Debevoise & Plimpton Private Equity Report

Summer 2010 | Volume 10 | Number 4

TRENDWATCH

The Terms They Are a-Changin' — Or Are They?

As our readers well know, private equity fundraising declined dramatically in 2009 as compared to the 2005 to 2008 period. Then, in September 2009, the Institutional Limited Partners Association released its Private Equity Principles *(the "ILPA Report"), giving investors an additional tool to use in negotiating the terms of their investments in private equity funds.*[1] *These developments have led many industry observers to the conclusion that the balance of power in negotiating private equity fund terms has shifted from fund sponsors (GPs) to fund investors (LPs). In this "Trendwatch," we analyze data from Debevoise & Plimpton LLP's proprietary funds database to determine whether, in fact, the key economic terms of buyout funds have changed since the end of 2008.*

In August 2009, a *Wall Street Journal* blog post headlined "The Terms They Are A-Changin'" stated that the "atrocious fund-raising market and the feeble deal environment have forced general partners to start listening and stop dictating, for the times have changed." The article offered one sponsor's carried interest reduction (from an above-market 25% to a standard 20% share of fund profits) and another sponsor's adjustment to certain aspects of its management fee calculation as evidence that the tables have turned.

Whether in fact GPs were able to dictate

CONTINUED ON PAGE 18

© 2010 The New Yorker Collection from cartoonbank.com. All Rights Reserved.

"No, I don't want you to change, but it would be great if you were completely different…"

WHAT'S INSIDE

3 GUEST COLUMN
A Discussion with John F. Lehman

5 Commitments After the Credit Crunch: Have Terms Changed?

7 Investment Adviser Registration: Preparing for the New Environment

9 ALERT
More Process and Disclosure, But Little Change, in Executive Compensation Practices

11 Consider This Before Renewing Your D&O and General Partner Liability Insurance

13 UK Bribery Act Requires Prompt Action by Global Private Equity Firms

15 UPDATE
EU Directive on Alternative Investment Fund Managers: Are the Trialogues Multiplying?

16 UPDATE
Placement Agents and In-House Fundraisers Must Register as Lobbyists in California

Letter from the Editor

If we needed a theme for our (Indian) summer issue, it might be that notwithstanding dramatic changes in the economic landscape, the credit markets, the fundraising scene, the regulatory environment and the deal climate, it might be that the more things change in the private equity world, the more they stay fundamentally the same. As we reviewed the articles for this issue, we found an almost surprising adherence to some well-established norms in the private equity marketplace.

On our cover, we are pleased to revive Trendwatch, a favorite feature of *The Debevoise & Plimpton Private Equity Report* in which we use our proprietary database of over 60 business and legal terms from over 1,800 private equity funds to track trends in fund agreements and structures. In this Trendwatch, Michael Harrell compared the terms of funds which have closed since 2008 with those that closed between 2005 and 2008 to identify whether the ILPA report and other economic factors had dramatically changed key economic terms of buyout funds. You may be surprised at his conclusion.

Elsewhere in this issue, Jeffrey Ross and Scott Selinger analyze the terms of financing commitments after the credit squeeze of 2008 and 2009. They report that while financing sources have gained some ground in expanding pricing and structural flex provisions and shortening commitment periods, the narrower "Sunguard" conditionality provisions that evolved during the boom years generally remain the market standard in larger sponsored deals.

Unlike many in the financial services industry, private equity firms not affiliated with banks largely dodged the Congressional bullet contained in the Dodd–Frank Act. While private equity sponsors will now have to register with the SEC as investment advisors, the burdens imposed by such registration should be manageable. We provide guidance on determining which entity in the sponsor family needs to register and on the most significant of the substantive and procedural regulatory challenges in store for newly registered investment advisers.

In our Guest Column, former Secretary of the Navy, John F. Lehman discusses his transition from the government to private equity and provides some thoughtful and well-informed perspective on the interaction between business and politics and the challenges to investing in the defense sector.

Private equity firms with portfolio companies conducting business in the UK should not miss our article on the recently adopted UK Bribery Act. Although this act is not due to take effect until April 2011, we note that its broad scope and expansive definitions may reach the activities of sponsors outside of the UK who maintain subadvisors or have UK-based portfolio companies. Unfortunately, waiting until closer to the effective date to review anti-corruption policies and procedures in light of the Act could be a costly mistake.

We also remind our readers of what to consider when renewing D&O and general partnership liability insurance and update you on the Dodd-Frank Act's changes to corporate governance and executive compensation rules and on the ongoing saga in the EU on the proposed regulatory framework for private equity and hedge fund managers operating in Europe.

As always, we look forward to your comments and your suggestions on what aspects of the private equity industry you would like to see featured in future issues of *The Debevoise & Plimpton Private Equity Report*.

Franci J. Blassberg
Editor-in-Chief

Private Equity Partner/Counsel Practice Group Members

The Debevoise & Plimpton Private Equity Report is a publication of

Debevoise & Plimpton LLP
919 Third Avenue
New York, New York 10022
1 212 909 6000

www.debevoise.com

Washington, D.C.
1 202 383 8000

London
44 20 7786 9000

Paris
33 1 40 73 12 12

Frankfurt
49 69 2097 5000

Moscow
7 495 956 3858

Hong Kong
852 2160 9800

Shanghai
86 21 5047 1800

Franci J. Blassberg
Editor-in-Chief

Stephen R. Hertz
Andrew L. Sommer
Associate Editors

Ann Heilman Murphy
Managing Editor

David H. Schnabel
Cartoon Editor

Please address inquiries regarding topics covered in this publication to the authors or any other member of the Practice Group.

All contents © 2010 Debevoise & Plimpton LLP. All rights reserved.

The Private Equity Practice Group
All lawyers based in New York, except where noted.

Private Equity Funds
Marwan Al-Turki – London
Kenneth J. Berman – Washington, D.C.
Erica Berthou
Jennifer J. Burleigh
Woodrow W. Campbell, Jr.
Sherri G. Caplan
Jane Engelhardt
Michael P. Harrell
Geoffrey Kittredge – London
Anthony McWhirter – London
Marcia L. MacHarg – Frankfurt
Jordan C. Murray
Andrew M. Ostrognai – Hong Kong
Gerard C. Saviola – London
David J. Schwartz
Rebecca F. Silberstein

Hedge Funds
Byungkwon Lim
Gary E. Murphy

Mergers & Acquisitions
Andrew L. Bab
E. Raman Bet-Mansour – Paris
Paul S. Bird
Franci J. Blassberg
Richard D. Bohm
Thomas M. Britt III – Hong Kong
Geoffrey P. Burgess – London
Marc Castagnède – Paris
Neil I. Chang – Hong Kong
Margaret A. Davenport
E. Drew Dutton – Hong Kong
Michael J. Gillespie
Gregory V. Gooding
Stephen R. Hertz
David F. Hickok – London
James A. Kiernan III – London
Antoine F. Kirry – Paris
Jonathan E. Levitsky
Guy Lewin-Smith – London
Li Li – Shanghai
Dmitri V. Nikiforov – Moscow
Robert F. Quaintance, Jr.
William D. Regner
Kevin A. Rinker
Jeffrey J. Rosen
Kevin M. Schmidt
Thomas Schürrle – Frankfurt
Wendy A. Semel – London
Andrew L. Sommer
Stefan P. Stauder
James C. Swank – Paris
John M. Vasily
Peter Wand – Frankfurt

Leveraged Finance
Katherine Ashton – London
William B. Beekman
David A. Brittenham
Paul D. Brusiloff
Pierre Clermontel – Paris
Alan J. Davies – London
Peter Hockless – London

GUEST COLUMN

A Discussion with John F. Lehman

John F. Lehman, founder and chairman of the middle-market private equity investment firm J.F. Lehman & Company, served for six years as Secretary of the Navy under President Ronald Reagan, and more recently as a member of the 9/11 Commission. As Secretary of the Navy, Dr. Lehman managed 1.2 million people and an annual budget of $95 billion. He brought to the Navy and worked to implement his vision for a 600-ship fleet. Dr. Lehman, who received his Ph.D. in International Relations from the University of Pennsylvania, led the Aerospace and Defense Group at PaineWebber, Inc. before founding J.F. Lehman & Company. He is also the author of several books, including On Seas of Glory *and* Command of the Seas.

Not surprisingly, the J.F. Lehman & Company funds have focused on businesses with a defense, maritime or aerospace focus. Debevoise partners Andrew Bab, Sherri Caplan and Rob Quaintance recently sat down with Dr. Lehman to get his views on the industry and its future, how business and politics interact and what the key challenges are when investing in these sorts of businesses.

John, how did you get into the private equity business?

When I was at the Navy I saw a great deal of uneconomic behavior at both the government and the private sector companies that served it. In general, the Navy focused on relationships with the bigger firms and avoided competitive bidding in the name of economies of scale. The military tried to tie itself to suppliers that it felt it could control to some degree. The thought was that by building these strong associations, the military could set the supply agenda — what to produce, when to produce it and how much to produce. Cost took a back seat to the professed needs of the military. From the defense company's perspective, the important thing was to bind oneself to the customer — knowing that you were the preferred supplier with all the benefits that this position implies. Defense companies did everything they could to be completely responsive to the government's demands, no matter how unreasonable, impractical or uneconomic they might be. Now I'm exaggerating a bit here, but both sides created a structure that was simply inefficient. As Secretary of the Navy, I tried to change the way the government did business — a goal that President Reagan wholeheartedly supported. I believed then, and still do, that many defense contractors could and should be much more focused on running themselves as businesses. My strong view is that by following sound business principles and through open market competition companies can best serve the nation's armed forces and provide the best goods and services at the lowest cost. My partners and I founded J.F. Lehman & Company on the premise that well-run, middle market defense companies, utilizing sound business principles, with strong, forward-looking products or service offerings, could be nimble and responsive enough to serve the government customer effectively and efficiently. The government would ultimately conclude that the best overall solutions do not necessarily come from the larger, entrenched prime contractors.

Was it hard to break in?

There are high barriers to entry to successfully investing in these sectors. The defense world has its own accounting policies, unique contracting vehicles and stringent regulatory requirements. Information can be difficult to access. The Pentagon is not one customer, but can be a labyrinth of hundreds of different customer entities each with their own cultures, budgets and priorities. If you set that against the backdrop of a dynamic defense policy and program environment, these can be challenging waters to navigate. We were able to do it successfully because we had the required expertise resident in the firm.

We're seeing significant changes in our armed services around the world. Military activity in Iraq and Afghanistan appears to be winding down, and the country's defense budget has stopped growing as rapidly. How

CONTINUED ON PAGE 4

Alan V. Kartashkin – Moscow
Pierre Maugüé
Margaret M. O'Neill
Nathan Parker – London
A. David Reynolds
Jeffrey E. Ross
Philipp von Holst – Frankfurt

Tax
John Forbes Anderson – London
Eric Bérengier – Paris
Andrew N. Berg
Pierre-Pascal Bruneau – Paris
Gary M. Friedman
Peter A. Furci
Friedrich Hey – Frankfurt
Adele M. Karig
Rafael Kariyev
Vadim Mahmoudov
Matthew D. Saronson – London
David H. Schnabel
Peter F. G. Schuur
Richard Ward – London

Trust & Estate Planning
Jonathan J. Rikoon
Cristine M. Sapers

Employee Compensation & Benefits
Lawrence K. Cagney
Jonathan F. Lewis
Alicia C. McCarthy
Elizabeth Pagel Serebransky
Charles E. Wachsstock

The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein. Any discussion of U.S. Federal tax law contained in these articles was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. Federal tax law.

would you expect these developments to affect private equity investment in the defense industry?

Well, perhaps paradoxically, I'd expect there to be significant new opportunities for investors in this sector, but they are not for the faint of heart. It's not just developments in specific theaters that affect the industry, but a broad change in our defense strategy and the structure of our armed services as a whole. We have been moving away from the old Cold War-era model, in which our nation's military trained and prepared for a monolithic threat from the Soviet Union, towards a more agile fighting force with a focus on the asymmetric threats of terrorism and smaller regional conflicts around the world. Additionally, demands are being placed on our national defense resources to deal with longer-term potential threats from nations emerging as regional or global powers.

What does that mean for investment in the defense industry? Well, for one thing, it means that there will likely be a wave of dispositions and acquisitions, particularly by the larger players, as firms try to predict the direction in which the Pentagon may be heading, realign their businesses accordingly and shed what they perceive to be older, non-core technologies. Businesses will try to reinvent themselves to meet the changing demands of their customer, which will require new capital, new ideas and, in many cases, new, knowledgeable management.

...I'd expect there to be significant new opportunities for investors in this sector, but they are not for the faint of heart....[T]here will likely be a wave of dispositions and acquisitions, particularly by the larger players, as firms try to predict the direction in which the Pentagon may be heading, realign their businesses accordingly and shed what they perceive to be older, non-core technologies.

For instance, a number of the larger prime contractors have sold, or are selling, their government systems engineering or systems integration business units in response to the government's desire to eliminate potential OCI issues (organisational conflicts of interest). These same companies have undergone a tremendous push to acquire businesses that they feel will position them best for the future defense dollar. Based on the recent M&A activity in the industry, the area of focus for many of the larger defense companies seems to be C4ISR (theater and tactical sensors, unmanned systems and cyber security) — those technologies, products and services that are being utilized against today's asymmetric threat.

You mentioned that investment in this sector is not for the faint of heart. What did you mean by that?

Whenever you deal with the government there are hidden risks, particularly for the uninitiated. Procurement policy is labyrinthine. Strategy and political focus change in ways that can make or break companies, especially those with a limited customer base, narrow product focus or those that are slow to adapt to new rules and demands. For instance, small companies with heavy exposure to particular defense programs such as the F-22 fighter or C-17 transport—programs that began life with optimistic volume assumptions—should see significant pressure on sales following the announced wind-down of these programs.

Let me give you another example. The Pentagon, as you may know, is required to spend 5% of its procurement budget to purchase goods and services from small businesses. If it had its druthers, it would probably not buy from many of these small businesses, either because there are better suppliers or because it prefers to buy from the larger companies under the assumption that there are economies of scale. A private equity firm evaluating one of these companies as a possible investment may see solid revenues coming from government customers. The firm concludes that it likes the track record and prospects for government spending in this area, so it goes ahead with the acquisition. Well, this "small business" is now part of the private equity firm's larger portfolio, and the company may no longer be classified as a small business! The Pentagon may direct its business elsewhere and fill the hole in its 5% small business quota with a different supplier, and the private equity firm's investment goes up in smoke…just like that.

You've shown us that one key to successful private equity investing in this sector is knowledge of hidden risks. What other factors do you think make investing in the defense space different?

Understanding of the target's technology is a key factor. Technology is a critical element for nearly any successful defense contractor. Is it truly unique and how easily can it be replicated or replaced by potential competitors looking to enter the market? Can it be adapted to changing

CONTINUED ON PAGE 21

Commitments After the Credit Crunch: Have Terms Changed?

Although much has been written, in this publication and elsewhere, about the evolution of conditionality in private equity acquisition agreements, there has been much less commentary on the symbiotic and largely parallel development of conditionality in debt financing commitments. This article explores the development of conditionality in commitment letters for acquisition financings from the days of market material adverse change ("market MAC") and diligence conditions, through the emergence during the LBO boom of a new paradigm, referred to as "SunGard conditionality," that substantially increased sponsor certainty that debt funding would be available at closing.[1] Contrary to the expectations of some during the credit crunch, absent a significant downturn in the credit markets, we expect that financing conditionality in sponsored acquisitions will continue to look more like the SunGard structure than anything that came before it.

Before-SunGard

Until early 2005, private equity acquisition agreements generally permitted a buyer to terminate the acquisition agreement without penalty if—despite the buyer's efforts—the debt financing necessary to consummate the transaction proved to be unavailable. This was necessarily the case because financing commitments for acquisitions were subject to their own set of distinct conditions that operated independent of the conditions in acquisition agreements. These typically included:

- a condition as to the accuracy of all of the representations in the definitive financing documentation;
- a condition that there be no default under the definitive financing documentation;
- a stand-alone no business material adverse effect ("business MAE") condition, which was sometimes broader than the business MAE in the acquisition agreement, and often included prospects of the target business and fewer or different exceptions;
- a no market MAC condition;
- a condition that security in all collateral be perfected;
- a condition that the financing sources had satisfactorily completed their diligence;
- a condition that no new material adverse information had arisen or become known prior to closing (an "information MAC"); and
- financial metric conditions, such as minimum EBITDA or maximum leverage.

In light of this divergence between the conditionality in acquisition agreements and debt financing commitments, broad financing outs in acquisition agreements were viewed by sponsors and their counsel as indispensable. The need for a financing condition, however, put private equity firms at a disadvantage to strategic buyers when competing for an acquisition target. Beginning with the increasingly competitive auctions in early 2005, both sellers and private equity sponsors in the U.S. looked for ways to eliminate the financing condition and put private equity buyers on an equal footing with corporate buyers.

The Emergence of SunGard Conditionality

The SunGard buyout in 2005 ushered in the new standard for conditionality in both acquisition agreements and debt financing commitments. The SunGard acquisition agreement and those that followed during this period introduced the reverse termination fee ("RTF") and limited specific performance structure in larger public transactions that has become customary and well-known. Similarly, the debt financing commitments in connection with these acquisitions sought to eliminate conditionality that differed from or was in addition to the conditionality under the acquisition agreement.

First, these debt financing commitments abandoned diligence conditions, information MAC conditions and financial metric conditions. Notably, SunGard and other early deals did include limited market MAC conditions which fell away entirely in later acquisitions, as discussed below. Second, these commitments limited the condition as to the accuracy of representations to (1) those in the acquisition agreement that are material to the interests of the financing sources and

CONTINUED ON PAGE 6

Contrary to the expectations of some during the credit crunch, absent a significant downturn in the credit markets, we expect that financing conditionality in sponsored acquisitions will continue to look more like the SunGard structure than anything that came before it.

---

[1] *For a discussion of the evolution of conditionality in private equity acquisition agreements, see "Acquisition Agreements After the Credit Crunch: What's Next?" in Vol. 8, Number 1, of the Debevoise & Plimpton Private Equity Report and "Allocating Financing Risk: Recent Trends in Sponsor-Led Public Company LBOs" in Vol. 10, Number 3, of the Private Equity Report.*

Commitments After the Credit Crunch (cont. from page 5)

then solely to the extent the buyer had a right to terminate the acquisition agreement as a result of any relevant inaccuracy, and (2) those in the definitive financing documentation that are in most respects of a purely ministerial or legal nature (*i.e.*, those relating to the corporate power and authority of the borrowers to enter into, and the enforceability of, the financing documentation, and compliance with Federal Reserve margin regulations and the Investment Company Act). This limited list of representations came to be known as the "Specified Representations." Third, conditionality relating to perfection of security was limited such that, to the extent perfection could not be completed prior to closing without undue burden or expense, perfection was expressly permitted to be achieved post-closing with certain very narrow exceptions (*e.g.*, the filing of UCC financing statements and the delivery of stock certificates). This new paradigm for conditionality of debt financing commitments quickly became known as "SunGard conditionality."

From the spring of 2005 through the middle of 2007, SunGard conditionality became the norm in debt financing commitments for large private equity-sponsored transactions. Following the groundbreaking developments in SunGard, conditionality for debt financing commitments tightened even further as the credit markets became more fevered and the LBO boom progressed. These developments included the elimination of the market MAC condition, the synching of the business MAE condition in the debt financing commitments with the business MAE condition in the acquisition agreement, and the agreement by financing sources to underwrite financing commitments on terms consistent with "sponsor precedent," thus reducing documentation risk, at least in theory. By the end of 2006 and the beginning of 2007, RTFs in acquisition agreements and limited conditionality in debt financing commitments, in the form of SunGard conditionality, had become ubiquitous in larger sponsored acquisitions.

In the absence of the broad conditionality of the pre-SunGard era, lenders have taken to protecting themselves from market risk through shorter commitment terms and an ever-expanding list of "market flex" provisions.

The Credit Crunch

The credit market meltdown and the very public brinksmanship between financial sponsors and their financing sources as to the availability of financing in a number of deals with SunGard conditionality, followed by the precipitous fall in the volume and size of leveraged acquisitions in 2008 and 2009, created considerable uncertainty as to the level of the conditionality that would be associated with future private equity acquisitions. Conventional wisdom suggested that, in the context of tighter credit markets and with the benefit of recent experience, financing sources might well demand a shift away from the RTF/SunGard standard towards something more analogous to pre-SunGard conditionality.

In some respects, early deal activity during this period supported this view. For example, staple financing commitments in connection with auctions, in the rare cases in which a staple was available, were highly conditional, along the lines of pre-SunGard leveraged acquisitions. For those leveraged deals that were done, commitments sometimes included old-style conditionality, including market MACs, limited due diligence outs, and financial metric conditions. The reintroduction of this conditionality and the deviation from SunGard conditionality in these transactions also forced sponsors to deviate from the RTF structure in their acquisition agreement to either a traditional financing out approach or to what have become known in some circles as "mini-financing outs" (*i.e.*, financial metric conditions in the acquisition agreement that parallel those demanded by financing sources in the debt financing commitments).

While deal flow was not sufficient to constitute a trend, many felt that the handwriting was on the wall and the halcyon days of RTFs and SunGard conditionality were gone for good. Under this view, private equity sponsors would once again find themselves at a disadvantage to strategic buyers when the buyout market returned in earnest.

Where's the Market Today?

Happily for all, deal activity has picked up significantly over the last year, and, happily for private equity sponsors and their advisors, it appears that the SunGard framework for debt financing conditionality that emerged during the 2005-2007 period has reasserted itself with only limited modifications around the edges. Despite expectations during the credit crunch to the contrary, we expect that trend to continue.

While there has not been, and, absent a significant disruption in the credit markets, we do not expect that there will be, a paradigmatic shift in the way sponsored deals get done, there is a heightened focus by financing sources on conditionality in debt financing commitments, and they are certainly seeking to roll-back some of the gains made by sponsors at the height of the buyout boom. We discuss below some of

CONTINUED ON PAGE 23

Investment Adviser Registration: Preparing for the New Environment

While most of the financial services industry is still reeling from the 2,300 plus page Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") that dramatically changed the regulatory environment, private equity sponsors should be relieved that they largely escaped the wrath of Congress. The Dodd-Frank Act should not have a significant impact on private equity sponsors (except, of course, those affiliated with banks that are subject to the Volcker Rule). However, most private equity sponsors will be required to register with the Securities and Exchange Commission (the "SEC"). Among other things, the Dodd-Frank Act repeals, effective July 21, 2011 (the "Effective Date"), the exemption from registration under the Investment Advisers Act of 1940 (the "Advisers Act") relied upon by most private equity fund sponsors.

While registration will impose some burdens, those burdens should be manageable. The SEC must still resolve some details — including the scope of new exemptions for venture capital fund managers and smaller private fund sponsors[1] — currently unregistered private equity fund sponsors should begin preparing to register and for the burdens that will be imposed by registration.

1 *Under certain circumstances, an advisory firm that has less than $100 million of assets under management would be required to register with the state in which it has its principal office and place of business and could not register with the SEC. This article does not address the issues that may be faced by state-registered investment advisers. A future article will address the regulatory issues faced by registered investment advisers that have their principal place of business outside of the United States.*

Getting Registered

Which Entities Should Register?

Substance is important, but the first step is getting registered. The first question that a private fund sponsor must address is identifying which entity should register: the manager, who undertakes the day-to-day management of the private fund, the fund's general partner, or both? This question may become more complicated depending on the manner in which the sponsor has organized the entities that manage its funds. The SEC staff has taken the view that, as a general matter, the general partner (which, from the SEC's perspective, is an investment adviser) need not register if the manager registers and (1) all of the investment advisory activities of the general partner are subject to the Advisers Act and SEC examination and (2) the general partner and all of its employees and persons acting on its behalf are subject to the registered adviser's supervision and control.

Form ADV

An investment adviser registers with the SEC by filing a Form ADV. Form ADV includes two parts. Part 1A requires general identification and financial information about the adviser and its business, including whether it maintains custody of client assets and information regarding the disciplinary history of the adviser and its employees. Part II of Form ADV, which is designed to be a client disclosure document, requires an adviser to describe, among other items, its advisory services, fees and compensation, brokerage practices, custody arrangements, material financial information (including, in certain circumstances, an audited balance sheet) and potential conflicts of interest with clients. An adviser's Form ADV must be periodically updated to reflect changes in its business.

The Advisers Act does not impose any substantive qualifications for registration on the firm or on firm employees. The firm is not required to have a minimum net worth. Firm employees are not required by the Advisers Act to meet any accreditation standards or pass any examinations. The state in which the adviser has a place of business may impose such standards, however.

Preparing and Filing Form ADV

Form ADV is filed with the SEC electronically via the Investment Adviser Registration Depository (the "IARD") maintained by the Financial Industry Regulatory Authority. Once an adviser establishes an IARD account, the adviser can access and complete Part 1A on the IARD and submit it electronically to the SEC. The firm's Form ADV will be publicly available on the SEC's website when the registration

CONTINUED ON PAGE 8

While registration will impose some burdens, those burdens should be manageable....The first question that a private fund sponsor must address is identifying which entity should register: the manager, who undertakes the day-to-day management of the private fund, the fund's general partner, or both?

becomes effective.[2]

The SEC will mail an order to the adviser once the adviser's registration is declared effective. The SEC must act on the application within 45 days of the filing. Therefore, the sponsor should be prepared to comply with the substantive requirements of the Advisers Act when it files its Form ADV.

Part II (or 2): A Key Disclosure Document

Currently, Part II requires advisers to respond to a series of multiple-choice and fill-in-the-blank questions organized in a "check-the-box" format. The SEC recently adopted amendments to Part II (which will be re-designated Part 2) (the "2010 Amendments") that will require this portion of Form ADV to be in narrative format, written in plain English and organized in the order specified by Form ADV. The new Part 2 will also be required to be filed with the SEC and will be publicly available on the SEC's website. An investment adviser that applies for registration after January 1, 2011 will be required to file its Form ADV in the new format.

The 2010 Amendments divide the revised Part 2 into two subparts. Part 2A contains 18 disclosure items that must be included in a narrative brochure (the "Brochure"). The Brochure will be filed with the SEC and will be publicly available on its website. Part 2B provides clients with information about the advisory personnel on whom the client relies for investment advice (the "Brochure Supplement").

The 2010 Amendments place a particular importance on the disclosure of conflicts of interest that may arise from client referral arrangements; brokerage practices; management fee differentials (*i.e.*, the conflict that may arise when some clients pay performance fees while others do not); personal trading by employees of the adviser; and participation by the adviser or its employees in client transactions.

Although the Brochure of a private fund sponsor will include information concerning the private funds that it manages, the mere availability of the Brochure on the SEC's website would not, by itself, jeopardize the ability of the private fund to rely on the private offering exemption provided by the Securities Act of 1933. The SEC warns, however, that the inclusion of private fund information beyond that required by Part 2 (such as performance information or financial statements) could jeopardize such reliance.

The release adopting the 2010 Amendments confirm that a private fund manager need not deliver its Brochure to an investor in a private fund managed by the adviser unless the manager provides advisory services to the investor separate and apart from the private fund. Given the nature of certain of the disclosures, however, a private fund sponsor may want to do so in any event, or at least consider incorporating the disclosures that appear in its Brochure in its private placement memoranda.

Disciplinary Information

The major focus of the SEC's review of an adviser's Form ADV is on the disciplinary history of the firm and its "Associated Persons." Associated Persons include the adviser's employees (other than those performing purely clerical or ministerial functions), officers, partners or directors and all persons directly or indirectly controlling or controlled by the adviser.

An adviser must disclose disciplinary history with respect to a variety of matters, including felony convictions, certain misdemeanor convictions, violations of investment-related laws and regulations (whether U.S. or non-U.S.) as well as suspensions of the authorization to practice as an investment adviser and proceedings brought by self-regulatory agencies. Certain matters need to be disclosed only if they occurred within the past 10 years; others are not subject to this time limit.

Based on this disciplinary disclosure, the SEC may deny registration or impose limits on the activities of the investment adviser. In addition, subsequent to registration, the SEC may, in its discretion, take action (ranging from censure to revocation of registration) if it finds that the adviser or any Associated Person has been subject to these types of disciplinary action.

Life as a Registered Investment Adviser

The Advisers Act imposes significant substantive requirements on a registered investment adviser and the conduct of its business. The following is a brief summary of the most significant of the regulatory challenges that a newly-registered investment adviser will face. The initial challenge involves developing compliance policies and procedures and appointing a chief compliance officer ("CCO") to administer the firm's compliance program. The CCO should be a person who

CONTINUED ON PAGE 25

The Advisers Act imposes significant substantive requirements on a registered investment adviser and the conduct of its business....The initial challenge involves developing compliance policies and procedures and appointing a chief compliance officer...to administer the firm's compliance program.

[2] *The 2010 Amendments require Part 2 to be filed electronically after January 1, 2011.*

ALERT

More Process and Disclosure, But Little Change, in Executive Compensation Practices

The recent financial reform legislation, commonly called the Dodd-Frank Act, addressed a *pot pourri* of corporate governance and executive compensation issues that have been promoted by shareholder activists (including confirming the SEC's authority to adopt its far reaching proxy access rules, which the SEC adopted in late August). However, with regard to executive compensation matters, the Act will not have any effect on privately-held companies, and will generally have limited substantive effect on public companies. This is because the "new" requirements largely mandate or embellish practices already widely in use or add disclosure that may complicate a company's public filings, but that should not have a direct substantive effect on how it pays its executives.

Say on Pay and Golden Parachutes

Public companies will now have to provide for a separate, non-binding shareholder vote to approve the compensation of certain executive officers ("Say on Pay"). At the first meeting subject to these requirements, each public company must also seek shareholder direction whether to have such a Say on Pay annually, bi-annually or tri-annually. Additionally, at any meeting that occurs more than six months after enactment at which shareholders are asked to approve an acquisition, merger, or other extraordinary transaction, the Dodd-Frank Act requires disclosure of any compensation payments triggered by such transaction ("golden parachute" payments), and requires that this "golden parachute" compensation be put to a separate, non-binding shareholder vote of approval, to the extent that the arrangements have not been subject to a prior Say on Pay vote.

Compensation Committee Independence

The Dodd-Frank Act requires the adoption of new mandatory listing requirements regarding compensation committee independence and their right to hire their own advisors. These requirements are not substantively different from policies or practices that most (if not all) public companies have long had in effect. Unlike the currently effective NYSE independence requirements, there is no express carve-out in the Dodd-Frank Act from these requirements for a public company where more than 50% of the voting power is owned by a person or group. As a result, unless the exchange or securities association uses the exemptive authority permitted under the Act to adopt a similar exemption, representatives of private equity sponsors may not be permitted to serve on the compensation committee of a portfolio company following a public offering even when the sponsor still controls a majority of the voting power. However, other considerations (such as compliance with Section 162(m) following the applicable transition period and Rule 16b-3) may already practically discourage such membership, even in a controlled entity.

The Dodd-Frank Act also requires the compensation committee of a public company to *consider* the independence of any outside advisor, applying independence factors to be identified by the SEC, and that the company's proxy statement include disclosure of whether the compensation committee retained a compensation consultant, as well as a discussion of any conflict of interest raised by the consultant's work.

Clawback on Erroneous Compensation

The Dodd-Frank Act also requires listed companies to develop and implement policies providing for both (1) disclosure of the issuer's policy on incentive compensation based on reported financial information and (2) recovery ("clawback") from current or former executive officers of "erroneously awarded" incentive compensation in the event of an accounting restatement required due to material noncompliance with financial reporting requirements under the securities laws. Unlike the current Sarbanes-Oxley (SOX) requirements, the new provision would apply to all executive officers, whether or not the officer engaged in misconduct, and go back three years instead of 12 months. Like the SOX requirements, however, the new broader clawback is only triggered by a financial restatement, and therefore may have limited practical effect.

CONTINUED ON PAGE 10

Alert: More Process and Disclosure, But Little Change (cont. from page 9)

Proxy/Filing Disclosures

Additionally, the Dodd-Frank Act mandates certain additional executive compensation/governance disclosure, principally in a public company's annual proxy statement:

- a clear description of compensation, including information showing the relationship between executive compensation actually paid and the financial performance of the issuer;
- an explanation of why the issuer has chosen to combine or separate the positions of chairman of the board of directors and chief executive officer (A quite similar requirement is already mandated under the disclosure rules.);
- discussion of whether executives or directors are permitted to hedge or offset any decrease in the market value of the issuer's equity securities; and
- disclosure of (1) median employee compensation, excluding the compensation of the issuer's CEO (or equivalent executive), (2) CEO compensation, and (3) the ratio of median employee compensation to CEO compensation. ■

Lawrence K. Cagney
lkcagney@debevoise.com

Recent and Upcoming Speaking Engagements

June 24, 2010

Rebecca Silberstein
David Schnabel
Funds 101 Seminar
Debevoise & Plimpton LLP
New York

June 28, 2010

James C. Scoville
"The Situation in the United States"
Ninth European Conference on Corporate Governance
The Ministry of the Economy and the IC-A
Madrid

July 1, 2010

Franci J. Blassberg
Jennifer J. Burleigh
Satish M. Kini
Gregory J. Lyons
Rebecca F. Silberstein
"The Volcker Rule and Its Ramifications"
Debevoise & Plimpton LLP
New York

July 12, 2010

David J. Schwartz
"Raising a Private Equity Fund"
Eleventh Annual Private Equity Forum
Practising Law Institute
New York

September 13, 2010

Maurizio Levi-Minzi
"Cross-Border Transactions, Business Formations and Investments: Legal Aspects, Business Trends and How Lawyers Can Add Value"
Fundamental Considerations for Cross-Border Transactions — Part I and II
New York State Bar Association's International Section and The International Association of Lawyers (UIA)
New York City

September 15, 2010

Andrew M. Ostrognai
"Private Equity Faces the Future: Candid Views from the Market Follow-Up"
The Changing Relationship Between LPs and GPs
The Bank of New York Mellon
Hong Kong

September 16, 2010

Gregory J. Lyons
"Impacts and Implications of Financial Reform and Other Legislation on Private Equity"
The Volcker Rule
Institutional Limited Partners Association
Webcast

September 30–October 1, 2010

Franci J. Blassberg
"Special Problems When Acquiring Divisions and Subsidiaries"
-and-
"Negotiating the Acquisition of the Private Company"
Twenty-Sixth Annual Advanced Course of Study on Corporate Mergers and Acquisitions
The American Law Institute-American Bar Association
New York

For more information about upcoming events visit www.debevoise.com

Consider This Before Renewing Your D&O and General Partnership Liability Insurance

For obvious reasons, few agreements entered into by a private equity sponsor or its portfolio companies are of more personal interest to the sponsor's principals and employees, or to the directors and officers of its portfolio companies, than general partnership liability and directors and officers insurance policies. It goes almost without saying that the renewal process for these policies be more than *pro forma* and that sponsors consider early on what questions to have in mind for discussion with their broker and carrier when their general partnership liability ("GPL") or portfolio company directors and officers ("D&O") coverage is up for renewal. However, unless there is a concerted focus on policy terms, the coverage offered by insurers may not be adequate.

GPL policies purchased by fund sponsors generally provide coverage for professional services rendered both to portfolio companies and to the funds themselves *and* cover private equity professionals in their capacities as directors, officers and managers of entities within the fund complex and portfolio companies. Portfolio company D&O policies, procured either by fund sponsors as part of a coordinated program or by the portfolio companies themselves, are more limited, covering individuals solely in their capacities as directors or officers of the portfolio company. They may also cover the portfolio company itself for securities claims.

Both GPL and D&O policies generally cover claims for breach of fiduciary duty, securities claims, mismanagement claims, employment practices claims and regulatory proceedings and investigations. In practice, however, coverage differs from policy form to policy form, making it necessary to consider key provisions carefully. GPL and D&O policy forms available in the market rarely are adequate without negotiated modifications.

Are all entities to be covered included in the definition of "Insureds" under the policy?

Begin by checking your organizational chart against the GPL policy definitions of "Named Insured," "Insured Entity," "Subsidiary," "Affiliate" and related terms. Are all the entities you want covered included as "Insureds" under the policy?

Gaps in coverage often occur because the definitions miss entire groups of entities, particularly when there are multiple funds and/or intermediate group companies. The consequences can be significant. If a complaint names five defendants, one of which is not an "Insured Entity," the carrier will generally look to allocate one fifth of the total loss as uncovered loss. Allocation is not generally in proportion to the actual responsibility of the covered and uncovered entities.

Simply listing all entities in an organization as "Insureds" can cause problems elsewhere in the policy, such as with respect to "claims reporting" provisions. Providing adequate coverage without these unintended consequences requires modifying multiple definitions to reflect the actual structure and activities of the entities intended to be covered.

Are there coverage gaps between the fund sponsor and the portfolio company?

The varied and complex relationships between fund sponsors and portfolio companies can give rise to unique issues in GPL and portfolio company D&O insurance policies. A few questions that regularly arise include:

- Does the "other insurance" clause under the GPL policy require that portfolio companies' D&O policies provide primary coverage to principals or employees of the sponsor who sit on portfolio company boards?
- Does the portfolio company D&O policy provide for an order of payments, ensuring that the D&O policy pays first? Fund sponsors generally wish to ensure that the portfolio company's D&O policy will pay out first, with the sponsor's GPL policy providing excess coverage in the event that the portfolio company D&O policy limits are exhausted.

Do the indemnification arrangements at the fund and portfolio company level contain ordering provisions?

When sponsor principals or employees occupy board seats at a portfolio company, applicable indemnification provisions should make clear that the portfolio company's obligations are primary and the fund's or sponsor's secondary, and that the fund and sponsor may recover from the portfolio company any amounts they pay out for indemnification that would have

CONTINUED ON PAGE 12

Gaps in coverage often occur because the definitions miss entire groups of entities, particularly when there are multiple funds and/or intermediate group companies. The consequences can be significant.

Renewing Your D&O and General Partnership Liability Insurance (cont. from page 11)

also been covered by the portfolio company's indemnification obligations. Otherwise, the sponsor or fund may only be able to recover at best a portion of such payments from the portfolio company (pursuant to a right of contribution among joint indemnitors).

What happens if there is a failure or refusal to indemnify?

Typical GPL and portfolio company D&O policies presume that sponsor principals and employees occupying board seats at a portfolio company will be indemnified by the portfolio company to the fullest extent permitted by law except where indemnification is not possible due to the portfolio company's insolvency. Where legally permitted indemnification does not occur, an individual officer or director will generally still be covered, but will need to fund personally the self-insured retention — which can exceed $1 million — that normally applies only to claims of the insured entity.

It is often possible to limit this presumption to the indemnification actually provided by the insured entity pursuant to its charter, by-laws or separate indemnification agreement, rather than the theoretical "fullest extent permitted by law" standard.

At least one carrier now offers a policy providing that if the corporate entity fails to advance/indemnify, the carrier will provide coverage from first dollar and will have subrogation rights against the entity with respect to any advancement/indemnification the entity owed to the insured person.

Insureds should insist that both the GPL and portfolio company D&O policies provide coverage to individual insureds for securities claims based on the individual's "controlling person" capacity.

Does the policy provide coverage for "controlling person" liability?

Insureds should insist that both the GPL and portfolio company D&O policies provide coverage to individual insureds for securities claims based on the individual's "controlling person" capacity. Without an affirmative grant of coverage, some carriers take the position that "controlling person" liability does not arise from the insured person's covered capacity as a director or officer, and that such liability is therefore uninsured.

Will a global D&O policy provide coverage for all the companies within the sponsor's group, wherever they are located?

In many jurisdictions, the law requires that coverage be purchased locally. Insurers under a global GPL or portfolio company D&O policy issued to a parent company in another jurisdiction may not be able to make payment to local directors and officers. Ideally, entities should choose a carrier that can issue both the global and local policies and should confirm that local legal issues will not act as barriers to coverage in all of the jurisdictions in which the entities may be subject to liability.

Does the policy provide adequate protection for claims brought within the bankruptcy context?

"Insured versus insured" exclusions can cause certain claims asserted in bankruptcy to be excluded from coverage. Some courts have held that claims brought by trustees, creditors, etc. are brought on behalf of the debtor, thus triggering the exclusion. Insureds should negotiate carve-backs that expressly include coverage for any claims brought by any party to whom the debtor may assign its claims or by any party appointed by any state or federal official, agency or court to take control of, supervise, manage, rehabilitate, dissolve or liquidate an entity.

***

As discussed above, there are a myriad of traps for the unwary financial sponsor in the general partnership liability and directors and officers insurance policy forms. These can be disarmed if attention to the terms of the policy and the sponsor's needs and structure are given sufficient attention at an early stage in the renewal process, and that extra effort may be just the difference in providing appropriate coverage and peace of mind to key constituents within a private equity organization. ■

Jeffrey S. Jacobson
jsjacobson@debevoise.com

Keith J. Slattery
kjslattery@debevoise.com

Claire Graham
cgraham@debevoise.com

UK Bribery Act Requires Prompt Action by Global Private Equity Firms

Private equity sponsors that "carry on business" in the UK should be mindful of the recently enacted UK anti-bribery legislation, which may require some adjustment to their current compliance programs. After repeated criticism by the Organisation for Economic Cooperation and Development that UK corruption legislation was ineffective and deficient, the UK finally has responded by passing the Bribery Act 2010 ("Bribery Act"). The Bribery Act is expected to come into force in April 2011 and will supplant the existing medley of common law and statutory corruption offences.

The introduction of a sweeping new "corporate offence" under section 7 of the Act marks a radical extension of the powers of the Serious Fraud Office and other UK prosecuting agencies because it authorizes them to prosecute foreign "commercial organisations" for corruption, so long as the commercial organisation carries on at least part of its business in the UK and the payor of the bribe intended to benefit the commercial organisation. This offence, combined with the broad and somewhat ambiguous definition of "commercial organisation," may reach the activities of private equity sponsors outside of the UK who maintain sub-advisors or have portfolio companies that operate or are organized within the UK. Accordingly, the new legislation bears careful scrutiny by private equity sponsors, wherever they may be organized or maintain their primary operations.

Importantly, it is not a defense that the commercial organisation had no knowledge of or involvement in any bribes that were paid. The sole defense available to commercial organisations under section 7 of the Bribery Act is to prove that "adequate procedures" were in place to prevent bribery. The meaning of "adequate procedures" and practical guidance as to what steps can be taken by sponsors to institute such procedures throughout their worldwide operations will be of particular concern in the months prior to the April 2011 implementation of the Bribery Act.

Overview of the Corporate Bribery Offence

Under the new corporate offence a relevant "commercial organisation" is criminally liable if any "associated person" bribes another intending to obtain or retain business (or a business advantage) for the commercial organisation, unless the commercial organisation can prove it had in place "adequate procedures" designed to prevent associated persons from committing bribery. If convicted of the corporate offence, a commercial organisation faces an unlimited fine.

For purposes of the corporate offence, it makes no difference whether the bribe was paid in the UK or anywhere else in the world. Nor is it required that the associated person be convicted of a bribery offence where the activity occurred.

To better understand the implications of the corporate offence for private equity firms, it is necessary to reflect on the meanings of "commercial organisation" and "associated person."

Commercial Organisation

A "relevant commercial organisation" is defined very broadly. It includes: (1) any body incorporated in the UK; (2) any partnership formed under UK law; and (3) any corporation or partnership, incorporated or formed outside the UK, which carries on a business, or part of a business, in the UK. The Act does not contain a definition of what it means to "carry on business" in the UK and even the prosecuting agencies have raised concerns over this lack of clarity.[1] As a result the Joint Committee recommended that the Government consider clarifying this term.

To date they have not done so. Many of the terms contained in the Bribery Act were deliberately framed in a broad way so that they can be applied by prosecutors and interpreted by courts in a purposive manner and so that formal limitations of corporate structure do not constrain the jurisdictional reach of the corporate offence. During the House of Lords Committee stage, the former Government Minister Lord Tunnicliffe acknowledged the Joint Committee's concern over the difficulty in interpreting what is meant by carrying on part of a business in the UK, but responded that "we believe the courts will interpret the

CONTINUED ON PAGE 14

1 *The Director of Public Prosecutions noted to the Joint Committee: "It is not clear on the face of the [Act] what 'carries on a business' means. We wonder whether a foreign body without a place of business in [the UK] would be a 'relevant commercial organisation.'" Joint Committee on the Draft Bribery Bill ¶ 157 (28 July 2009).*

The bottom line for private equity funds and management entities that are subject to the UK Bribery Act is that it is difficult to know when activity in one part of the world will be attributed to the fund or management entity by virtue of its far-flung "associated persons."

UK Bribery Act Requires Prompt Action (cont. from page 13)

term in a common-sense manner."

While the precise application of the Bribery Act to various entities within a private equity complex that touches the UK is therefore uncertain, it is expected that in the following scenarios at least, a private equity fund may satisfy the definition of "carrying on business" in the UK:

- Operating a subadvisor office in the UK;
- Serving as parent company to a UK incorporated subsidiary (unless it could be proven that the parent was entirely passive); and
- Listing on a stock exchange based in the UK.

Given the intent of the legislation, it is safe to assume that some non-UK entities in a typical fund structure are "carrying on business" in the UK and hence the sponsor should seriously consider adopting adequate procedures now as a safeguard.

Associated Person

The other crucial element of the corporate offence which requires consideration is the meaning of an "associated person." As with the definition of "commercial organisation" there is a substantial level of uncertainty surrounding the definition of "associated person" which makes it difficult to understand and predict just how far the prosecuting agencies will extend their reach in prosecuting the corporate offence.

Section 8 of the Bribery Act defines an associated person as one who "performs services for or on behalf of" the relevant commercial organisation. Section 8 makes clear that the capacity in which an associated person performs services on behalf of the commercial organisation does not matter. Accordingly, an associated person may be an employee (where there is a rebuttable presumption that performance is on behalf of the commercial organisation), agent, sub-contractor or subsidiary.

Section 8 further instructs that whether an associated person performs services for or on behalf of a commercial organisation is to be determined "by reference to all the relevant circumstances" and makes explicit that the determination should not be made merely by reference to the formal nature of the relationship between the parties. This formulation captures the advice of the Law Commission in its 2008 report "Reforming Bribery" in which it stated that "the test of whether a subsidiary company is providing services 'on behalf of' a main company should be a substantive rather than a formal test." In practice this means that a subsidiary may not use artful language in a contract that it enters in order to shield the parent company from liability for a corporate offence if the subsidiary pays a bribe in connection with that contract with the intent to obtain or retain business for the parent.

Commercial organisations must be especially mindful in their dealings with agents, joint venture partners and consortia. While it may be commercially accepted that a commercial organisation may have limited control over an agent or joint partner, this may not exempt the commercial organisation from liability under section 7 if its agent or partner pays a bribe unbeknownst to the relevant commercial organisation.

The bottom line for private equity funds and management entities that are subject to the UK Bribery Act is that it is difficult to know when activity in one part of the world will be attributed to the fund or management entity by virtue of its far-flung "associated persons."

Adequate Procedures

The Bribery Act requires the UK Secretary of State to publish guidance about procedures that relevant commercial organisations can implement to prevent associated persons from paying bribes. The final guidance is expected to be published early in 2011. The Government released draft guidance on September 14 and has opened a consultation period for public comment on the proposed guidance. The draft makes clear that the guidance will not be prescriptive, in recognition of the need for organisations to develop procedures appropriate to their own circumstances, the business sectors in which they operate, and their particular risk profile.

The proposed guidance is organized around the following six key principles:

- *Risk assessment.* The commercial organisation regularly and comprehensively assesses the nature and extent of the risks relating to bribery to which it is exposed.
- *Top level commitment.* The top level management of a commercial organisation (be it a board of directors, the owners or any other equivalent body or person) are committed to prevent bribery. They establish a culture within the organisation in which bribery is never acceptable. They take steps to ensure that the organisation's policy to operate without bribery is clearly communicated to all levels of management, the workforce and any relevant external actors.
- *Due diligence.* The commercial organisation has due diligence policies and procedures which cover all parties to a business relationship, including the organisation's supply chain, agents

CONTINUED ON PAGE 28

UPDATE

EU Directive on Alternative Investment Fund Managers: Are the Trialogues Multiplying?

The European Parliament's summer recess in July marked a pause in the ongoing discussions ("trialogues") among representatives of the three principal legislative bodies of the European Union (the "Commission," the "Council" and the "Parliament") that are seeking to agree on the text of a directive that will create a new framework for the regulation of private equity and hedge fund managers operating within Europe.

Legislators had hoped that the competing texts approved by the Parliament and Council in May could be reconciled in time for a plenary session of Parliament on July 6th, but that schedule has now slipped and the trialogues are continuing through September and may extend deeper into the fall. In the meantime, the presidency of the Council has changed again under the six-month rotation system, this time to Belgium, shifting the political backdrop to the trialogues. Figure 1 shows a chronology of the major developments involving the directive since the Commission introduced its proposal in April 2009. (For more information on the key differences among the competing proposals, see the Spring 2010 edition of *The Debevoise & Plimpton Private Equity Report*, "EU Directive on Alternative Investment Fund Managers: Are the Trialogues Almost Over?")

The most controversial stumbling blocks on the path to finalizing the directive are the so-called "third country" issues, referring to the provisions that potentially restrict alternative investment fund managers based outside the EU from marketing their funds to investors based inside the EU. In an attempt to move the process forward, the Commission has reportedly started circulating compromise proposals on an issue-by-issue basis ("mini-trialogues"?). Negotiations take place in closed sessions, so reports on progress are unconfirmed.

The crux of the debate appears to be whether or not managers based outside

CONTINUED ON PAGE 17

Figure 1

April 2009	Commission publishes first draft of a proposed directive on alternative investment fund managers.
October/November 2009	Swedish presidency of the Council publishes two further revised compromise proposals.
November 2009	Parliament's Economic and Monetary Affairs Committee ("ECON") publishes its draft report on the directive.
November/December 2009	Swedish presidency of the Council publishes a series of compromise proposals.
January 2010	Spain takes over the Council presidency.
February/March 2010	Spanish presidency of the Council publishes its series of revised compromise proposals.
May 2010	ECON publishes its final report on the directive.
May 2010	ECON and the Council separately approve their respective draft texts of the directive.
June/July 2010	ECON, the Council and the Commission begin "trialogues"to develop common position on the directive, but fail to reach agreement in time for Parliament vote originally scheduled for July 6.
July 2010	Belgium takes over the Council presidency.
August 2010	Belgian presidency of the Council publishes revised compromise proposals.
October 2010	Rescheduled date for Parliament vote on the directive — may be postponed to October.
January 2012	Target implementation date for the directive.

ALERT

Placement Agents and In-House Fundraisers Must Register as Lobbyists in California

As this issue of *The Debevoise & Plimpton Private Equity Report* goes to press, California Governor Schwarzenegger is expected to sign into law (or to permit to become effective without his signature as of September 30) Assembly Bill No. 1743, a bill supported by CalPERS and passed by a wide margin in the California Legislature. The bill requires an individual who acts as a placement agent for a private fund seeking investment from California state retirement plans to register as a lobbyist in California — effectively prohibiting such a person from being paid typical placement fees in respect of any capital commitments made by California state plans to the funds represented by the placement agent. For purposes of the bill, the term placement agent also includes an individual who acts as a "solicitor" — that is, a person who acts as a finder, marketer or other intermediary for an investment adviser seeking to manage the investments of California state retirement plans. It also requires the state plans, CalPERS and CalSTRS, to report to the State of California by August 1, 2012 on their use of placement agents.

Who Must Register?

The bill requires placement agents to register as lobbyists with the State of California,[1] if they represent private equity or hedge funds (or other investment funds) or money managers in seeking investments or business from California state public retirement systems. The bill also requires individuals acting as placement agents in connection with any potential investment by a California local public retirement system to comply with any applicable requirements imposed by a local government agency.

Importantly, the bill covers not only external placement agents, but also any employee, officer, director, equityholder, partner, member or trustee of a private fund manager or other money manager who acts as a placement agent in such context, unless the person spends one-third or more of his or her time managing the investments owned or managed by the firm. This means, for example, that firm employees who participate in seeking capital commitments from California state plans — including, it seems, not only investment professionals, but potentially also legal, financial and investor relations/marketing personnel — must register unless the "one-third" exemption is applicable to them. The availability of this exemption is likely to be more difficult to demonstrate for employees who are not investment professionals.[2]

Unfortunately, the bill does not provide guidance on what activities are considered (for purposes of the "one-third" test) to constitute managing investments owned or managed by the firm. We are currently considering this question, but the answer is far from clear at this point. Certain fund sponsors and money managers might need to limit contacts between non-investment personnel and California state plans during the fundraising or solicitation process.

Impact of Registration

Placement agents covered by the bill are required to comply with California laws regarding lobbyists, most notably California's Political Reform Act of 1974. That Act sets forth registration, recordkeeping and reporting requirements, as well as certain prohibitions on campaign donations and gifts to public officials, the willful violation of which may subject offenders

CONTINUED ON PAGE 17

[1] *We believe that the bill should be effective on January 1, 2011. The California Constitution provides in relevant part that ". . . a statute enacted at a regular session [of the Legislature] shall go into effect on January 1 next following a 90-day period from the date of enactment of the statute . . . ."*

[2] *The bill also provides an exemption from the definition of "placement agent" for employees, officers, directors and affiliates of an external manager, if the external manager: is a federally registered broker-dealer or investment adviser; was selected through a competitive bidding process and is providing services pursuant to a contract executed as a result of that bidding process; and has agreed to the fiduciary standard of care set forth in the California Constitution when managing a portfolio of assets of a state public retirement system. Since private funds, other than certain infrastructure funds, generally do not participate in a competitive bidding process to obtain investments from state plans, this exemption is likely to be of limited utility to most private funds seeking state money.*

Update: EU Directive on Alternative Investment Fund Managers (cont. from page 15)

the EU should be able to (1) continue marketing their funds to EU-based investors in accordance with the different private placement regimes of the various EU member states (*i.e.*, the status quo), or (2) substantially comply with the directive and obtain an EU-wide passport, enabling them to market to investors based throughout the EU in accordance with the directive's uniform placement regime. Some favor allowing managers to use either approach, while others support a phasing out of the traditional private placement regime over a multi-year period.

Other important issues that linger unresolved relate to the degree of disclosure that private equity funds (in contrast to other investors) must provide about their plans and strategy when investing in portfolio companies, and whether or not the directive should include specific rules against "asset stripping," with opponents of these additional disclosure requirements and rules arguing that they run counter to the EU principle of maintaining a level playing field for all types of investors.

The plenary vote on the directive in the European Parliament has been postponed until October to allow more time to reach agreement on the final text of the directive. If so, this may delay the target implementation date of January 2012 for the directive's main provisions (2015 is the target date for implementing the provisions on third country issues). We will continue to monitor progress and report on relevant developments. ■

Geoffrey Kittredge
gkittredge@debevoise.com

Anthony McWhirter
amcwhirter@debevoise.com

Philip Orange
porange@debevoise.com

Alert: Placement Agents and In-House Fundraisers (cont. from page 16)

to criminal penalties. Firms employing placement agents may also be subject to certain filing requirements set forth by that Act.

Most notably, the bill amends the Act to prohibit lobbyists, and thus placement agents required to register as lobbyists, from receiving performance-based compensation from California state plans. Therefore, at a minimum, placement agents are not permitted to receive success fees calculated as a percentage of capital raised. To the extent the compensation packages and bonuses of internal placement agents are contingent on securing business with a California state retirement plan, such payments could well be prohibited. It appears that flat, upfront fees will be permitted, but this may be less than optimal from the perspective of placement agents and some fund managers. ■

Michael P. Harrell
mpharrell@debevoise.com

Kenneth J. Berman
kjberman@debevoise.com

Ellen Lieberman
elieberman@debevoise.com

Jamie E. Doninger
jedoninger@debevoise.com

Looking for a past article?

A complete article index, along with all past issues of the *Debevoise & Plimpton Private Equity Report*, is available in the "publications" section of the firm's website, www.debevoise.com.

The Terms They Are a-Changin' — Or Are They? (cont. from page 1)

terms in boom times is an interesting subject for debate in another forum. But there is no debating that since 2008 fundraising has been much more difficult, and has taken much longer, than was the case from 2005 through 2008. There also is no doubt that LPs and their advisors are vigorously negotiating fund terms these days, in many cases citing the ILPA Report to support their arguments. Does it follow that the terms of private equity funds have changed? Are anecdotal reports of GP concessions in the slower fundraising market reflective of an industry-wide shift of power from GPs to LPs?

We attempted to answer these questions using Debevoise & Plimpton's proprietary database, which tracks more than 60 business and legal terms of over 1,800 private equity funds. We limited our analysis to the key economic terms of the buyout funds in our database that are larger than U.S.$250 million in size.[2] Within this data set, we compared the terms of funds that had final closings from 2005 through 2008 against the terms of funds raised since 2008. Our sample included over 160 buyout funds that had final closings between 2005 and 2008 and another 24 funds raised since then. To be sure, it is too early to reach a definitive view — relatively few buyout funds were raised in the last 21 months. But our analysis suggests that overall we have not yet seen a substantial shift in the key economic terms of buyout funds, although in three areas there appears to have been some limited or partial movement to adopt proposals in the ILPA Report. Nine of the most important fund terms that we analyzed are discussed below.

Timing of Carried Interest Distributions

The ILPA Report proposes that LPs should receive from a fund distributions equal to the amount of all capital that they contributed to the fund before the GP receives any carried interest distributions from the fund, rather than the GP receiving carried interest on a deal-by-deal basis (*i.e.*, as each investment is sold).[3] While the "return all contributed capital first" distribution model has been standard for many years for European funds, U.S.-based buyout fund sponsors generally have used the "deal-by-deal" model — and our data confirms that this remains the case. Of the U.S.-focused buyout funds in our database that were raised between 2005 and 2008, nearly 90% returned capital on a deal-by-deal basis, and for funds that were raised after 2008, 93% returned capital on a deal-by-deal basis.

Carried Interest

Almost all of the GPs of buyout funds in our database receive 20% of fund profits as carried interest. Of the buyout funds in our database that were raised between 2005 and 2008, the average carried interest percentage was 20.36%, and for funds raised since 2008 the average was 20.04%. The data showed no variation based on the size of the fund.

Preferred Return

Our data clusters around 8.00% as the standard return on invested capital that LPs must receive before carried interest may be distributed to the GP. Of the buyout funds in our database that were raised between 2005 and 2008, the average preferred return was 7.74%, and for funds raised since then the average preferred return was 8.05%. The data showed very little variation based on the size of the fund.

Management Fees During the Investment Period

The ILPA Report states that management fees paid during a fund's investment period should not be "excessive," but does not propose a standard to determine when fees become "excessive," stating only that the fees should be based on "reasonable operating expenses and reasonable salaries." LPs have long argued that management fee percentages should have declined more than they did as fund sizes increased over the last 20 years, and that management fees should not be a source of wealth creation for the GP.

Our data does not shed light on whether management fees historically have been excessive, but we can report that there was little difference in average management fees between funds in our sample raised before 2008 and funds raised after 2008. For vintage year 2005-2008 funds with capital commitments of $2 billion or more, average investment period management fees were 1.58%, and 1.52% for funds of the same size raised since 2008. For funds with capital commitments of less than $2 billion raised between 2005 and 2008, average

CONTINUED ON PAGE 19

1 *The ILPA Report can be found at www.ilpa.org. This comprehensive report, which has been endorsed by over 130 institutional investors, focuses on alignment of the interests of GPs and LPs, fund governance and transparency concerns, and sets forth in its Appendix A a description of "Private Equity Preferred Terms." A brief overview of the ILPA Report can be found in the Summer 2009 issue of The Debevoise & Plimpton Private Equity Report.*

2 *We did not include in our database "runs" private equity funds whose investment strategies focus on infrastructure, real estate, senior and mezzanine debt, venture, distressed debt and other non-buyout strategies. Although including non-buyout funds in our analysis would have given us a larger data sample, funds pursuing these strategies often have terms that differ significantly from those of buyout funds even in ordinary markets.*

3 *For a discussion of the "return all contributed capital first" vs. the "deal-by-deal" distribution models, see the Fall 2000 issue of The Debevoise & Plimpton Private Equity Report.*

The Terms They Are a-Changin' — Or Are They? (cont. from page 18)

investment period management fees were 1.94%, and 1.97% for funds of the same size raised since then.

Management Fees After the Investment Period

The ILPA Report stresses that management fees should "step down significantly" at the end of a fund's investment period. Typically management fees paid by a fund to the fund manager or adviser after the fund's investment period ends are calculated based on invested capital (often including associated fund fees and expenses) rather than committed capital. In addition, not only does the "base" on which management fees are calculated change at the end of the investment period, but often the fee percentage is reduced as well (*e.g.*, from 2.00% to 1.00%). Our analysis suggests that more funds may be reducing their management fee percentages after the end of the funds' investment periods.

Whether or not these post-investment period reductions evidence a trend, our data shows that funds with capital commitments of $2 billion or more raised between 2005 and 2008, had average post-investment period management fees of 1.24%, and funds of the same size raised after 2008 had lower average post-investment period management fees of 1.10%. Similarly, funds with capital commitments of less than $2 billion raised between 2005 and 2008 had average post-investment period management fees of 1.81% and funds of the same size raised after 2008 had lower fees of 1.73%.

Sharing of Transaction and Other Fees

The ILPA Report calls for 100% of fee income received by the GP and its affiliates in connection with fund investments (such as transaction, investment banking, break-up, monitoring, directors and other similar fees) to accrue to the benefit of the fund, to better align the interests of GPs with those of LPs. This kind of fee sharing typically is accomplished by reducing the management fee paid by the fund by an amount equal to 100% (or, if the fee sharing is less than 100%, a lower percentage) of the transaction and other such fees received by the GP and its affiliates (a so-called "fee offset").

The focus on sharing of transaction fee income is not new. A review of our database shows that over at least the past two decades, GPs of buyout funds have agreed to LP requests to share larger and larger percentages of the fee income that GPs receive with the funds that they control (and thus with the LPs in those funds).[4] Since the end of 2008, we have seen an increasing number of fund sponsors agree to a 100% fee offset when raising a new fund. In addition, during this same period a handful of existing funds amended their fund agreements to increase their fee offset percentages from 50% to 66-2/3%, 75% or 80%.

While it is too early to say whether a 100% fee offset will become "market" as the ILPA Report recommends, the general trend of increasing fee offset percentages is reflected in our data for the time periods discussed in this article. For the period from 2005 through 2008, 64% of the funds in our sample provided for a fee offset percentage of 80% or higher (up to 100%), whereas for funds in our sample raised after 2008, 86% of funds provided for a fee offset percentage of 80% or higher. It is worth noting that, for the period from 2005 through 2008, 23% of the funds in our sample provided for a fee offset percentage of 50% or less (with 9% providing for no fee offset), whereas for funds in our sample raised after 2008, only 14% of funds provided for a fee offset of 50% or less (and no funds provided for a 0% fee offset).

GP Clawback: Joint and Several Guarantees

So-called "clawback" provisions are intended primarily to ensure that LPs are protected from the risk of the GP receiving more than the carried interest percentage (typically 20% of cumulative net profits over the life of the fund) to which it is entitled because, for example, the GP receives carry on successful investments that are disposed of early in the life of the fund, and then investments that remain in the portfolio are disposed of at cost or at a loss. A typical clawback provision requires that at the end of the life of the fund the GP return any excess carried interest distributions that it may

CONTINUED ON PAGE 20

...[O]verall we have not yet seen a substantial shift in the key economic terms of buyout funds, although... there appears to have been some limited or partial movement to adopt proposals in the ILPA Report [in management fees after the investment period, fee offsets and interim clawbacks].

[4] *In the early days of the buyout business, 100% of transaction fees typically were retained by the GP and its affiliates. Beginning in the 1990s, but especially from the mid- to late-1990s on, more and more buyout funds provided for fee offsets of 50% of transaction fees. After the Internet bubble burst, and most notably in the 2003 to 2004 period, we started to see a substantial number of new buyout funds increase their fee offset percentages (as compared to predecessor funds) to 66-2/3%, 75% or 80%.*

The Terms They Are a-Changin' — Or Are They? (cont. from page 19)

have received, and typically also requires each individual recipient of carried interest (usually a member or partner of the GP) to guarantee his or her proportionate share of the GP's clawback obligation (*i.e.*, give a "several" guarantee).[5]

The ILPA Report proposes that a number of modifications be made to standard "clawback" provisions to strengthen the effectiveness of those provisions if they are needed. For example, the ILPA Report suggests that each recipient of carried interest distributions guarantee the GP's entire clawback obligation (*i.e.*, give a "joint and several" guarantee), rather than only a several guarantee of such person's proportionate share of the GP's clawback obligation. On this issue, our data shows that very few of the funds raised during the time periods that we examined provided for joint and several clawback guarantees; most provided for several guarantees. Specifically, only five of the funds in our sample that were raised between 2005 and 2008 provide for joint and several clawback guarantees, and only one of the smaller number of funds raised after 2008 so provides.

GP Clawback: Interim Clawbacks

In addition to the beefed up guarantees discussed above, the ILPA Report also recommends that GPs should make clawback payments (*i.e.*, return any excess carried interest payments) no later than two years after a clawback obligation arises (a so-called "interim" clawback), rather than waiting until the end of the term of the fund to calculate and make clawback payments. In our practice over the past year or so we have been hearing LPs request more frequently the addition of interim clawbacks, and we have seen some movement by GPs to accept interim clawbacks. However, none of the interim clawbacks that we have reviewed provide for more than a one-time interim adjustment at the end of the investment period (rather than continuous testing for possible clawback obligations), and even then the interim clawbacks are subject to a number of limitations and cure periods.

But there is at least some movement. For funds in our sample that were raised between 2005 and 2008, 10% of the funds provide for some kind of interim clawback, whereas for funds raised after 2008, 16% of the funds so provide.

GP Clawback: After-Tax Calculation

The clawback amount that a GP is required to pay back to the fund should the GP receive any excess carried interest distributions typically is limited in the following respect: the GP need not pay back more than the carried interest amounts that were distributed to the ultimate carried interest recipients, net of the taxes payable on such amounts by the carried interest recipients. The ILPA Report proposes instead that clawback amounts should be calculated gross of taxes paid, not net of taxes. While certain LPs raise this issue (and have for years), our data does not suggest that GPs are increasingly accepting this proposal. Of the buyout funds in our database that were raised between 2005 and 2008, only 7% calculated the clawback obligation gross of taxes, and, for funds raised after 2008, only 3% calculate the clawback obligation gross, rather than net, of taxes.

* * *

The data presented above do not, of course, fully answer the question of whether the fundraising slowdown of the past two years has resulted or will result in a private equity industry-wide shift of power from GPs to LPs. As noted at the beginning of this article, the limited amount of fundraising by buyout funds since the end of 2008 has left us with a relatively small sample to analyze. Furthermore, it may be that the changes proposed in the ILPA Report are only now beginning to gain traction. More changes in terms may come, at least for funds whose after-fee performance has been less than stellar. Finally, the ILPA Report makes a large number of non-economic proposals in the areas of fund governance and transparency — proposals that are not discussed above but some of which we suspect certain GPs will be more willing to accommodate than changes to fund economic arrangements. We look forward to revisiting trends in fund terms as more data becomes available. ■

Michael P. Harrell
mpharrell@debevoise.com

Daniel Z. Sinrod
dzsinrod@debevoise.com

5 *For a description of clawbacks and a discussion of proposed changes requested by LPs (which proposals predate the ILPA Report by many years), see the Fall 2000 issue of The Debevoise & Plimpton Private Equity Report.*

policies and strategies in Washington? To what secondary uses can it be put? Any investor in this space will need to form an educated view as to the customer's current and future needs, within the broader political, strategic and policy context. Development of products usable by the Pentagon can take quite some time, and unlike in many other sectors, there is often quite a bit of iterative give and take between customer and supplier as systems and parts and products are developed to meet specific — but often changing or ripening — needs. The bidding process can also take a long time. All of this requires significant capital, while returns may not kick in until years down the road.

Cyclicality is also more important in some of the industries on which we focus than in others. Take commercial aerospace, for instance. Companies whose fortunes are tied to commercial aerospace — and there are a lot of them in a lot of sectors — can easily be affected by this same cyclicality. We are always mindful of the long-term cyclicality of the aerospace market and its sub-segments (commercial jet, business jet, rotorcraft, general aviation), not just the recent past performance and management projections.

Of course, there are always the special legal issues near and dear to the lawyers' hearts that affect business in these industries, whether it's the FAR, the Jones Act, ITAR, FAA regulations, FCPA, NISPOM and security clearances, and the list of acronyms goes on.[1]

[1] *The FAR are the Federal Acquisition Regulations; the Jones Act deals with the merchant marine; the ITAR are the International Traffic in Arms Regulations, which are U.S. export controls for defense services and equipment; the FAA is the Federal Aviation Administration; the FCPA is the Foreign Corrupt Practices Act; and NISPOM is the National Industrial Security Program Operating Manual, which contains regulations governing the protection of classified information in industry.*

How does the procurement process affect defense businesses? Have you seen situations where good companies lose out because of the capriciousness of the process? And if so, what can you do about it?

You can write a tome about government procurement policy! There are so many different constituencies and interests that go into determining how to procure, what to procure and how much to procure that it is nearly impossible to keep on top of it all. The FARs themselves are hundreds and hundreds of pages long, all in tiny print! All these rules and regulations can be extremely challenging to navigate and often result in frustration for all constituents. One prominent example of the inefficiencies of the defense procurement process and challenges with respect to the FAR is the Air Force's acquisition of a new aerial refueling tanker, the KC-X. The initial RFP was posted at the beginning of 2007 and to this day, we do not have a contractor for this program.

How do politics affect the defense industry and the defense budget?

U.S. military spending, including war funding, will be over $650 billion in fiscal 2010. Procurement and strategy will be invariably affected by politics and the prevailing security environment. For instance, the Obama Administration has set a flat budget for the Pentagon over the next five years. But that doesn't mean spending on military hardware will be flat too. The Pentagon has vast personnel costs covering the men and women currently in the armed services, veterans, and the over 25,000 employees who work at the Pentagon itself. Do you know that the Pentagon will spend approximately $50 billion on health care alone this year? And as our wars and activities around the world produce more veterans and soldiers in need of long-term medical care, coupled with the generally rising cost of health care, the DoD's personnel costs are likely to skyrocket.

Because the overall defense budget is mostly comprised of personnel costs and procurement costs, a flat budget equates to less money for procurement if personnel costs balloon. Additionally, I see our nation's procurement dollar not going as far as it once did because the inflation adjusted cost of procuring needed military hardware and systems is also increasing. Let me explain.
Since the Reagan Administration, the Pentagon bureaucracy has grown enormously and achieved effective control of the procurement process. The result has been significant lengthening of the procurement process with consequent huge growth in costs. Secretary Gates and his procurement undersecretary, Ash Carter, have recently announced major reforms that in fact focus on the right issues. Let us hope that they persevere. It will take years to roll back the bureaucratic

CONTINUED ON PAGE 22

Whenever you deal with the government there are hidden risks, particularly for the uninitiated. Procurement policy is labyrinthine. Strategy and political focus change in ways that can make or break companies, especially those with a limited customer base, narrow product focus or those that are slow to adapt to new rules and demands.

Guest Column: A Discussion with John F. Lehman (cont. from page 21)

bloat. So here we have a flat budget with increasing healthcare and increasingly expensive goods and services. The obvious result is the military simply won't be able to buy nearly as many planes, ships, systems or weapons as it has in the past — or as it may need. Larger companies are going to have to shed divisions and businesses — which can mean first-rate opportunities for potential buyers who understand the businesses and are willing to study and bear the risks we've been talking about. There are definitely disruptive forces at play in the defense sector today; which, as long-term investors, we like.

Given all these challenges working with the government, how do you go about diversifying your customer base?

First of all, as I mentioned earlier, the "government" isn't a single customer by any means. Each branch of the military is a separate procurement center, as are many of the internal departments. And even within the branches of the military there are an abundance of different buyers. So you can really think of the government as a panoply of potential customers. The frustrating thing is that each customer generally has its own set of bidding processes, acquisition policies and budgetary constraints — navigating through them all is a challenge. And worse, you sometimes come across internal competition, so that one branch will refuse to buy from your company if you sell to another branch!

That creates literally hundreds of potential customers within the government. In addition, many goods and services that were first developed for the government may also be easily adapted for commercial use. Systems and parts and services for the aerospace industry are obvious examples.

You mentioned earlier the importance of considering the secondary uses for a target's defense technology. Have you acquired businesses with the intention of bringing what was originally a defense technology to the commercial market? Is it difficult?

Although we generally do not acquire a business solely on the thesis that we will bring a defense technology to the commercial market, the commercial viability of technology originally used in defense applications is something we always consider when we evaluate an acquisition opportunity. Depending on the company and the particular technology, we may incorporate a commercial element as part of an overall strategic plan for a portfolio company as we did with our former portfolio company, Atlantic Inertial Systems. AIS designed and sold inertial guidance sensors typically used in rockets and aircraft. They were also able to sell a variant of these sensors to the automotive safety market.

It's generally not too difficult to commercialize certain defense technologies. There are a few obstacles that sometimes create issues, but companies can generally steer around them. Dual use products are subject to export controls imposed by the Commerce Department, but they're not generally more restrictive than the ITAR regulations applicable to military goods and services. You do have to be fastidious about work time for employees: government contracts are generally on a cost plus basis while commercial work is often on a fixed cost basis. You have to be very careful that employees allocate their time properly as between the military and the commercial pieces. The company can get into a lot of trouble if its employees aren't meticulous about this.

How well do you think defense companies interact with the military and the government? What could be done to improve the relationship between customer and supplier?

Some companies do a better job than others, of course. In an odd way, there's a tension between serving the military's needs and running a tight, efficient commercial business. As I noted earlier, I think making companies more commercially oriented and more efficient is better for everyone involved. And it wouldn't be a terrible thing if the government would put more procurements out to auction. ■

It will take years to roll back the bureaucratic bloat....The obvious result is the military simply won't be able to buy nearly as...[much] as it has in the past — or as it may need. Larger companies are going to have to shed divisions and businesses....There are definitely disruptive forces at play in the defense sector today; which, as long-term investors, we like.

Commitments After the Credit Crunch (cont. from page 6)

the provisions in debt financing commitments that have received, and we expect will continue to receive, significant attention.

Specified Representations

One area in which financing sources have successfully dialed back SunGard to some extent is the "Specified Representations," the accuracy of which will be conditions to funding. In addition to the ministerial and legal representations traditionally included as conditions to funding, the Specified Representations now often include representations as to solvency; perfection of security in collateral (subject to the SunGard limitations on perfection); the financing not conflicting with organisational documents, law or material contracts; and compliance with the PATRIOT Act. For the most part, private equity buyers have accepted these additions to one extent or another. For example, it is always best practice to limit the non-contravention of material contracts representation to specified contracts that are actually critical to the interests of the financing sources (*e.g.*, material existing facilities or indentures that will remain outstanding following the transaction). Absent this limitation, this addition could introduce significant financing risk to sponsored acquisitions. In addition, in response to the Hexion/Huntsman litigation and other similar disputes, thoughtful sponsors insist that solvency be tested on a consolidated group basis, and others have gone further by demanding that the form of solvency certificate to be delivered to the financing sources at closing be agreed at the commitment stage. This approach helps to manage the risk that the parties will disagree on how solvency should be tested, a subject on which there can be surprisingly distinct views.

In addition, however, some financing sources are attempting to significantly broaden the scope of the Specified Representations beyond those described above, to include, for example, representations as to full and accurate disclosure to financing sources, the absence of government and third-party consent requirements, the accuracy of financial statements and the absence of undisclosed material litigation and liabilities. The inclusion of the accuracy of these representations as conditions precedent to funding introduces a significant divergence in the conditionality in a sponsor's financing commitments from the conditionality in the acquisition agreement. A sponsor should consider any such request with a careful and skeptical eye. For example, the inclusion of a representation with respect to accuracy of disclosure made to financing sources, essentially, would amount to an information MAC condition, which is not "market" for large sponsored transactions. Sponsors have, in most cases, been successful in resisting the expansion of the "Specified Representations" to the extent any addition would introduce meaningful closing risk for which the buyer is not protected under the acquisition agreement.

Perfection of Security in Collateral

Financing sources are seeking also to broaden the SunGard security perfection requirements to include, for example, delivery of U.S. intellectual property security agreements and other actions to perfect security in other collateral, such as material properties. Filing requirements with respect to U.S. intellectual property security agreements are not unlike those relating to UCC financing statements and, therefore, in most cases, likely would not lead to meaningful additional closing risk. In contrast, the perfection of security interests in other collateral, particularly any which depend on the cooperation of third parties, could add significant closing risk. For the most part, private equity sponsors have successfully resisted meaningful expansion of the SunGard collateral perfection requirements.

Market Risk and Flex

With the potential exception of financial metric conditions, which have appeared in some transactions following the credit crunch, the other conditions that were eliminated under SunGard conditionality, such as market MAC, diligence and information MAC conditions, have not resurfaced, although some financing sources may still include requests of this kind in their initial proposal. However, this is not to say that financing sources have returned to the credit practices of the bull markets of 2006 and 2007.

In the absence of the broad conditionality of the pre-SunGard era, lenders have taken to protecting themselves from market risk through shorter commitment terms and an ever-expanding list of "market flex" provisions. During the LBO boom, "flex" provisions were typically limited to "pricing flex," often within a narrow range of 25 to 50 basis points. In our experience, today, this range has become significantly wider, with increases to the maximum interest rate triggered by the failure to achieve certain minimum ratings, the time elapsed between signing the commitment and closing, and changes in a designated high yield and/or syndicated loan market index.

In addition to "pricing flex," broad "market flex" to add, modify or eliminate specified terms has become common. Typical "market flex" terms that financing sources may seek to facilitate their marketing efforts include the addition of call protection and increased cash flow

CONTINUED ON PAGE 24

Commitments After the Credit Crunch (cont. from page 23)

sweeps and the modification or removal of incremental facilities, equity cures, non-pro rata buybacks and certain restricted payment and debt incurrence baskets.

Finally, "structure flex" provisions are often requested, and sometimes agreed upon, allowing financing sources to shift the allocation of debt among the various facilities and tranches being provided. Sponsors are understandably wary of the documentation and closing risk that would accompany any "structure flex" that would allow financing sources the right to flex debt to new facilities or tranches the terms of which are only vaguely described in the commitment.

Clearly, this additional "flex" can have negative implications for a sponsor's cost of capital, returns on equity and the post-acquisition operational flexibility of the acquired business. On balance, however, the broader "flex" that has become more typical in financing commitments can be viewed as a positive development, in that it has provided financing sources with the flexibility they need to extend credit within SunGard-type financing commitments. As deal activity continues to increase and competition among financing sources to provide capital becomes more intense, we expect the breadth of this "flex" to come under pressure.

Documentation Risk and Standards

In response to the Clear Channel litigation, and other similar disputes relating to the negotiation of, or the failure to negotiate in good faith, the definitive financing documentation, there is a heightened sensitivity in commitment letter negotiation among sellers and buyers alike to documentation risk as a significant element of conditionality. Similarly, financing sources do not currently seem to be willing to underwrite terms on a basis "consistent with sponsor precedent." At the same time, many private equity sponsors are not particularly satisfied with the vagueness inherent in that standard, or the even more vague "customary terms" underwriting standard often insisted upon by financing sources.

As a result, in many cases, financing sources and sponsors have agreed on a middle of the road approach, whereby financing sources, with certain negotiated exceptions, underwrite a specific precedent, either particular to the target or to the sponsor. Even where precedent is target specific or a recent market precedent, financing sources commonly have been unwilling to underwrite that precedent unconditionally and insist upon the ability to diverge from the precedent based on market practice (either at the time of commitment or at the time of closing). While these negotiations and the relevant language in the commitment can be quite nuanced, these nuances can introduce significant conditionality and uncertainty into a sponsor's debt financing commitment. To understand this risk, one must only consider what it might have meant if financing sources had the right to take into account market practice during the depth of the credit crunch when credit markets were essentially closed for business. Whatever the standard eventually agreed upon, sponsors should expect to spend a lot more time and effort negotiating documentation standards than at any time in the past.

* * *

As the leveraged acquisitions market continues to recover from the doldrums of 2008 and 2009, the terms of debt financing commitments remain in large part broadly consistent with those that arose during the LBO boom, in parallel with the no financing condition/RTF structure in acquisition agreements. Absent a significant tightening in credit markets, we expect this approach to deal-making to continue, at least in acquisition transactions with a significant competitive dynamic. That being said, experiences from the credit crunch have had a meaningful influence on financing sources and their evaluation of, and approach to managing, their risk in connection with leveraged acquisitions. As a result of this reevaluation, financing sources have insisted on broad "flex" provisions and shorter commitment terms to address market risk and have, less successfully, sought to roll back SunGard conditionality.

Going forward, we expect sponsors to seek to recover some of the ground recently lost to financing sources in broadened "flex" provisions, and, as described above, for skirmishes to be fought around the boundaries of conditionality. However, absent a significant downturn in the credit markets, we do not expect a meaningful shift away from the RTF/SunGard structure that has become the market standard in larger sponsored deal-making over the past five years. ■

Jeffrey E. Ross
jeross@debevoise.com

Scott B. Selinger
sbselinger@debevoise.com

Investment Adviser Registration (cont. from page 8)

understands the Advisers Act and is empowered with full responsibility and authority to develop and enforce appropriate policies and procedures.

SEC Oversight; Compliance Programs

The SEC actively monitors compliance with the Advisers Act through its inspection program. An SEC inspection often occurs within a year after initial registration with the frequency of examinations dependent upon the firm's risk profile. The Dodd-Frank Act's impact on this frequency is unclear, particularly with regard to advisers to private funds.

The SEC conducts routine and "for cause" inspections, both of which typically involve a visit to an adviser's offices. In addition to reviewing books and records, the SEC staff will want to discuss the firm's compliance environment with the firm's CCO and other members of senior management. The result of an SEC exam is, more often than not, a "deficiency letter" that will identify potential violations of the Advisers Act or perceived weaknesses in the firm's internal controls and risk management. The adviser will be required to respond to the letter and explain the steps that it is taking to address the matters raised by the SEC staff or why the SEC staff's observations were erroneous.

The SEC examination staff also may refer violations to the SEC's Division of Enforcement for further action. Violations of the Advisers Act may result in the imposition of civil or administrative sanctions by the SEC, as well as substantial monetary penalties.

The prospect of an SEC examination demonstrates the importance of establishing a robust compliance program. Registered investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act by the adviser or any of its supervised persons and to appoint a CCO. Each registered investment adviser must also review its policies and procedures annually to determine their adequacy and the effectiveness of their implementation.

The contents of a firm's compliance policies are generally driven by the substantive requirements of the Advisers Act and how they apply to the firm's business. The SEC has not mandated a specific set of "one size fits all" policies. In the private fund sponsor context, the SEC likely would expect compliance policies to address, among other issues, policies designed to prevent disclosures from being misleading, particularly disclosures relating to the firm's track record; the valuation of fund investments; and, if applicable, the allocation of investment opportunities among the funds managed by the firm.

Books and Records

The Advisers Act imposes extensive books and records requirements. An adviser must keep true, accurate and current books and records reflecting its financial affairs and describing transactions for and communications with its clients. During an SEC inspection, an adviser's books and records are usually the subject of careful review.

In the case of an adviser to a private fund (such as a private equity fund), the adviser's books and records generally include the books and records of the fund. Pursuant to the Dodd-Frank Act, the SEC is expected to promulgate new rules that will require extensive recordkeeping and reporting relating to private funds, including information relating to the use of leverage and side letters. This information may be shared with other regulators.

The recordkeeping rules also require a registered investment adviser to maintain the records necessary to form the basis for, or demonstrate the calculation of, the adviser's performance track record that appears in various communications. One question that the SEC or its staff will have to consider in the coming year is whether a fund sponsor that is required to register as a result of the Dodd-Frank Act will be allowed to use its track record if it does not have the appropriate back-up records. In the past, the SEC staff has shown flexibility on these issues.

A firm should develop document retention policies that are designed to facilitate compliance with the books and records rules. These policies should address the retention of e-mail, which may require significant investments in new software and hardware.

Performance-Based Fees; Management Agreements

Advisory contracts with a registered adviser generally may not provide for compensation based on a share of capital appreciation, such as the "carried interest" typically charged to a private fund. However, the prohibition against performance fees does not apply with respect to fees charged to, among other things, (1) private funds consisting only of "qualified purchasers" (*i.e.*, "Section 3(c)(7) funds"), (2) "qualified clients" who have $750,000 under management with the firm or have a net worth of $1.5 million and (3) clients that are non-U.S. residents. The financial criteria in clause (2) above may increase, as the Dodd-Frank Act requires that they be adjusted to give effect to inflation.

Management agreements with clients must contain a provision requiring the client's consent to an "assignment" of the agreement. For purposes of the Advisers Act, an "assignment" is a technical term that includes certain transactions that involve a transfer of a controlling interest in the firm.

CONTINUED ON PAGE 26

The concept of "control" under the Advisers Act is not limited to situations where a person holds a majority of the voting interests or exercises primary control over the firm. This broad definition of "assignment" means that a variety of transactions, including steps taken in connection with succession planning or the retirement of a founding partner, could require the consent of the firm's clients.

Disclosure Requirements; Financial Reporting

In addition to the annual delivery of its Brochure, a registered investment adviser must promptly disclose to any client or prospective client all material facts with respect to a financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients.

Apart from the disclosure of material financial impairments, investment advisers are generally not required to disclose financial information about their operations or the firm. However, the Brochure must include the firm's audited balance sheet for the most recent fiscal year if the adviser requires prepayment of more than $500 (or $1,200 after January 1, 2011) in fees per client six or more months in advance. If an adviser collects fees six or more months in advance, it may want to consider modifying its payment arrangements to avoid this requirement.

Most private equity fund sponsors are likely to be required to register with the SEC by July 21, 2011. The process of preparing the sponsor's Form ADV and of establishing the necessary compliance policies and procedures will require careful planning and substantial lead time.

Advertising and Marketing

Generally, the Advisers Act prohibits registered advisers from distributing any advertisement that, among other things, contains untrue statements of material fact or that is otherwise false or misleading. The SEC through its rulemaking and "no action" letters has provided extensive guidance on the presentation of past performance, including prohibitions on the use of testimonials. These advertising restrictions have been the subject of numerous enforcement actions by the SEC, particularly in connection with advertisements containing misleading information about the adviser's past performance. The firm should determine the applicability of these positions to its marketing materials.

The SEC has also prohibited an adviser from retaining a solicitor to assist it in establishing client relationships unless the adviser enters into a written agreement with the solicitor addressing certain matters, oversees the activities of the solicitor and arranges for the solicitor to provide certain disclosures to clients.

Antifraud Provisions

The antifraud provisions are the "guts" of the Advisers Act and are the basis for many SEC enforcement proceedings. Generally, the antifraud provisions are interpreted broadly to prohibit any fraudulent conduct on the part of an adviser and its employees. Among other things, the antifraud provisions have been interpreted to impose on the adviser an affirmative duty of utmost good faith to act solely in the best interests of its clients and to make full and fair disclosure of all material facts, particularly where the adviser's interests conflict with those of its clients. Thus, an adviser may be required to provide disclosures to clients beyond those called for by Form ADV.

Along with specific antifraud rules discussed elsewhere in this article, the SEC has adopted rules that (1) require an adviser to disclose to its clients any placement fees it receives and (2) prohibit conduct that defrauds investors or prospective investors in pooled investment vehicles managed by the investment adviser. Often these rules apply to both registered and unregistered advisers.

Pay-to-Play Prohibitions

The SEC recently adopted a new anti-fraud rule designed to prohibit certain "pay to play" practices relating to the solicitation of business from state and local governments.[3] The rule imposes significant restrictions on the political contributions and certain other fundraising activities by an investment adviser and its affiliates, officers and employees when the investment adviser provides (or is seeking to provide) advice to local or state government entities, whether directly or through a private fund. The rule will also prohibit an investment adviser from using a third-party solicitor or placement agent to solicit business or investments from state or local governments unless the solicitor or placement agent is either a registered investment adviser or a registered broker-dealer (as applicable). Certain provisions of this rule must be complied with by March 14, 2011 or, in the case of the provisions relating to the use of solicitors and placement agents, September 13, 2011.

CONTINUED ON PAGE 27

---

3 *See Client Update: SEC Adopts New Pay-to-Play Rule, available at http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=8200106a-2f07-49b1-a3e6-99f1b0470e06.*

Investment Adviser Registration (cont. from page 26)

Custody of Client Assets

The safeguarding of client assets is a key concern of the SEC. Generally, a registered investment adviser who has "custody" of client funds or securities must (1) maintain the funds and securities with a "Qualified Custodian," such as a bank or registered broker-dealer; (2) have a reasonable belief that the Qualified Custodian is sending quarterly account statements to the clients; and (3) subject itself to an annual surprise examination by an independent accountant.

The adviser or a related person may act as the Qualified Custodian if the adviser or the related person fall within the definition of "Qualified Custodian" (*e.g.*, the adviser or the related person is a broker-dealer). However, the surprise examination will be required to be performed by an independent accountant who is registered and inspected by the Public Company Accounting Oversight Board (a "PCAOB-Registered Accountant") and the Qualified Custodian will be required to provide an internal control report (such as a Type II SAS-70) covering its custody arrangements.

A private fund sponsor will generally be deemed to have custody of a fund's assets by virtue of being the fund's general partner. The sponsor may avoid the second and third of these requirements if (1) the private fund is audited annually by an independent PCAOB-Registered Accountant and (2) the private fund's audited financial statements are distributed to fund investors within 120 days (180 days, in the case of a fund of funds) of the end of its fiscal year. This audit may also reduce the burdens that may be imposed by the Qualified Custodian requirement. Certain uncertificated, privately offered securities (*e.g.*, privately offered limited partnership interests) need not be maintained with a Qualified Custodian if the sponsor complies with the audit provision. A private fund sponsor will still be required to maintain the private fund's other securities and funds with a Qualified Custodian, including, for example, stock certificates issued by portfolio companies.

Code of Ethics; Personal Securities Trading

A registered investment adviser must adopt a code of ethics that sets forth, among other things, a standard of conduct for its employees and requires compliance with federal securities law and requires the adviser's "access persons" (employees with access to certain types of information) to periodically report their personal securities transactions and holdings to the adviser's CCO or other designated persons. Certain types of personal securities transactions (such as purchases of IPOs and private placements) are subject to an enhanced review and approval process. The transaction reports must be reviewed by the adviser and retained in its books and records for SEC review.

In recent years, the SEC has subjected the personal securities trading activities of an adviser's employees to intense scrutiny and has imposed numerous sanctions where it has found that the conflicts of interest presented by such practices have violated the provisions of the Advisers Act.

Policies to Prevent the Misuse of Non-public Information

A registered investment adviser must establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information by the investment adviser or any Associated Person. The adequacy of these procedures is often the focus of SEC examinations and has been the focus of SEC enforcement actions even in circumstances where there is no allegation that material non-public information was misused.

Other Policies

A registered investment adviser's compliance policies should also address other areas in order to comply with SEC rules or to meet SEC staff expectations. These policies include the following:

- Proxy voting policies and procedures;
- A business continuity plan identifying procedures relating to an emergency or significant business disruption;
- Anti-money laundering policies; and
- Consumer privacy policies.

* * *

Most private equity fund sponsors are likely to be required to register with the SEC by July 21, 2011. The process of preparing the sponsor's Form ADV and of establishing the necessary compliance policies and procedures will require careful planning and substantial lead time. Private fund sponsors should start preparing for registration now—not just for the registration form but also for life under the SEC's watchful eyes. With careful preparation, these new requirements should be eminently manageable. ■

Kenneth J. Berman
kjberman@debevoise.com

Gregory T. Larkin
gtlarkin@debevoise.com

UK Bribery Act Requires Prompt Action (cont. from page 14)

and intermediaries, all forms of joint venture and similar relationships and all markets in which the commercial organisation does business.

- *Clear, practical and accessible policies and procedures.* The commercial organisation's policies and procedures to prevent bribery being committed on its behalf are clear, practical, accessible and enforceable. Policies and procedures take account of the roles of the whole work force from the owners or board of directors to all employees, and all people and entities over which the commercial organisation has control.
- *Effective implementation.* The commercial organisation effectively implements its anti-bribery policies and procedures and ensures they are embedded throughout the organisation. This process ensures that the development of policies and procedures reflects the practical business issues that an organisation's management and work force face when seeking to conduct business without bribery.
- *Monitoring and review.* The commercial organisation institutes monitoring and review mechanisms to ensure compliance with relevant policies and procedures and identifies any issues as they arise. The organisation implements improvements when appropriate.

The draft guidance includes suggestions of the ways in which organisations might apply these principles when creating or revising their anti-bribery policies and procedures. Among the suggested procedures that should be included in any sensible anti-corruption scheme are: (1) board responsibility for the anti-corruption program; (2) senior officer responsibility for oversight of the anti-corruption program; (3) a corporate code of conduct which includes an anti-corruption element; (4) risk management procedures; (5) a gifts and hospitality policy; (6) anti-corruption training for relevant employees; (7) the need to conduct due diligence on potential business partners, agents and proposed business projects to identify corruption risks; (8) contract terms addressing corruption, especially in agency agreements; (9) financial controls; (10) supply chain management; and (11) reporting and investigation procedures that encourage employees to report corruption in a safe and confidential manner.

Private equity funds and managers potentially subject to the Bribery Act would be well-advised to begin thinking now about how such policies and procedures would apply to their particular business.

"Adequate procedures" will resemble, at least to some extent, those found in a typical U.S. "FCPA compliance manual." However, we should point out that there are substantive differences between the U.S. FCPA and the UK Bribery Act and hence a typical FCPA manual may be insufficient in some respects. For instance, facilitation payments are unlawful under the Bribery Act, in contrast to the FCPA. Moreover, the Bribery Act applies to private and public corruption and therefore sweeps more broadly than the FCPA which is limited to bribery of foreign public officials. For many sponsors it will be necessary to adjust their programs to meet the most expansive requirements of each relevant jurisdiction.

Conclusion

What does this mean for private equity firms? In light of the potentially expansive way in which terms such as "associated person" and "carrying on business" may be applied by the UK enforcement agencies, private equity firms that may be regarded as carrying on business in the UK would be well-served to review and, if necessary, overhaul their internal procedures and make sure that adequate procedures are in place across their worldwide operations.

Since most contemporary anti-corruption programs hold directors responsible for implementation of effective corporate-wide policies aimed at combating corruption, and because of the fact that private equity fund principals often serve on the boards of their portfolio companies, private equity firms need to satisfy themselves that all of their portfolio companies conducting any business in the UK have robust procedures in place to deter corruption.

Further, prior to making an investment in a portfolio company conducting any business in the UK, private equity firms should perform adequate due diligence on the target company's risk profile, the countries where the company operates, previous business transactions and use of agents or other third parties in order to identify as far as possible corruption-related risks under the Bribery Act.

Waiting until the Bribery Act is implemented in April 2011 before reviewing anti-corruption procedures and implementing changes required to comply with the Act could prove a costly mistake. ■

Geoffrey P. Burgess
gpburgess@debevoise.com

Tom Epps
tepps@debevoise.com

Amanda D. Zakowich
adzakowich@debevoise.com