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Private Equity

In this issue

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Maximizing Value in Minority Investments


by **Graham Defries** and **Andrew Harrow**[*]

Private equity sponsors seeking to acquire interests in public and listed companies in Europe must look closely at the requirements of takeover laws in the various member states of the European Union to determine at what level of ownership a requirement to make a "mandatory offer" for a company will be required. The requirement to make a mandatory offer will arise once a certain percentage of the voting rights of such a company has been acquired by an investor. This article provides an overview of the mandatory offer requirements in the United Kingdom, France, and Germany and explains how a private equity sponsor can acquire an economic interest in a company in excess of the mandatory offer threshold without triggering a mandatory offer requirement.

The City Code on Takeovers and Mergers (the "Takeover Code") is a statutory set of rules that governs takeover activity in the United Kingdom. The Takeover Code is monitored and enforced by the Takeover Panel (the "Panel") and applies to:

(i) all companies that have their registered offices in the United Kingdom, the Channel

Islands, or the Isle of Man, if any of their securities are admitted to trading on a regulated market in the United Kingdom, the Channel Islands, or the Isle of Man; (ii) public companies that have their registered office in the United Kingdom, the Channel Islands, or the Isle of Man and that are considered by the Panel to have their central place of management and control in the United Kingdom, the Channel Islands, or the Isle of Man; and (iii) a very limited class of private companies.

The Takeover Code has statutory status in the United Kingdom, and non-compliance may result in sanction by the Panel, the Financial Services Authority, and any regulatory body to which the offending organization belongs.

Rule 9 of the Takeover Code requires, except with the consent of the Panel, any person:

(i) who acquires, whether by a series of transactions over a period of time or not, any interest in shares that (taken together with shares in which persons "acting in concert" with him are interested) carry 30% or more of the voting rights of a company; or (ii) who, together with persons acting in concert with him, is interested in shares carrying between 30%. and 50% of the voting rights of a company and who acquires an interest in any other shares that increases the percentage of shares carrying voting rights in which he is interested, to make a mandatory offer to the holders of any class of equity share capital whether voting or non-voting and also to the holders of any other class of transferable securities carrying voting rights to acquire all such shares for cash at a price not less than the highest price paid by the offeror or any person "acting in concert" with him for any interest in shares of that class during the 12 months prior to the announcement of that offer.

Persons "acting in concert" comprise persons who, pursuant to an agreement or understanding (whether formal or informal), cooperate to obtain or consolidate control of a company or to frustrate the successful outcome of an offer for a company. The Panel itself acknowledges that, whilst there are certain relationships where the parties are deemed to be acting in concert, the Takeover Code definition of "acting in concert" is drawn in deliberately wide terms. The Panel has publicly stated that an understanding "*may arise from a hint*" and covers situations where "*the parties act on the basis of a nod or a wink*." The Panel accepts that there is rarely direct evidence of acting in concert and recognizes that "*business men may not require much by way of formal expression to create such an understanding*." Care must therefore be taken where there is any risk that a private equity sponsor could in any way be seen to be operating pursuant to any sort of understanding with another shareholder in the same company.

There are similar considerations in respect of companies listed on regulated markets in France and Germany. Mandatory Offers in France are regulated by the Monetary and Financial Code and the General Regulation of the Autorité des Marchés Financiers ("RGAMF") and in Germany by the German Acquisition and Takeover Act ("WpÜG").

The requirement to make a mandatory offer in France arises where a person acting alone or in concert:

(i) comes to hold (directly or indirectly and whether by way of acquisition, subscription, redemption, etc.) more than one third of a company's equity securities or voting rights; or (ii) holds directly or indirectly between one third and one half of the total number of equity securities and voting rights of a company and who, within a period of less than 12 consecutive months increases such holding by two percent or more.

The German mandatory offer requirement arises where a person acquires "control" of the company in question. Control, for these purposes, is obtained where a shareholder together with persons whose voting rights are attributed to such shareholder, holds at least 30% of the voting rights in the company. Voting rights are attributed to a shareholder where such shareholder has influence over the voting rights or where the coordinated conduct of that shareholder and a third party holding voting rights is deemed to influence the company's 'entrepreneurial direction' permanently or considerably.

It is possible to seek waivers from the requirement to make a mandatory offer in each of the United Kingdom, France, and Germany; however, waivers are generally only given in very limited circumstances, and the relevant authorities should be approached at an early stage and before the relevant voting shares are acquired.

There are ways for private equity sponsors who wish to acquire a material economic interest in a company to do so without falling foul of the mandatory offer requirements.

One such way in the United Kingdom is for investors to acquire a mixture of voting shares and non-voting convertible shares. Provided that the percentage of voting shares held by an investor and any persons acting in concert with it remains below the 30% threshold an investor can acquire and hold any amount of non-voting shares that may grant the same or different economic rights to the voting shares.

It may be possible in certain circumstances to approach the Panel to obtain its approval of a structure whereby the private equity sponsor may convert non-voting shares into voting shares at any time such that the percentage of the company's voting rights it holds exceeds 30% but remains less than 50%. Such an arrangement would require a 'whitewash' under the Takeover Code (which requires shareholders to approve the terms) prior to the investment being made, and the Panel may not give its approval to such a structure without further restrictions on these rights in addition to advance shareholder approval.

The specific share rights attaching to the non-voting convertible shares will to a large extent depend on the commercial deal agreed with the investee company and, if necessary, its other shareholders; however, it will in any event be necessary to liaise with the Panel to ensure that they are happy with the proposed structure and the class rights attaching to the non-voting shares. The Panel will usually require safeguards to be put in place to ensure that the general principles and spirit of the Takeover Code are being observed and, in particular, that the shareholder in question cannot convert non-voting shares such that its shareholding will equal or exceed 30% of the voting shares of the company. This can be achieved by amending the company's constitutional documents to provide that non-voting shares cannot be converted into voting shares if and to the extent that such a conversion would result in the shareholder in question, together with any persons acting in concert with it, holding 30% or more of the voting rights in the company.

Provided that the share rights attaching to the non-voting convertible shares entitle the holder to convert shares at any time on notice to the company, subject always to the prohibition on its holding of voting shares not breaching the 30% threshold, an investor will be able to sell down its voting shares in order to create or support a market in the company's shares and at the same time convert its non-voting shares into voting shares in order to maintain its voting rights in the company.

It is possible to achieve a similar result in France and Germany. In each case, provided that an investor (and any persons acting in concert with him) does not hold more than the relevant percentage of voting rights in the company in question, it is possible for him to benefit from a percentage of the economic rights of the company in excess of the percentage at which a mandatory offer would be required if the additional securities had voting rights.

In France, an investor would commonly acquire convertible bonds with specific terms and conditions so that the holder benefits from economic interests equivalent to those he would have had with a higher equity interest in the company. It is also possible for companies to issue preferred shares to achieve the same economic effect; however, it is less common for French listed companies to issue preferred shares, and in any event, a French company may not issue preferred shares representing in excess of 25% of its share capital.

Similarly, in Germany the same economic effect would be achieved by a company issuing non-voting preferred shares (*stimmrechtslose Vorzugsaktien*). The preferred shares would have the same economic rights as ordinary shares but no voting rights. However, it is not possible in Germany for the preferred shares to be converted into ordinary shares by the shareholder unilaterally. In order to effect a conversion, the company's shareholders would be required to pass a shareholder resolution, and the company's articles would need to be amended. There is therefore less scope for an investor to actively manage his holdings of ordinary and preferred shares to support a market in the company's shares.

In addition to holding voting shares, it is of course open to private equity sponsors to agree with the company that the private equity sponsor will be represented on the company's board. Any such board representation will need to be disclosed to the market in accordance with local disclosure requirements.

With the leveraged buyout market still in the recovery phase, and the continuing weakness in equity markets providing opportunities to make investments in public companies relatively cheaply (particularly if it is a minority stake with no control premium), there is a resurgence of interest among private equity firms seeking to make sizeable minority investments in publicly held companies. As we have outlined above, the way these investments need to be structured will differ in the three largest economies in the European Union. However, it is possible with the right structuring for a private equity sponsor to obtain an economic interest that is significantly higher than the thresholds at which a mandatory offer must be made under the rules applicable in the United Kingdom, France, and Germany without triggering the requirement to make such an offer.

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Recent Developments in Acquisition Finance

by **Scott M. Zimmerman** and **Jeffrey M. Katz**

The past few months have been witness to some significant developments in acquisition finance in terms of both judicial decisions and evolving deal terms. This article will survey some of the more notable developments.

In terms of court decisions, there was the *Amcan Holdings*[1] decision issued by New York's appellate division earlier this year, which held that a signed term sheet is not an enforceable contract where it expressly conditioned consummation of the financing transaction on negotiation and execution of further definitive documentation. This raises concern in the acquisition finance context, where certainty of financing is important to both buyers and sellers in the LBO context and where financing commitment letters routinely subject the financing in question to further definitive documents. *Amcan* still is only the holding of one New York appellate court, and the market has not yet addressed potential implications of this ruling for sponsors—not overly surprising in the recent credit environment.

The *Tousa* decision[2] of the U.S. bankruptcy court in Florida is currently on appeal and, unless overturned, may result (among other things) in sponsors being required to demonstrate to LBO lenders the solvency of each entity in a target group on a pro forma basis after giving effect to the LBO, rather than on an enterprise basis. Lenders would likely also require that additional diligence be undertaken in the furnishing of solvency opinions by financial experts retained for such purpose.

In the context of loan-to-own strategies, in *DBSD North America*[3] the U.S. bankruptcy court in New York disqualified ("designated") the votes of Dish Network, which had purchased certain debt of bankrupt DBSD in an effort to gain control of it through the reorganization process. In a ruling that surprised many observers, the court held that objectives such as gaining control are "ulterior motives" that go beyond a creditor's permissible maximization of recovery on its acquired debt position and can subject the holder to disqualification of its right to vote on or object to a plan of reorganization. This decision was affirmed on appeal by the District Court and is now on further appeal to the Second Circuit Court of Appeals.

In a victory for lenders, the New York Court of Appeals unanimously held in *DDJ v. Rhone*[4] that it is not always unreasonable for lenders to rely on representations made by a borrower as to the accuracy of its unaudited finan-

cial statements where the lenders conducted no related due diligence, despite "hints" in the financial statements from which readers of the financial statements "might have been put on their guard." The court concluded that the lenders were not required to conduct their own audit or to submit the preparers of the financial statements to questioning, and could justifiably rely on the negotiated representations. The court held that, if the borrower's sponsors actually knew of the falsity of the financial statements in question and knowingly caused the borrower, which they controlled, to make representations to the lenders they knew were false, a cause of action by the lenders for fraud against the sponsors could be maintained.

Finally, on the judicial front, in the context of loan agreement amendments and selective fee payments by a borrower to consenting lenders only, the U.S. Fifth Circuit Court of Appeals recently ruled in *Highland v. Lifecare*[5] that such discrimination among lenders is permissible and does not breach the implied covenant of good faith and fair dealing where the loan agreement in question did not expressly require equal inducements to all lenders and where only majority approval was required for the amendments in question.

The above underscores the importance of ensuring that loan documentation contains favorable language in these areas.

With respect to deal terms, several trends are worth noting.

Where outstanding portfolio company loans are coming due in the next 12 to 24 months, and an extension of the maturity is not possible due to lack of unanimous lender agreement, various legal technologies are being employed that can approximate an extension of maturity—depending, as usual, on how each particular loan agreement reads.

For loan agreements that allow amendments to the lenders' ratable sharing provision with majority lender consent only (and/or that allow extensions of maturity of each lender's loan with only the consent of that lender), it is sometimes possible to bifurcate an existing tranche of term loans into an extending sub-tranche and a non-extending sub-tranche, and to compensate extending lenders only. This will depend on certain other provisions of the loan documents as well, such as the absence of provisions prohibiting disparate treatment of different lenders. The recent decision in *Highland v. Lifecare* discussed above supports such an amend-and-extend approach in an appropriate setting. A similar bifurcation may be achievable in certain cases by use of an accordion feature in a loan agreement to create a new tranche.

Where a loan agreement requires unanimous lender approval to amend the ratable sharing provision and to extend, other possible approaches may be workable within the confines of a particular set of loan documentation. Under a forward commitment, for example, which has been used mainly in Europe, a sub-group of existing lenders can commit, prior to the looming maturity of an existing loan, to make new loans available to the borrower on the maturity date, in order to refinance all or a portion of the existing loan. No amendment of the existing loan agreement is technically done, so no consent of any existing lender is required on that score. Various forms of compensation may be paid to the forward-committing lenders and, as usual, the existing loan documents need to be carefully reviewed to ensure that they are not inadvertently tripped.

Where lending commitments are made by arrangers for loans intended for syndication, arrangers generally have been attempting to broaden the coverage of flex provisions. Some of the heartiest recent negotiations have centered around the scope of the flex (e.g., will it cover potential changes to loan structure, possible additional financial tests, and other terms beyond pricing) and when flex may be exercised (e.g., only pre-closing, by a post-closing cut-off date, or—and perhaps most contentiously—anytime at all, even if it won't lead to a "successful syndication," so that it may simply be used to offset arranger losses in the event a deal cannot be successfully syndicated, where the loans may have declined significantly in value after closing).

Also in the commitment letter context, alternate-transaction fees (imposed by arrangers on utilization by a sponsor of another financing source to consummate the acquisition) tend to be broadly drafted initially, but should (and usually can) be cut back to provide that they will be payable only if the arranger is not taken up on its offer to match the terms of the alternative financing that is on the table.

Regarding commitment conditionality, "Sungard language" (referring to commitment conditionality relating to the target) prior to the 2007 financial crisis was usually limited to matters relating to corporate authority and enforceability in respect of the loan documentation and like matters within the target's control (in addition to representations in the acquisition documents material to the lenders that gave the buyer the right to walk). These limitations enhanced the certainty of financing for both buyer and seller. It has recently become common to see "modified Sungard" conditionality that extends also to target representations as to solvency, status of the financing as senior debt, perfected status of liens, and non-violation of law in respect of the loan documents. These may be cut back in negotiation, but it is improbable in the current environment to revert to pre-crunch language.

Lastly, in terms of pricing, recent financings typically include a Libor floor as well as a base/prime rate floor calculated off a Libor rate plus some margin (usually one-month Libor plus 1%) in an effort to maintain the traditional variance between the two rates and prevent a recurrence of the inversion that occurred in 2008 when Libor jumped suddenly and exceeded the prime rate. Original issue discounts and call premiums also have been used with greater frequency to provide inducements to lenders where needed.

In the current environment, what is "market" one day may not be so the next, depending on intervening market events. It seems that the only certainty now is that leverage ratios will stay substantially lower than in the pre-crunch era, required equity contributions will stay greater, and sponsors and other parties will need to be vigilant in negotiating commitment papers and financing documents that give them what they bargained for.

1 Amcan Holdings, Inc. v. Canadian Imperial Bank, 70 A.D.3d 423, 894 N.Y.S.2d 47 (2010).

2 *In re Tousa, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009).

3 *In re DBSD North America, Inc*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), aff'd, No. 09-10156, 2010 WL 1223109 (S.D.N.Y. Mar 24, 2010).

4 *DDJ Management., LLC v. Rhone Group L.L.C.*, No. 131, 2010 WL 2516811 (N.Y. June 24, 2010).

5 See *Highland Crusader Offshore Partners v. Lifecare Holdings*, No. 09-10554, 2010 U.S. App. LEXIS 9514 (5th Cir. May 10, 2010).

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LPs Like What They See in ILPA Guidelines

by **Carl A. de Brito** and **Roger Mulvihill**

In September 2009, the Institutional Limited Partners Association (the "ILPA"), an organization of some 215 institutional investors, released a set of private equity principles intended to establish "best practices" guidelines for the private equity industry (the "Guidelines"). An earlier attempt in 1996 by Mercer Investment Consulting to set industry guidelines failed to gain traction, partly because fund raising was not particularly difficult, and sponsors could generally obtain adequate funding on more favorable terms. The ILPA private equity principles are generally considered more favorable to limited partners than many of the customary terms and conditions, but at first the impact of the Guidelines was not immediately apparent in practice. However, the evidence continues to mount that important principles set forth in the Guidelines are requested by limited partners, and often incorporated, in many new fund formations. Moreover, recent studies of investor and sponsor attitudes reflect many of the recommendations set forth in the Guidelines. (Some well known placement agents have advised new funds in particular to conform to the guidelines in so far as practical.) The following outlines a number of areas in which deal terms and conditions appear to be changing, largely at the insistence of limited partners who often cite the Guidelines and a desire to better align the interests

of GPs and LPs. Sources include our own experiences in fund formation from both the sponsor and investor perspectives as well as a variety of industry sources.

No Fault Terminations

Even before the issuance of the Guidelines, GPs and LPs struggled with the concepts of no fault suspension of investment periods and no fault fund terminations. The ILPA recommends a two-thirds vote of the LPs (by interest) to dissolve the fund or remove the GP without cause and a majority vote of the LPs (by interest) to terminate or suspend the investment period without cause. It appears that many LPs are requesting the sponsors to conform to the ILPA standards on suspension and termination, with many GPs holding out for the more traditional 75% in interest standard for termination of the fund or removal of the GP. It's too early to tell, but stay tuned. At a minimum, we believe that more liberal suspension and termination provisions will continue to rank high on the limited partners' wish list.

Management Fees

The Guidelines suggest that management fees should reflect reasonable operating expenses (including salaries) that are based on a fee model developed by the GP in connection with the organization of the fund. Management fees would then step down significantly on the formation of a follow-on fund and at the end of the investment period. Recent studies have consistently reflected investor concern that management fees, particularly for larger funds, have significantly exceeded budgetary needs. Although generally resisting a budget model, some larger funds have reportedly lowered their management fees by a quarter of a percent or by restricting the traditional 2% management fee to commitments below a threshold level with a 1.5% fee on commitments in excess of the threshold amount. There have been discussions on tying management fees to actual fund investment so that the fee would increase as the funds are put to work, although few funds seem to have implemented such an approach yet and generally continue to charge fees on aggregate capital contributions during the investment period. One concern expressed by sponsors regarding the tying of fees to actual investments is the cash flow difficulties in funding GP operations before investments are closed, particularly in an unsettled financing market. Consistent with past practice, the Guidelines treat placement agent fees as a general partner expense. However, the Guidelines also regard general partnership insurance as a partnership charge that is something of a departure from past practice.

Deal Fees

The Guidelines recommend that all "transaction, monitoring, directory, advisory and exit fees" charged by the general partner accrue to the benefit of the fund and a 100% transaction fee offset is now a common investor request. Some larger funds have gone from a 50–50 split on transaction fees to a 65–35 split or even an 80–20 split, but significant restrictions on portfolio fee income could adversely impact smaller sponsors that may find it more difficult to retain talent. Many investors in the industry thought deal fees were excessive, and a movement toward the ILPA position seems inevitable.

Waterfall Structure

The Guidelines consider an "all-contributions-plus-preferred-return-back-first" model ("full pay out") as the best practice. This model has been more common in Europe and for venture capital funds generally and, among other things, reduces the likelihood of GP clawback issues. However, full payout has not been the preferred waterfall structure in most U.S. buyout funds, and the Guidelines also recognize an "enhanced deal by deal" model that contemplates the return of all realized costs for a specific investment with continuous makeup for partial impairments and writeoffs and return of all accumulated fees and expenses (as opposed to the return of only fees and expenses allocated—pro rata or otherwise—for the exited deal). Although it's too early to tell, there are clear pressures from potential investors for the full payout model.

Carried Interest

The traditional 20% carry seems well entrenched and the Guidelines do not specifically comment on the recommended size of the carry other than to note that it should be directed predominantly to "professional staff and expenses related to the success of that fund." Even before the Guidelines, some sponsors reduced the carry on new funds in return for an even higher carry (e.g., 30%) if the fund succeeds in returning more than a specified percentage of committed capital (e.g., 300%). General partner clawbacks of carry have been traditionally calculated by reducing the clawback by taxes paid or payable by the recipients. However, the Guidelines appear to provide for the opposite ("clawback amounts should be gross of taxes paid"), a burdensome recommendation for the personal bank accounts of the sponsors' principals, particularly in light of the likely increase in the federal tax on carried interest under various financial reform legislative initiatives. In addition, the Guidelines contemplate that clawback liabilities, if any, should be calculated and disclosed to the LPs as of the end of each reporting period together with the GP's plan to "resolve the clawback." This comment has begun to appear in LP term sheet modification requests with some frequency and, aside from the theoretical difficulty in calculating the amount in some cases, may be difficult for many sponsors to resist.

Valuations

The inconsistent nature of some GP portfolio company valuations has irked some LPs who sometimes found the same portfolio company valued differently by different GPs. These inconsistencies are particularly frustrating for LPs who need to prepare audited financial statements themselves under the vague and evolving standards of FAS 157 as applied to the generally illiquid investments of private equity funds. The Guidelines contemplate that Limited Partner Advisory Committees would review valuation policies and practices and at least quarterly review portfolio company valuations. Although the recommendations in the Guidelines are largely consistent with current practice, some LPs have recently suggested that the Advisory Committee approve specific portfolio writedowns and write ups. Sponsors seem to be resisting this suggestion and, given the difficulties inherent in valuing portfolio companies under evolving accounting principles, it may even be a questionable idea from the Advisory Committee's point of view.

Reporting and Transparency

The Guidelines contemplate more detailed and consistent reporting for GPs on a variety of matters, including management and other fees, capital calls, management economic arrangements (including profit sharing splits and vesting schedules), and management company activities (such as the participation of other LPs in management company interests or the formation of public listed vehicles). Fund sponsors seem to have accepted the need for greater transparency, if occasionally reluctantly.

Many of the ILPA recommendations are little more than a codification of existing practices. Will the more controversial recommendations stick? Institutional Limited Partners are a hard group to corral, and when a better fund raising environment inevitably emerges, some skeptics feel the pressure to invest in the best performing funds with the tier one managers will significantly dilute the influence of the Guidelines. Some proposals, though, that are particularly beneficial to the institutional LPs—like greater transparency and the handling of transaction fees and terminations, and possibly even "full payout" waterfall structures—may be entrenched enough to survive in some form.

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SEC Adopts "Pay-to-Play" Rule Affecting Advisers to Private Equity Funds: New Placement Agent Rules Expected

by **Edward L. Pittman**

Introduction

The Securities and Exchange Commission ("SEC") on June 30, 2010 voted to adopt a new rule under the Investment Advisers Act of 1940 ("Advisers Act"), Rule 206(4)-5, that narrowly limits political contributions by the advisers and their employees who provide services to public pension funds. The new rule is designed to prevent "pay to play" practices involving public funds. Failure to comply with the Rule will result in lost advisory fees and foreclose certain business opportunities.

The SEC also determined, however, not to ban the use of third-party placement agents by private equity funds and others. Instead, the new Rule requires that advisers only use third parties to solicit public funds that are either registered investment advisers, subject to the limits of the new Rule, or registered broker-dealers that will be subject to new rules addressing political contributions that will be proposed by the Financial Industry Regulatory Authority ("FINRA"). The use of unregistered intermediaries, like "finders" or "consultants," to market private equity funds will not be permitted.

The Rule will become effective on September 13, 2010. However, depending upon the nature of their services, advisers will have until either March 14, 2011 or September 13, 2011 to develop policies and come into compliance. At that time, advisers should have appropriate compliance policies in place.

Executive Summary

The Rule will prohibit an adviser from: (1) providing advisory services for compensation to a "government entity" within two years following a "contribution" to an "official" of the government entity by the adviser or its "covered associates;" (2) using third-party intermediaries, including placement agents, to market to public funds unless they are either registered investment advisers or registered broker-dealers; and (3) coordinating or soliciting contributions to certain officials of public funds or to political parties of a state or locality where the adviser is providing or seeking to provide advisory services to a public fund. The SEC also adopted rule amendments that require a registered adviser to maintain certain records regarding the political contributions made by the adviser and its covered associates.

Background

The SEC's decision to adopt the Rule was, in large part, due to a number of high-profile investigations and criminal and civil actions conducted by law enforcement authorities in New York, New Mexico, Illinois, Ohio, Connecticut, and Florida, as well as the SEC itself, involving the alleged payment of kickbacks by advisers seeking mandates from state pension and retirement funds. Significant portions of the Rule are based directly on the provisions of Municipal Securities Rulemaking Board ("MSRB") Rules G-37 and G-38 ("MSRB Rules") that apply to municipal underwriters.

Two-Year "Time Out" for Impermissible Contributions

General Provisions of the Final Rule

The Rule prohibits any adviser from providing advisory services for compensation to a "government entity" within two years after a "contribution" to an "official" of the government entity by the adviser or its "covered associates." The SEC refers to such period as a "time out."

Covered Associates and Executive Officers

The Rule limits contributions by an adviser and its "covered associates." The Rule defines the term "covered associate" to include (1) general partners, managing members, or "executive officers" of the adviser (or a person with a similar status or function); (2) any employees who "solicit" business from public funds, and any direct or indirect supervisor of those employees; and (3) a political action committee ("PAC") controlled by the adviser or a covered associate. The term "executive officer" includes any senior officers of the adviser, as

well as anyone in charge of a principal business unit, division, or function (e.g., sales, administration, or finance); any other officer of the adviser or person who performs a "policy-making function," whether or not they are employees of the adviser. For example, persons who are employed by an affiliate or an offshore parent may fall within the definition of a "covered associate" if they have a "policy-making" role with respect to the adviser, or supervise any sales efforts involving public funds. Careful analysis of the individuals that may be deemed covered associates under the Rule will be necessary to prevent potential violations of the ban on contributions to officials and to comply with the Rule's additional recordkeeping requirements.

Direct and Indirect Contributions

The term "contribution" is broadly defined under the Rule to include both traditional cash contributions as well as "anything of value." The latter term is very broad and would encompass activities such as providing office space or facilities to a candidate, purchasing tables at fundraisers, or permitting employees to engage in campaign-related activities while being paid by the employer. Unpaid volunteer activities by individual employees is not prohibited, nor are charitable contributions made at the request of a public official. However, advisers should be careful not to reimburse any expenses associated with campaign-related activities by employees who are volunteering. The Rule also prohibits acts done indirectly that, if done directly, would result in a violation of the Rule. Thus, any contributions made through third parties, including consultants, attorneys, family members, friends, or companies affiliated with the adviser will violate the Rule.

Official

The restrictions on contributions under the Rule apply to contributions made to elected officials or candidates whose public office would offer them the ability to directly or indirectly influence the hiring of the adviser by a public fund. For example, an impermissible contribution to the governor of a state may prohibit the adviser from doing business with a public pension fund that is subject to oversight by any board members appointed by the governor. While the focus of the Rule is primarily on state and local entities, contributions to a federal campaign also are included if the candidate for federal office currently is an official of a state or local government entity.

Covered Advisory Services

The types of advisory services covered by the Rule also are very broad and include traditional money management services; consulting services offered to public pension plans; and management of "covered investment pools." The Rule defines the term "covered investment pool" to include private equity funds, hedge funds, venture capital funds, and collective investment trusts, as well as investment companies registered under the Investment Company Act of 1940 ("1940 Act") that are "an investment option of a "plan or program of a government entity" (e.g., college savings plans ("529 plans") and retirement plans ("403(b) plans")) or (2) any company that would be an investment company under Section 3(a) of the 1940 Act but for the exclusions in Sections 3(c)(1), 3(c)(7) and 3(c)(11).

Two-Year "Look Back"

Generally, the contribution prohibitions in the Rule apply to political contributions made by an adviser and its covered associates over the prior two years (or, in some cases, six months), regardless of whether the covered associate is currently an associated person of the adviser, or whether the covered associate was an associated person of the adviser at the time the contribution was made. There is an exception in the Rule for newly hired covered associates, provided that the individual, after becoming a covered associate of the adviser, does not solicit public funds on behalf of the adviser.

Despite comments from industry members, the SEC did not create a blanket exemption to address problems that might result under the Rule from mergers involving organizations with public fund clients. Instead, the SEC suggested that it would address problems resulting from mergers on a case-by-case basis through the exemptive process. One effect of this decision by the SEC is to place greater emphasis on the need for due diligence in this area in connection with any mergers of financial organizations.

"For Compensation"

A violation of the Rule occurs only if the adviser provides services "for compensation" after an impermissible political contribution has been made to an official. To avoid violating the Rule, the adviser may (1) resign from any engagement by the relevant government entity, or (2) continue to provide services to an existing client, but forego any compensation. This provision of the Rule may present challenges, particularly in the context of structured products. The SEC specifically acknowledged in the Adopting Release some of the concerns expressed by commenters on this point. In the context of venture funds and private equity funds, the SEC suggested that an adviser might waive or rebate the portion of its fees, or any performance allocation or carried interest, attributable to assets of public funds. However, the SEC warned that any adviser that might consider redeeming the interest of a public fund in order to avoid a violation of the Rule should consider disclosing this as a risk factor in the private placement memorandum or other disclosure document.

Another issue considered by the SEC was the use of sub-advisory and fund-of-funds arrangements. The SEC indicated that generally the adviser that did not make a contribution prohibited by the Rule could continue to receive advisory compensation from the public fund. Thus, a subadviser may continue to receive compensation even if the adviser may not.

Exceptions and Exemptions

The Rule contains two exceptions from the two-year time out and a provision under which an adviser may apply to the SEC for an order exempting the adviser from the two-year time out. The most significant of the exceptions permits individual covered persons, but not the adviser, to make de minimis contributions of up to $350 per election to an official for whom the covered person is entitled to vote, as well as $150 per election to an official for whom the covered person is not entitled to vote. For purposes of the Rule, primary and general elections are considered separate elections. A second exception from the Rule generally allows inadvertent contributions to an official for whom a covered associated is not entitled to vote, provided, among other things, that the adviser discovers the impermissible contribution within four months after it is made, and the adviser is able to seek a return of the contribution from the candidate. Finally, the SEC also indicated that it would consider exemptive requests based on a variety of factors, including whether or not the adviser had adequate procedures in place at the time of the contribution.

Prohibition on Use of Third-Party Placement Agents, Finders, and Solicitors

The SEC had initially considered a ban on the use of third-party intermediaries to market to public pension plans. However, after adverse comments from private equity firms and from many other corners of the industry—as well as public funds—the SEC determined only to prohibit an adviser from marketing through third-parties who were not either a registered investment adviser or a registered broker-dealer.

Following September 13, 2011, advisers will not be permitted to use unregistered finders and consultants, or to offer other forms of direct and indirect incentive compensation to third parties for referrals. However, advisers may continue to pay compensation to third parties for services other than soliciting investments.

While the SEC chose to permit the use of registered broker-dealers to offer private equity funds to public funds, it did so in anticipation of a new rule that it expects to be proposed by FINRA. The FINRA rule is likely to mirror provisions of the SEC's Rule and MSRB rule G-37. FINRA rules generally are filed with the SEC for public comment and approval. The SEC anticipates that the FINRA rule will be submitted during the next 12 months. One effect of any new FINRA rule may be to require advisers to conduct additional due diligence of the policies and procedures of placement agent in this area, or to redraft agreements to permit the fund to use alternative placement agents in the event of a violation of the FINRA rule by the placement agent with respect to particular public funds.

The SEC's decision to permit private equity funds to use registered broker-dealers as placement agents, and the adoption of a new FINRA rule, will have no direct effect on state and local laws or public fund policies. However, it could influence some public funds and lawmakers to reconsider their current positions.

Recordkeeping Requirements

Amendments to the provisions of the SEC's recordkeeping rules under the Advisers Act also were adopted. The amended rule generally requires advisers to public funds to maintain records regarding the contributions made by the adviser and its covered associates to public officials and to state or local political parties and PACs. In addition, an adviser must also keep a list of the names and business addresses of each registered broker-dealer or adviser that is retained to solicit public funds on its behalf.

Effective and Compliance Dates

The Rule and the amendments to the recordkeeping and cash solicitation rules under the Advisers Act are effective as of September 13, 2010 ("Effective Date"). However, except as provided below, advisers generally need not comply with the terms of the Rule before March 14, 2011. Thus, political contributions made prior to March 14, 2011 will be "grandfathered" and will not be counted against an adviser for purposes of the two-year look forward or look back provisions under the Rule. Advisers may no longer use third-party intermediaries to solicit public funds, except in compliance with the Rule, after September 13, 2011. Advisers to registered investment companies generally are not subject to the requirements of the Rule until September 13, 2011.

Conclusion

The Rule will likely present compliance challenges to those advisers that interact with public pension funds and other pooled government investment vehicles. The greatest challenges will be encountered in larger, integrated organizations with dotted line reporting. Chief compliance officers of advisory firms will need to learn the new requirements of the Rule, and develop policies and procedures that are similar to those employed by government contractors. In addition, they will need to engage in a significant education and training process to alert their personnel to potential problems that may arise from inadvertent activities on their part. Advisers also may need to reexamine their relationships with third parties, including any referral arrangements. Placement agents will likely be subject to new FINRA rules on political contributions in the next twelve months.

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CRC and Private Equity


by **Jonathan Angell** and **Alison Lympany**

The UK's Carbon Reduction Commitment (Energy Efficiency) Scheme 2010 (the Scheme) has been the subject of much debate in the private equity sector. Private equity firms, their funds, and otherwise unrelated portfolio companies may be grouped together as one organization and collectively responsible for compliance with the Scheme.

Registration under the Scheme is mandatory for qualifying organizations, and the date for registration is September 30, 2010. Any private equity fund holding shares in a company with UK operations should consider now whether it qualifies and needs to register.

What Is the Scheme?

The Scheme is a mandatory emissions trading scheme, designed to cut the carbon emissions of "non-energy intensive" large commercial organizations. If group usage in the UK for 2008:

- exceeded 6,000 MWh (equivalent to an electricity bill of £500,000), the Scheme applies in full;
- is below 6,000 but above 3,000 MWh, details of all "settled" half hourly electricity meters and 2008 consumption through those meters will need to be disclosed to the Environment Agency (the EA), which administers the Scheme; or
- is below 3,000 MWh, details of all settled half hourly meters must be provided.

How Does the Scheme Operate?

Organizations participating in the Scheme will have to:

- monitor and record their group's energy use each year.
- determine how many carbon allowances to purchase from the Government based upon the group's forecasted emissions. Allowances will be auctioned annually starting in April 2011, with a diminishing number of allowances available from 2013, forcing participants to become more energy efficient.
- apportion those allowances, and their cost, across the group.
- aggregate group energy consumption and submit an annual report to the EA, each July.
- surrender to the EA sufficient carbon allowances for the group against the reported emissions, on the basis of one allowance per tonne of CO_2.
- if the group has insufficient allowances to surrender, purchase additional allowances on a secondary market from other participants or the Government via a process known as the "safety valve." Emissions purchased this way will be more expensive than those sold at auction.
- apportion recycling payments across the group. A recycling payment is a payment by the Government from the revenue it has raised from the sale of allowances. The Scheme is intended to be revenue neutral for the Government. Recycling payments will be adjusted upwards or downwards depending

upon how energy efficient a participant has been. The relative performance of all participants in the Scheme in reducing emissions will be published in a league table.

Groups and Organizations

Under the Scheme, a group of companies is one organisation and must register as a single participant. The group is assessed as at the "qualification date" of December 31, 2008.

Principal responsibility for compliance of the group rests with the highest parent undertaking of the group (which must nominate an alternative UK-based member of the group if it is not based in the UK). However, all group members—including those outside the UK—are jointly and severally liable for compliance.

Membership of a group is determined by applying the tests set out in section 1162 of the UK Companies Act 2006. This effectively means that an undertaking (**P**) is a parent of a subsidiary undertaking (**S**) if:

- P holds a majority of the voting rights in S;
- P is a member of S and has the right to appoint or remove a majority of S' board directors;
- P has the right to exercise dominant influence over S or actually exercises (without any express right) dominant influence over S;
- P is a member of S and controls alone, pursuant to an agreement with other members, a majority of the voting rights in S; or
- P and S are managed on a unified basis.

Square Peg, Round Hole?

So far, so good—but what does this mean for private equity? It will be apparent that many of the above group concepts do not readily translate to a typical private equity fund structure. Portfolio companies will have no common purpose or, indeed, any connection whatsoever (aside from the funds' investment), and so do not readily fit within a "normal" group concept. The UK Department for Energy and Climate Change's policy (notwithstanding this illogicality and despite representations from industry bodies) is that the tests should be applied to private equity. The rationale is to include as many organizations in the Scheme as possible. The EA has also advised private equity firms to take an inclusive approach to grouping, so where there is any doubt, firms should err on the side of caution and include an entity within the group.

Applying the Tests to Private Equity

The application of the group provisions to a particular private equity firm, its funds, and portfolio companies will be a question of fact, on a case-by-case basis, and potentially extremely complex. While the normal group accounting principles, and therefore the auditors, will be a sensible starting point, further detailed analysis will be required. Recent EA guidance makes clear the following:

- **The limited partnership (LP)** (the most commonly used private equity fund structure in the UK, and an undertaking for Companies Act purposes). Its portfolio companies, general partner, fund manager, and limited partners will form part of the CRC group if they meet the Companies Act tests;
- **The portfolio companies.** If the LP has more than 50% of the portfolio company, then one or more of the group tests are likely to be satisfied. Even if the LP holds less than 50% the portfolio company may be caught if the LP, as a shareholder, has the right to appoint a majority of its directors (or otherwise controls the board) or can be said to exercise a dominant influence;
- **The general partner (GP).** Assets and investments are treated as held by the LP, and not the GP (as the GP holds these for the benefit of the LP in a fiduciary capacity). The GP will be the parent undertaking of the LP if it is "entrenched" (i.e., it cannot be removed as GP). If the GP can be removed at the discretion of the limited partners (under a "no fault divorce" type provision), then the GP will not be the parent, unless it exercises a dominant influence over the LP. This is clearly fact-specific—restrictions on the GP under the LP agreement (for example, geographic and/or industry constraints) may be sufficient to deny the GP a dominant influence for these purposes;
- **The private equity firm and any fund manager.** If the GP is the parent, then the firm (which normally is the direct or indirect parent of the GP) will also be within the group. The same analysis applies to a fund manager; and
- **The limited partners.** By their nature, limited partners are unlikely to form part of the CRC group. Their relationship to the LP ordinarily means that they would not satisfy the Companies Act tests. However, if any one limited partner has a significant investment in the LP and exercises a high degree of influence over it, it may satisfy some of the group tests under the Companies Act and merit further consideration.

The above is illustrative—and necessarily somewhat simplistic (looking at a single LP). The position becomes more complicated where there are multiple and/or parallel fund structures. For example, no fault divorce provisions may be exercisable for some **multiple funds** (which would arguably then be excluded from a group), but not others (which would then be grouped). In the case of **parallel funds**, an assessment will need to be made as to whether the parallel LPs may be treated as a single parent undertaking of each portfolio company. This will be the case if the LPs are managed on a unified basis.

Given the EA's "inclusive" approach, detailed analysis and careful consideration is required—and comprehensive records kept. The EA, when auditing compliance, will expect robust evidence supporting the exclusion of particular entities.

The Consequences of Failing to Comply

As the Scheme is lightly regulated, in that organisations are responsible for self-certification of their energy use, the penalties for non-compliance are strict. The EA will audit approximately 20% of the organisations in the Scheme each year. In the event of non-compliance, automatic fines generally apply up to a maximum of £45,000 (around $68,500). Supplying false or misleading information, obstructing the EA in carrying out an investigation, and non-compliance with an enforcement notice are criminal offences. Directors may be personally liable.

Remember that liability for compliance is joint and several, so default by one group member may result in another member incurring fines or criminal liability. Penalties aside, the poor performance of one could increase the cost of compliance across the entire group. Compliance with the Scheme, and managing these new risks, will present private equity firms (particularly whose with more complex structures) with a significant ongoing administrative burden.

September 30, 2010 is fast approaching—and the work is only just beginning.

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News from the Group

Upcoming/Recent Seminars and Speaking Engagements

July 27 Thomas Vartanian participated as a speaker in a webinar hosted by the American Bankers Association titled "Analysis of Proposed Banking Reform: Changes in Bank Activities, Spin Off and Restructuring Required, Volcker Rule Issue, Enforcement Considerations, and Changes in Affiliate Rules."

July 28 Dechert hosted a webinar titled "Financial Regulatory Reform" that provided an overview of the regulatory reform legislation recently passed by Congress, with a focus on the implications for investment funds and asset managers. Topics included private fund adviser registration, systemic risk regulation/Volcker Rule, SEC reform, and corporate governance.

August 26 Howard Kleinman will participate as a speaker on the "Brazil Legal and Regulatory Overview" panel at the South America Alternative Investments Mid-Atlantic Roundtable in Philadelphia hosted by Latin Markets Brazil.

September 7–8 Jonathan Angell will speak on a panel titled "Legal Agreements in Private Equity" at the BVCA Training and Professional Development Programme in London.

September 28 Eric Siegel and Mark Thierfelder will be participating as panelists in a program hosted by Marsh titled "Issues in Risk Management: What's The Deal? Managing Merger and Acquisition Risk in Today's Business Climate" in Washington, D.C.

To obtain a copy of the related presentation materials, please contact:

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Our Practice Continues to Expand Worldwide

Thomas Vartanian, **David Ansell**, and **Robert Ledig** joined Dechert's Washington, D.C. office and together form one of the premier financial institutions practices in the United States. Mr. Vartanian, Mr. Ansell, and Mr. Ledig have worked together for more than 25 years counseling a broad spectrum of leading companies in the financial services industry on sophisticated transactional and litigation matters, including mergers and acquisitions, private equity investments, securities offerings, proxy contests, bank regulatory issues, internal and government investigations, and securities class action litigation.

Declan O'Sullivan, who joined Dechert as managing partner of our new Dublin office, advises domestic and international clients in the establishment and authorization of all types of investment funds, private equity funds (including hedge funds), UCITS, and property funds.

James Waddington, who joined Dechert's London office, advises commercial and investment banks and private equity and hedge funds in connection with fund formation and fund investments, lending and borrowing arrangements, finance and derivative transactions, credit default swaps, debt and equity offerings, and insolvency and restructuring matters.

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