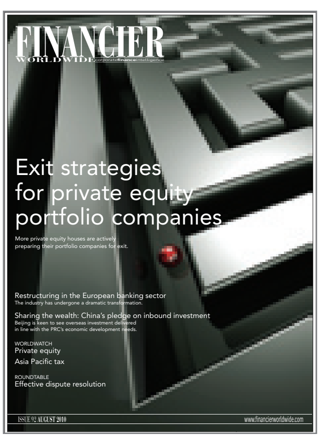
WORLDWATCH

PRIVATE EQUITY



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WORLDWATCH

PRIVATE EQUITY

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AUSTRALIA

Fortune favours the bold (and well structured)

BY ANDREW BULLOCK, DEBORAH JOHNS AND PETER FEROS

In the shadow of double-dip fears in the mature markets of the northern hemisphere, Australia is, in contrast, enjoying a more positive economic and investment environment. In the middle of 2010, we have an economy that technically never entered recession during the GFC; a domestic corporate base that was extensively recapitalised and de-levered in 2009; four of the world's top 15 capitalised banks; and strong leverage to the emerging markets to our north, which are forecast to grow GDP by at least 7.5 percent this year. Despite all of this, as in most mature markets, a sense of uncertainty is depressing the corporate M&A markets. An exception to this is in transactions led and arranged by financial sponsors.

P2Ps

Public to private transactions have historically been the most elusive trades for financial sponsors operating in Australia. P2Ps are typically triggered by a private equity sponsor seeing more value than the public markets in a listed asset. Accordingly, the bids face immediate perceptions of being opportunistic and underpriced. In this context, P2P bids in Australia have often foundered on the reluctance of listed target boards to concede that more value may be released in a private environment; on adverse independent expert reports (which are generally obtained in the context of most deals that are agreed with target boards); or on the refusal of public market fund managers to sell blocking stakes – notwithstanding the overwhelming acceptance of the proposal by other shareholders.

We have now seen two P2P transactions complete even though they were not initially recommended by the target boards and were deemed neither 'fair' nor 'reasonable' by the independent expert.

The past 18 months, however, have seen some interesting developments in P2Ps. We have now seen two P2P transactions complete even though they were not initially recommended by the target boards and were deemed neither 'fair' nor 'reasonable' by the independent expert.

In the take-private of MYOB Limited, an accounting and enterprise business software provider, we saw Australia's first hostile sponsor-led P2P by a consortium arranged by Archer Capital. Gingered up by GPG and some other large institutional shareholders, the bid structure aggressively committed those shareholders to sell into the bid. To the extent the bidder ended up with less than the 90 percent of acceptances required to effect a compulsory acquisition (or 'squeeze-out') of the minorities (a real possibility given the 50.1 percent minimum acceptance condition) the bid was unlevered and used only equity from Archer and its coinvestors' funds. However, if the 90 percent acceptance threshold was achieved, leverage was available (because security over the target assets could be assured). The consortium therefore offered a higher price to target shareholders if this level was achieved. Ultimately, more than 90 percent accepted and, after a few regulatory skirmishes around the manner in which the activist shareholders committed to the bid, the acquisition completed successfully.

In the bid for Energy Developments Limited earlier this year, the situation was slightly different. Energy Developments operates landfill, coal mine methane and remote area gas and energy assets in Australia, Europe and the United States. Those assets are typically project financed and so significant financial leverage was already embedded in the target pre-bid (and because it did not accelerate on a headstock transaction, did not need to be replaced). In this case, the sponsor, Pacific Equity Partners, could not get a recommendation from the target board – even after it achieved more than 50 percent of acceptances. PEP ultimately took the view that the funds it advises could live with a significant majority position in a public company and that it would be better placed to deploy funds in support of the company making further acquisitions than increasing its price to meet the requirements of a few hold-out shareholders. In the end, PEP funds acquired 80 percent of EDL, leaving it listed with a board dominated by PEP representatives and run with a private equity based structure – with profits being reinvested rather than paid out as dividends and management being incentivised with a private equity style management equity plan.

In this type of deal, the challenges of accessing the due diligence materials necessary to make a bid (particularly a debt-financed one) but remaining free to make a hostile bid are significant. Processes for being relieved of standstill obligations and to ensure that there is no trading on undisclosed price sensitive information need to be managed carefully and, to a considerable extent, require some concessions from, or cooperation with, the target. In our experience, this is manageable in transactions like those described above, where, despite being non-plussed by the offer price, boards do not wish to restrain their shareholders from making their own decisions to sell into a bid.

Managed Investment Trusts (MITs)

The Australian tax treatment of gains made by private equity funds investing in Australia has been thrown into question since the Australian Taxation Office attempted to restrain the repatriation of the proceeds of the TPG-led consortium's exit from Myer last year.

What has emerged since is a structural safe harbour for non-property related gains made by passive financial investors and a concessional withholding arrangement for those investors in relation to distributions of certain income.

Tax free or concessionally taxed capital gains. Recent changes ensure that by using appropriately structured investment vehicles, gains from the realisation of many Australian investments are treated as being on capital account and subject to more concessional capital gains tax (CGT) treatment. To access this concession, the investment vehicle must be an Australian trust which meets the conditions to qualify as a managed investment trust (MIT) summarised below. The benefits of an MIT are (i) for Australian resident investors who are individuals and superannuation funds, eligibility for the CGT discount regime (like 'taper relief') in respect of gains on qualifying assets; and (ii) for foreign investors, the availability of a complete CGT exemption where the gain is made in respect of qualifying assets which do not comprise 'Taxable Australian Property'.

Concessional 7.5 percent rate of withholding. While less likely to be of benefit to private equity investors (but of material interest to foreign infrastructure sponsors), qualification as an MIT also means that a final withholding tax of 7.5 percent applies to certain distributions made by an MIT to investors resident in 'information exchange countries'. These countries include the United States, the United Kingdom, Canada and New Zealand (and soon should include the Cayman Islands, the Bahamas, Bermuda and the British Virgin Islands).

Qualification requirements. There are a number of conditions which need to be satisfied in order for a trust to qualify as an MIT. The most relevant requirements for private equity and infrastructure sponsors (in addition to the requirement that the trust not carry on, or control another entity which carries on, a 'trading business') are as follows. First, the trust must have 25 or more investors. Special tracing rules exist for 'special investors' (being investors which are collective investment vehicles with certain characteristics) which enable those investor entities to count as more than one member for the purposes of this test. Depending on the jurisdiction of, and structure of a foreign private equity fund, it may well be traced-through for the purposes of this condition (meaning it can count its LPs for the purposes of this 25 investor test). Second, 10 or fewer investors (who are not 'special investors') must not have a direct or indirect interest of 75 percent or more in the trust. Third, one foreign resident individual may not have a direct or indirect interest in the trust of 10 percent or more. Fourth, the total number of members who are retail investors must not be more than 20 and the retail investors have a total direct and indirect interest of 10 percent or less. Finally, and importantly, the trust must be operated or managed by a person holding an Australian Financial Services Licence that covers the provision of financial services to wholesale clients (or it must be operated or managed by such a person's authorised representative).

Potential uses for MITs. The use of a trust which qualifies as an MIT has potential application as part of a general private equity fund structure for investing into Australia. For funds which previously considered investing into Australia via offshore fund structures, the MIT structure may now provide greater certainty of outcome. In addition, it may be used on a deal by deal basis, for consortia with a significant percentage of wholesale (i.e., sophisticated) investors choosing to invest in a particular target company (subject to the application of the 'trading business' limitation referred to in the qualification conditions above). We have already seen a number of infrastructure sponsors structure proposed acquisitions with transaction-specific MITs as they can very easily satisfy the qualification conditions. ■

Andrew Bullock
Partner
Sydney, Australia
T: +61 2 9263 4126
E: abullock@gtlaw.com.au

Andrew led the Gilbert + Tobin teams advising on the Energy Developments and MYOB transactions referred to in this article. He acts for a range of private equity and infrastructure sponsors in Australia on both public markets and private treaty transactions.

Deborah Johns
Partner
Sydney, Australia
T: +61 2 9263 4120
E: djohns@gtlaw.com.au

Deborah advises on fund structuring and fund establishment issues across the buyout and venture industry in Australia. Her practice covers MITs, conventional unit trusts and venture capital limited partnerships.

Peter Feros
Partner
Sydney, Australia
T: +61 2 9263 4163
E: pferos@gtlaw.com.au

Peter Feros heads Gilbert + Tobin's transactional tax team and advises predominantly on cross border fund and investment structuring.

BRITISH VIRGIN ISLANDS

BVI legal and regulatory framework – insight for offshore private equity investors

BY KERRY ANDERSON AND CHRISTOPHER SIMPSON

The global financial crisis has had a major impact on private equity investors globally and has put the investment funds industry, in particular, under intense scrutiny. The British Virgin Islands (BVI) is one of the largest offshore fund domiciles which, like its onshore counterparts during the height of the crisis, saw unprecedented fund redemptions, closures and outright collapses. With that in mind, the intent of this overview is to highlight certain elements of the legal and regulatory structure in the BVI, which facilitates private equity transactions through the use of BVI corporate vehicles.

Types of vehicles, attraction and licensing

In the BVI, the most popular vehicle for carrying out private equity transactions is the BVI business company (BVI BC). A BVI BC is a separate legal entity distinct from its members, and continues in existence until its dissolution. For private equity transactions, the BVI BC is generally structured as a limited liability company, which limits the liability of its members to the amounts, if any, unpaid on their shares. In addition to BVI BCs, BVI limited partnerships (BVI LP) are also used as vehicles for private equity transactions. Unlike a BVI BC, a BVI LP does not have separate legal personality and is a partnership formed by two or more persons with one or more general partners and one or more limited partners. Each general partner in a BVI LP is jointly liable with the other general partners for all debts and obligations of the partnership incurred while it is a general partner. A limited partner has the benefit of limited liability, provided he or she is not also a general partner and provided he or she does not participate in the control of the partnership business. Unit trusts are also used for private equity transactions but not as frequently as BVI BCs and BVI LPs.

BVI BCs structured as closed-ended funds are outside the scope of funds regulation in the BVI and therefore can be set up as a standard company without any fund licensing requirements.

BVI BCs structured as closed-ended funds (which would tend to include most leverage buyout funds) are outside the scope of funds regulation in the BVI and therefore can be set up as a standard company without any fund licensing requirements. However, if the BVI BC is structured as an open-ended fund, it will be subject to the BVI Securities and Investment Business Act, 2010 (SIBA) and will require licensing by the BVI Financial Services Commission (FSC). Under SIBA, a fund is defined as an entity that collects and pools investor money for the purpose of collective investment, and issues either shares in a company, interests in a limited partnership or units in a unit trust that entitle the holder to receive, on demand, an amount computed by reference to the value of their proportionate interest in the whole or part of the net assets of the fund. SIBA came into effect in May 2010 and as part of the process for the enactment of SIBA, the Mutual Funds Act, 1996 was repealed. SIBA not only enhanced the mutual funds regime in a number of ways but also introduced legislation to regulate other types of investment business, public issues of securities and market abuse.

Private equity fund managers are attracted to the BVI for a number of reasons including: the absence of direct taxes in the BVI, which allows funds to maximise returns to their investors; no income, withholding or capital gains taxes in the BVI with respect to shares, interests or units of the fund owned by investors; no capital or stamp duties levied in the BVI on the issue, transfer or redemption of shares, interests or units of a fund and a stable and well regulated environment.

Under SIBA, there are three categories of licensed BVI funds: (i) private; (ii) professional; and (iii) public funds. The licensing requirements and procedures are more stringent in the case of public funds, which are primarily suitable for retail investors. Private and professional funds are primarily suitable for sophisticated, individual and institutional investors. The distinction between private and professional funds is that private funds have no minimum investment requirement although they are restricted to only 50 members and are also restricted as to the way in which the offering can be marketed. Professional funds have a minimum investment of $100,000 for each investor and they must confirm in the subscription documents that they are professional investors. A BVI BC may also be structured as a segregated portfolio company, which is becoming increasingly popular among private equity investors to enhance the fund structure and related tax benefits. A segregated portfolio company permits a fund to separate its assets into different portfolios with distinct liabilities. This structure can provide some additional flexibility to fund managers by allowing them to pursue different investment strategies for different types of investors and assets, without losses in one portfolio affecting the assets or investors in another. The type of vehicle used for private equity fund investments is usually dependent upon the investors' own domestic fiscal conditions and so although the fund is offshore, investors will need to seek advice from onshore legal and tax advisers. As it relates to BVI funds, European investors are more inclined to use BVI BCs, US investors, limited partnerships and Japanese investors, unit trusts. There is a rebound in the market and although banks are still tight on lending, the stock markets are up and so private equity investors do have capital to make specific and calculated investments.

Recent legal and regulatory developments

Like most fund markets, the BVI has seen its fair share of legal and regulatory developments spurred on by the global financial crisis. The inability of several funds in the BVI to meet all redemption requests during the crisis resulted in litigation in a number of cases. For example, a decision by the BVI High Court of Justice (SV Special Situations Fund Limited v. Headstart Class F Holdings Limited, 2008) has confirmed the ability of a person to petition for the winding-up of a fund based upon an unpaid redemption request. This decision has caused more funds to put in place redemption lock-out ▸▸

periods and gates, which gives fund managers more control over the outflow of money out of the fund on any given redemption day. The establishment of valuation committees and boards, which are more independent of the fund managers, are also becoming more frequent in fund structures.

From a regulatory perspective, the FSC, in addition to its other requirements with respect to licence applications, will apply a 'fit and proper' test to assess the suitability of the principals behind the fund. The 'fit and proper' test is designed to test the principal's character and experience in the financial services industry and this becomes particularly important in relation to the choice of functionaries for the fund. The test has existed for quite some time now but given the recent crisis it may be applied more strictly. The FSC also has a 'four eyes' principle, in which all applicants for licensing are required to have at least two directors. In addition, all private, professional and public funds are obligated to file with the FSC a 'Mutual Funds Annual Return' for the financial period ending 31 December of each year within six months of the end of the financial period, and funds that are incorporated as segregated portfolio companies are required to deliver their audited annual accounts to the FSC within six months of their financial year end.

The BVI is also continuing to maintain its alignment with international standards, while at the same time seeking to remain an attractive jurisdiction. New anti-money laundering legislation that requires financial institutions and service providers to identify the beneficial owners of companies and tax information exchange agreements are part of this international alignment process. Currently, the BVI is on the OECD's white list and is committed to meeting future standards. The BVI places great importance on maintaining high standards and this has enabled it to become the first member of the International Organization of Securities Commissions to be admitted through IOSCO's Multilateral Memorandum of Understanding Concerning Consultation and Co-operation and the Exchange of Information. An extensive review concluded that the BVI's legislative and institutional regimes on international cooperation met IOSCO's standards.

Conclusion

Despite the global economic crisis, the BVI has been able to maintain a modern, user-friendly and well regulated environment for private equity investors. Legislative enactments such as the Insolvency Act, 2003, the BVI Business Companies Act, 2004 and the recently enacted SIBA, 2010 together with adequate regulation will ensure that BVI continues to stay on the cutting edge of the offshore funds industry in the years to come. ■

Kerry Anderson
Partner
British Virgin Islands
T: +284 494 5808
E: KAnderson@onealwebster.com

Kerry Anderson is a partner in O'Neal Webster's commercial department where he advises domestic and international clients on a range of corporate/commercial and real estate matters. His extensive experience includes the sale and purchase of BVI companies, property financing, joint ventures, private placements, corporate restructuring, and property acquisition and disposal and investment funds.

Christopher Simpson
Counsel
British Virgin Islands
T: +284 494 5808
E: CSimpson@onealwebster.com

Christopher Simpson is Counsel at O'Neal Webster and his practice focuses primarily on banking and finance, corporate and commercial law and investment funds. He advises a client base of leading financial institutions, corporations and law firms on all aspects of corporate finance and general aspects of banking and corporate law.

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GERMANY

The recovery of private equity – a series of false dawns?

BY RICHARD BURTON AND JOACHIM ENGLERT

There has been much talk recently about a 'two-speed' European private equity market. At one extreme are the high quality assets which change hands at double digit multiples in ultra-competitive auctions – frequently with debt packages that appear to resemble a return to 'normality', if such a concept exists. Many of these are secondary or even tertiary buyouts, with corporate buyers reluctant to compete with financial bidders other than for the most strategic assets. At the other end of the deal spectrum are those businesses which take an absolute age to prepare, diligence and sell – if indeed a sale is achievable at all. In many cases this is because they are lower quality companies, perhaps in financial distress or even insolvency, or are simply run-of-the-mill businesses carrying a price tag which has lost all connection with economic reality.

While the rest of Europe may be demonstrating two speeds, Germany so far seems to be content with just one – the slow and difficult variety, accompanied by a high level of execution risk for all parties. There are signs that this may finally be changing as we move through the summer, but the trend remains fragile – and we have experienced a number of false dawns before.

In the first six to nine months after Lehman, it proved virtually impossible to value most businesses, particularly in the heartlands of German engineering. As order intake and current trading continued to decline as each month went by, few investors or management teams were bold enough to call the bottom. Where this was not the case and a business in fact remained crisis-resistant, potential buyers held off as long as possible from committing to a deal, as they waited for the seemingly inevitable decline to hit. Even 'distressed' investors seemed reluctant to take part in the increasing number of sales being conducted by Germany's insolvency administrators, uncertain whether they would be dealing with a 'lucky buy' or simply a poor business.

The road to recovery for private equity has been accompanied by a series of false dawns. So far, 2010 has seen the German M&A market trapped in an imbalance of supply and demand.

And when trading conditions began to stabilise (for many businesses this was in the second half of 2009), other barriers to deal-doing remained. A crucial hindrance was the capacity taken up within many deal teams by the restructuring of existing investments. This has proven to be very time-consuming, with many restructuring situations taking a year to 18 months to work through and obtain the agreement of all stakeholders. In cases where a consensual solution proved impossible – Almatis and Stabilus come to mind – legal action by one or more aggrieved parties provided a further distraction.

From summer 2009 onwards, the recovery in public equity markets also meant that listed groups found it surprising easy to raise new capital from new equity or bond issues – for example, both Infineon and Heidelberg Cement were able to boost their debt-equity ratios by tapping the public markets in preference to possible alternative solutions proposed by financial sponsors. Hence, the use of private equity money to recapitalise Deutschland AG – as promoted by a number of the US 'mega-funds' in the months following Lehman – did not come to fruition. This meant that many funds, which confidently entered 2009 with the intention of putting their investors' money to work, found they were unable to deliver on their intentions.

At the end of 2009, market sentiment was boosted by a series of very large announced or planned deals. Cable company Unitymedia was sold for €3.5bn by private equity owners BC Partners and Apollo to a US trade buyer and EQT snapped up Springer Science & Business Media for €2.3bn in a secondary buyout – the largest European LBO of the year. In terms of pipeline, the large funds could look forward to bidding for ratiopharm, Siemens Hearing Aids and potentially Kabel Deutschland in the first quarter of 2010. Yet, this renewed activity proved to be another false dawn for the industry. The 'return of leverage' supposedly heralded by the Springer deal (which featured a €1.5bn debt package) was in fact nothing of the sort; rather, it represented a substantial deleveraging of the existing €2.3bn debt on the company's balance sheet. What a great deal for the banks during a financial crisis! Not only were they able to achieve full repayment of over a third of their total exposure – at a time when write-downs of this magnitude were on the negotiating table for deals in trouble – but the new deal enabled the rolled-over portion of the debt to be re-priced at higher margins.

As for the other pipeline deals, ratiopharm proved a step too far for most private equity bidders and was eventually sold to a trade buyer (Teva), Siemens Hearing Aids generated some healthy private equity interest but was withdrawn by the vendor after falling short of original price expectations, while Providence Equity Partners, the owner of Kabel Deutschland, ultimately opted for the IPO route after briefly testing sponsor appetite for a further buyout. The deals which did happen represented an eclectic mix of minority growth investments (e.g., KKR and Rudolf Wild), 'loan to own' plays such as Triton's acquisition of Stabilus and an underlying level of 'noise' in the sub-€50m segment.

In summary, the road to recovery for private equity has been accompanied by a series of false dawns. So far, 2010 has seen the German M&A market trapped in an imbalance of supply and demand. After dealing with the urgent restructuring cases or otherwise retreating from buy-side activity during 2009, the vast majority of funds announced that they were back in the market for new deals – at the right price – at the start of 2010. Yet the very same players were also convinced that 2010 was not the right time to sell their own assets – far better, they said, to wait till 2011. While this was understandable (after all, selling even the most durable businesses off the back of reported 2009 earnings was far from ideal), this simply created a one-sided market with numerous potential buyers but precious few willing sellers. ▸▸

What's more, the funds' own view of life was – and continues to be – mirrored in the corporate world by a dearth of quality businesses slated for carve-out.

So where do we go from here? Quite simply, the only way is up. More 'normal' private equity deals are finally starting to get done this summer (SiC Processing, Simons Voss and Teufel, to name but a few) and there is now a trickle of portfolio assets coming onto the market which should provide some attractive mid-market deals in the second half of the year. And if the stated intentions of the funds are taken at face value, this trickle could yet turn into a much more substantial flow as we move into 2011.

There are a number of fundamentals that lend weight to this. Buy-side demand will remain high due to the need to deploy the substantial volumes of unspent capital – a situation made more acute by impending fund expiry deadlines. On the sell-side, the pressure to demonstrate exits is starting to intensify – both as a prerequisite to raising successor funds and the simplest way of dealing with the 'wall of debt repayment' looming ever larger on the horizon from 2013 onwards. Better-than-expected 2010 earnings look set to provide a further boost, particularly for manufacturing businesses experiencing a genuine 'V-shaped' recovery. There are even some encouraging signs of liquidity returning to leverage finance despite the recent volatility in the Euro-based financial markets.

Is dawn finally about to break for German private equity? ■

Richard Burton
Partner
Frankfurt, Germany
T: +49 (0)69 9585 1251
E: richard.burton@de.pwc.com

Richard Burton is a partner in PwC's Transactions practice. He is PwC's private equity leader in Germany and the EMEA region. He is one of the most experienced advisers operating in the German private equity market.

Dr Joachim Englert
Partner
Frankfurt, Germany
T: +49 (0)69 9585 5767
E: joachim.englert@de.pwc.com

Joachim Englert is a partner in PwC's Business Restructuring practice. He advises companies, private equity funds and finance providers in restructuring and distressed M&A situations. He is one of Germany's most experienced restructuring practitioners.

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GERMANY

Regulation of private equity in Germany

BY DR BENEDIKT WEISER

When it comes to private equity in Germany, surprisingly, the level of regulation on funds and fund professionals is low relative to other European jurisdictions. Unlike German tax law, which is perpetually in flux and meticulously addresses every aspect of the private equity business on both the fund and investment side, there is no overarching regulatory framework governing the behaviour of private equity funds and professionals; rather, specific regulations govern distinct components of the industry.

Private equity fund managers are not regulated in Germany, regardless of whether they manage retail or sophisticated investor funds. Only fund managers investing in financial instruments for the account of natural persons as investors may be required to obtain a licence as a financial service provider under the German Banking Supervisory Act (Kreditwesengesetz – KWG). Distributing interests in funds does not require a licence as a financial service provider as long as the interests do not qualify as financial instruments. Interests in limited partnerships, be it the typical Anglo-Saxon style limited partnership or the German KGs (Kommanditgesellschaften), typically do not qualify as financial instruments, unless they are structured as tradable securities, including listed or otherwise readily tradable interests. In the retail space, managers must file a mandatory prospectus with the German Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin), unless an exemption is available. Sponsors most often avail themselves of the exemption for funds with a minimum subscription amount of €200,000.

Only fund managers investing in financial instruments for the account of natural persons as investors may be required to obtain a licence as a financial service provider under the German Banking Supervisory Act.

Although providing advice on potential investments is technically a regulated activity if the investment is in financial instruments including listed or unlisted stock, a specific exemption exists for private equity advisers. However, an often-overlooked requirement exists for a licence for bringing about deals regarding financial instruments, which can be a regulated activity.

On the investor side, insurance companies are one of the most significant groups of institutional investors. German insurance companies investing in private equity are governed by the German Investment Ordinance on the Investment of Restricted Assets of Insurance Undertakings (Anlageverordnung – AnlV). The AnlV tends to make these investors difficult to handle, particularly for non-German fund sponsors.

In this patchy regulatory environment, three recent developments are worth expanding on: the Draft Investor Protection Act, the Draft AIFM Directive and the AnlV.

Draft Investor Protection Act

In June 2009, the BaFin proposed to treat interests in limited partnership fund vehicles as financial instruments. This would trigger application of the full scope of regulation to the distribution of these interests. In May 2010, the German Federal Ministry of Finance responded to the proposal by publishing a preliminary draft of an Act on Strengthening Investor Protection and Improving the Functionality of the Capital Market (the 'Draft Investor Protection Act'). In essence, only limited partnership interests for whom a mandatory prospectus must be filed with the BaFin, would qualify as financial instruments. Therefore, given the available exemptions, and specifically the exemption for funds with a minimum subscription amount of €200,000 per investor, this new regulatory regime would practically only affect the German retail fund market. Though the Draft Investor Protection Act is significant not only for private equity, but also for shipping, real estate, energy, and other sectors, the effects of the BaFin's initial proposal would have been far more considerable.

Draft AIFM Directive

The EU recently took a critical look at alternative investment funds, and their response was the draft Alternative Investment Fund Managers (AIFM) Directive ('Directive'). The Directive was drafted to regulate the management and distribution of alternative investment funds in the EU, including private equity funds. The Directive establishes a regulatory framework for AIFM including authorisation, valuation, disclosure, and other operational requirements. The Directive will especially impact the acquisitions by private equity funds of targets in Europe.

EU lawmakers recently postponed further work on the Directive until September due to substantial debate on the Directive's contents. However, the Directive could be enacted as soon as late 2010 or early 2011, and the Directive's implementation in the member states would probably need to be done within two years. The Directive will not necessarily be enacted in its current form, which, for purposes of this article and in view of various recent drafts, is the position of the European Parliament as of first reading, as published in the Report by the Rapporteur, Jean Paul Gauzes on 28 May 2010 (A7-0171/2010). A chapter especially relevant for private equity fund managers relates to acquiring control in a non-listed company.

The Directive requires disclosures for fund managers that acquire control or a significant interest in a non-listed company domiciled in the Community. Any time a fund manager acquires 10, 20, 30, or 50+ percent in such a company, the fund manager must make disclosures to its own shareholders, the target's shareholders and employees, and relevant national authorities. Although this only applies to companies in the EU employing 50+ people, the disclosures significantly increase the responsibility and potential liability of private equity fund managers. Critics generally claim that affected private equity funds may be disadvantaged on the market when competing ▸▸

with other funds that do not have to observe the information requirements.

The Directive is expected to create vigorous barriers for the entry of non-EU AIFM to the European market. EU-Investors will be prohibited from investing in alternative investment funds that are not subject to regulation equivalent to the EU regulation under the Directive. This is increasingly motivating AIFM to look at EU-jurisdictions for setting up their new funds.

AnlV

On 29 June 2010, the German government enacted a revised AnlV for German insurance companies. Some amendments have been long expected. The AnlV extends the limits on investments in non-listed funds and companies from 10 to 15 percent of the restricted assets. The AnlV further abolishes the restriction barring German insurance companies from acquiring more than a 10 percent interest in non-listed funds or companies.

Others, however, have been introduced on rather short notice, and prompt new questions.

Interests in funds structured as limited partnerships qualify for the restricted assets of German insurance companies if they are domiciled in the EEA or an OECD member state, and if certain disclosure, liquidity, and security requirements are met. The new InvO additionally requires the target company to 'have a business model and enter into entrepreneurial risk' ('Activity Requirement'). According to the InvO's reasoning, a company is not active if its value is generated by the sum of its assets only, as would be the case with open-ended securities funds that merely buy and sell financial investments.

The Activity Requirement will have significant effects on a private equity fund's eligibility for the restricted assets of German insurance companies. The Activity Requirement will apply on a look-through basis at the level of the fund's investments for those funds that can claim their sole purpose is merely the holding of equity participations and subordinated loans. Others will need to show there is activity with entrepreneurial risk, which may create tax-related issues. Further, the look-through can be tricky for a fund of funds.

Conclusion

Investor demand and regulations are generating strong impulses for private equity funds to move into the regulated space. This will trigger further costs that put pressure on smaller sponsors. Innovative structures will have a competitive advantage when it comes to fundraising. ■

Dr Benedikt Weiser
Partner
Frankfurt, Germany
T: +49 69 79 41 1637
E: bweiser@mayerbrown.com

Dr Benedikt Weiser practices M&A, Private Equity, Finance, Capital Markets and Corporate Law. He focuses on advising both investors and fund sponsors on structuring and forming investment funds (private equity, real estate, infrastructure, Mezzanine and Hedge Funds) and navigating global tax and regulatory issues. He is Co-Industry Group Leader of Mayer Brown's global Investment Funds Group.

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Current status of Portuguese private equity

BY FRANCISCO XAVIER DE ALMEIDA AND VASCO RODRIGUES

Although private equity transactions may date back to the beginning of the 20th century, private equity would not gain its true form until after World War II, when venture capital and private equity firms American Research and Development Corporation and J.H. Whitney & Company were incorporated in 1946 in the United States. These firms were known for their investments in the buyouts of Digital Equipment Corporation and Florida Foods Company (which developed the Minute Maid orange juice), respectively, which created massive returns for their investors.

In Portugal the first private equity legal framework was enacted in the mid-1980s to facilitate alternate forms of financing of small and medium companies (SMEs) as opposed to traditional bank loans – this piece of legislation created the private equity companies (*sociedades de capital de risco* – SCRs) as a vehicle for private equity investment.

In its early stages (and, to a certain extent, today), banks and State wholly-owned entities dominated the industry, whereas their investments were primarily focused on distressed assets and turnarounds and not in private companies with high growth potential (as originally intended).

In the 1990s, private equity in Portugal took a step back with a surge of IPOs and privatisations flooding the markets and proving to be the primary target of investor demand. It was not until the end of the decade and beginning of the 21st century that private equity made its foothold in the markets, mostly because, on the one hand, there was an increase of investor demand and, on the other hand, legal developments came forward which: (i) facilitated the incorporation and operation of private equity companies and funds; and (ii) created tax benefits applicable to these investment instruments.

Moreover, the creation of private equity funds run by private and independent managers, such as Explorer Investments, Magnum Industrial Partners, and ECS Capital, greatly contributed to the development of the industry in the last decade.

The creation of private equity funds run by private and independent managers, greatly contributed to the development of the industry in the last decade.

Legal background

As the industry expanded, the legal regime applicable to SCRs and private equity funds (*fundos de capital de risco* – FCRs) was significantly amended in 2007 with the enactment of Decree-Law 375/2007, of 8 November, providing more flexibility and simplicity to the private equity activity. SCRs and FCRs maintained their position as the primary vehicles for private equity activity, whilst a new vehicle for private equity investment was created, the private equity investors (*investidores em capital de risco* – ICRs).

Main features of SCRs and ICRs

SCRs are companies incorporated under the companies limited by shares *(sociedades anónimas)* legal rules. SCRs may invest directly in other companies by purchasing minority or majority shareholdings in such companies or manage FCRs, acting on behalf of the FCRs' investors. If the SCR's sole activity is to manage FCRs, the share capital requirements for its incorporation are lower (€250,000) than if it intends to carry out private equity investments directly (€750,000).

ICRs are deemed, under the current legal framework, as private equity companies (SCRs) which must take the form of wholly-owned limited liability companies (*sociedade unipessoal por quotas*), the share capital shall be held by a single private individual. The creation of this instrument is based on the recognition by the Portuguese legislator of the relevance of business angels in the industry. Capital requirements of ICRs follow general corporate rules for these types of companies, i.e., €5000.

Main features of FCRs

FCRs incorporated in accordance with Portuguese laws are tax exempt, which makes them the preferred vehicle for private equity activities.

Under Portuguese law, FCRs are deemed as autonomous assets which are owned directly by the investors (LPs). The liability of investors is limited to their participation in the fund and although FCRs do not qualify as legal persons, legal action may be brought against them in a court of law.

The invested capital in a FCR is represented by participation units held by each investor, the minimum value of which must exceed €50,000 and, in aggregate, shall amount to at least €1m.

The operation of FCRs is carried out by a management company (general partner) – usually an SCR – who acts on behalf of participants of the fund (the LPs). The management company is legally bound to protect the interests of the LPs and to act in accordance with high standards of diligence and professional skills in all facets of the operation.

FCRs are subject to a management bylaws *(regulamento de gestão)*, drafted by the management company, which provide for a set of rules that the FCR and management company must follow in its operation, e.g., FCR's term and investment policy, indebtedness ratios, identification of the different categories of participation units and their respective rights and conditions, distribution of earnings to LPs and management company's fees.

New challenges

The global financial crisis may be deemed as both a blessing and curse for the private equity industry.

A blessing because the financial crisis presented private equity firms with investment opportunities in companies which have a good business model and maintain a high growth potential, but may be facing liquidity or financial issues which undermine their present value and, therefore, may be bought out for a lower consideration. Firms with liquidity may find excellent investment opportunities at low cost and, therefore, possibly maximising their returns in the future.

This is however the silver lining, as the financial crisis also created at least two major obstacles for the private equity industry.

The first is related with the fundraising activity, as the investor base has demonstrated that it is less prone to invest in FCRs.

The second is the credit crunch that has affected the markets in general and private equity firms in particular, especially those which focus their activities on leveraged buyouts. The credit freeze has also had an impact on the day-to-day operation of the companies held by private equity firms, jeopardising the growth and exit strategy that had been put in place at the time the investment was made.

For legal practitioners, the current environment has also given rise to new challenges, as lawyers are expected to be more creative in their participation in deals in order to overcome any issues that arise during a transaction. It is clear that transactions are taking a longer period of time to be finalised. In some cases, because of the uncertainty that has affected the markets in others because target's shareholders may feel unwilling to sell at the prices the market is giving them and may wish to hold out on selling their businesses at a later stage in a boom market. Legal advisers must play a crucial part as they may act as mediators and come up with solutions that fit the parties' needs and facilitate the conclusion of transactions.

Portuguese M&A activity has suffered deeply from the present market conditions and we have witnessed a sharp decline in deals since its peak in 2007. Private equity has not, however, followed this trend, as the amounts invested by private equity rose by 13.7 percent in 2009, according to the Portuguese Private Equity Association *(Associação Portuguesa de Capital de Risco)*.

In conclusion, all players, from private equity managers, to investors and lawyers, must adjust to these new market conditions if they intend to prosper in the current climate. ■

Francisco Xavier de Almeida
Partner Coordinator of the Capital Markets and Private Equity practice
Lisbon, Portugal
T: +35 121 095 8100
E: falmeida@rpa.pt

Francisco Xavier de Almeida joined RPA as an equity partner in 2007. He started his career at Grupo Legal Português (a joint venture with Simmons & Simmons) and moved to Linklaters in 2004 where he stayed until 2007. He studied law at Universidade Católica Portuguesa and has a LLM in banking and finance from the London School of Economics and Political Science.

Vasco Rodrigues
Senior Associate
Lisbon, Portugal
T: +35 121 095 8100
E: vrodrigues@rpa.pt

Vasco Rodrigues joined RPA in 2004 and has mainly worked in the Corporate and M&A / Capital Markets and Private Equity practices. Before RPA he was a trainee at Macedo Vitorino & Associados and an intern at Mullerat, in Barcelona. He studied law at Universidade Nova de Lisboa and has a LLM in international business law, from the King's College London.

UNITED STATES

Carried interest taxation: on the edge of a sea change?

BY MATTHEW P. LARVICK

So-called 'carried interests' are a popular form of equity compensation for managers of venture capital, private equity, and other investment funds. Such interests, represented by equity in a partnership or limited liability company, reward the fund's manager with a share – often 20 percent – of the fund's gains from its investments.

On 28 May 2010, the House of Representatives passed the American Jobs and Closing Tax Loopholes Act of 2010 (the 'Proposed Legislation'). Under the Proposed Legislation, taxable income generated by carried interests would be subject to ordinary income recharacterisation, regardless of whether the income would have otherwise been capital gains. Since individuals are taxable on ordinary income at a higher maximum rate than long-term capital gains (currently 35 percent versus 15 percent), this change would result in a significant tax increase for many fund managers.

As we finalise this article for publication, the Proposed Legislation is facing continued debate in the Senate. However, even if the bill is not enacted this go-around, this topic has been subject to increasing Congressional attention in recent years and may well resurface again. Thus, fund managers are well advised to monitor continuing developments in the area. Following is a discussion of the principal aspects of the Proposed Legislation, as modified to date by amendments proposed in the Senate.

The Proposed Legislation would mandate per se ordinary income treatment for 75 percent of the 'flow through' net income from an investment services partnership interest.

How would the Proposed Legislation change the tax treatment of carried interests?

Under current law, a carried interest may generate capital gains or ordinary income, depending on the nature of the taxable income generated by the fund's underlying investments. For example, if a fund sells an investment and generates a long-term capital gain, a portion of this gain is allocated (or 'flows through') to the fund's manager. Moreover, the sale of a carried interest held for more than one year normally generates a long-term capital gain, except to the extent the fund holds certain ordinary income-flavoured assets.

The Proposed Legislation would significantly change this treatment for carried interests, referred to in the legislation as 'investment services partnership interests'. The Proposed Legislation would mandate per se ordinary income treatment for 75 percent of the 'flow through' net income from an investment services partnership interest. Moreover, 75 percent of the gain realised from the disposition of such an interest would be per se ordinary income. The Proposed Legislation would also subject the recharacterised ordinary income component to self-employment tax.

In the case of gains from assets held at least five years, and from the sale of an interest attributable to such assets, only 50 percent, rather than 75 percent, of the gain would be subject to ordinary income recharacterisation. For these purposes, the holding period for 'Section 197 intangibles', such as goodwill, is treated as not less than the holding period of the associated investment services partnership interest. In the case of non-individual taxpayers, ordinary income recharacterisation applies to all (rather than to 75 percent or 50 percent) of the associated income discussed above.

The Proposed Legislation contains provisions designed to forestall avoidance of the new rules. For example, with limited exception, any disposition of an investment services partnership interest would trigger the tax on the ordinary income component, even if the transaction otherwise would have been a non-recognition transaction for income tax purposes. Second, a distribution of appreciated property to the holder of an investment services partnership interest would trigger taxable income recognition for the ordinary income component, notwithstanding that, with certain exceptions, distributions of property from partnerships generally are not otherwise taxable. The Proposed Legislation also extends to 'disqualified interests', which are certain non-equity instruments (such as options or convertible debt) tied to the performance of an entity's assets.

What types of carried interests would be covered?

The Proposed Legislation would target 'investment services partnership interests'. An investment services partnership interest means any interest a partnership which is held, directly or indirectly, by any person if it was reasonably expected, at the time such interest was acquired, that such person (or a related person) would provide a substantial quantity of certain services with respect to assets held directly or indirectly by the partnership. The services are: (i) advising as to the advisability of investing in, purchasing, or selling any 'specified asset'; (ii) managing, acquiring, or disposing of any 'specified asset'; (iii) arranging financing with respect to acquiring 'specified assets'; and (iv) any activity in support of the foregoing services.

For the above purposes, 'specified assets' includes shares of stock in a corporation, notes, bonds, debentures, other evidences of indebtedness, interest rate, currency and equity swaps, real estate held for rental or investment, interests in partnerships, actively traded commodities (including derivatives and certain hedges relating thereto), and options or derivative contracts with respect to any of the foregoing. Certain 'family farms' would be excluded.

How would co-investments be treated?

In addition to receiving a carried interest in a fund, a fund manager often will 'co-invest' alongside investors. To potentially mitigate ordinary income recharacterisation for such interests, the Proposed Legislation provides special treatment for 'qualified capital interests'.

A 'qualified capital interest' means the portion of an interest in partnership capital attributable to the contribution of money or property (but not services) to the partnership in exchange for the interest. However, an interest will not be treated as a qualified capital interest to the extent that it was acquired using proceeds of a loan made or guaranteed by another partner, the partnership, or a person related to the foregoing. A qualified capital interest is further adjusted upwards and downwards to reflect net allocations of taxable income (including income recognised upon the grant of the interest), losses and distributions.

The Proposed Legislation provides that 'flow through' income attributable to a qualified capital interest is not subject to ordinary income recharacterisation. For this exception to apply, however, the taxable income allocations made to such interest must be made in the same manner as to other qualified capital interests held by unrelated partners not providing the proscribed services, and such other allocations must be 'significant'. However, unless otherwise provided in regulations, the same-allocation requirement is not violated if the allocations made to such interest do not reflect the cost of investment management services provided by the holder of the interest or a related person, such as for self-charged carry and management fees.

In the event of a disposition of an investment services partnership interest of which a qualified capital interest is a component, a portion of the gain or loss is exempt from ordinary income recharacterisation. The exempt portion is based on the gain or loss that would be allocated to the qualified capital interest if all of the partnership's assets were sold at fair market value, compared to the gain or loss that would be allocated to the overall investment services partnership interest in such case.

The Proposed Legislation would generally apply to taxable years ending (and distributions and dispositions occurring) after 31 December 2010, and the disqualified interest provisions would take effect on such date. If the Proposed Legislation is enacted, many fund managers will find that the anticipated after-tax return from their carried interests has been significantly diminished. ■

Matthew P. Larvick
Shareholder
Chicago, IL, United States
T: +1 (312) 609 7970
E: mlarvick@vedderprice.com

Matthew Larvick is a shareholder in the tax group of Vedder Price P.C. His experience includes forming, structuring, and advising private equity and hedge funds, corporate joint ventures, and real estate investment vehicles. He is also an adjunct professor in the IIT Chicago-Kent College of Law Graduate Tax Program.

UNITED STATES

US private equity industry assesses impact of financial industry reform legislation

BY CYANE B. CRUMP, JAMES S. SEEVERS, JR. AND PETER G. WEINSTOCK

While the US private equity industry gains momentum and recovers from periods of inactivity, Congress passed, and the President is expected to sign, the 'Dodd-Frank Wall Street Reform and Consumer Protection Act' – comprehensive financial reform legislation intended to address the perceived causes of the financial industry-led economic downturn. Several aspects of the Act will impact the private equity industry. Fund managers will seek to adapt to the amendments to the Investment Advisers Act of 1940. Some fund managers will need to register with the SEC for the first time and others will experience changes in their compliance frameworks. Further, regulated financial institutions will attempt to navigate the 'Volcker Rule' components of the Act, which limit the ability of banks and their affiliates to sponsor, invest in or engage in certain transactions with private equity and other private investment funds.

Private Fund Investment Advisers Registration Act of 2010

The Act includes the 'Private Fund Investment Advisers Registration Act of 2010' (PFIARA), the most recent incarnation of a variety of similar bills considered by Congress in recent years designed to: (i) require more fund managers to register as investment advisers under the Advisers Act; and (ii) impose enhanced reporting and disclosure requirements applicable to all registered investment advisers. While these reforms were perhaps directed primarily at hedge fund managers, they also will impact private equity managers.

The PFIARA will be effective one year after enactment in July 2011 – but investment advisers may register before the effective date.

The PFIARA eliminates the 'private adviser' or '15 client' exemption from registration under the Advisers Act, the exemption commonly relied on by private equity fund managers sponsoring less than 15 investment vehicles. In its place, there are several new exemptions applicable to a variety of fund managers, including:

Small private fund managers. The PFIARA exempts from registration (but not recordkeeping and reporting) advisers that solely advise 'private funds' and have assets under management in the US of less than $150m. The term 'private fund' is defined to include any investment fund that relies on the exceptions from investment company status found in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.

Venture capital fund managers. The PFIARA exempts from registration (but not recordkeeping and reporting) advisers solely to one or more 'venture capital funds'.

Family offices. The PFIARA excludes 'family offices' from the definition of 'investment adviser', resulting in the exclusion of family offices from coverage by the Advisers Act, including its registration, record keeping and reporting requirements.

Foreign private advisers. The PFIARA adds a new narrow exemption from registration for 'foreign private advisers'. To qualify, the adviser must have no place of business in the United States and must have fewer than 15 US investors with aggregate assets under management of less than $25m attributable to such investors.

In addition, the PFIARA directs the SEC, in carrying out its rulemaking, to provide for registration and examination procedures for advisers to 'mid-sized private funds' that reflect the level of systemic risk those funds present, although such advisers are not exempt from the registration requirements generally.

Congress did not define the terms 'mid-sized private fund', 'venture capital fund' or 'family office', but directed the SEC to do so. As a result, it is not yet clear what advisers will be covered or how the recordkeeping, reporting and other regulations under the Advisers Act will differ for such advisers. Prior versions of the PFIARA included an additional exemption for 'private equity fund' managers, leaving to the SEC what constitutes a private equity fund. Such an exemption is noticeably absent from PFIARA.

As a result of these changes and subject to SEC rulemaking laying out the new exemptions, it appears that private equity managers with more than $150m in assets under management will need to register. Many of these firms, particularly the larger ones, have already registered for a variety of reasons, not the least of which is the sense that the LP community, particularly fiduciary investors, have a strong preference for investing with registered investment advisers. However, there are likely to be many middle-market fund managers and newer fund managers now needing to register as a result of PFIARA.

The PFIARA also directs the SEC to require registered investment advisers to private funds to maintain and file additional records and reports regarding the private funds they advise, including information relating to assets and investments under management, trading practices, use of leverage, counterparty credit risk exposures, valuations and side letters. We suspect these additional disclosures will assist the SEC in focusing attention (and possibly enforcement activities) on potential conflicts of interest, investor disclosures, valuation matters and other related topics on which the LP community increasingly has focused. As a result, even those fund managers that are already registered will need to run their businesses with a renewed focus on compliance.

The PFIARA will be effective one year after enactment in July 2011 – but investment advisers may register before the effective date.

The Volcker Rule

The Act also includes provisions, known as the 'Volcker Rule', restricting certain regulated financial institutions from engaging in proprietary investment activities, requiring the new Financial Stability Oversight Council to conduct a study, and directing certain federal banking regulators and the SEC to issue regu lations implementing the Volcker Rule.

The Volcker Rule applies to banking entities, including insured banks or thrifts, companies that control insured banks or thrifts, companies that are treated as bank holding companies and their affiliates and subsidiaries. Since smaller banking entities generally have not focused on private equity as a business strategy, such banking entities generally will be less affected by the Volcker Rule.

The Volcker Rule imposes three general categories of restrictions on these entities. First, it prohibits these entities from acquiring or retaining any interest in or sponsoring a 'hedge fund' or 'private equity fund'. Second, it prohibits these entities from entering into a 'covered transaction' (including loans, purchases of assets or securities and guarantees) with a hedge fund or private equity fund. Third, these entities are prohibited from engaging in proprietary trading. The terms 'hedge fund' and 'private equity fund' are loosely defined to include many private investment funds.

The Volcker Rule permits certain de minimis investments in hedge funds and private equity funds that would otherwise be prohibited if those investments: (i) do not exceed 3 percent of the total ownership interests of any particular fund; and (ii) do not represent in aggregate more than 3 percent of the Tier 1 capital of the banking entity. This exception also permits organising, offering and serving as a general partner or managing member of the fund, provided the banking entity complies with a number of conditions. While this 3 percent exemption initially may appear helpful to the industry, it raises a number of questions. For example, what happens if a banking entity relying on this exemption experiences appreciation of fund investments or depreciation in other sectors resulting in an over-allocation to private funds? Presumably, these and other important questions will be addressed in the rulemaking process.

Compliance with the new prohibition on 'covered transactions' between a banking entity serving as investment adviser to a fund and the fund may be challenging. As a practical matter, 'covered transactions' include a number of related-party transactions between the fund and affiliated banking entities. Some banking entities will need to choose between providing debt financing and serving as sponsor to a fund group receiving an equity interest with potential for performance fee/carried interest returns.

Banking entities with captive fund management groups or fund portfolios will need to carefully assess their portfolios for compliance with the new Volcker Rule. As a consequence, we may see more activity in secondary sales of LP portfolios, spin-outs of alternative asset management operations and other divestitures of fund businesses by banking entities.

The Volcker Rule is effective on the earlier of: (i) 12 months after the date of issuance of the implementing rules; or (ii) two years after the date of enactment. After enactment, there is a two-year divestiture period. The Federal Reserve may provide up to three additional one-year extensions, provided the divesting party is using good faith to expedite its termination of ownership.

The Act could have real and lasting impacts on the private equity industry. It is clear that additional private equity fund managers will need to register with the SEC, but it is not clear the extent to which SEC rulemaking will exempt managers of certain funds or the extent to which enhanced fund disclosure and reporting will change GP behaviour and/or SEC priorities. Further, it appears alternative asset fund sponsorship and investment by banks will wane, while spin-outs and secondary portfolio sales will rise. However, whether continued meaningful bank participation in the industry is viable at all will depend on rulemaking by multiple federal agencies. Private equity participants will not sit idly by, but will engage, react and evolve as does their regulation. ■

Cyane B. Crump
Partner
Richmond, VA, United States
T: +1 (804) 788 8214
E: ccrump@hunton.com

Cyane B. Crump is a partner in the Private Equity practice of Hunton & Williams LLP. Her transactional practice focuses on corporate and securities matters with a particular emphasis on private investment fund formations and compliance.

James S. Seevers, Jr.
Partner
Richmond, VA, United States
T: +1 (804) 788 8573
E: jseevers@hunton.com

James S. Seevers, Jr. is a partner and the chair of the Private Equity practice of Hunton & Williams LLP. He regularly represents sponsors of private equity and other private investment funds and alternative asset investors in all aspects of their businesses, including fund formation and structuring, offerings, investments, platform establishment, secondary transactions, divestitures and compliance matters.

Peter G. Weinstock
Partner
Dallas, TX, United States
T: +1 (214) 468 3395
E: pweinstock@hunton.com

Peter G. Weinstock is a partner and the co-chair of the Financial Institutions Corporate & Regulatory practice of Hunton & Williams LLP. His practice focuses on corporate and regulatory representation of financial institution franchises.