Debevoise & Plimpton

Private Equity Report

WHAT'S INSIDE

"It's the S.E.C. How do you plead?"

Another Message to Private Equity Firms on Broker Registration – This Time from Enforcement

On June 1, 2016, the U.S. Securities and Exchange Commission(the "SEC") settled an enforcement action against a U.S. private equity firm (the "PE Sponsor") for a number of violations, including acting as an unregistered broker.[1] In its settlement order and public statements, the SEC emphasized that the PE Sponsor had acted as an unregistered broker because it sourced, structured and negotiated the acquisition and disposition of portfolio companies for the funds that it managed and charged the portfolio companies transaction fees for those services. All private equity fund sponsors should carefully review their transaction fee structures in light of this enforcement action.

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1. In the Matter of Blackstreet Capital Management, LLC, SEC Release Nos. 34-77959, IA- 4411 (Jun. 1, 2016).

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Private Equity Firms As Brokers

Since the beginning of the private equity industry in the 1970s, many private equity firms have collected fees from portfolio companies in connection with the acquisition or disposition of portfolio companies by funds closely affiliated with the private equity firm. Typically, the private equity firm would have sourced, negotiated and executed the transaction—sometimes but not always with the involvement of an investment bank or other registered broker-dealer—as a core part of the mix of investment advisory services that the private equity firm provided to the fund.

The issue of whether this practice would result in the private equity sponsor becoming a broker has been on the SEC's radar since at least 2013, when the Chief Counsel of the SEC's Division of Trading and Markets gave a speech (the "TM Speech") raising this issue.[2] At or about the same time, the SEC's Office of Compliance Inspections and Examinations asked several private equity firms to provide explanations of why they were not required to register as brokers based on their receipt of transaction fees. However, the SEC staff has not provided any further public guidance and, until now, there have been no enforcement actions.

The settlement order released on June 1 states that in connection with the acquisition and disposition of portfolio companies or their assets, "some of which involved the purchase or sale of securities," the PE Sponsor "provided brokerage services to and received transaction-based compensation from the portfolio companies" and that this activity caused the PE Sponsor "to be acting as a broker" without having registered as such under Section 15 of the U.S. Securities Exchange Act of 1934. The services that the PE Sponsor provided included "soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions."

The settlement order does not go into any further detail concerning the nature of these services or whether the PE Sponsor engaged in any abusive activities in connection with providing these services. The SEC emphasized that the limited partnership agreements ("LPAs") governing the PE Sponsor's funds "expressly permitted [the PE Sponsor] to charge transaction or brokerage fees." The significance of this statement is unclear. The settlement order also notes that the PE Sponsor did not retain an investment bank or broker-dealer to provide these brokerage services, but instead performed these services in-house. The settlement order does not clarify whether the presence of an investment bank or broker-dealer in the transaction would have changed the result.

In addition, the settlement order does not address whether the PE Sponsor offset transaction fees against its management fee. In the TM Speech, the then-Chief Counsel of the Division of Trading and Markets stated that "to the extent the advisory fee is wholly reduced or offset by the amount of the transaction fee, one might view the fee as another way to pay the advisory fee, which, in my view, in itself would not appear to raise broker-dealer registration concerns." The settlement does not clarify whether the SEC staff continues to hold this view.

Other Issues Addressed in the Settlement Order

The PE Sponsor was also charged with a number of violations under the anti-fraud provisions of the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), largely related to issues that the SEC has focused on in other enforcement actions involving private fund sponsors. This enforcement action serves as a reminder of the SEC's concerns over conflicts of interest and disclosure.

- *Operating Partner Fees.* The PE Sponsor charged fees to portfolio companies of one fund for providing various employees of the PE Sponsor to perform certain senior-level operating and management services to these companies in circumstances where the companies were having difficulty recruiting suitable talent to work directly

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2. See Debevoise Client Update: SEC's Division of Trading and Markets Delivers a Message to Private Fund Sponsors About Potential Broker-Dealer Registration Issues (18 April 2013), available at http://www.debevoise.com/insights/publications/2013/04/secs-division-of-trading-and-markets-delivers-a-__.

for them. The fund's LPA did not expressly address these types of fees or specifically authorize the PE Sponsor to charge these fees to the portfolio companies.

- *Political and Charitable Contributions and Entertainment Expenses.* In several instances, the PE Sponsor used fund assets for purposes that were not expressly authorized by the funds' LPAs, including to make political and charitable contributions and to pay for certain entertainment expenses. The SEC noted that the PE Sponsor had provided disclosure that the fund assets had been used to make political and charitable contributions and to pay entertainment expenses; however, the disclosures had not been made until after the limited partners had committed their capital and after the contributions had been made and the expenses incurred. In the case of the entertainment expenses, the PE Sponsor did not take sufficient steps to ensure that the expenses were allocated appropriately among the PE Sponsor and the funds or to adequately track or keep records of the entertainment.
- *Conflicted Transactions.* The PE Sponsor provided employees who performed services for portfolio companies with the opportunity to invest alongside the funds in these companies pursuant to agreements that granted the portfolio companies exclusive rights to repurchase the employees' shares at fair market value in the event of the employees' departure or termination. On one occasion, and in violation of these agreements, the PE Sponsor purchased a departing employee's shares "without disclosing its financial interest or obtaining appropriate consent to engage in the transaction."
- *Avoiding Capital Calls.* The principal of the PE Sponsor acquired fund interests from certain limited partners and then directed the fund's general partner (which he also controlled) to waive his obligation to satisfy future capital calls associated with new investments. These acquisitions and subsequent waivers were contrary to the terms of the fund's LPA.
- *Inadequate Policies and Procedures.* The PE Sponsor was found to have failed to adopt written policies and procedures reasonably designed to prevent violations of the Advisers Act as required by Rule 206(4)-7 with respect to the matters described above.

Penalties

The settlement order describes sanctions that include a censure of the PE Sponsor, a cease and desist order and payments of approximately $3.1 million, including a $500,000 civil penalty, $2.3 million of disgorgement and $300,000 of prejudgment interest. Approximately $500,000 of the disgorgement and prejudgment interest will be paid to one of the PE Sponsor's funds (and its limited partners) that was affected by the alleged violations.

* * *

As noted above, this settlement signals the SEC's heightened focus on transaction fees. All private equity firms should carefully review their transaction fee structures in light of this enforcement action. In addition, the settlement serves as a useful reminder to private equity firms to review fund disclosures concerning fees and expenses and to obtain appropriate consents before engaging in transactions that present conflicts of interest.

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Fasten Your Seatbelts: Brexit's Implications for Private Equity

"The spectrum of potential models on which the UK could base its new relationship with the EU ranges from a Norway-like arrangement, representing the closest possible post-Brexit relationship with the EU without actually being a member of the EU, to a trade-only arrangement, with the UK trading with the EU merely as a member of the World Trade Organization…."

On June 23, 2016, Britain will hold a historic referendum to decide whether to exit the European Union ("EU"). Media coverage has become frenzied as Eurosceptics and Europhiles exhaust every conceivable argument as to the pros and cons of leaving or staying in the EU. What is much less certain, however, is what happens after June 23 if the British public vote in favour of leaving the EU. The reality is that, until we know precisely what type of relationship with the EU the UK would re-negotiate in the event of a Brexit, it is impossible to say how exactly private equity firms and funds, and their portfolio companies, would be affected by Britain's departure. What is certain is that following an "out" vote, the uncertainty would continue as negotiations evolve over a period of years.

Post-Brexit Models

The spectrum of potential models on which the UK could base its new relationship with the EU ranges from a Norway-like arrangement, representing the closest possible post-Brexit relationship with the EU without actually being a member of the EU, to a trade-only arrangement, with the UK trading with the EU merely as a member of the World Trade Organization ("WTO").

Among the most commonly mentioned models are:

European Economic Area ("EEA") membership. This model would closely mirror the relationship Norway currently enjoys with the EU. As a member of the EEA, Britain would pay a fee to preserve its access to the single market and to continue enjoying the benefits of free movement of goods, services, workers and capital. However, although the UK would still be required to implement a large portion of EU legislation, it would lose all formal influence over the EU legislative process.

Switzerland-like arrangement. This model would require Britain to apply to join the European Free Trade Association ("EFTA") and then negotiate a raft of bilateral agreements with the EU governing UK access to the single market. The substance and scope of these agreements would likely vary based on the sector to which the particular agreement applied. Looking at the Swiss model, for example, the Swiss and the EU did not reach an agreement with respect to financial services and Swiss banks are required to operate in the EU through subsidiaries located in the EU. The EU has labelled this model complex and flawed, making it less likely that it would agree to a similar approach in the event of a Brexit.

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Turkish model. This model would mirror the customs union currently in place between the EU and Turkey. The UK would enjoy tariff-free access to the internal market for goods, but not with respect to services. Further, the UK's ability to enter into agreements with other countries without EU consent would be limited.

Free trade agreements ("FTA"). This model would mirror the recently negotiated FTA between Canada and the EU. In contrast to a customs union, entering into a FTA with the EU would not require the establishment of common external tariffs. As such, the UK would be free to impose different quotas and customs than those imposed by the EU on third-party countries. A potential issue with such an arrangement, however, is that FTAs are usually designed for trade in goods rather than services. This would mean, for example, that the UK's ability to export financial services to the EU might be significantly hindered.

World Trade Organization. This model, in which the UK would trade with the EU solely on the basis of being a WTO member, would mark the greatest departure from the current EU-UK relationship. Although EU law would no longer apply in the UK under this arrangement, Britain would lose the associated benefits of the internal market that it currently enjoys. As an example, UK exports to the EU could face high tariffs and EU product standards would still need to be satisfied by exporters.

"Another consideration for private equity firms is the effect of a Brexit on their portfolio companies, from day-to-day governance to the ability to exit such investments."

Shifting Regulatory Landscape

The European Alternative Investment Fund Managers Directive ("AIFMD") perhaps is the most fundamental European regulatory change impacting managers of private funds in recent memory. The AIFMD is an EU directive that aims to establish a harmonised regulatory and supervisory framework for fund managers (European and non-European) that manage and/or market alternative investment funds in the EU. Currently, there are significant differences between the AIFMD regime applicable to a European fund manager and the AIFMD regime applicable to a non-European fund manager.

A UK fund manager generally is required to be authorised by the UK Financial Conduct Authority to "manage an alternative investment fund." Such authorisation gives rise to more burdensome regulatory obligations than applied prior to the implementation of the AIFMD. The benefit of AIFMD authorisation is that a UK fund manager may avail itself of a pan-European "marketing passport" in respect of its European funds. The marketing passport allows for the marketing of a fund to "professional investors" across Europe without having to rely on national private placement regimes, *i.e.*, the UK fund manager only has to comply with one set of rules to market its European fund across Europe. The marketing passport currently is not available to a non-European fund manager, with the consequence that a non-European fund manager must navigate the divergent national private placement regimes when marketing a fund to European investors.

In the event of Brexit, and subject to the type of relationship negotiated between the UK and the EU, the position of the UK fund manager will need to be carefully considered both as to:

(i) the nature and scope of the regulatory regime that the UK fund manager is subject to. For example, will the UK fund manager face the same regulatory obligations as it currently faces?

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(ii) the type of access the UK fund manager will have, and the routes that need to be followed to gain access, to its European investor base. For example, will the UK fund manager be in a position to continue to use the AIFMD marketing passport?

Operating and Exiting Investments Post-Brexit

Another consideration for private equity firms is the effect of a Brexit on their portfolio companies, from day-to-day governance to the ability to exit such investments.

An obvious concern would be a loss of access to the internal EU market and the consequent loss of free movement of goods, services, workers and capital. A business based in the UK that relies on European employees, for example, or that is heavily dependent upon the import or export of goods or services to or from the EU would be forced to consider how best to adapt as a result of any new barriers.

Key portfolio company contracts, such as financing agreements, may also be affected. Geographical definitions referencing the EU, force majeure clauses, material adverse change clauses and repayment events are just some of the terms that might need to be re-examined in light of a potential Brexit.

A Brexit might affect sponsors' own planned exits from their portfolio companies. Currently, if companies want to offer shares to the public within the EEA or to list them on a regulated market, regulatory approval of their prospectus or equivalent securities offering document (if required) needs to be obtained in one member state alone. Following a Brexit, however, this principle of "mutual recognition" might no longer apply to UK companies, the result being that a company wanting to offer shares to the public in the UK or list on a UK exchange and elsewhere in the EEA would need to obtain approval of its prospectus by regulators in both locations. Firms looking to exit their investments via a listing on a regulated market post-Brexit would need to bear in mind these potential cost and timing implications.

In addition to the prospect that final post-Brexit arrangements disrupt sponsor plans for operating existing portfolio companies, sponsors will need to be prepared for the economic costs of uncertainty. It will take time for the issues arising from a Brexit to be resolved and, during the period of uncertainty, ordinary course operating and exit activities may be more challenging. Finally, a Brexit would put further short-term pressure on already fragile European economies, potentially affecting portfolio company business models more broadly.

Conclusion

The *immediate* impact of a Brexit is fairly certain. The UK would have to notify the European Council of its intention to leave, after which it would officially cease being a member state upon either the date of entry into an agreement with the remainder of the EU with regard to its exit terms or, failing that, automatically two years after notification, unless the European Council unanimously agrees to extend this period. What remains uncertain, however, is what form an exit agreement is likely to take and its effects on private equity firms' participation in the UK and EU markets. In practice, reaching an agreement on UK exit terms would likely be an extended process involving exhaustive negotiation that could well take longer than two years. Not until we know the precise terms of any agreement, however, will we truly appreciate the impact of a Brexit on businesses, including private equity firms, currently operating throughout the EU. Fasten your seatbelts.

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Heading for the Exit? Be Sure Your Registration Rights Work

"In this article, we explain what registration rights are, why they matter, and the key issues on which private equity firms should focus as they structure these arrangements."

Successful exits are critical for private equity sponsors. A sale at an attractive valuation providing immediate liquidity is typically the cleanest and simplest path, but for some portfolio companies and in some markets an initial public offering ("IPO") will yield a better valuation—or may even be the only plausible path to exit. It can be a long road from the initial investment to an IPO. Smart financial sponsors nonetheless seek to lock in generous registration rights provisions at the time of the initial investment, when sponsor leverage is at its maximum and other shareholder constituencies with differing interests may not yet have developed, in order to maximize returns should an IPO turn out to be the best path to exit. Effective registration rights are even more important for sponsors that elect to take public company stock as consideration for sale of a portfolio company, a situation in which the selling sponsor often will not have control over the listed company but can find itself holding a block of stock large enough that registration rights are necessary to obtain an efficient exit from the position. In this article, we explain what registration rights are, why they matter, and the key issues on which private equity firms should focus as they structure these arrangements.

What Are Registration Rights and Why Do They Matter?

Under the U.S. federal securities laws, a security may be offered and sold only pursuant to a registration statement filed with the U.S. Securities and Exchange Commission (the "SEC") under the U.S. Securities Act of 1933 or pursuant to an applicable exemption from such registration. Securities sold in transactions registered under the Securities Act may be freely sold into the public capital markets. Stock held by sponsors in portfolio companies, even after an IPO, is typically not registered and may not be freely sold. And public company stock received by financial sponsors in consideration for the sale of a portfolio company is also often not registered, or is otherwise subject to limitations on transfer as a "control security."

Registration rights ensure that an investor can sell previously unregistered securities freely into the public capital markets. They consist of contractual rights obligating a company to facilitate the public resale of previously unregistered securities through one or more transactions registered with the SEC. Registration rights are typically granted at the time of an investment in unregistered equity securities and may be housed in a dedicated registration rights agreement or another transaction document, such as a stockholder's agreement. They come in two flavors: "demand" rights, which permit an

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investor to require a company to effectuate the registration of the investor's securities on an appropriate registration statement form under the Securities Act, and "piggy-back" rights, which permit an investor to require a company to include the investor's securities in a registration statement under which securities are registered for sale by the company or another investor. Demand rights may specifically permit an investor to require a company, if it is not already public, to effectuate an initial public offering or other public listing of its securities in order to facilitate the exercise of its registration rights in conjunction with or following the IPO.

In the absence of Securities Act registration, unregistered or otherwise restricted securities are most commonly sold pursuant to Rule 144 of the Securities Act. While useful, Rule 144 precludes the sale of restricted securities during an applicable holding period (which is either six months or one year, depending on the relevant facts) and subjects the sale of "control" securities (generally, securities held by a sponsor that also has a seat on the board or owns 10% or more of the company's stock) to volume and manner of sale limitations. Other exemptions from registration may be available. However, reliance on another exemption would limit the pool of potential investors to institutional and certain other sophisticated investors and typically causes purchasers to demand a "liquidity discount" on the purchase price since the securities will be "restricted" in the hands of the purchaser.

> "Customary registration rights contain a broad range of provisions that govern the frequency, timing and nature of an investor's ability to require a company to help facilitate its public sale of securities."

Getting Registration Rights Right

Customary registration rights contain a broad range of provisions that govern the frequency, timing and nature of an investor's ability to require a company to help facilitate its public sale of securities. Negotiation dynamics around key registration rights provisions are informed by the investor's desire to preserve the right to effectuate numerous (and potentially rapid) sales, and the company's desire for orderly public dispositions of securities that minimize interference with ordinary course business and capital-raising activities.

Is Your Security a "Registrable Security"? A threshold question is whether the security held by an investor falls within the scope of the registration rights. Registration rights are typically limited to securities that are thought to "need" them in order to achieve liquidity. An investor will want to ensure that registrable securities remain so at least until the investor is able to resell the securities under Rule 144 without limitation (*e.g.*, until any applicable holding period has fallen away and until the securities it holds cease to be "control" securities).

General Limitations – Size, Frequency and Scope. An investor's natural inclination is to negotiate for open-ended registration rights that permit unlimited and frequent registrations of as many or as few securities as desired. From the company's perspective, limiting the number or frequency of registrations (or "take-downs" under a shelf-registration statement) during a given period (or in the absolute) and setting a minimum number of securities with respect to which registration rights may be exercised helps to limit management distraction (especially management's participation in "roadshows" and other marketing efforts) and the investment of company resources. These types of limitations could have a significant restrictive effect on an investor's ability to effectively and timely monetize its investment. Sponsors should consider whether the proposed restrictions unreasonably impair their ability to achieve investment goals and are appropriately tailored relative to the number and value of the securities held. Specifically, sponsors should review whether registration

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rights fall away after a date certain or following the occurrence of certain events (*e.g.*, the registrable securities outstanding fall below a certain numerical or fair market value threshold) and whether the fall away trigger aligns with the sponsor's investment horizon.

Cutting Back the Piggies. As noted above, piggy-back rights allow an investor to have its securities included in a registration statement for the offer and sale of securities initiated by the company or another investor. Typically, only larger holders receive demand registration rights, while piggyback rights are granted to a broader group. However, market demand may not be sufficient to absorb all shares proposed to be offered and sold. Further, while market demand may be sufficient to absorb the offered shares, the market clearing price may be depressed and the subsequent trading price of the securities may be negatively affected if the size of the offering is not calibrated appropriately. Registration rights typically contain a mechanism intended to address this situation in marketed offerings whereby some number of shares may be eliminated from an offering. This mechanism, by which shares are "cutback" according to a stipulated priority, is typically initiated at the direction of the underwriter for the offering with the type of offering and identity of the party initiating the registration or offering usually dictating the level of priority into which an investor's shares fall. If a registration statement is filed by the company for a primary offering of its shares, it would be typical for the company's shares to have first priority over piggy-backing investors. Similarly, in the case of a demand registration, the demanding holder would typically receive top priority. If several large investors hold relatively equivalent numbers of registrable securities, it would also be common for the securities owned by those investors to be grouped together for purposes of a cutback to facilitate a more orderly approach to marketed secondary transactions.

> "Getting registration rights right can mean the difference between a highly successful investment and a frustrating hit to internal rates of return caused by a delayed exit."

Suspension Periods – How Often and for What? Registration rights will customarily provide a company with the right to suspend or postpone a requested registration (or shelf takedown request) under certain circumstances, most commonly when the company would be required to publicly disclose material non-public information prematurely. Understandably, the company will want to reserve the authority to suspend the registration and prevent premature disclosure of that information. However, a company's ability to suspend a registration is typically cabined by frequency and duration limitations on the suspension period. Sponsors should focus on these provisions to be certain the company is not able to effectively block its ability to sell during favorable market windows.

Lock-Ups – How Long and for Which Transactions? Parties to registration rights agreements are generally required to execute a lock-up agreement (especially investors with significant holdings). These agreements will block sales of securities around the time of underwritten sales of the company's equity securities, including sales made in connection with an IPO and secondary sales. Sponsors need to be careful that lock-ups do not impede the ability to opportunistically sell into open-market windows, especially given the potential interaction with suspension periods as described above.

Facilitating Block Sales. Once a company has achieved a certain "seasoned" status, it may no longer

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be necessary to conduct extensive (or any) marketing efforts in connection with an SEC-registered distribution of shares. Without the drag of a marketing process, an investor may be able to efficiently and quickly sell a large number of shares by arranging for the acquisition of a block of shares through a registered "bought deal" or "block sale." These transactions are common among investors focused on hitting short market windows (*e.g.*, an investor could require a company to file an automatically effective shelf registration statement on Form S-3 and immediately thereafter execute a block sale under that shelf). Many registration rights agreements do not adequately or explicitly contemplate these types of transactions as market practice has generally outpaced registration rights technology. In order to retain the flexibility to facilitate effective and timely execution, these provisions should be drafted with consideration given to the nature and timing (if any) of piggyback notices that a demanding investor must deliver to nondemanding holders when contemplating a block sale of securities. Similarly, with speed integral to the success of block sales, investors should also consider how soon following a demand in respect of a block sale the company must file the registration statement and make other SEC filings necessary to effectuate the transaction.

Summing It Up

Getting registration rights right can mean the difference between a highly successful investment and a frustrating hit to internal rates of return caused by a delayed exit. Buried beneath the legal detail are key business judgments, and the time to make them is early when the sponsor is able to shape the playing field most effectively with an eye to a successful exit.

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April 15, 2016
Debevoise Wins *Who's Who Legal* Award for New York Firm of the Year

April 11, 2016
Partner Jim Pastore Recognized in *Cybersecurity Docket's* Incident Response 30

April 4, 2016
Partner Nicole Levin Mesard Elected as 2016 Fellow to the American College of Real Estate Lawyers

March 30, 2016
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March 25, 2016
M. Natasha Labovitz Named a "Dealmaker of the Year" by *The American Lawyer*

March 1, 2016
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Latest *Sun Capital* Decision Clouds Controlled Group Analysis

"The Court's decision is somewhat difficult to reconcile with the applicable statutory and regulatory authority."

The continuing *Sun Capital* saga took another sharp turn on March 28, 2016, as the District Court in Massachusetts held that two separate, but affiliated, private equity investment funds—each of which held less than a controlling interest in one of its bankrupt portfolio companies—are jointly and severally liable for the unfunded pension liabilities of the portfolio company.

The Court's decision is somewhat difficult to reconcile with the applicable statutory and regulatory authority. Although the facts on which the decision relies could be argued to be equally applicable to any funds that choose to invest in a target together—even funds of unaffiliated private equity sponsors that join in a club deal—we believe statements made by the Court indicate the decision at least should be limited to actions taken in unison by affiliated funds. Of course, this is cold comfort to most private equity firms using parallel fund structures.

Background

Two separate funds managed by Sun Capital Partners (Sun Capital's Fund III and Fund IV) invested in a portfolio company called Scott Brass. Fund III (actually two parallel funds, although no decision in the case has ever held this to be an important distinction) held a 30% interest in the investment, while Fund IV held a 70% interest. Scott Brass incurred a $4.5 million withdrawal liability when it went bankrupt and terminated its active participation in a multiemployer pension plan. Under the U.S. Employee Retirement Income Security Act of 1974 ("ERISA"), that liability can be enforced against any member of the "controlled group" of entities that includes the employer. The pension plan sought recovery from Fund III and Fund IV, arguing that the funds were part of the controlled group of entities that included the employer, Scott Brass.

There are two essential elements to controlled group liability under ERISA:

- the entities in the group must be engaged in a "trade or business"; and
- they must be under "common control."

A separate decision by the First Circuit Court of Appeals in 2013 addressed the "trade or business" prong of the ERISA controlled group liability test.[1] The March 28 decision addresses the "common control" prong of the test.

Prior to the March 28 decision, the "common control" prong of the test appeared to involve a reasonably straightforward application of well-developed tax principles. ERISA Section 4001(b) provides that

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1. See *Debevoise & Plimpton Private Equity Report*: The Sun Capital Case: Does It Affect the Taxation of Your Private Equity Fund's Gain? (Fall 2013), available at http://privateequityreport.debevoise.com/the-private-equity-report-fall-2013-vol-13-number-4/the-sun-capital-case-does-it-affect-the-taxation__.

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> under regulations prescribed by the [Pension Benefit Guaranty Corporation ("PBGC")], all employees of trades or businesses (whether or not incorporated) which are under *common control* shall be treated as employed by a single employer and all such trades and businesses as a single employer. The regulations prescribed under the preceding sentence *shall be consistent and coextensive with regulations prescribed for similar purposes by the Secretary of the Treasury under section 414(c)* of [the U.S. Internal Revenue Code (the "Code")].[2]

Section 414(c) of the Code and the related regulations apply a formulaic test. The test provides that any parent or subsidiary that sits in an 80% or greater ownership chain is deemed to be under common control (the "414 Ownership Principles"). Under these principles, ownership is measured, in the case of a corporation, by vote or value, and in the case of a partnership, by capital or profits.

The Court Discovers a "Partnership-In-Fact"

There was no question, as a factual matter, that Fund III and Fund IV each held less than an 80% ownership interest in Scott Brass, and therefore were not under "common control" based on this formulaic test. However, the Court viewed the use of this "bright-line ownership-based test" as being in "tension with the purposive approach of" ERISA. Instead, the Court found that the funds had created a deemed "partnership-in-fact" directly above their investment in Scott Brass. By deeming a partnership to exist between the two funds, the Court was able to conclude that each fund was "jointly and severally liable" for the bankrupt entity's multiemployer withdrawal liability.

We believe that the Court's finding that a deemed partnership somehow existed can be viewed, generously, as artificial and, perhaps less generously, as intended to reach a desired result. Although the decision uses the word "clear" multiple times in concluding that a partnership-in-fact existed, the decision does not establish any clear rules to establish how a partnership-in-fact is to be found (in this case, or in the next one). While observing that "the record is not clear on the precise scope" of the partnership-in-fact between Fund III and Fund IV—including which portfolio companies were covered—the Court determined that "it was clear beyond peradventure that a partnership-in-fact existed sufficient to aggregate the Funds' interests and place them under common control with Scott Brass." The Court reached this conclusion based on the facts that the funds (1) were not passive investors, brought together by happenstance, (2) had jointly invested using the same structure in five prior investments over four years, and (3) engaged in joint activity in deciding to invest. The Court's determination was apparently also influenced by the fact that, while the funds were organizationally separate, there was "no meaningful evidence of independence in their relevant co-investments." The Court also noted, without indicating the weight afforded to such fact, that all of the affiliated funds "were formally independent entities with separate owners but ultimately made their decisions under the direction of [the same two individuals]."

In declining to follow the 414 Ownership Principles to the letter, the Court instead adhered to the principle that ERISA "is a statute that allows for and may in certain circumstances require, the disregard of [organizational] formalities." The Court asserts that the question of "organizational liability is not answered simply by resort to organizational forms, but must reflect the economic realities of the business created by [the funds]." While recognizing that this view appears to create an inconsistency in the law, the Court invites "the relevant political actors" to consider "whether their enactments can be better harmonized by statute and/or regulation."

A Possibly Broad and Definitely Confusing Decision

On its face, the decision is maddeningly frustrating. As we noted at the outset, the facts on which the decision relies could be argued to be equally applicable to any funds that choose

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2. Emphasis added.

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to invest in a target together—even funds of unaffiliated private equity sponsors that join in a club deal. Although this is cold comfort to most private equity firms, at least one can point to several statements made by the Court that indicate that the decision should be limited to actions taken in unison by *affiliated* funds. For example, the Court stated "the record shows that the 70/30 split does not stem from t*wo independent funds*[3] choosing, each for its own reasons, to invest at a certain level." The Court also found no evidence of "disagreement between Sun Fund III and Sun Fund IV over how to operate [Scott Brass], as might be expected from independent members actively managing and restructuring an individual concern." Moreover, the Court found that the interposition of an intermediate holding limited liability company above the operating entity to permit each of the funds to stay below the threshold ownership required under the 414 Ownership Principles "is likewise a choice that shows an identity of interest and unity of decision-making between the Funds rather than independence and mere incidental contractual coordination." Finally, the Court concluded that the goals expressed as justifying the bifurcated ownership structure were perceived as "top-down decisions to allocate responsibility jointly."

It also is difficult to understand how the Court's finding that a partnership-in-fact exists leads to the conclusion that the two funds are jointly and severally liable for the withdrawal liability. The Court determined that there is not a singular partnership between the two funds that covers all their activities and investments. Moreover, if there were such a deemed partnership between the funds, each of the funds would own less than 80% of such partnership. Yet the decision seems to say that all the investments of each of the two funds are exposed to the bankrupt portfolio company's obligation to the multiemployer plan. We believe that this apparent inconsistency can be reconciled only if one takes the view (as the multiemployer pension plan appears to have argued before the Court) that the funds are liable for the pension obligations because they are general partners (as opposed to limited partners) of the partnership-in-fact. While this distinction is not expressly stated in the holding, the Court stated that, "if such a partnership existed, it would have complete ownership of [Scott Brass], be commonly controlled with [Scott Brass], and, if it is also a trade or business, pass withdrawal liability to the Sun Funds *as its partners*."[4] Thus, it is reasonable to conclude that the Court's analysis was that the two funds created a general partnership that was the common parent of Scott Brass under the 414 Ownership Principles, with respect to which the two funds were deemed to have unlimited liability, not under the 414 Ownership Principles, but rather as general partners under common partnership pass-through liability principles.

What's Next?

It is unclear how the rationale of the decision will fare on appeal. The Court's decision to interpose a deemed partnership could be challenged as inconsistent with the Congressional mandate to follow the 414 Ownership Principles. In addition, the Court's rationale effectively (and potentially permanently) guts a prior holding of the First Circuit in the same case, namely that fund sponsors should be able to initially structure their investments so as to avoid incurring these liabilities. On the other hand, one can read the First Circuit's 2013 *Sun Capital* decision to be sympathetic to the result in this case. It is possible that the First Circuit would instead choose to accept the District Court's analysis as described above. If so, hopefully the First Circuit will provide greater clarity on when a partnership-in-fact may or may not be found.

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3. Emphasis added.
4. Emphasis added.

New Incentive Compensation Rules: Implications for Private Equity Firms

"The minimum requirements of the proposed rules apply only to PE Managers with total consolidated assets of $1 billion or more, not counting any non-proprietary assets."

The U.S. Securities and Exchange Commission (the "SEC")has been working together with other U.S. federal financial regulators since 2011 to issue regulations under Section 956 of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that would restrict incentive compensation practices in an effort to curb "inappropriate" risk-taking at banks, broker-dealers, investment advisers and other covered financial institutions ("CFIs"). In late April and early May of this year, the SEC and several other agencies released revised proposed rules to implement Section 956.[1] The SEC's version of the proposed rules provides detail that applies specifically to investment advisers—including advisers to private equity funds ("PE Managers") and other private funds—and to broker-dealers. The proposed rules differ significantly from the original rule proposals issued in 2011.

Will the Proposed Rules Apply to All PE Managers?

No. The minimum requirements of the proposed rules apply only to PE Managers with total consolidated assets of $1 billion or more, not counting any nonproprietary assets. (In other words, third-party assets under management by the PE Manager are not included in consolidated assets for this purpose, even if GAAP requires those assets to be consolidated onto the PE Manager's balance sheet.) PE Managers with total consolidated assets of less than $1 billion are not subject to the proposed rules at all.

The more stringent provisions of the proposed rules would apply to PE Managers with $50 billion or more in total consolidated assets. However, we are not aware of more than a handful of private equity firms meeting that threshold.[2]

What Are Highlights of the Proposed Rules?

Highlights of the proposed rules applicable to any PE Manager with total consolidated assets between $1 billion and $50 billion are as follows:

- nonproprietary assets are not included in the determination of asset thresholds, even if reflected on the consolidated balance sheet, exempting all (or almost all) PE Managers—other than those controlled by bank holding

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1. See Debevoise Client Update, Compensation Practices at Financial Institutions Targeted: Proposed Incentive Compensation Rules Aim to Curb Excessive Risk-Taking, at http://www.debevoise.com/~/media/files/insights/publications/2016/04/20160426c_compensation_practices_at_financial_institutions_targeted.pdf.
2. For a detailed discussion of the requirements applicable to CFIs with $50 billion or more in total consolidated assets, please see the Debevoise Client Update referenced in note 1 above. For these larger institutions, the proposed rules: require the deferral of 40-60% of incentive compensation for 3-4 years *after* the end of a performance period (or for 1-2 years where the performance period is 3 years or more); prescribe new requirements on the form of deferred compensation; subject a broader pool of executives and significant risk-takers of the institution to these more stringent provisions; prohibit accelerated vesting of deferred awards; impose a new seven-year post-vesting clawback; circumscribe the use of certain performance measures; and prohibit hedging, among other new requirements.

companies—from the more exacting requirements of the rules and many PE Managers from the proposed rules altogether;

- in determining incentive compensation to be awarded for all employees and directors, covered PE Managers must (1) take into account both financial and nonfinancial risk-based measures and (2) subject these awards to risk adjustments, which may prove difficult to implement for standard carried interest arrangements;
- although reporting obligations are curtailed from the 2011 proposal, the proposed rules contain expanded recordkeeping requirements; and
- new corporate governance procedures are mandated, which (among other things) may require covered PE Managers to establish a board-level compensation oversight function.

The proposal contemplates a fairly lengthy transition period and a significant "grandfathering" provision. Final rules will become effective on the first day of the first calendar quarter that begins at least 540 days after the final rule is published, and the proposed rules would not apply to any incentive compensation plan with a performance period that began before the effective date of the final rules. Similar transition periods apply when a PE Manager first becomes subject to the rules.

How Are Covered PE Firms Determined Under the Proposed Rules?

CFIs under the Dodd-Frank Act include, among other institutions, investment advisers, as defined under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"), whether or not the investment adviser is required to register under the Advisers Act. Thus, the proposed rules apply both to registered investment advisers and to "exempt reporting advisers" and other international firms (including those based outside of the United States) operating under various Advisers Act exemptions.

The proposed rules introduce a new categorization framework with three asset levels to tailor prohibitions to the size of each institution. The three tiers are as follows: *Level 1*, CFIs with total consolidated assets greater than or equal to $250 billion; *Level 2*, CFIs with total consolidated assets greater than or equal to $50 billion and less than $250 billion; and *Level 3*, CFIs with total consolidated assets of greater than or equal to $1 billion and less than $50 billion. The SEC's regulatory regime for broker-dealers and investment advisers generally would apply the rules on an entity-by-entity basis, although (1) advisers that are treated by the SEC as a single investment adviser because they are operationally integrated may be aggregated and (2) broker-dealers and investment advisers that are considered subsidiaries of bank holding companies will be tagged with the consolidated asset level of the parent.

> "[T]he proposed rules apply both to registered investment advisers and to 'exempt reporting advisers' and other international firms (including those based outside of the United States) operating under various Advisers Act exemptions."

In welcome news for our PE Manager clients, as noted above, the newly proposed rules clarify that, for investment advisers only, non-proprietary assets (such as client assets under management) are *not* included in determining the adviser's total consolidated assets. This means that private fund assets and other assets under management that are consolidated into a PE Manager's balance sheet will not be counted in determining average total consolidated assets. As a result, many PE Managers will not be subject to the proposed rules at all. PE Managers that are covered by the rules (other than those controlled by Level 1 or Level 2 bank holding companies) most likely

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will be considered Level 3 CFIs and, therefore, required to comply with only the minimum requirements (thus escaping the proposed rules' most draconian provisions).

The proposed rules do allow the regulators, however, to treat a Level 3 CFI with at least $10 billion in total consolidated assets as a higher level institution (*e.g.*, as a Level 2 or Level 1 CFI) with respect to some or all of the rules *if* the CFI's complexity of operations or compensation practices are consistent with those of a Level 1 or 2 entity. The agencies expect to use this authority on an infrequent basis and only with advance notice. It does not appear that PE Managers would be likely targets of this potential exercise of discretion because they typically do not engage in the high-risk behaviors and compensation practices associated with the larger regulated institutions.

How Will Carried Interest Arrangements Be Impacted?

"Incentive-based compensation" under the proposed rules means any variable compensation, fees or benefits that serve as an incentive or reward for performance. This can include compensation earned under an incentive plan, annual bonuses or discretionary awards.

This means that:

- Payments made exclusively for reasons other than to induce performance (such as salary and retention awards) are intended to be excluded from the rules.
- Dividends and appreciation on owned (*i.e.*, vested) equity interests are also excluded.
- Annual bonuses paid out of management fees or from other PE Manager income would in most cases be covered by the rules.
- Carried interest arrangements and incentive arrangements based on fund performance may fall within the definition of "incentive-based compensation" under the proposed rules, but it is unclear how the proposed rules would apply to those arrangements.

For all incentive-based compensation, the rules envision: (1) a performance period (*e.g.*, a calendar year), followed by (2) an "award" to an individual of a specific amount of incentive compensation determined based on performance during the period (*e.g.*, a bonus paid to an employee after the end of a calendar year that was calculated based on the employee's performance during such calendar year), and (3) for the larger institutions covered by the rules, a deferral period after which the award vests and pays out. In addition, under the minimum requirements of the proposed rules, (1) each CFI must apply both financial and nonfinancial performance measures *during* the performance period (*i.e.*, *before* the incentive compensation is awarded) and (2) the compensation to be awarded must be subject to risk adjustments to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and nonfinancial performance, as discussed in more detail below.

This paradigm works with respect to annual bonuses paid to employees of PE Managers. It is not at all clear, however, how this paradigm applies to carried interest arrangements. Grants of carried interest generally are not preceded by a performance period (except to the extent award levels are based on past performance, such as fundraising success or a history of successful investing). Rather, the award of a share of the carried interest (*i.e.*, the grant of a profits interest) typically is made up-front at the commencement of a fund or commencement of employment, and sometimes at the time an investment is made.

Of course, it is true that carried interest distributions, if any, made to an employee of a PE Manager upon the sale of a portfolio investment are directly linked to the successful (or not) performance of the investment; but this is inherent in the nature of the interest. The carried interest percentage typically is *not* adjusted up or down following grant based on any assessment of performance factors. Reductions are made only to the extent time vesting is not satisfied

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or other adjustment mechanics put in place at the time of grant are utilized. In other words, there generally is no assessment of an individual's performance after the employee is given a right to share in the carry, or an adjustment to that percentage based on the employee's performance. Unless the amount of carry granted is made subject to downward adjustment (which is unusual), there is no opportunity to conduct risk adjustments as required by the rules.

In order to comply with the proposed rules, PE Managers may need to take into account risk measures for prior funds, build in risk metrics prior to the award of carried interests, or subject the carried interest to longer-term vesting periods and/or post-grant adjustments.

Many PE Managers will not want to restructure their carried interest arrangements in these ways, especially since the changes do not seem necessary to address the types of "inappropriate" risk-taking that the proposed rules were intended to address. After all, carried interest arrangements currently in use already expressly link performance to risk because carried interest distributions are only made when gains are realized in respect of a portfolio investment. We anticipate that the industry will submit comments on the proposed rules (just as they did in 2011), including requests for clarification on whether and how the proposed rules should apply to carried interest arrangements.

What Other Requirements Would Apply to the Incentive Compensation Arrangments of PE Managers?

For all PE Managers covered by the proposed rules, incentive compensation arrangements must not encourage "inappropriate" risks (1) by providing covered persons with "excessive" compensation or (2) that could lead to material financial loss.

> "We anticipate that the industry will submit comments on the proposed rules… including requests for clarification on whether and how the proposed rules should apply to carried interest arrangements."

The general framework for determining when incentive compensation is "excessive" remains largely unchanged from the 2011 proposal. Compensation is considered excessive when amounts paid are unreasonable or disproportionate to the value of the services performed by the covered person, taking into account all relevant factors, including six mandated factors: (1) the combined value of all compensation, fees or benefits provided; (2) the compensation history of the covered person and other individuals with comparable expertise at the CFI; (3) the financial condition of the CFI; (4) compensation practices at comparable institutions (based on factors like asset size, location and complexity of operations/assets); (5) for post-employment benefits, the projected total cost and benefit to the CFI; and (6) any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the CFI. The new rules clarify that this list is not meant to be exclusive but leave open the question of how relevant factors should be weighed in determining whether the amount of compensation is excessive.

In addition, incentive compensation must (1) appropriately balance risk and reward; (2) be compatible with effective risk management and controls; and (3) be supported by effective governance. With respect to all covered persons at a PE Manager subject to the rules (*i.e., all* employees and directors), each of the following newly proposed criteria must be met, in each case, prior to the award of incentive compensation:

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- *All incentive compensation arrangements must include both financial and nonfinancial measures of performance.* Financial measures are generally tied to achievement of strategic objectives, but financial measures alone cannot be the basis for determining incentive compensation. Nonfinancial measures of risk-taking activity must be taken into account.
- *The arrangement must be designed to allow nonfinancial measures to override financial measures when appropriate in determining incentive compensation.* Any violation of risk performance measures means that the employee should not be eligible to receive the full target amount of incentive compensation under the proposed rules.
- *Any amounts to be awarded would be subject to adjustment to reflect actual losses, inappropriate risks taken, compliance deficiencies or other measures or aspects of financial and nonfinancial performance.* A loss in value of equity is not considered an adjustment; the cash or percentage of equity awarded would have to be adjusted downward.

As discussed above, these requirements could prove difficult to apply in the standard carried interest context. In addition, for other types of incentive compensation in a PE Manager, for example, annual bonuses to employees, these new rules would require the enumeration of specific nonfinancial, risk-based criteria, as well as financial performance criteria, for each covered person of a firm.

Additional requirements, including deferral and clawback requirements, apply to larger (Level 1 and Level 2) CFIs.

What Are the New Disclosure and Reporting Requirements?

The proposed rules thankfully omit the annual reporting requirements of the 2011 proposal, but do impose certain disclosure and significant documentation and recordkeeping requirements on covered PE Managers. These include the annual creation and maintenance for seven years of records that document the structure of incentive compensation arrangements and demonstrate compliance with the final rules, which must be disclosed to the applicable regulator upon request. There is no requirement to report the actual amount of compensation to individuals. More exacting recordkeeping requirements apply to larger (Level 1 and Level 2) CFIs.

What Are the New Corporate Governance Requirements?

The proposed rules include a requirement for all CFIs, including covered PE Managers, that the board of directors or a committee of the board: (1) conduct oversight of the CFI's incentive programs; (2) approve incentive arrangements for senior executive officers, including the amounts of all awards and, at the time of vesting, payouts under such arrangements; and (3) approve any material exceptions or adjustments to incentive compensation policies or arrangements for senior executive officers. These rules may require CFIs to establish a board-level oversight function.

What's Next?

The proposed rules are subject to public comment. The comment period ends on July 22, 2016. Following public comment, final rules will be adopted by the various agencies.

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Japanese Securities Law Amendments: Is Your Fund Compliant?

"These amendments have added potentially onerous requirements for general partners seeking to avoid registration with Japan's regulators."

Recent amendments to the Japanese securities laws have introduced additional compliance burdens for private equity sponsors marketing their funds in Japan. These amendments have added potentially onerous requirements for general partners seeking to avoid registration with Japan's regulators. While it is unlikely these new rules will cause fund sponsors to avoid marketing in Japan altogether, sponsors should take note of the new compliance requirements and, where possible, consider taking steps once fundraising is complete to limit the ongoing application of these new requirements.

QII Targeted Exemption for Marketing and Fund Management

Prior Regime. Many private equity sponsors have historically relied on the "QII Targeted Exemption" of Japan's Financial Instruments and Exchange Law (the "FIEL") to market private equity funds in Japan. This exemption allows the general partner to offer fund interests and serve as an "investment manager" of a fund with Japanese investors without registration with the Japanese regulator, so long as (1) there is at least one "Qualified Institutional Investor" ("QII") and no more than 49 Japanese fund investors that are not QIIs and (2) the fund imposes certain restrictions on transfer by Japanese investors. Categories of QIIs include Japanese banks and insurance companies.

New Requirements. Prior to the recent amendments, the "QII Targeted Exemption" merely required the filing of a simple notice with the Japanese regulator. Under the amended law, which took effect on March 1, 2016, the general partner of a private equity fund is now also required to: (1) appoint a Japanese local representative; (2) comply with record-keeping requirements; (3) beginning April 1, 2017, file various annual reports with the Japanese regulator, certain of which (including, among others, financial statements for the entity making the notice filing, often the general partner of the general partner) will be made publicly available; (4) comply with certain new conduct requirements, including substantive fiduciary duty standards and prohibitions on certain conflicted transactions; and (5) submit additional information with the notification filing, including affidavits of good conduct. While these new requirements should largely be manageable for many sponsors, the rules are complex and, in certain cases less than clear, particularly as relates to certain of the new conduct requirements. Sponsors should consult Japanese counsel in specific cases.

No Grandfathered Status. Funds that made notification filings in reliance on the QII Targeted Exemption prior to March 1, 2016 are not exempt from these new compliance requirements. However, there is a grace period until September 1, 2016

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solely with respect to the requirements to appoint a local representative and update notification filings.

Outsourcing Exemption for Marketing Only

There is a second exemption from registration (the "Outsourcing Exemption") that applies to marketing activities carried out by a licensed placement agent in Japan. Historically, this exemption has received relatively little use, due in part to the fact that it imposes significant restrictions on the ability of a sponsor's representatives to communicate directly with prospective investors in Japan, and in part to the fact that, in practice, the sponsor will still need to rely on another exemption for ongoing fund management. However, there may be renewed interest in exploring this alternative in light of the new requirements applicable to the QII Targeted Exemption.

De Minimis Exemption for Ongoing Fund Management

A third exemption (referred to as the "De Minimis Exemption") allows fund sponsors to avoid registration with respect to ongoing management of a fund with Japanese investors. To qualify, (1) the fund, directly or indirectly, may have no more than nine Japanese investors, all of which must be QIIs or certain other permitted categories of investors, and (2) the aggregate capital contributions of these investors to the fund may not equal or exceed one-third of the total capital contributions to the fund.

> "Funds that made notification filings in reliance on the QII Targeted Exemption prior to March 1, 2016 are not exempt from these new compliance requirements. However, there is a grace period until September 1, 2016 solely with respect to the requirements to appoint a local representative and update notification filings."

Unlike the QII Targeted Exemption, the De Minimis Exemption does not trigger the new substantive compliance requirements described above. Therefore, fund sponsors should consider relying on the QII Targeted Exemption solely during fundraising, and thereafter relying on the De Minimis Exemption for ongoing fund management if the conditions are met. In such a case, a fund sponsor should file an abolishment notification with the Japanese regulator withdrawing its QII Targeted Exemption notification filing once fundraising in Japan is complete.

Similarly, fund sponsors should review their existing funds that previously relied on the QII Targeted Exemption and are no longer fundraising to determine whether those funds are able to withdraw the notification filing and rely instead on the De Minimis Exemption going forward.

Nevertheless, since the De Minimis Exemption provides an exemption from registration only with respect to ongoing investment management, sponsors will still need to rely on either the QII Targeted Exemption or the Outsourcing Exemption in respect of fundraising activities in Japan.

Conclusion

As noted above, these recent amendments to the QII Targeted Exemption will add additional layers of compliance obligations for private equity sponsors marketing their funds in Japan or to Japanese investors. While the full practical impact of these obligations remains to be seen, there are certain steps sponsors can take now to limit the need to rely on the QII Targeted Exemption, both with respect to funds that are currently in fundraising and, potentially, with respect to older funds.

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UK Carried Interest Taxation: the Good, the Bad and the Ugly

"From April 6, 2016, all carried interest amounts attributable to carry recipients residing in the UK will be classified as 'good' or 'bad' carried interest."

Last year was not the best year for private equity fund managers who hoped that the UK taxation status quo would hold steady. In the past year, we have seen: the Disguised Investment Management Fee rules take effect; the abolition of base cost shift on carried interest; the deemed UK sourcing of carried interest; and, as examined below, a new classification regime for carried interest in which "bad" carry may be subject to a combined tax rate of 47%.

From April 6, 2016, all carried interest amounts attributable to carry recipients residing in the UK will be classified as "good" or "bad" carried interest. "Good" carried interest will be taxable as it was before April 6. So, if it derives from a capital transaction, like the sale of a company, the carry will be eligible for taxation as capital gains at 28% (carried interest is specifically excluded from the new 20% capital gains tax rate), but without the benefit of base cost shift. "Bad" carry on the other hand, irrespective of the distribution's source, will be taxable as if it were a disguised investment management fee and will be subject to UK income tax and national insurance at a combined rate of 47%.

Whether an amount is "good" or "bad" carried interest depends on the weighted average holding period of the fund's investments. Each time carried interest is paid, the average holding period must be calculated and all current investments treated as sold on the date of the calculation. At the time of writing, "good" carry arises when a fund's weighted (by value) average holding period hits 40 months, with a taper starting at 36 months. For example:

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Investment A	Acquire 100	–	–	–	Dispose
Investment B	–	Acquire 100	–	–	–
Investment C	–	Acquire 300	Dispose	–	–

If, in the above example, carry is payable in each of years three and five and each investment is made at the start of, and sold at the end of, the relevant year, then, even though it ostensibly looks like the average holding period is well within the 40 month requirement, the high-value, short-term Investment C skews the calculation. Consequently, the average holding period calculations will be as follows:

Year 3	*Year 5*
A: 100 x 3 = 300	A: 100 x 5 = 500
B: 100 x 2 = 200	B: 100 x 4 =400
C: 300 x 2 = 600	C: 300 x 2 = 600
Average holding period = (300 + 200 + 600)/(500) = 2.2 years	Average holding period = (500 + 400 + 600)/500 = 3 years

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This example shows how a high value, short-term investment can skew the average holding period and demonstrates the importance of a provision in the regime that allows carried interest to be treated as conditionally exempt from the income-based carried interest rules for up to ten years after the day on which the fund starts to invest. Without this concession, during the initial years of a fund's life when there are unrealized investments, it would be difficult to satisfy the 40 month average holding period requirement.

That's the good and the bad. Now on to the ugly. The rules are dense and not for the fainthearted. They also contain some technical errors, which make their application somewhat uncertain. In recognition of the fact that sponsors employ different strategies, there are a number of sub-regimes within the rules, which adjust (for the most part favorably) the calculation of the average holding period. These regimes deal with:

- *Substantial equity stake, controlling equity stake and venture capital funds.* For these funds, the regime permits certain follow-on investments and partial disposals to be made without negatively affecting the average holding period calculation.
- *Real estate funds.* For these funds, the regime similarly allows for certain follow-on investments and partial disposals without negatively affecting the average holding period, while also recognizing that investments are not always in securities or even into the same asset. For example, a follow-on investment may be in adjacent property.
- *Fund of funds and secondaries funds.* For these funds, the regime resolves the tricky question of what constitutes the "investment" for the average holding period calculation, with an investor fund and its investments falling within this sub-regime being permitted to look at the investee fund rather than the underlying portfolio investments. In addition, the regime provides for favorable follow on and partial disposal treatment.
- *Direct lending funds.* For these funds, the regime presumes carried interest to be income-based carried interest, although the presumption can be rebutted if the fund satisfies various conditions.
- *Special opportunities funds.* For these funds or, more specifically, debt funds that invest in distressed debt with a view to securing (1) direct or indirect ownership of the debtor's assets or (2) assets that are subject to a security interest in respect of the debt, the debt and relevant assets are treated as one investment for the purposes of calculating the average holding period. These are referred to as "loan to own" investments. We assume that this should catch situations where a fund obtains control of the debtor itself, but this is not entirely clear in the definition.

The conditions and exceptions to the above sub-regimes are fairly involved and no fund should assume that it will necessarily fall within the regime relevant to its investment strategy. For example, to qualify, a venture fund must satisfy conditions regarding the type of investments it makes, and then, further conditions with regard to each specific investment, including conditions relating to portfolio company activities, the fund's involvement at board level and the use to which invested capital with be put.

> "Overall, the new income-based carried interest rules are certainly better than those originally drafted in December 2015. The trade off, however, is the level of complexity that has been added to the regime."

Provision has been made in the draft rules for "unwanted short-term" investments. Inevitably, there are a series of conditions which need to be satisfied for an unwanted short term investment to be outside the income-based carry rules. Notably, the time limit for such disposal is

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variable depending on the asset class; for investments in land, the period is 12 months, for securities in unlisted companies, 6 months and for "direct loans", either 120 days or 6 months depending on the fund's other investments. These timings seem broadly in line with the market, but must be kept in mind by management teams when planning such activities.

The overall makeup of a fund's investments will also need to be considered: the new regime ceases to apply once it is reasonable to assume that at least 25% of the fund's investments will be in unwanted short-term investments. There are some technical issues with the drafting of this concession, which means that it is not as valuable as it perhaps initially seems and, as with the sub-regimes discussed above, no assumptions should be made.

The much vaunted exclusion for carried interest holders operating in an employee environment has been retained, which is helpful for any manager that is a corporation. Wide anti-avoidance rules, however, mean that managers currently operating as partnerships should not view incorporation as an easy fix.

Investment managers receiving carried interest in the UK in respect of services performed for the fund prior to their arrival in the UK will be able to receive a proportion of their carried interest outside of this regime.

Overall, the new income-based carried interest rules are certainly better than those originally drafted in December 2015. The trade off, however, is the level of complexity that has been added to the regime. Fund managers need to take stock of their current arrangements and consider how they plan to deal with these rules for carried interest arising on or after April 6, 2016.

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Recent and Upcoming Events

October 27, 2016
Fall GC Forum Dinner
Debevoise Event
Debevoise & Plimpton LLP
New York

September 29, 2016
PE Industry-Wide Fall Party
Debevoise Event
Debevoise & Plimpton LLP
New York

September 14, 2016
Navigating the Private Equity Landscape in India
Geoffrey P. Burgess,
Parveet Singh Gandoak
IFLR India M&A Forum 2016
International Financial Law Review
Mumbai, India

July 14, 2016
Update: AIFMD and its Impact on Non-EU Based Fund Managers
Sally Gibson, Andrew M. Ostrognai,
Gavin Anderson
Debevoise Seminar
Debevoise & Plimpton LLP
Hong Kong

July 13, 2016
Who Is an Investment Adviser? Regulatory Jurisdiction
Kenneth J. Berman
Fundamentals of Investment Adviser Regulation 2016
Practising Law Institute
New York

June 29 and 30, 2016
Monitoring Compliance at Private Equity Firms: Issues for CCOs
Kenneth J. Berman
PLI's Seventeenth Annual Private Equity Forum
Practising Law Institute
New York

June 27 and 28, 2016
How Much Due Diligence is Enough?
Andrew M. Levine
ACI's Midwest Anti-Corruption Compliance Forum
American Conference Institute
Chicago

June 16, 2016
Managing Emerging Cyber-Risks
Luke Dembosky
Debevoise Seminar
Guildhall
London

June 16, 2016
Fund Terms and Investment Strategies – The Latest Regulatory and Tax Considerations for Real Estate Funds
Sally Gibson
BVCA Real Estate Forum
BVCA
London

June 13, 2016
Spring Investor Relations Forum Dinner
Debevoise Event
Debevoise & Plimpton LLP
New York

June 7 and 8, 2016
Current M&A Issues
Paul S. Bird
and
Private Equity Today
Kevin M. Schmidt
15th Annual IBA International M&A Conference
International Bar Association
New York

June 7, 2016
Current Trends in Asset Management
Kenneth J. Berman, Gregory V. Gooding,
Robert B. Kaplan, William D. Regner
Debevoise Seminar
Debevoise & Plimpton LLP
New York

June 3, 2016
Private Equity M&A Activity in Japan and Across Asia
Christopher Smeall,
Gaikokuho-jimu-bengoshi, Ezra Borut
and
Fund Terms and Legal Negotiations: Key Points for Investors in the Current Environment
Andrew M. Ostrognai, Gavin Anderson
Debevoise Seminar
Debevoise & Plimpton LLP and MVision
Tokyo

May 25 and 26, 2016
Real Estate Related Investments
Michael Bolotin
7th Annual Private Investment Funds Tax Master Class
Financial Research Associates
New York

May 24, 2016
Fund Restructurings
Katherine Ashton
PEI Secondaries Breakfast
Private Equity International
London

May 24, 2016
Funds Structuring and Funds Formation: Commonly Used Structures, Key Terms and Current Trends
Natalia A. Drebezgina,
Geoffrey Kittredge, Michael Sabin
Debevoise Seminar
Debevoise & Plimpton LLP
Moscow

May 20, 2016
Privacy, Consumer Protection & Cybersecurity Challenges in Digital Payments
Paul L. Lee
Digital Financial Services & Emerging Payments Summit
Columbia University
New York

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May 19, 2016
Alternative Sources of Liquidity: New Opportunities in the Sponsor-Led Restructuring Space
Katherine Ashton
5th Annual Private Equity Secondaries Conference
C5
London

May 17, 2016
Critical Mistakes to Avoid When Managing Complex Litigation
Sean Hecker
18th Annual New York Conference on the Foreign Corrupt Practices Act
American Conference Institute
New York

May 13, 2016
Emerging Cyber Threats and Considerations When Planning for Incident Response
Luke Dembosky
Business Law Section's Spring Meeting
New York State Bar Association
New York

May 12, 2016
Legal Strategies – Balancing GP Interests and Maintaining Marketable Positioning to LPs
Geoffrey Kittredge, Peter A. Furci, Matthew W. Howard
EMPEA Fundraising Masterclass
EMPEA
Washington, DC

May 12, 2016
New Op Risk Proposal Reaffirms Benefits of Strong Cyber & Enforcement Strategies
Matthew L. Biben, Courtney M. Dankworth, Luke Dembosky, Satish M. Kini, Gregory J. Lyons, Jim Pastore, David L. Portilla
Debevoise Seminar
Debevoise & Plimpton LLP and RMA
New York

May 10 and 12, 2016
Adjustments to the Basis of Partnership Assets
Peter A. Furci
Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances 2016
Practising Law Institute
New York

May 9 and 10, 2016
Cybersecurity
Jim Pastore
5th Annual White Collar Crime Institute
New York City Bar
New York, NY

May 10, 2016
Preparing for a New Kind of Storm: The Merger of Criminal and National Security Cyber Threats
Luke Dembosky
NCFTA Forum
The National Cyber-Forensics & Training Alliance
Pittsburgh, Pennsylvania

May 10, 2016
Spring CFO/CCO Forum Dinner
Debevoise Event
Debevoise & Plimpton LLP
New York

May 6, 2016
Unrelated Debt-Financed Income Issues for Private Investment Funds
Michael Bolotin
2016 ABA Section of Taxation May Meeting
American Bar Association
Washington, DC

May 5, 2016
Critical Cybersecurity Concerns for Private Equity Firms
Luke Dembosky, Jim Pastore, Julie M. Riewe
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Debevoise & Plimpton LLP
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May 5, 2016
Drivers of Success and Lessons Learnt
Katherine Ashton
Women in Private Equity and Venture Capital Forum: Ideas in Action
BVCA
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May 4, 2016
Leveraged Financing Today
David A. Brittenham
and
Acquisition Finance Update
Jeffrey E. Ross
Leveraged Financing 2016
Practising Law Institute
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April 13, 2016
Emerging SEC Enforcement & Exam Issues
Kenneth J. Berman, Robert B. Kaplan, Julie M. Riewe, Rebecca F. Silberstein
Debevoise Seminar
Debevoise & Plimpton LLP
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Recent Client Updates

Listed below are Debevoise & Plimpton Client Updates published since our last issue that are most relevant to the private equity industry. They can be found at www.debevoise.com.

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Another Message to Private Fund Sponsors on Broker Registration – This Time from Enforcement
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Proposed Order Regarding the SEC's Performance Fee Rule: Inflation Adjustments to Qualified Client Thresholds
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India Shuts Down Mauritius Route: Time to Rethink Investment Structures
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May 10, 2016
SEC Adopts Final Rules Reflecting JOBS Act Changes to Registration Requirements
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Treasury's Sweeping Proposed Regulations Attack Related-Party Debt
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