of foreign merger partners (through "inversion" transactions). For many U.S. healthcare companies, these tax-driven arrangements are a matter of necessity in an internationally competitive environment. Leaders in Congress concerned about these developments are eager for significant tax reform, and some believe that the outcome of the election creates an opportunity, which has not been present in the recent past, for major tax legislation.

Although details of any legislation are speculative at this time, the broad themes are likely to be removing the disincentive to invest domestically and encouraging the repatriation of offshore earnings.

As discussed elsewhere in this issue, in June 2016, House Republicans prepared a tax policy paper (known as the Blueprint), which many believe will be the starting point for legislation. The most important provisions of the Blueprint are:

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- The corporate tax rate would be a flat 20%.
- Businesses could immediately expense 100% of the costs of business investment (including in plants and equipment, but excluding investments in land).
- Accumulated offshore earnings (whether or not they are ultimately repatriated) that are held in cash or cash equivalents would be subject to an immediate 8.75% tax, and accumulated offshore earnings held in other forms would be taxed at a 3.25% rate (which could be paid over an 8-year term).
- Prospectively, foreign earnings and distributions from foreign subsidiaries would be exempt from U.S. tax, thereby eliminating the penalty for repatriating earnings (*i.e.*, removing the "lockout effect").
- Interest expense in excess of interest income would be non-deductible.

With the exception of the last proposal concerning the disallowance of interest expense, these provisions, if enacted, could be expected to remove a disincentive to invest in the U.S. and to stimulate the repatriation of foreign earnings, which could be used to spur investment and acquisition activity or be distributed to shareholders.

Reduction in Federal Regulation

In keeping with his business-friendly message, Mr. Trump has voiced his general commitment to regulatory reform, including implementing measures to reduce the size of the federal government and decrease the costs of regulatory compliance for U.S. businesses and shifting regulatory responsibilitie—especially with regard to health insurance—from the federal government to the states.

The First 100 Days Action Plan that the Trump campaign released in late October includes proposals to, among other things, place a hiring freeze on federal employees and require that, for every new federal regulation, two existing regulations be eliminated. In addition, both the First 100 Days Action Plan and the 310-word health plan released after the election highlight the need to "reform" the Food and Drug Administration (the FDA). Both plans emphasize the need to "cut red tape" and approve "new and innovative medical products." Although details of the proposed reform have not been made available, it could include accelerating the process to approve new drugs, approving new uses for already-approved drugs and lowering the bar to approving generic drugs. While FDA reform could potentially make the approval process more rapid and less burdensome for pharmaceutical and biotech companies, it could also introduce heightened competition into the marketplace.

Free Trade Agreements

As discussed elsewhere in this issue, opposition to free trade agreements has been a pillar of Mr. Trump's platform. The pharmaceutical industry, which operates globally and relies on manufacturing conducted outside of the U.S., is generally in favor of free trade.

Mr. Trump voiced his strenuous opposition to the Trans-Pacific Partnership (TPP) throughout the campaign, and the TPP has effectively died since the election, with the Obama administration acknowledging that there is no path forward for the 12-nation pact. The collapse of the treaty may have mixed consequences for different subsectors within the pharmaceutical industry. For example, manufacturers of branded pharmaceutical products generally supported provisions of the TPP that would have expanded patent protections and market exclusivity for new pharmaceutical products and provided a harmonized and more predictable framework for addressing third party challenges to intellectual property underlying their pharmaceutical products (modeled on the Hatch-Waxman Act). However, some industry players were also concurrently lobbying against other provisions of the TPP that would have shortened the period for data exclusivity protection for biologics to less than the period granted under U.S. law, while other players (such as generics companies) and patient advocacy groups were lobbying in favor of shortening those exclusivity periods.

Whether Mr. Trump would actually seek to renegotiate or withdraw from the North American Free Trade Agreement (NAFTA) remains to be seen. Doing so could jeopardize pharmaceutical companies' cross-

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border operations in Mexico and Canada and roll back the intellectual property protections under the treaty. However, Congressional approval may well be required to abrogate a treaty entered into by the U.S., potentially presenting a real obstacle to the success of such a proposal. In any event, Mr. Trump's positions on free trade agreements may make it more difficult for the pharmaceutical industry to use free trade agreements to gain access to new markets in the future.

Antitrust Merger Review

Many sectors within the healthcare industry have experienced waves of consolidation. These mergers have come under increased regulatory scrutiny. Notably, last summer, the U.S. Department of Justice sued to block two major mergers in the health insurance sector: Anthem Inc.'s proposed $54bn acquisition of Cigna Corp. and Aetna Inc.'s $37bn acquisition of Humana Inc.

While the traditional assumption is that merger review by antitrust authorities is more lax during Republican administrations than during Democratic administrations, Mr. Trump has made a number of statements that could put that assumption in doubt. He has, for example, been vocal in advocating for increased competition in the marketplace with respect to drug pricing, healthcare services and insurance offerings. During the campaign, he also praised the enforcement of antitrust laws to prevent the formation of large corporate conglomerations. He also criticized AT&T's planned takeover of Time Warner and said he would seek to block the merger.

While it is too early to tell what the antitrust enforcement priorities will be under a Trump administration, many observers believe that a more merger-friendly climate is ahead. The CEO of Aetna stated recently that Aetna's stock rose significantly after the election because investors believed the Department of Justice under the Trump administration will be more likely to approve the Aetna-Humana merger.

Enforcement Priorities

The healthcare industry is affected not just by what laws and regulations are on the books, but also how they are enforced. The Obama Justice Department made healthcare fraud a high priority and was also, in the aftermath of the 2008 market collapse, focused on individual criminal culpability in healthcare as well as other industries. Mr. Trump's voters may favor an ongoing focus on individual criminal prosecutions as part of their disaffection with corporate elites; on the other hand, Republican administrations tend not to pursue such cases with as much vigor.

The Obama administration also brought a significant number of high-profile bribery cases against the healthcare industry under the Foreign Corrupt Practices Act (FCPA), racking up enormous penalties. Mr. Trump has called the FCPA a "horrible law" so it seems that he may not favor as aggressive an approach to FCPA enforcement. A reduced risk of investigation and enforcement in the FCPA area might well benefit healthcare companies operating globally.

The False Claims Act (FCA) is another statute that looms large in the healthcare space. If the Department of Justice elects to pursue fewer FCA cases against healthcare companies, that may leave more cases to be brought by private plaintiffs. That may reduce healthcare companies' ultimate exposure, but would create more potential for harassing litigation by private parties in the interim.

Much more will be known in the coming weeks and months about the Trump administration's plans and how they may impact the healthcare industry. Likewise, we will likely develop a better sense for the views of the new Congress. One thing is clear: significant changes are likely coming and they will present both benefits and disadvantages for players in the healthcare sector.

Andrew L. Bab
albab@debevoise.com

Jennifer L. Chu
jlchu@debevoise.com

Mark P. Goodman
mpgoodman@debevoise.com

Maura Kathleen Monaghan
mkmonaghan@debevoise.com

What to Expect: Portfolio Company IPOs and SEC Review

"The relationship between private equity firm and IPO issuer presents a core group of issues and a short list of recurring themes in the SEC review and comment process."[1]

Private equity portfolio companies are estimated to have represented nearly a quarter of all U.S.-issuer initial public offerings (IPOs) in 2015, with that proportion being even higher in prior years. The relationship between private equity firm and IPO issuer presents a core group of issues and a short list of recurring themes in the U.S. Securities and Exchange Commission (SEC) review and comment process.[1] For certain of these issues, the SEC staff has issued substantially identical comments to multiple private equity-backed issuers, suggesting that they have developed models for reviewing private equity-backed IPOs. In advance of an initial IPO registration statement filing, and when structuring pre- and post-IPO relationships, private equity firms and their counsel should consider these trending comments and likely areas of SEC scrutiny to avoid potential IPO disclosure difficulties and to guide the drafting of IPO registration statement disclosure.

Related-Party Transaction Disclosure

Among these recurring issues, related-party transactions were a key area of focus in SEC review. SEC staff comments frequently included a request to disclose all related-party transactions. In fact, our analysis identified one such comment which was provided word-for-word to multiple private equity-backed issuers:

> *Please disclose in this subsection, or under a separate heading in your prospectus summary, any payments, including dividend payments, compensation, or the value of any equity that [the private equity firm] or its affiliates, and your directors or executive officers received or will receive in connection with the offering.*

Related-party disclosure drew particular focus in cases where a significant number of contemporaneous transactions—such as repayment of indebtedness, termination of consulting arrangements with the private equity firm and restructuring of the issuer or the private equity fund's ownership—were disclosed. Where these types of transactions occur at or shortly prior to the IPO, the SEC staff often commented on compliance with use of proceeds disclosure requirements as well:

> *We note that an affiliate of [the private equity firm] holds a portion of the outstanding term loan facility; to the extent [that the private equity firm] or its affiliates will receive a portion of the proceeds of the offering that are used to discharge indebtedness, please disclose that fact here.*

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1. The authors reviewed SEC comment letters in IPOs of private equity–backed issuers that closed from January 2015 through June 2016 with gross proceeds of at least $100 million. The comments analyzed are only those with respect to the private equity firm (and fund) and its relationship with the issuer, not the financial and business disclosure of the issuer itself.

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Often, contemporaneous transactions will trigger a requirement to present pro forma financial data. For issuers engaged in transactions with a private equity firm at the time of the IPO, the SEC staff frequently challenged pro forma financial statement disclosure, including requests for revised and expanded disclosure related to management and termination fees paid to private equity firms and repayment of indebtedness.

Disclosure of Post-IPO Control

Another area of focus in SEC comments was the private equity firm's continuing control of the IPO issuer. SEC comments most frequently requested additional disclosure on the topic of control in the prospectus summary. These requests ranged from general disclosure of the private equity firm's control, to descriptions of arrangements for post-IPO nomination of directors and executive officers.

> *Please clarify that your principal shareholders will continue to be controlling shareholders after this offering and will have the right to designate a number of directors to your board pursuant to a shareholders' agreement.*

The SEC staff also frequently requested additional information and disclosure with respect to any arrangement or understanding with a director or executive officer pursuant to which he or she was or is to be selected as a director or executive officer post-IPO.

In addition to comments on the prospectus summary, the SEC staff frequently requested additional risk factor disclosure about the nature and extent of post-IPO control by the private equity firm, and the potential for conflicts of interest with public investors.

> "SEC comments most frequently requested additional disclosure on the topic of control in the prospectus summary."

Beneficial Ownership Disclosure

The final key area of focus in the SEC comments we reviewed related to beneficial ownership disclosure. The IPO registration statement must include tabular disclosure of certain information relating to beneficial owners of more than five percent of the registrant's voting securities. Beneficial owners are any persons who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise have or share voting power and/or investment power with respect to the securities.

Because the structures through which private equity funds own interests in portfolio companies can be complex and often include several affiliates, disclosure of ownership interests frequently includes disclaimers of beneficial ownership by affiliates of the private equity firm and fund. The SEC staff frequently challenged such disclaimers of beneficial ownership where the staff had formed an initial view that certain persons or entities controlled the portfolio company or the private equity firm or fund. These comments frequently requested that the portfolio company either provide its legal analysis supporting the disclaimers (which will ultimately become publicly available after completing the IPO) or remove them.

In addition, the SEC staff also frequently requested that private equity-backed issuers identify natural persons affiliated with the private equity firm or fund in the tabular ownership disclosure. These comments generally focused on whether such individuals participated in investment decisions by the private equity firm or fund, or otherwise could be deemed to have voting or dispositive control over securities held by the private equity fund.

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> *Please include the natural persons or persons who have voting and dispositive control of the shares included in Funds affiliated with [the private equity firm] listed in the table.*

Indicative of their concerns relating to disclosure of both ownership and control, the SEC staff also frequently requested that IPO issuers provide structure charts in the prospectus summary or provide additional information to highlight the issuer's ownership and governance. These included requests to provide detail with respect to conversion and exchange rights, ownership interests of pre-IPO owners as a group and ownership percentages generally. In several cases, this information had already been provided elsewhere in the draft disclosure, but the SEC staff specifically requested that it also be brought forward to the prospectus summary.

Summary: Trending SEC IPO Comment Topics

- Transactions with related parties and the use of proceeds in contemporaneous transactions with the private equity firm, including related pro forma financial information.
- Disclosure of the private equity firm's control post-IPO, including increased prominence of such disclosure in the prospectus summary, additional risk factors and more detailed organizational/structure charts.
- Beneficial ownership, including disclaimers of beneficial ownership by affiliates of the private equity firm or fund and identification of natural persons who have voting or investment discretion over securities held by the private equity fund.

Paul M. Rodel
pmrodel@debevoise.com

Benjamin R. Pedersen
brpedersen@debevoise.com

UK Telco Fined for Cyber Breach: Lessons Learned

> "The TalkTalk penalty is a timely reminder of the global trend of increasing regulatory scrutiny of businesses' cybersecurity posture. Companies can learn from TalkTalk's experience to better protect themselves."

On 30 September 2016, the UK's Information Commissioner's Office (ICO) fined TalkTalk Telecom Group plc a record £400,000 for alleged data security failings that allowed a hacker to access almost 157,000 customers' personal information. The monetary penalty serves as an opportunity for companies to regularly reassess their cybersecurity risk profile—particularly in the context of mergers, acquisitions and post-M&A integration—and ensure that their systems and controls meet regulators' latest expectations.

What Went Wrong?

In 2009, TalkTalk, the UK TV, broadband and telecoms provider, acquired the UK operations of the Italian telecoms operator, Tiscali. According to the ICO, unknown to TalkTalk, Tiscali had legacy webpages that allowed access to a customer database and which remained accessible via the internet post-acquisition.

The database was stored on an outdated version of MySQL, affected by a software bug for which a fix had been available since 2012. In October 2015, a hacker exploited this vulnerability on three legacy Tiscali webpages to access the database. The hacker acquired almost 157,000 customers' personal data such as their names, addresses, dates of birth, telephone numbers, email addresses and financial information.

The ICO fined TalkTalk for what were, in the regulator's view, two breaches of the UK Data Protection Act 1998: First, for failing to take appropriate technical and organisational measures against the unauthorised or unlawful processing of personal data. Second, for keeping customers' data for longer than was necessary for the purposes it had been collected.

While the ICO found that TalkTalk had not deliberately breached its obligations, its purported failings still represented a "serious oversight" which led the ICO to issue a record breaking £400,000 fine.

Lessons Learned

The TalkTalk penalty is a timely reminder of the global trend of increasing regulatory scrutiny of businesses' cybersecurity posture. Companies can learn from TalkTalk's experience to better protect themselves. The following takeaways from the TalkTalk penalty notice may be helpful.

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***First**, (re)identify your information architecture.* Companies should know what data they hold and where and how. This is not a one-off task; companies should constantly monitor changes which may affect their data security requirements. In the ICO's view, by apparently failing to audit Tiscali's webpages either during pre-acquisition due diligence or following acquisition in 2009, TalkTalk left the door open for hackers six years later.

Businesses may, therefore, wish to identify ahead of time situations that might require a non-routine reassessment of their data architecture, such as acquiring another company, changing data hosting arrangements or retiring old IT systems.

***Second**, adopt tailored and proportionate protections.* Not all data should necessarily be treated equally. Companies are well advised to determine which data assets are most critical, not only to the company itself, but also to its customers. For instance, the ICO said TalkTalk ought reasonably to have known that failing to adequately protect this particular database could cause substantial damage to those whose data was stored on it.

A proportionate protection framework may enable a company to deploy resources where they are needed most and to use cybersecurity budgets more efficiently. In TalkTalk's case, the ICO emphasised that the fact that the customer database contained financial information heightened the need for robust technical and organisational safeguards. It found that TalkTalk overlooked the need to ensure that it had robust measures in place to protect such data, despite having the financial and staffing resources available to do so. Companies may, therefore, wish to differentiate between the types of data they hold, how each category is protected and how long each is kept to help minimise cybersecurity risk efficiently and in a risk-based manner.

"A proportionate protection framework may enable a company to deploy resources where they are needed most and to use cybersecurity budgets more efficiently."

***Third**, be proactive.* While cyber threats are often asymmetric (you cannot control a hacker), businesses should consider whether they have adequate systems and controls in place which allow them to identify and monitor suspicious activity and discover vulnerabilities. This ranges from the high tech (*e.g.*, periodic penetration testing and real time data monitoring) to routine housekeeping (*e.g.*, enforcement of document retention policies that call for periodic purging of older data). The ICO penalised TalkTalk for not updating its database software to address a known vulnerability, in what it called an "ongoing contravention". It is therefore important that companies have ways to systematically pre-empt, identify and quickly resolve these sorts of issues.

***Fourth**, be ready to respond and remediate.* Regulators do not expect perfection. Companies may, however, be cast as a villain, rather than a victim, if they are not prepared to deal with an attack quickly, effectively and transparently, with a focus on protection of consumers. The ICO recognised that TalkTalk had been the subject of a criminal attack as a mitigating factor in its decision to fine the company. The ICO also recognised, as mitigating factors, that TalkTalk took substantial remedial action, notifying affected customers and offering 12 months of free credit monitoring.

Companies generally are better placed to deal with a breach if they have a carefully crafted incident response plan in place ahead of time. By pre-emptively thinking about how and who will deal with incidents of varying degrees of severity, businesses can respond more quickly and more effectively when they arise. For

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example, knowing in advance what information you will need to give regulators, customers and the press (and who will give it) may help a business channel scarce resources in a time of crisis.

“Companies generally are better placed to deal with a breach if they have a carefully crafted incident response plan in place ahead of time.”

The Future

With regulators’ ever-increasing focus on cybersecurity showing no signs of abating, companies should act now to ensure they have a robust framework to address cybersecurity risk. While some may see the TalkTalk fine as relatively lenient, the EU General Data Protection Regulation, which comes into force in May 2018, brings with it the potential for increased penalties of up to the greater of €20 million or 4% of global annual turnover for the preceding financial year. The UK Financial Conduct Authority is also increasingly interested in cybersecurity issues and expects all regulated entities to have a pervasive “security culture…from the Board down to every employee.”

Companies (especially those that are FCA-regulated) are likely, therefore, only to see the cost of noncompliance increase in the future. If applied to TalkTalk, for example, the new EU regime hypothetically could have resulted in a monetary penalty of more than £50 million, far exceeding the maximum £500,000 penalty it could have received at present. Businesses may, therefore, wish to act now, rather than pay the tariff later.

Saqib Alam
saqibalam@debevoise.com

Luke Dembosky
ldembosky@debevoise.com

Jeremy Feigelson
jfeigelson@debevoise.com

Robert Maddox
rmaddox@debevoise.com

James J. Pastore
jjpastore@debevoise.com

Jane Shvets
jshvets@debevoise.com

Final Section 385 Regulations Exempt Common Private Equity Fund Structures

"The proposed regulations were issued in response to perceived abuses involving so-called 'inversion' transactions but had a much broader reach. They would have dramatically and unfavorably changed long-established rules and practices for distinguishing between debt and equity issued between related parties."

The U.S. Internal Revenue Service rocked the tax world in April 2016 by issuing proposed regulations under Section 385 of the U.S. Internal Revenue Code. The proposed regulations were issued in response to perceived abuses involving so-called "inversion" transactions but had a much broader reach. They would have dramatically and unfavorably changed long-established rules and practices for distinguishing between debt and equity issued between related parties. These regulations have now been finalized and, while still far-reaching, the final regulations have a narrower scope and impose a lighter administrative burden than the April version of the regulations. Fortunately for the private equity industry, common fund structures and portfolio company borrowings are now much less likely to be caught by the final regulations than would have been the case had the regulations been adopted as originally proposed.

The Regulations Recharacterize Certain Debt as Equity

The final Section 385 regulations apply to debt issued by a U.S. corporation to another corporation that is part of the same "Expanded Group." An Expanded Group generally means a group of corporations that are directly or indirectly 80%-owned (by vote or value) by a common parent corporation. As noted above, the regulations proposed last April were issued in response to perceived abuses involving inversion transactions, which often use intercompany debt to reduce the taxes paid by U.S. members of the corporate group. However, the scope of the regulations was and is not limited to these "earnings-stripping" transactions. In a drastic departure from decades of settled law and practice, both the proposed and final regulations automatically recharacterize debt issued by one Expanded Group member to another (an Expanded Group Instrument or EGI) as equity for U.S. federal income tax purposes in some cases, even though the EGI would be treated as debt under general U.S. tax principles. Once recharacterized, interest payments on the debt instrument will no longer be deductible, and will instead be treated as distributions on equity potentially subject to U.S. withholding tax if paid to a non-U.S. member of the Expanded Group.[1]

To avoid recharacterization, EGI issuers must satisfy documentation requirements each time they issue debt to another Expanded Group member. The documentation must contain evidence of the following:

- an unconditional obligation to pay a sum certain,

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1. As background, there are important differences between the tax treatment of debt and equity. Interest on debt is deductible, and dividends are not. Repayments of principal on debt are not taxable, while payments on equity are generally treated as taxable dividends. Finally, dividends are generally subject to withholding taxes when paid to non-U.S persons, while principal and most interest payments on debt are not.

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- the holder's legal rights as a creditor (for example, the right to cause an event of default or acceleration of the EGI),
- a reasonable expectation of repayment (which may consist of cash flow projections, financial statements, business forecasts, etc.) and
- actions evidencing an ongoing debtor-creditor relationship (including evidence of payments of principal and interest or, in the event of default, evidence of the EGI holder's reasonable exercise of its creditor's rights).

Fortunately, the final regulations extended the time period for satisfying the documentation requirements to the date the EGI issuer is required to file its federal income tax return (including extensions). EGI issuers must also navigate a complex "funding rule" that automatically recharacterizes as equity an EGI issued within 36 months before or after a dividend distribution or certain intragroup acquisitions by the EGI issuer, absent an applicable exception. The documentation requirements apply to debt issued on or after January 1, 2018, while any EGI issued on or after April 5, 2016 is at risk of recharacterization under the funding rule.

The Final Regulations Are Onerous, But Less So Than Those Originally Proposed

So, where's the good news for the private equity industry? For starters, the regulations as originally proposed threatened to extend these rules to loans made by investments funds to "blocker" corporations, but the IRS did not do so in the final regulations. Under the final regulations, blocker loans are generally outside of the scope of these rules unless the blocker corporation is directly or indirectly owned by an 80% corporate shareholder and is a domestic corporation. This could occur where (1) a domestic blocker corporation is established for a single corporate investor in a fund of one or a separately managed account or (2) an offshore feeder entity, treated as a corporation for U.S. tax purposes and established for non-U.S. and tax-exempt investors, makes an investment through a domestic blocker corporation. The IRS noted that it continues to study blocker loans. Although blocker loans are not covered by the final regulations, private equity funds may find it prudent to comply with the documentation requirements to better withstand any IRS challenges to debt characterization of blocker loans under a general debt-equity analysis.

> "Despite these improvements, the final regulations remain very complex and impose new burdens and limitations on common intercompany financing transactions at the portfolio company level, such as debt push-down transactions. As a result, advice on proper structuring is essential."

The final regulations also turn off certain "downward" attribution rules that, under the proposed regulations, would have created Expanded Groups from corporations that are only marginally related to each other. For example, under a literal reading of the proposed regulations, a bank and a private equity fund's corporate portfolio company would be members of an Expanded Group if the parent of the bank owned any interest in the private equity fund, no matter how small. As a consequence, any loan made by the bank to the portfolio company would have been subject to potential recharacterization under the proposed regulations. These downward attribution rules have been eliminated from the final regulations.

Of good news more generally, the final regulations allow EGI issuers to make distributions out of earnings and profits accumulated since April 4, 2016 without triggering automatic recharacterization under the funding rule, a more generous look-back period than was provided under the proposed

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regulations. In addition, the final regulations allow certain contributions of equity to the Expanded Group member to shield distributions that are not otherwise protected by the earnings and profits exception. The final regulations also exempt the first $50 million of debt of an Expanded Group from recharacterization. And unlike the proposed regulations, the final regulations exempt debt issued by non-U.S. corporations and S corporations.

Despite these improvements, the final regulations remain very complex and impose new burdens and limitations on common intercompany financing transactions at the portfolio company level, such as debt push-down transactions. As a result, advice on proper structuring is essential.

A Final Thought

The regulations remain controversial and were heavily criticized by the business community and by Republican Congressional leaders, who said that they were rushed through the approval process for political reasons. Given the election outcome, might the Trump Administration scrap the final regulations? Only time will tell. Stay tuned.

Gary M. Friedman
gmfriedman@debevoise.com

Peter A. Furci
pafurci@debevoise.com

Adele M. Karig
amkarig@debevoise.com

Peter F.G. Schuur
pfgschuur@debevoise.com

Rafael Kariyev
rkariyev@debevoise.com

Debevoise & Plimpton

New York
919 Third Avenue
New York, NY 10022
1 212 909 6000

Washington D.C.
801 Pennsylvania Avenue N.W.
Washington, D.C. 20004
1 202 383 8000

London
65 Gresham Street
London
EC2V 7NQ
44 20 7786 9000

Paris
4 place de l'Opéra
75002 Paris
33 1 40 73 12 12

Frankfurt
Taunustor 1 (TaunusTurm)
60310 Frankfurt am Main
49 69 2097 5000

Moscow
Business Center Mokhovaya
Ulitsa Vozdvizhenka, 4/7
Stroyeniye 2
Moscow, 125009
7 495 956 3858

Hong Kong
21/F AIA Central
1 Connaught Road Central
Hong Kong
852 2160 9800

Shanghai
13/F, Tower 1
Jing'an Kerry Centre
1515 Nanjing Road West
Shanghai 200040
86 21 5047 1800

Tokyo
Shin Marunouchi Bldg. 11F
1-5-1 Marunouchi, Chiyoda-ku
Tokyo 100-6511
Tel: +81 3 4570 6680
Fax: +81 3 4570 6681