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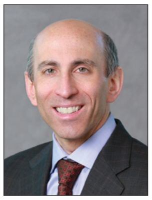
# Private Equity

In this issue



Dechert LLP

## Jobs Act Implications for Private Equity



by **Robert M. Friedman** and **David S. Rosenthal**

The recently enacted Jumpstart Our Business Startups Act, or the "JOBS Act," will change the way private funds solicit and secure subscription commitments from investors and raise capital for portfolio companies by permitting general solicitation and general advertising in Regulation D private placements (offerings to accredited investors) and in Rule 144A offerings (offerings to qualified institutional buyers). Private funds also should benefit from the provisions of the JOBS Act increasing the number of stockholders of record a company may have before being required to register with the SEC and exempting certain persons from registering as a broker-dealer when maintaining a platform to conduct private placements. The JOBS Act will also make it easier for certain portfolio companies of private funds to more easily offer securities to the public markets.

### Change to General Solicitation and Advertising Rules

The SEC has been directed to revise its rules for offerings of securities under Section 506 of Regulation D to remove the prohibition under Section 502 of Regulation D on general solicitation and general advertising of offers and sales of securities provided: (1) all purchasers of securities in the offering are accredited investors and (2) the issuer of securities takes reasonable steps to verify that purchasers are accredited investors, using methods to be determined by the SEC. Note that presently, in determining the status of offerees and purchasers of securities under Regulation D, issuers must "reasonably believe" each offeree and purchaser is an accredited investor. In the future, issuers

will be required to verify purchasers meet the accredited investors standard based on criteria and processes established by the SEC.

The SEC also has been directed to revise its rules to provide that securities sold under Rule 144A may be offered to persons other than "qualified institutional buyers," including by means of general solicitation or general advertising, provided that securities are sold only to persons that the seller, and any person acting on its behalf, reasonably believes is a qualified institutional buyer.

Presently, in order for an offering of interests in a private fund to qualify as a private offering exempt from the general requirement that offers and sales of securities must be registered with the SEC, the interests may not be offered publicly and are sold in private placements. Rule 506 under Regulation D provides a safe-harbor under Section 4(2) of the Securities Act of 1933, as amended (the Securities Act), for offers and sales to accredited investors. However, the offers and sales may not be made by any form of general solicitation or general advertising, thus prohibiting communication through advertising in newspapers, magazines or similar publications, radio and television broadcasts and public seminars.

Counsel to private funds often are called upon to review communications with the media by representatives of private funds to determine whether the rule on general solicitation or advertising has been breached. Many counsel also strongly discouraged clients from appearing on speaker panels while their private funds were being marketed. In some cases, offerings have been delayed on account of overzealous public communications. The JOBS Act will eliminate those concerns and allow for public advertising of private fund interests so long as actual sales are only made to accredited investors. Furthermore, broker-dealers and placement agents need not have a pre-existing relationship with an offeree or knowledge that the offeree is an accredited investor, before delivering private placement materials and soliciting a sale of private fund interests. Portfolio companies of private funds will also benefit from these changes.

## Change Under Investment Company Act

In addition to the present restrictions on general solicitation and advertising under the Securities Act, private funds also are subject to limitations on public offering of interests under the Investment Company Act of 1940, as amended (the Investment Company Act).

A private fund that relies on Section 3(c)(1) of the Investment Company Act, for funds with fewer than 100 beneficial owners, or Section (3(c)(7) of the Investment Company Act, for funds with only qualified purchasers, to avoid being deemed an "investment company" is required not to be making and not to presently propose to make a public offering of its securities. The JOBS Act clarifies that offers and sales of private fund interests exempt under Rule 506 of Regulation D, as modified (see above), will not be deemed to be public offerings under Federal securities laws as a result of general advertising or general solicitation.

## Change to Increase Number of Stockholders of Record Prior to Required Registration with the SEC

Section 12(g) of the Securities Exchange Act of 1934, as amended, has been amended to loosen the requirement for when an issuer must register a class of equity securities as follows: Registration is required if on the last day of the preceding fiscal year the issuer has total assets exceeding $10 million and a class of equity securities "held of record," by either (1) 2,000 persons or (2) 500 persons who are not accredited investors. The JOBS Act also excludes from the definition "held of record" securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of Section 5 of the Securities Act and requires the SEC to adopt safe-harbor provisions issuers can follow to determine whether holders of their securities received them pursuant to an employee compensation plan in transactions exempted from registration requirements of Section 5 of the Securities Act.

## Change in Required Broker-Dealer Registration for Persons Maintaining a Platform to Conduct Private Placements

A person who meets the conditions listed below will not be required to register as a broker-dealer if it assists in the offer and sale of securities under Rule 506, as revised, solely because (i) that person maintains a platform permitting the offer and sale, negotiation or general solicitation or general advertisement of securities, (ii) that person co-invests in such securities, or (iii) that person provides ancillary services with respect to those securities. "Ancillary Services" means the provision of due diligence services, so long as those services do not include, for separate compensation, investment advice or recommendations to issuers or investors and the provision of standardized documents to issuers and investors, so long as the person does not negotiate the terms of issuance for and on behalf of third parties and issuers are not required to use the standardized documents as a condition of using the service. It is a condition, however, that such person and each associated person (i) receive no compensation in connection with the purchase or sale of such security (ii) do not have possession of customer funds or securities in connection with such purchase or sale, and (iii) not be subject to statutory disqualification.

## What Has *Not* Changed?

- The change to the rules on general solicitation and general advertising apply only to private placements made under the Rule 506 of Regulation D safe-harbor for private offerings. Private placements under Section 4(2) of the Securities Act that do not meet the Rule 506 requirements will not benefit from any modification of the restrictions on general advertising and general solicitation under Rule 506.
- Regulation S contains a restriction on "directed selling efforts" which includes placing an advertisement in a publication "with a general circulation in the United States that refers to the offering of securities being made in reliance upon this Regulation S." The SEC is not required to provide relief from the restrictions on general advertising and solicitation under Regulation S and so issuers will have to consider any public advertising in an offering that includes a Regulation S component.
- Anti-fraud rules remain in effect and must be complied with in offerings under the revised rules for general solicitation and general advertising.

## Portfolio Company IPOs

Certain provisions of the JOBS Act should be helpful to private equity funds whose portfolio companies that qualify as emerging growth companies are contemplating initial public offerings. An emerging growth company is defined as an issuer whose revenues were less than $1.0 billion in its last fiscal year. In particular, the JOBS Act's "testing the waters" provision and the ability to submit to the SEC a draft IPO registration statement and amendments of an emerging growth company on a confidential basis may encourage private equity firms to more seriously consider initial public offerings for their portfolio emerging growth companies. Specifically, the testing the waters provision allows an emerging growth company and its investment bankers to contact accredited institutional investors to assess their appetites for investing in the potential IPO of such company. The confidential filing provision allows an emerging growth company to submit its IPO registration statement and amendments to the SEC on a confidential basis provided that it publicly files such registration statement and amendments with the SEC 21 days prior to the company's official road show. The combination of these provisions should encourage private equity funds to commence the IPO process for their eligible portfolio companies. First, with the information learned in the "testing the waters" process, private equity funds and their portfolio companies will get a better sense of whether the IPO might be successful prior to committing to the full expense of the IPO process, as well as being able to continually assess accredited institutional investors' appetites for the offering throughout the SEC registration process. Second, the confidential submission process allows companies to commence and continue through a large part of the IPO process with the SEC without the general public being aware of the IPO attempt, thereby avoiding the public embarrassment or taint if the IPO cannot be completed.

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## Recent Developments in Acquisition Finance


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

There have been some important recent legal developments that will likely impact acquisition finance. This article will survey some of the more notable ones.

The Eleventh Circuit Court of Appeals, on May 15, 2012, overturned[1] a prior District Court decision stemming from the bankruptcy case of Tousa, Inc., affirming a bankruptcy court's earlier 2009 decision that had ordered the return, on fraudulent transfer grounds, of over $400 million that had been repaid to prior lenders of the Tousa parent company in connection with a secured financing to the parent and its subsidiaries.

The bankruptcy court's 2009 decision had startled the lending community, whose tension was relieved by the District Court's 2011 reversal. By rejecting the District Court's ruling, the Circuit Court has raised these concerns anew, which may significantly impact the acquisition finance market.

The case, at its core, involved the repayment of previously existing debt owed only by the Tousa parent (Old Debt) with proceeds of a debt financing to the parent and its various subsidiaries, secured by liens on their assets (New Debt). The bankruptcy court, affirmed now by the Circuit Court, held that (i) the subsidiaries did not receive "reasonably equivalent value" for the liens they granted in their assets (to secure the New Debt that rendered them insolvent), because the proceeds of the New Debt were used to pay off the Old Debt for which the subsidiaries were not liable, and the granting of liens by the subsidiaries was thus a fraudulent transfer under the Bankruptcy Code, and (ii) the holders of the Old Debt were beneficiaries of the fraudulent transfer subject to disgorgement of the repayment received. The Circuit Court, among other things, rejected the District Court's ruling that intangible benefits such as the delay and avoidance of bankruptcy for certain affiliates constitutes "reasonably equivalent value" as a matter of law. Instead, the Circuit Court ruled that the determination of "reasonably equivalent value" for such purpose is a fact-driven one, and that the bankruptcy court had not exceeded its authority in determining that the intangible benefits to the subsidiaries in this case were insufficient, in light of the somewhat extreme facts with which the court had been presented. The Circuit Court did not rule on the bankruptcy court's holding that the determination of insolvency is properly made for each subsidiary individually (and not on a consolidated basis), and remanded the case back to the District Court for consideration of appropriate remedies consistent with the Circuit Court decision.

Although not binding on Federal courts in the second or third circuits (which include New York and Delaware, respectively), the Eleventh Circuit's decision is likely to be taken seriously by lenders throughout the country, due to the rank of that Court and the nature of its ruling in the case.

The decision presents important issues for lenders, especially in cases in which entities not indebted to them are involved in their repayment and in precarious financial condition. It had generally been assumed in the loan markets that repayment of a valid antecedent debt held by a non-insider is subject to disgorgement only during the applicable 90-day preference look-back period immediately prior to filing of a bankruptcy petition. After *Tousa*, the potential disgorgement period is seemingly extended to at least the two-year look-back period for fraudulent transfers, and possibly longer under analogous state fraudulent conveyance laws.

Among the unanswered questions the market will need to sort through in *Tousa*'s wake are:

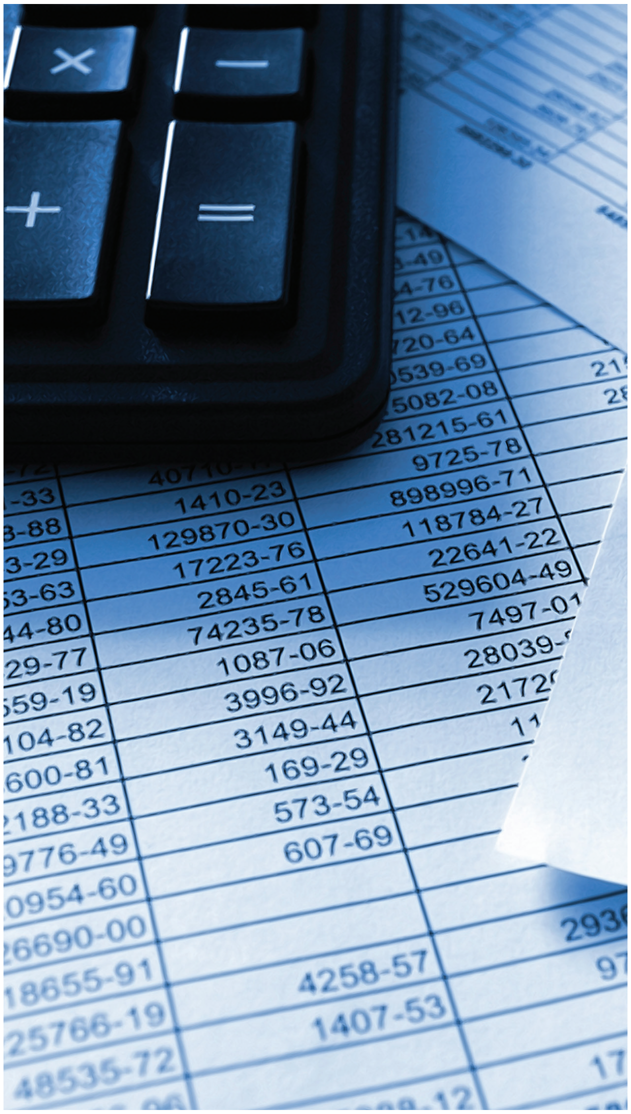
- Will lenders financing an acquisition require a sponsor to make an equity investment greater than it otherwise would be required to, in order to reduce risk of a later judicial finding of insolvency of the acquired group (notwithstanding solvency assurances given at closing)?
- Will acquisition lenders require solvency certificates and other evidence of solvency on a consolidating — i.e., entity-by-entity — basis as well, rather than just on a consolidated basis, as has been market practice? If so, will compliance be feasible? Will the value of secured guarantees from subsidiaries whose solvency is questionable on a stand-alone basis be discounted by lenders in their credit

analysis? If so, what will be the impact on loan pricing?

- Will lenders begin to incorporate into acquisition financing commitment and loan documentation terms relating to the eventual repayment of their loans, such as informational requirements as to the identity of and circumstances surrounding any non-obligor involved in repayment? Would lenders consider imposing new conditions to their own repayment in a stressed or distressed context? Could any such conditions be designed (e.g., perhaps as optional rights) consistent with lenders' interests in being repaid?
- To what extent will committees of unsecured creditors in bankruptcy cases, and others seeking to unwind secured financings, be successful in attempts going forward, in different factual settings under a fraudulent transfer theory, to broaden application of the *Tousa* holding by using its principle of determining solvency and benefits received on an individual-entity basis?

The Delaware Supreme Court recently affirmed a Court of Chancery decision in *SV Investment Partners, LLC v. ThoughtWorks, Inc.*[2] which had held, in the context of preferred stock that was required to be redeemed out of "funds legally available" for redemption, that "funds legally available" is narrower in scope than "surplus." In rejecting a claim by the preferred shareholders that "funds legally available" is equivalent to "surplus" in such context, both courts held that "funds legally available" includes the concept that the funds be at hand or readily accessible, and the courts gave substantial deference to the company's board of directors in determining whether it in fact had funds available from time to time for redemption of the preferred shares, including its determination of needed levels of ongoing cash reserves. The Court of Chancery had determined that, for the preferred shareholders to have prevailed, they would have had to demonstrate that the issuer's board had acted in bad faith in determining the availability of funds for redemption, or would have needed to have relied on unreliable information, or "made determinations so far off the mark as to constitute actual or constructive fraud." The decision sounds a cautionary note for investors financing an acquisition through the purchase of redeemable preferred shares.

The case arose out of the purchase in 2000 by SV Investment Partners, LLC (SVIP) of 94% of the Series A Preferred Stock of ThoughtWorks, Inc. (ThoughtWorks). The holders of the preferred shares were entitled to redeem the shares for cash beginning five years after issuance "out of funds legally available therefor." In the event insufficient funds were available for redemption of all the preferred stock so elected to be redeemed, any funds becoming available after the initial redemption were required to be applied to continuous redemptions until the preferred shares in question were fully redeemed. When SVIP exercised its redemption right, ThoughtWorks' board concluded that, while the company had cash, it had no legally available funds for the redemption. SVIP asserted that the company had



sufficient "surplus" as defined by Section 160 of the Delaware General Corporation Law, and therefore had sufficient "funds legally available" for the redemption. The Court of Chancery, however, concluded that the two terms were not synonymous and that the latter "contemplates 'funds' (in the sense of cash) that are 'available' (in the sense of on hand or readily accessible through sales or borrowing) and can be deployed 'legally' for redemptions without violating Section 160 or other statutory or common law restrictions, including the requirement that the corporation be able to continue as a going concern and not be rendered insolvent by the distribution."

The Court of Chancery makes it clear that the terms of a corporate charter, including preferred stock's rights, duties, powers, preferences, etc., are contractual in nature and thus subject to contractual construction by courts. Additionally, a board may not authorize a redemption of preferred equity unless both (i) the corporation's net assets exceed the redemption amount and (ii) after the redemption the corporation has the ability to continue to pay its debts as they come due. As such, in considering whether to finance acquisitions using preferred equity, investors should consider spelling out in detail what assets must be legally available to make a redemption, whether the corporation will be required to sell assets to make redemptions, and whether the board must use a specific method of valuation in determining what funds or other assets are available to make redemptions. In terms of limiting a board's ability to establish cash reserve levels that could interfere with redemptions, investors could, for example, include in their charter provisions negotiated levels of maximum cash reserves, beyond which funds would be available for redemption.

Last fall, we discussed the Circuit Court split resulting from the Seventh Circuit's ruling in *River Road v. Amalgamated Bank*.[3] There, the Seventh Circuit ruled in favor of the secured creditor's ability to credit bid in a Chapter 11 auction; this ruling was in direct contrast to rulings reached by the Third and Fifth Circuits in similar cases. In December, the U.S. Supreme Court granted certiorari under the caption *RadLAX Gateway Hotel, LLC v. Amalgamated Bank,* to address whether a debtor may pursue a Chapter 11 plan that proposes to sell assets free of liens without allowing the secured creditor to credit bid, but instead providing it with the "indubitable equivalent" of its claim under Section 1129(b)(2)(A)(iii) of the Bankruptcy Code.[4]

The Loan Syndications and Trading Association (LSTA), a loan industry trade association, filed an amicus brief in support of Amalgamated Bank in favor of granting certiorari. In its brief, the LSTA noted that "[s]ecured creditors' ability to credit bid at auctions of their collateral is central to the detailed scheme of protections that the Bankruptcy Code provides them." Further, it noted that the uncertainty and inconsistency between federal circuits "will impose additional risks on secured lenders, raising the cost of capital at a particularly inopportune moment for the national economy."

The U.S. Supreme Court has now issued its ruling,[5] siding with the position of the Seventh Circuit and the LSTA, and delivering a major victory to secured parties, by holding unanimously that secured creditors must be allowed to credit bid if a debtor seeks to sell assets constituting collateral under a plan of reorganization free of the liens of the secured parties.

We previously discussed potential regulation affecting banks and certain designated non-banks consisting of more stringent capital reserve requirements for lending commitments maintained by the lending institution from time to time, under the framework of the Basel III reforms recommended in 2010 by the Basel Committee on Banking Supervision. On December 20, 2011, the U.S. Federal Reserve Board issued proposed rules that would begin implementation of enhanced liquidity requirements proposed by Basel III, including a new Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR).[6]

The proposed rules introduce liquidity stress test requirements for certain banks and require them to maintain liquid assets sufficient to meet projected net cash flows under the stress tests. The proposed rules also state that the Board will propose a second phase of regulations to implement the LCR and NSFR. The LCR would require banks to hold an amount of high-quality liquid assets sufficient to meet expected net cash outflows over a 30-day time horizon under stress scenarios. The NSFR would require banks to enhance their liquidity risk resiliency out to one full year. These new requirements could eventually increase costs of borrowing from regulated institutions, which would need to maintain liquid assets sufficient to meet projected net cash outflow obligations under lending commitments available for drawdown and related exposures. While the implementation timetable announced by the Basel Committee generally calls for implementation of the LCR and NSFR tests by 2015 and 2018, respectively, the reforms become binding on relevant institutions only through their adoption and implementation by relevant banking authorities, such as the Federal Reserve Board and European Banking Authority. The Federal Reserve Board has stated that, under the terms of Basel III, banks under its jurisdiction will be required to comply with the LCR and NSFR tests by 2015 and 2018, respectively.[7]

In its assessment of the long-term economic impact of the enhanced liquidity and capital proposals of the Basel Committee, the Bank for International Settlements notes,[8] using various assumptions it characterizes as conservative: "First, each 1 percentage point increase in the capital ratio raises loan spreads by 13 basis points. Second, the additional cost of meeting the liquidity standard amounts to around 25 basis points in lending spreads . . . ."[9] The report emphasizes the potential economic benefits of more conservatively capitalized banks and avoidance of future bank failures and related crises. If lending commitments become less attractive to banks, they could become more costly and generally more difficult to obtain, or they might be made available as a special service by banks primarily to their better customers who generate revenue for the banks from unrelated transactions. This potentially could present an additional challenge to sponsors seeking revolving financing for portfolio companies or for targets of a contemplated acquisition.

We look forward to updating you on these and other developments in the coming months.

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1 *In re Tousa, Inc.*, No. 11-11071, 2012 WL 1673910 (11th Cir. May 15, 2012).

2 37 A.3d 205 (Del. Supr. 2011).

3 *River Road Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642 (7th Cir. 2010).

4 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 845 (2011).

5 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, No. 11-166, 2012 WL 1912197 (U.S. May 29, 2012).

6 Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.

7 *Id.* at 600.

8 *An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements*, Bank for International Settlements (August 2010).

9 *Id.* at 4.

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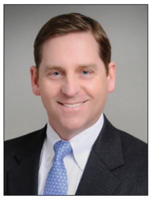
## What's the Deal With Fracking? Regulation, Litigation and Due Diligence[1]



by **Abbi L. Cohen** and **John M. Ix**

Recent enhanced drilling techniques have made it economically feasible to drill wells in certain shale formations, like the Marcellus Shale, and tap into the estimated trillions of cubic feet of natural gas trapped within those formations. This has resulted in numerous M&A transactions involving companies in the shale gas exploration and production (E&P) business as well as those related businesses that support or benefit from shale gas E&P. PE firms too have been looking at the possibility of investing in companies in shale related activities. According to a report by PricewaterhouseCoopers, "merger and acquisition activity in the shale arena has been booming since 2008, and much of it consists of foreign investors, international oil companies and even some national oil companies partnering with U.S. independents in joint ventures."[2] Given the importance of natural gas development to the U.S. economy and environment, it is reasonable to expect that the level of transaction activity in this sector will continue to grow at a brisk pace.

M&A transactions in the shale gas E&P sector have been, and will continue to be, completed against a backdrop of changing regulatory requirements for some time to come. The recent and rapid expansion of Marcellus Shale gas E&P activities has left many regulators struggling to catch up. A quickly changing regulatory regime can affect the timing and size of the expected rate of return on an investment and/or increase the environmental risks in an investment or financing. The jurisdiction in which a target's natural gas assets are located as well as the stage of the target's natural gas E&P also could have an effect on deal risk. Consequently, environmental due diligence of proposed M&A transactions in the "up-stream" shale gas E&P sector should include not only the environmental profile and compliance status of the target but also an evaluation of the environmental regulatory regime in the relevant jurisdictions — both in effect and proposed. The purpose of this article is to offer suggestions for specific environmental due diligence inquiries in light of the current and changing regulatory regime.

## The Marcellus Shale and "Fracking"

The Marcellus Shale is located principally beneath parts of New York, Ohio, Pennsylvania, and West Virginia. It ranges in depth from 4,000 feet to 8,500 feet below the ground surface (bgs). The advent of enhanced drilling techniques, such as horizontal drilling and hydraulic fracturing (fracking or fracing), has made it possible and economically feasible to extract natural gas from the Marcellus Shale. Fracking stimulates gas extraction by pumping a fluid and a "proppant" — such as sand — down a well under high pressure to fracture the gas-bearing rock formation. The proppant keeps the fractures open so more gas can be extracted. Fracking fluid typically consists of more than 98% water and sand, with less than 2% chemical additives that may include friction reducers, biocides, gels to carry the proppant into the fractures, solvents, surfactants and other additives. Marcellus Shale wells each use between 3.0 million and 5.0 million gallons of water. Approximately 15 percent of the fracking fluid injected into shale gas wells returns to the surface as so-called "flowback" water.

## The Environmental Issues Raised in the Fracking Discussion

The primary environmental debates regarding fracking address whether: (1) the released natural gas can migrate out of the wells and impact the environment; (2) the fracking fluid can escape and impact the environment during injection; (3) improperly designed or installed wells will result in releases of natural gas or fracking fluid; and (4) the fracking fluid and flowback water can be stored and disposed of in an environmentally sound manner.

Views diverge over whether creating fractures in the Marcellus Shale itself presents an unreasonable risk of impacting water resources. Because the Marcellus Shale is located 4,000 to 8,500 feet bgs and groundwater is located approximately 600 feet or less bgs, however, it seems unlikely the hydraulic fracturing process could result in contamination of drinking water resources. Nevertheless, improperly designed or installed well casings and surficial releases of waste flowback water prior to injection or treatment have been alleged to result in impacts to surface and groundwater. As with conventional gas wells, there also have been allegations that defectively designed or installed fracking wells can result in blow-outs.

Waste flowback water can contain relatively high concentrations of total dissolved solids (TDS); naturally occurring radioactive material; and volatile organic compounds (VOCs). During the return of flowback water to the surface, methane, other VOCs, and toxics in the flowback can be released to the atmosphere unless controlled. Approximately 60% of flowback water is recycled. The primary means of disposal of waste flowback water that is not recycled are: (i) deep injection back into the ground and (ii) transportation to potentially remote storage and treatment locations by pipeline or truck, after which it is discharged to surface water. Deep injection of waste flowback water has been alleged to be a potential cause of earthquakes. The second disposal option also raises environmental questions. The typical publicly owned treatment works (POTW) can only treat TDS and radioactivity through dilution, and inadequate treatment of waste flowback water has been identified by the U.S. Environmental Protection Agency (EPA) as a potential cause of surface water contamination.

Fracking wells emit methane gas and other VOCs into the atmosphere. More generally, shale gas E&P can result in increased industrial activity, trucking, and general construction activities, prompting discussion of potential community impacts. The President's FY 2013 budget includes $14 million for research on the effect of hydraulic fracturing on air quality, water quality, and ecosystems.

## Recent Legislative and Regulatory Developments

The rapid expansion of natural gas E&P in the Marcellus Shale has created a rapidly changing legislative and regulatory environment. A great deal of attention has been focused on the public disclosure of chemical additives used in fracking. Currently, federal law requires disclosure of fracking fluid additives (and underground injection well permits) only where diesel fuel is used in the fracking fluid. Proposed Department of Interior regulations would impose a disclosure obligation on wells drilled on federal and Indian lands. Some states also require fracking fluid additive disclosure.

In addition to disclosure, the federal government has recently initiated regulatory activity addressing perceived risks to surface water, drinking water and air. In 2011, EPA announced its intent to develop regulations governing pre-treatment of flowback water before discharge to wastewater treatment plants. Those regulations will likely require some form of evaporation/distillation to meet the current federal drinking water standard for TDS at an estimated cost of $0.25 per gallon.[3] EPA also is currently studying the potential impact of hydraulic fracturing on drinking water supplies. It proposes to issue initial study results in 2012 and final results in 2014. It was only on April 17, 2012 that the EPA published new regulations governing air emissions from fracking wells. The new rules require reductions in VOCs from completions of new gas wells and recompletions of existing gas wells that are fractured or refractured. EPA would minimize the VOC emissions by requiring the use of "green completion" technology at an estimated cost of $34,000 per well per completion.

State governments and regional compact authorities (e.g., the Susquehanna River Basin Commission) are also actively involved in regulating fracking. Fracking bans or moratoria, at least in the short term, exist in certain states and regions (e.g. New York and the Delaware River Basin) while they actively evaluate the perceived risks of fracking and how best to mitigate such risks. State and regional compact regulations governing Marcellus Shale fracking vary in their approaches to where fracking may occur and what operational requirements for well installation and fracking are required. In addition, state fee payments have begun to increase. For example, Pennsylvania recently enacted legislation imposing a per-well fracking "impact fee," which varies based on a formula tied to annual average natural gas prices.

Increased federal, state and regional regulation of fracking will increase the time and cost to obtain permits and site, construct and operate new wells. The relative differences between state and regional approaches to fracking regulation also can have a significant effect on the value of, or the time to recover on, an investment in a given geographical area.

## Environmental Due Diligence for Transactions Focusing on Marcellus Shale Fracking

In evaluating environmental regulatory risks associated with transactions involving upstream Marcellus Shale gas E&P companies, consider including some or all of the following questions in your environmental due diligence review:[4]

1. What is the environmental risk profile of the target:
   - (a) Is the target the subject of any pending environmental regulatory compliance investigation or other administrative proceeding? Any pending or threatened environmental claims or litigation?
   - (b) Does the target have a history of well blow-outs or issues associated with alleged poor well-construction or operating practices?
   - (c) Has the target shifted any of its environmental compliance, contamination or litigation risks to third parties, including insurance companies, sellers/buyers of assets or businesses, or joint venture partners, if any?
   - (d) Is the target subject to SEC reporting? Are the target's estimates of natural gas reserves and/or environmental risk, if applicable, supportable?
2. For targets who have existing wells, consider the following:
   - (a) In what regions, states and municipalities are the target's wells located? Have impact fees been imposed or proposed?
   - (b) If the wells are still generating flow-back, how is it managed?
     - (i) If the target relies on a wastewater treatment plant, can the plant continue to treat the wastewater in compliance with the Clean Water Act and/or state law?
     - (ii) If the target uses injection wells, does it use fracking fluid that includes diesel fuel? Does the target have an underground injection permit?
   - (c) Does the target monitor groundwater and/or drinking water?
     - (i) Are there any impacts noted?
     - (ii) Are there other potential sources of contamination in the area including abandoned wells?
     - (iii) Is there any proposed or ongoing investigation, remediation or other response action with respect to the impacted groundwater, including the provision of alternative drinking water supplies?
   - (d) Does the target disclose the chemical constituents (and relative amounts of such constituents) of its fracking fluid?
   - (e) Does the target have a Title V Clean Air Act permit? Does the gas well utilize "green completion" technology consistent with soon-to-be-required federal air regulations?
3. For targets who propose installing new wells, consider the following:
   - (a) In what regions, states and municipalities are the target's proposed well sites located? Have impact fees been imposed or proposed?
     - (i) Is there a ban, moratorium or limit on new well installations or the number of wells installed by a single legal entity?
     - (ii) Are there proposed or enacted well set-back requirements that could effectively limit the target's ability to install new wells?

(b) What will be the source of the fracking water supply?

(c) Will the target need a regional water withdrawal permit? Consider the timing and cost of permitting.

(d) Is any source water authorization subject to any low-flow (i.e., drought) restrictions that could impact the timing of fracking?

4. How will the flowback water be managed?

(a) Is injection feasible/permitted? Consider timing of applicable permit.

(b) Does the target plan on using fracking fluid that could contain diesel fuel?

(i) Consider the timing and cost of obtaining an injection permit, if necessary.

(c) Does the target have access to a wastewater treatment facility that can accept the flowback water? Consider any added wastewater transportation and treatment costs.

(d) Is the target planning on constructing a dedicated wastewater treatment plant? Consider capital costs and the timing and cost of permitting.

(e) Will well installation require a construction permit under state air pollution laws and/or a Title V permit?

(i) Consider the timing and cost of permitting. Consider the cost of "green completions" and/or other required air emission control technology.

(f) Has the target performed baseline groundwater sampling of drinking water supplies?

(i) Are there any known impacts to groundwater in the vicinity of the proposed gas well(s)?

(ii) Has the target evaluated whether there are any constituents in its fracking fluid that are present in the existing drinking water supply? Can the target make substitutions to its fracking fluid to avoid problems of proof?

### Conclusion

Investments in and acquisitions of businesses engaged in Marcellus Shale E&P are being conducted against a backdrop of evolving laws and regulations. Although it appears it will be some time before the full extent of environmental regulatory challenges associated with fracking in the Marcellus Shale can be well defined, by following the regulatory debate and by asking appropriate due diligence questions, investors can take the first steps in managing these challenges.

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1 Adapted, with permission, from an article published by the Daily Environment Report, 80 DEN B-1, 04/26/2012. Copyright © 2012 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com.

2 PricewaterhouseCoopers LLP, *Maximizing Value of Shale Joint Ventures* (2011), available at http://www.pwc.com.

3 40 Pa. Bull. 4835, at 12 (Aug. 21, 2010).

4 These questions do not include basic environmental regulatory questions that might be relevant to any construction-based project or those relating to the transportation and distribution of the shale gas.

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## New German Tax Legislation Affects Private Equity Funds and Their German Investors

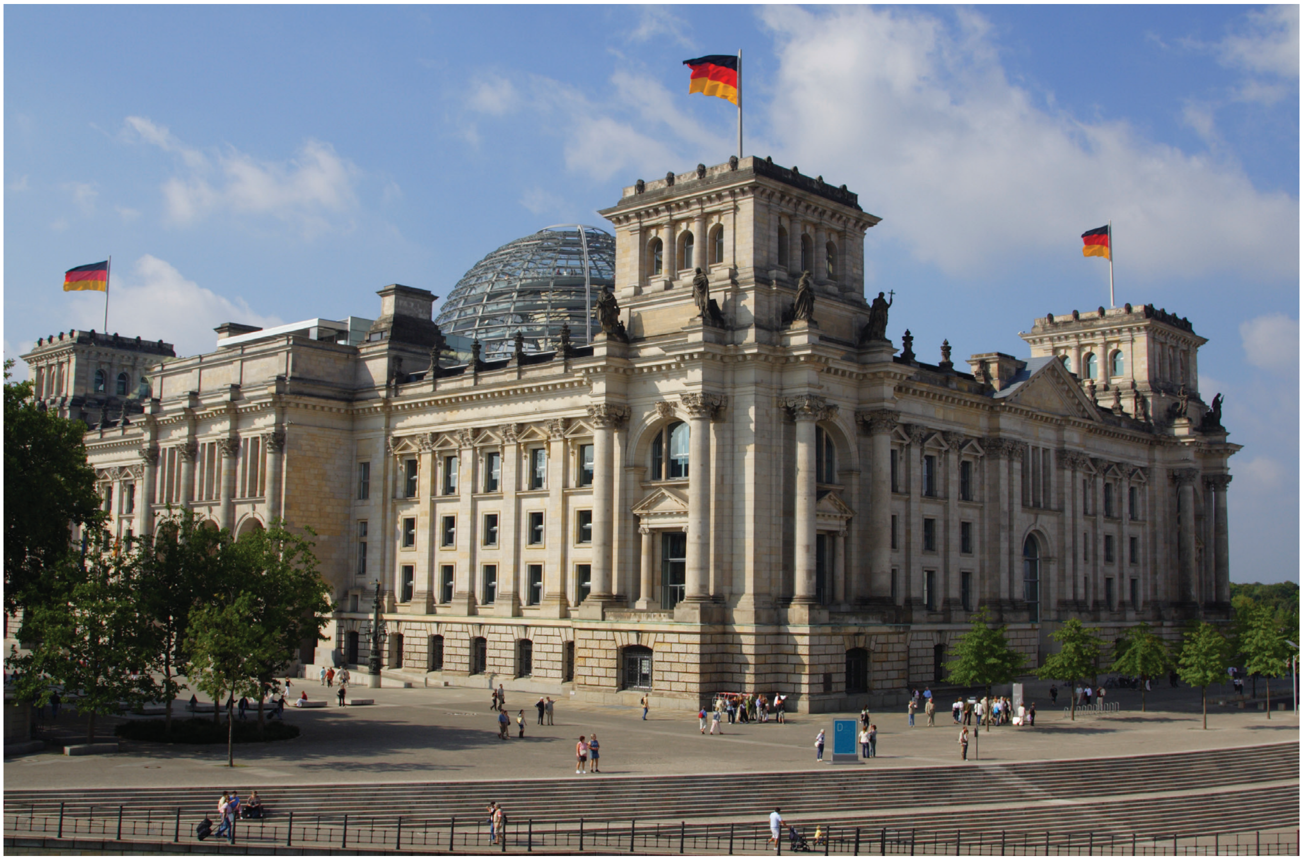
by **Hans Stamm**

### Change of German/ Luxembourg Double Tax Treaty Affects Private Equity Funds With German Investments

On 23 April 2012, Germany and Luxembourg signed a new double tax treaty (the Treaty) which is to replace the previous double tax treaty dating back to 1958. The new Treaty may affect international private equity funds with investments into Germany. Such investments are often structured by using

Luxembourg holding companies (e.g., SOPARFI) for German inbound investments. Some of the relevant chances include the following:

- Certain income from German portfolio companies (including from dividends) is subject to German taxation or suffers German withholding tax. Such German tax may be reduced under the provisions of the Treaty. In the past it was not clear whether certain funds as investors in German portfolio companies would benefit from the relief available under the Treaty. The Treaty now clarifies that, in principle, Luxembourg investment funds (including the so-called SICAR which is often used by private equity funds) is able to claim Treaty benefits.
- Investment into real estate companies: The Treaty provides for a new provision which covers capital gains from shares in companies which derive more than 50 % of their value directly or indirectly from real estate assets. Hence, investments in German real estate companies, held through a Luxembourg holding company, may be subject to German tax under the new Treaty.
- Hybrid debt instruments (often used by private equity and real estate funds): Investments in German portfolio companies are often capitalized through hybrid debt instruments (e.g. profit participating loans, "PPL") by which a certain portion of German derived profits is repatriated. Under the current Treaty, interest payments from such financial instruments were (subject to the individual terms) not subject to any German withholding tax. Under the new Treaty, however, Germany is entitled to apply its German withholding tax rate (of 26.375 %) to payments under such financial instruments, if they qualify as so-called "profit participating instruments" (i.e. if the respective "interest" payment under such financial instrument is linked to the profit of the German "borrower").
- Application of new rules: It is expected that the new Treaty will be ratified by the Luxembourg and German parliaments in due course and, in principle, will apply as of 1st January 2013.



Thus any restructuring of existing investment structures would need to be implemented during the course of 2012.

## Decision by the German Federal Fiscal Court Clarifies Taxation of German Investors in Private Equity Funds

Private equity funds are typically structured in the form of limited partnerships which from a tax perspective are intended to be structured as so-called "flow through entities". As a consequence profits from investments in portfolio companies should not be taxed at the fund level but rather at the investor level. German tax resident investors as limited partners in private equity funds typically are concerned whether income from foreign partnerships would be qualified as income from a "trade or business" (*gewerbliche Einkünfte*) or rather as mere income from administrative activities (*vermögensverwaltende Einkünfte*). Such distinction is particularly of relevance for certain German tax exempt investors. Also for German taxable investors such distinction is of relevance since income from a foreign partnership which would — from a German tax perspective — create income from a "trade or business" (*gewerbliche Einkünfte*) would be exempt from German trade tax (which is a municipal tax of about 12%–16%). In the past no clear guidance existed in the form of binding tax legislation or court cases. The German Federal Ministry of Finance (BMF) published a tax decree in 2003, which now, however, has been substantially qualified by the new court case.

On October 26, 2011, the German Federal Fiscal Court (BFH) published a landmark decision (dated August 24, 2011) on the fiscal consequences of an investment made in a foreign private equity fund. According to this decision, any profits from foreign private equity fund realized by German investors generally qualify as income from a "trade or business", for which also the application of the so-called tax exemption system of a tax treaty may be eligible.

Cause for the decision was the participation of German institutional investors in an English private equity fund. The German investors, who had been subsidiaries of a German financial services company, were together with other institutional investors from different countries limited partners in a limited partnership with registered office in London. The English private equity fund involved for the day-to-day investment management a company, which was also located in England. The fund had a four year investment phase with a subsequent realization phase. The investment activities focused on smaller and larger buy-outs with regional focus in the UK. The fund acquired a total of 22 equity participations through leveraged buy-outs with a percentage holding between 3% and 61% with an average holding period of four years.

In essence, the German Federal Fiscal Court has taken the view that in general private equity funds which pursue a "buy-to-sell" strategy and complete an exit of their portfolio investments within four years should be treated as conducting a "trade or business". Also the court referred to the use of debt financing (although the court case does not distinguish whether such debt financing is being used at the fund level or in the underlying investment structure of the fund) as an indication for such commercial activity.

Furthermore, the Federal Fiscal Court decision generally confirms that also a private equity fund, through its local investment manager, can create a permanent establishment within the meaning of a double tax treaty. As a consequence income from such a private equity fund which can be attributed to such a permanent establishment may even be fully tax exempt for German investors under an applicable double tax treaty. However, the practical implications of the latter point may be limited, since most of the (revised) double tax treaties with Germany provide for a so-called "subject to tax clause". As a consequence income which is not subject to tax in the foreign permanent establishment (e.g., in case of an English PE Fund) would then be subject to tax at the level of the German investors.

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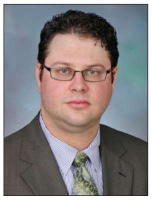
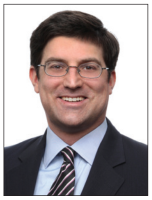
# SEC and CFTC Adopt Private Fund Systemic Risk Reporting on Form PF





by **Michael L. Sherman** and **Eric Simanek**

The U.S. Securities and Exchange Commission (SEC) on October 26, 2011 unanimously adopted a new rule (Rule) and new form under the Investment Advisers Act of 1940 (Advisers Act) to implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[1] These provisions require certain investment advisers, including advisers to private equity funds, registered with the SEC to file the new Form PF (Form PF" or Form) with the SEC.[2] Form PF is designed to provide the new Financial Stability Oversight Council (FSOC) with information necessary to help it monitor the systemic risk created by private funds and to determine whether particular entities should be designated as "significant financial institutions" (SIFIs).[3] In addition, the information obtained by the FSOC from Form PF filings is intended to enable the FSOC to consider and recommend to primary financial regulators new regulations designed to mitigate systemic risk.[4]

While those who commented on the proposed rule generally supported the goal of Form PF to serve as part of a regime to monitor systemic risk, commenters, industry professionals and regulators resisted the inclusion of private equity fund advisers among the list of advisers required to report on Form PF. They argued that private equity funds and their sponsors do not pose a risk to the financial system because they are not interconnected, are relatively small and do not typically engage in risky borrowing. Nonetheless, the final Rule requires reporting by private equity funds advisers, but it eases the reporting burden by such advisers.

The attached appendix includes a chart that summarizes the types of private funds for which reporting is required, describes each type of private fund and sets forth relevant asset thresholds and related reporting and updating obligations.

## Purpose of Form PF

The Dodd-Frank Act established the FSOC with the mission of monitoring, and responding to, systemic risks to the stability of financial markets in the United States. The Dodd-Frank Act also directs the FSOC to determine whether to designate particular non-bank financial companies as SIFIs to be regulated by the Board of Governors of the Federal Reserve System (FRB) and recommend to the FRB heightened prudential standards for SIFIs and large bank holding companies.[5] In furtherance of this goal, the Dodd-Frank Act directs the SEC to require certain investment advisers to "private funds" to file reports on the private funds they advise and share these reports with the FSOC to the extent the FSOC deems necessary in assessing the systemic risk posed by a private fund.[6] To that end, the SEC and the U.S. Commodity Futures Trading Commission (CFTC) designed Form PF, in consultation with the FSOC, to gather from registered advisers to private funds information necessary for the FSOC to fulfill its mandate.[7]

## FSOC's Use of Information Collected on Form PF

The FSOC recently published a second proposed notice of rulemaking regarding its designation of SIFIs.[8] The notice includes proposed interpretative guidance discussing the standards the FSOC will apply in determining whether to evaluate a non-bank financial company for potential designation as a SIFI and what factors it will consider in making such an evaluation.[9]

Under the proposed guidance, a U.S. non-bank financial company would qualify for review for a potential SIFI designation if it has $50 billion or more of global consolidated assets and satisfies one or more of five other quantitative factors, including having $20 billion or more of outstanding loans borrowed and bonds issued or a leverage ratio exceeding 15:1 (Stage 1 thresholds).

The FSOC proposal notes that while it will apply the Stage 1 thresholds to all companies, including asset management companies, private equity firms and hedge funds, these companies may pose risks that are not well measured by the Stage 1 thresholds. The proposal also notes that currently there is generally less data available for private equity firms and hedge funds than for other companies.

However, the FSOC observes that registered advisers to hedge funds and private equity funds will be required to file Form PF beginning in 2012 and that it will use such data as well as data from other sources to consider whether to establish an additional set of metrics or thresholds tailored to evaluate hedge funds and private equity funds and their advisers for possible designation as SIFIs.

## SEC's Use of the Information Collected on Form PF

Although designed primarily to provide information to the FSOC, the SEC has indicated that it may use the information for both examination and enforcement purposes. For example, a senior SEC staff member has indicated that the SEC may analyze the performance data provided by registrants in Form PF to identify anomalies that may require further attention.

Moreover, since Form PF is an SEC filing, advisers should expect that during examinations the SEC staff will review the processes and procedures used by advisers in completing the Form. As a result, registered advisers should determine early on whether they are subject to Form PF and consider whether it will be necessary for them to update their compliance program to reflect the requirements of Form PF. In addition, when advisers complete the new items in Schedule D of Form ADV as part of their next annual update, they will need to determine which of their accounts are private funds and which persons are the adviser's "related persons," and to reflect this determination in any Form PF reporting made by the adviser.

## Two-Tier Reporting Requirement

As was the case in the proposed rule, Form PF provides for a two-tier reporting requirement, whereby "large" advisers to particular types of funds will be subject to a more detailed reporting requirement than are smaller advisers and large advisers to other types of funds.[10]

Advisers to private equity funds having, in the aggregate, at least $2 billion in "regulatory assets under management" (RAUM) in private equity funds will be subject to the more detailed reporting requirements.[11] This represents an increase from the $1 billion threshold in the proposing release and means that fewer private equity fund advisers will need to file the more detailed portion of Form PF relating to private equity funds. RAUM consists of the assets of the applicable funds managed by an adviser and is calculated gross of outstanding indebtedness and other accrued but unpaid liabilities. RAUM also includes uncalled capital commitments. Advisers may use the total assets on the fund's balance sheet to determine gross assets.[12] This calculation methodology is the same as that used for determining RAUM for purposes of Form ADV. Advisers to any private fund, including a private equity fund, with less than $150 million in RAUM need not file Form PF.

Advisers to hedge funds having, in the aggregate, at least $1.5 billion in RAUM in hedge funds will be subject to the more detailed reporting requirements.[13] This threshold was increased from $1 billion in RAUM in the proposing release.

Advisers to liquidity funds having, in the aggregate, at least $1 billion in RAUM in liquidity funds and money market funds will be subject to the more detailed reporting requirements.[14] With respect to liquidity fund advisers, such advisers must count registered money market fund assets towards the RAUM threshold.

## Aggregation of Assets

For purposes of determining whether an adviser meets any of the asset thresholds described above, an adviser must aggregate assets of accounts that pursue substantially the same investment objective and strategy and invest side by side in substantially the same positions as the private funds managed by the adviser (Parallel Accounts), unless the value of the Parallel Accounts exceeds the value of the private funds. This provides significant relief to advisers that are not primarily private fund advisers.

Further, an adviser must aggregate assets of persons advised by any "related person" that is not operated separately from the adviser. This would exclude as a related person any person that is not required to be listed on Item 7.A of Schedule D of the adviser's Form ADV in instances where the adviser: (i) has no business dealings with the related person in connection with advisory services the adviser provides to its clients; (ii) does not conduct shared operations with the related person; (iii) does not refer clients or business to the related person and the related person does not refer

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prospective clients or business to the adviser; (iv) does not share supervised persons or premises with the related person; and (v) has no reason to believe that its relationship with the related person otherwise creates a conflict of interest with the adviser's clients.[15]

An adviser may, but is not required to, report the private fund assets that it manages and the private fund assets that its related persons manage, on a single Form PF. This allows advisers with integrated risk management systems to provide a single report.

## Frequency of Reporting

Large hedge fund advisers and large liquidity fund advisers must complete and file Form PF quarterly. All other qualifying private fund advisers, including large private equity fund advisers and small advisers, must file Form PF once per fiscal year.[16]

In response to numerous commenters' descriptions of the difficulties that large hedge fund and private equity fund advisers would face in responding accurately within the proposed 15-day filing deadline, the SEC extended the deadline for filing Form PF following each reporting period, except for large liquidity fund advisers. Large private equity fund advisers, smaller hedge fund advisers and other private fund advisers must file Form PF within 120 days of the end of each fiscal year. Large hedge fund advisers have 60 days to file Form PF following each fiscal quarter, while large liquidity fund advisers must file Form PF within 15 days of the end of each fiscal quarter. Advisers that must file on a quarterly basis with respect to certain accounts need not file quarterly with respect to all their accounts. For example, if a large hedge fund adviser also manages private equity funds with less than $2 billion in RAUM, the adviser may file Form PF annually with respect to its private equity accounts, while filing quarterly with respect to its hedge fund accounts.

## Liability for the Information Filed

The final rule revised the proposal in two significant ways in order to lessen the potential for liability for the information filed. First, the final Form does not contain the proposed certification requiring an authorized individual from the adviser to affirm under penalty of perjury that the statements made in the Form PF are true and correct. Commenters expressed concern that the estimates and judgment calls required by Form PF would not allow an officer to state with certainty that the Form is true and correct, and officers could not rightly be held liable for perjury in such circumstances. Advisers can still be held liable under the Advisers Act for willful misstatements or omissions of a material fact in any report filed with the SEC. While there is no obligation to provide Form PF data to investors, to the extent the information is provided to investors the usual standards for potential liability would apply.

The final rule allows advisers to use their internal methodologies when calculating the data required by Form PF, rather than detailed formulas prescribed by the SEC in the proposed Form. The instructions to Form PF clarify that advisers may use methodologies that they use for internal and investor reporting purposes. Further, Form PF permits, but does not require, an adviser to explain any assumptions it makes in responding to the Form's questions. Given the opportunity, it could prove useful to an adviser to explain its assumptions in order to demonstrate its good faith in completing the Form, particularly if the SEC or CFTC staff disagrees with the data reported on the Form.

## Confidentiality

The CFTC and SEC will share information collected on Form PF with the FSOC to the extent requested by the FSOC in furtherance of its assessment and monitoring of systemic risk. Under amendments to the Advisers Act added by the Dodd-Frank Act, the CFTC, SEC and FSOC may be compelled to reveal any information provided on Form PF, but only under very limited circumstances.[17] For example, upon proper request, Form PF data may be shared with other federal departments or agencies or with self-regulatory organizations, in addition to the CFTC and FSOC, for purposes within the scope of their jurisdiction. However, such agencies may not be compelled, under the Freedom of Information Act, to disclose to the public information reported on Form PF. Information may also be shared with Congress, but only in accordance with a confidentiality agreement.[18] Form PF information may be used in examinations as well as enforcement actions brought by the United States or the SEC. In connection with an enforcement action, relevant information derived from or included in an adviser's Form PF could be made public. The SEC is working to design controls and systems to protect the confidentiality of the information contained in Form PF.[19] If the SEC staff does not believe that such systems are adequate by the compliance date for required Form PF filings, the SEC will consider delaying the compliance date.

## Compliance Date

The SEC adopted a two-stage phase-in period for compliance with the Form PF filing requirements. Advisers with at least $5 billion in RAUM attributable to hedge funds, liquidity funds or private equity funds as of the last day of the fiscal quarter most recently completed prior to June 15, 2012 must begin filing for periods on or after June 15, 2012. Advisers who do not meet that threshold must begin filing for periods on or after December 15, 2012. Most hedge fund advisers with greater than $5 billion in RAUM must make their initial Form PF filing by August 29, 2012, and most liquidity fund managers with relevant assets under management in excess of $5 billion must begin filing on July 15, 2012.[20] All others advisers must file their first Form PF for the first period ending after December 15, 2012. For most other filers (including all private equity fund advisers with a fiscal year ending December 31), this means that their first Form PF will be due on April 30, 2013, using data as of December 31, 2012.[21]

These dates represent a significant delay of the effective dates from the proposed effective date of December 31, 2011. The filing dates were delayed in order to allow advisers greater time to prepare for the filing and in recognition of the fact that the Form was adopted later than expected. In preparation for the filing, an adviser should: (i) identify the funds that qualify as private funds for purposes of Form PF and identify the type of each such fund (e.g., hedge fund, liquidity fund); (ii) identify the information to be included in the Form for each covered private fund; (iii) develop the automated systems necessary to collect, create or aggregate the data required by the Form; and (iv) conduct diligence on any outside service providers the adviser hires to aid in the preparation of the filing. The SEC is requiring larger advisers to file earlier under the assumption that larger advisers have the resources to prepare the filing in a shorter time frame.

## How to Prepare

Advisers should start now to determine if they have the information needed to complete Form PF. Much of the information relates to risk management, and those systems will vary among advisers. Moreover, much of the information will need to be aggregated at the adviser level, which many advisers do not currently do for risk management purposes. In addition, some information relates to the nature of the investors in private funds managed by an adviser. The categories required by Form PF do not correspond to the existing categories used for SEC private placement purposes. Although advisers may obtain some of this data through their current subscription agreements and through anti-money laundering checks, it may be difficult and costly to obtain necessary information. While the Form provides some relief with respect to investors who acquired an interest in the fund prior to March 31, 2012, going forward, advisers will be expected to have this data. As a result, many advisers should consider amending their subscription documentation now to obtain this information (as well as the information required by Form ADV).

## Conclusion

The final Form PF incorporates many significant revisions that should ease the burden on reporting advisers. The SEC staff clearly considered the comments it received and implemented suggestions such as increasing the threshold for advisers subject to the detailed reporting requirements, delaying the compliance date for the rule, increasing the amount of time after the end of the fiscal period for filing, eliminating the certification under penalty of perjury and allowing advisers to use their internal methods for calculating the information required by Form PF. These revisions allowed Form PF to be unanimously adopted by the SEC, which praised the SEC staff's efforts to reduce the reporting burden while still gathering the information required by the FSOC.

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1 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 Final Rule, Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71128 (Nov. 16, 2011) (Adopting Release). See also, Proposed Rule, Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators

and Commodity Trading Advisors on Form PF, SEC Release No. IA-3145 (Jan. 25, 2011).

[3] The SEC and CFTC consulted extensively with the other member agencies of the FSOC in developing Form PF to tailor the information to what the FSOC requires to perform its responsibilities. SIFIs, which stands for "systemically important financial institutions," is the commonly used acronym for significant financial institutions. The Dodd-Frank Act and the rules proposed by the FSOC thereunder do not use this term, but refer only to "significant nonbank financial companies" and "significant bank holding companies."

[4] Adopting Release, *supra* note 2.

[5] Sections 112 and 113 of the Dodd-Frank Act.

[6] Section 404 of the Dodd-Frank Act.

[7] As noted in the Adopting Release, "the policy judgments implicit in the information required to be reported on Form PF reflects FSOC's role as the primary user of the reported information . . . [t]he SEC would not necessarily have required the same scope of reporting if the information reported on Form PF were intended solely for the SEC's use." Adopting Release, *supra* note 2, at 71129-30.

[8] Second Notice of Proposed Rulemaking and Proposed Interpretive Guidance, 76 Fed. Reg. 64264 (Oct. 18, 2011).

[9] See *DechertOnPoint*: FSOC Issues New Proposed SIFI Designation Rule, available at http://www.dechert.com/FSOC_Issues_New_Proposed_SIFI_Designation_Rule_10-19-2011.

[10] As noted below, the largest fund managers are also subject to accelerated initial filing dates for Form PF.

[11] A "private equity fund" is defined in Form PF as any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course.

[12] Rules Implementing Amendments to the Investment Advisers Act of 1940, SEC Release No. IA-3221, n.83 (June 22, 2011).

[13] Form PF defines "hedge fund" generally to include any private fund having any one of three common characteristics of a hedge fund: (i) a performance fee that takes into account market value (instead of only realized gains); (ii) high leverage; or (iii) short selling. This definition excludes private equity funds that satisfy clause (i) by calculating currently payable performance fees in a way that takes into account unrealized gains solely for the purpose of reducing such fees to reflect net unrealized losses. It also excludes funds that use short selling solely to hedge currency exposure or to manage duration. Lastly, it excludes vehicles established for the purpose of issuing asset-backed securities. A commodity pool that is required to be reported on Form PF is treated as a hedge fund for such purpose.

[14] A "liquidity fund" is defined in Form PF as any private fund that seeks to generate income by investing in a portfolio of short term-obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors. Essentially, a liquidity fund is an unregistered money market fund.

[15] See Instructions to Item 7.A of Form ADV.

[16] Advisers may intermittently re-file Form PF to correct errors in previous filings or because they manage private funds in various categories with different filing requirements. However, filers are not required to revise information that they believed in good faith was correct at the time of filing, even if such information has been revised for other purposes, following the filing.

[17] See Section 204(b) of the Advisers Act.

[18] The August 2011 leak by Senator Bernie Sanders to the Wall Street Journal of confidential information reported to the CFTC could call into question the effectiveness of confidentiality provisions when data is provided to Congress. Senator Sanders released information contained in routine reports to the CFTC by participants in the commodities markets regarding their positions. This information is reported with the understanding that it will remain confidential.

[19] In October of 2011, an unidentified entity gained access to confidential reports of SEC personnel regarding their securities holdings and transactions. Natasha Singer, *It Guards the Markets, but What About Itself?*, N.Y. Times, October 22, 2011, available at: http://www.nytimes.com/2011/10/23/business/at-the-sec-questions-about-its-own-privacy-controls.html?scp=8&sq=securities+and+exchange+commission%2C+securities+holdings&st=nyt.

[20] These dates assume a fiscal year end of December 31.

[21] These dates assume a fiscal year end of December 31.

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## Appendix

<table>
<tr><th>Type of "Private Fund"[1] Managed</th><th>Definition</th><th>Asset Thresholds</th><th>Filing Deadlines[2]</th><th>Required Section(s) of Form PF</th></tr>
<tr><td rowspan="3">"Hedge Fund"</td><td rowspan="3">A private fund (other than a securitized asset fund) having any one of three common characteristics of a hedge fund: (a) a performance fee that takes into account market value (instead of only realized gains); (b) high leverage; or (c) short selling, other than for purposes of hedging currency or managing duration.<br>Also, any commodity pool, even if not required to rely on Section 3(c)(1) or 3(c)(7).</td><td>$5B or more in relevant assets[3]</td><td>Quarterly within 60 days after end of fiscal quarter.<br>Initial filing due for first fiscal quarter ending on or after 6/15/2012.<br>(For most advisers, 8/29/2012, with a fiscal quarter ending 6/30/2012.).[4]</td><td rowspan="2">1a (aggregate data)<br>1b and 1c (fund by fund data)<br>2a (aggregate data)<br>2b (fund by fund data)</td></tr>
<tr><td>At least $1.5B but less than $5B in relevant assets</td><td>Quarterly within 60 days after end of fiscal quarter.<br>Initial filing due for first fiscal quarter ending on or after 12/15/2012.<br>(For most advisers, 3/1/2013, with a fiscal year ending 12/31/2012.)</td></tr>
<tr><td>At least $150M but less than $1.5B in relevant assets</td><td>Annually within 120 days after end of fiscal year.<br>Initial filing due for first fiscal year ending on or after 12/15/2012.<br>(for most advisers, 4/30/2013, with a fiscal year ending 12/31/2012.)</td><td>1a (aggregate data)<br>1b and 1c (fund by fund data)</td></tr>
</table>

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## Appendix (cont'd)

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<tr><td>At least $1B but less than $5B in relevant assets</td><td><u>Quarterly</u> within <u>15 days</u> after end of fiscal quarter.<br>Initial filing due for first fiscal quarter ending on or after 12/15/2012.<br>(For most advisers, 1/15/2013.)</td></tr>
<tr><td>At least $150M but less than $1B in relevant assets</td><td><u>Annually</u> within <u>120 days</u> after end of fiscal year.<br>Initial filing due for first fiscal year ending on or after 12/15/2012.<br>(For most advisers, 1/15/2013.)</td><td>1a (aggregate data)<br>1b (fund by fund data)</td></tr>
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<tr><td>At least $2B but less than $5B in relevant assets</td><td rowspan="2"><u>Annually</u> within <u>120 days</u> after end of fiscal year.<br>Initial filing due for first fiscal year ending on or after 12/15/2012.<br>(For most advisers, 4/30/2013.)</td></tr>
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| Type of "Private Fund"[1] Managed | Definition | Asset Thresholds | Filing Deadlines[2] | Required Section(s) of Form PF |
|---|---|---|---|---|
| **Other Types of Private Funds:** | Any *private fund* that is not a *hedge fund*, *liquidity fund* or *private equity fund*. Including:<br>**"Real Estate Fund"**<br>A *private fund* that is not a *hedge fund*, does not provide redemption rights in the ordinary course and invests primarily in real estate and real estate related assets.<br>**"Securitized Assets Fund"**<br>A *private fund* whose primary purpose is to issue asset backed securities and whose investors are primarily debt-holders.<br>**"Venture Capital Fund"**<br>Any *private fund* which represents that it is a venture capital fund; invests only in equity securities and acquired at least 80% of such securities directly from the issuer; uses less than 15% leverage that must be short-term; provides investors with no withdrawal rights except in extraordinary circumstances; and is not registered under the Investment Company Act of 1940. Rule 203(l)-1 under the Investment Advisers Act of 1940 provides the definition of a venture capital fund.<br>**"Other Private Fund"**<br>A *private fund* that is not a *hedge fund*, *liquidity fund*, *private equity fund*, *real estate fund*, *securitized asset fund* or *venture capital fund*. | At least $150M in *relevant assets* | Annually within 120 days after end of fiscal year.<br>Initial filing due for first fiscal year ending on or after 12/15/2012.<br>(For most advisers, 4/30/2013.) | 1a (aggregate data)<br>1b (fund by fund data) |

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## Appendix (cont'd)

[1] A "Private Fund" is any issuer that must rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940.

[2] The asset threshold for quarterly filings (*i.e.*, \$1.5B for hedge funds or \$1B for liquidity funds) is measured as of the last day of each month within the fiscal quarter and quarterly filings are required if the threshold is exceeded on any measurement date. Where filings are required on a quarterly basis (i.e., larger hedge fund and liquidity fund managers), the 1st, 2nd and 3rd quarter filings are "updates" in which the adviser needs only to update information that relates to particular funds, while the initial and subsequent 4th quarter filings require updating the entire form. Additionally, when an adviser manages more than one type of fund, the adviser must file an update based on the shortest deadline, but is required at that time only to update those items related to the relevant type of fund (e.g., a larger liquidity fund manager that also advises hedge funds and private equity funds must file a fourth quarter update within 15 days after fiscal year end for items related to liquidity funds but can file an amendment related to the hedge funds within 60 days after fiscal year end and then a subsequent update related to the private equity funds (or other types of private funds) within 120 days after fiscal year end). When filing a subsequent update of this type, the adviser is not required to alter or update information previously filed for the quarter.

[3] For hedge funds, "relevant assets" means AUM attributable to hedge funds, taking into account aggregation principles for parallel accounts and affiliates.

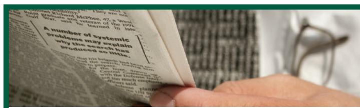
[4] As noted in the adopting release for Form PF, the overwhelming majority of advisers that will report on Form PF have 12/31 fiscal year ends.

[5] For liquidity funds, "relevant assets" means AUM attributable to liquidity funds and registered money market funds, taking into account aggregation principles for parallel accounts and affiliates.

[6] As there is no requirement that a private equity fund make "equity" investments, other types of funds that are not commonly referred to as private equity (e.g., "mezzanine funds") often will fall into this category.

[7] For private equity funds, relevant assets means AUM attributable to private equity funds, taking into account aggregation principles for parallel accounts and affiliates.

[8] For other private funds, relevant assets means AUM attributable to private funds of all types, taking into account aggregation principles for parallel accounts and affiliates.



# News from the Group

## Upcoming/Recent Seminars and Speaking Engagements

**December 18 François Hellot** will participate as a speaker in a private equity program in Paris organized by AFIC titled "Participations cotées : de l'acquisition à la cession – module 4 : Sortie de la participation cotée." The seminar will explore how to sell a listed participation, structure a merger transaction involving a listed company, delist and manage related risks.

**October 4 Olivia Guéguen** will participate as a speaker in a private equity event titled "Opérations de sortie et de build-up," which will look at how to structure and negotiate build-up transactions, including managing the pre-contractual documentation, the timetable, the SPA and post-closing matters.

**July 10 David Vaughan** participated in "Practising Law Institute's 13th Annual Private Equity Forum" in New York. As part of the panel "Monitoring Compliance at Private Equity Firms: Issues for CCOs," he discussed Advisers Act compliance issues as well as marketing materials and public website issues.

**June 20 Dechert** presented a webinar titled "Fundamentals of CFTC Registration and Compliance: What Private Fund Managers Need to Know," which discussed the U.S. Commodity Futures Trading Commission's recently adopted final rules that modify or eliminate certain CFTC registration and operational exemptions widely used by U.S. and non-U.S. private investment fund managers. As a result, private funds (including certain mutual fund subsidiaries) that use commodity futures, commodity options, or many other derivatives face a significantly altered regulatory landscape.

**June 14 Mark Thierfelder** and **Jonathan Kim** participated in a one-hour webinar briefing hosted by Strafford Publications titled "M&A Transactional Insurance: Tools for the Deal Professional." The program focused on M&A transactional insurance, which is becoming increasingly popular among buyers and sellers as a form of added protection in structuring transactions and as a mechanism to close deals, and explored the potential issues that can arise when structuring and negotiating transactional insurance.

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

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## Our Practice Continues to Expand Worldwide

Dechert boosted its German corporate practice with the additions of new partner **Sven Schulte-Hillen** and new national partner **Markus J. Friedl** in Frankfurt (March and July respectively). Sven focuses on complex multi-jurisdictional M&A and corporate finance transactions for clients ranging from family offices to private equity firms, domestic and global, as well as on capital fund formation and corporate restructurings. Markus advises companies and financial investors on national and cross-border M&A transactions and restructurings, as well as on general corporate and corporate finance law matters.

**Paul Wang** joined Dechert's Beijing office as a corporate partner in May 2012. He focuses his practice on venture capital and private equity, and represents clients in mergers and acquisitions and a variety of private and public offerings of common and preferred stock, convertible securities and debt securities.

We announced the addition of a leading emerging markets team in April 2012 and the opening of offices in Dubai and Tbilisi to bolster our international corporate, mergers and acquisitions, capital markets, financial services and investment funds practices. Led by new partner **Camille Abousleiman**, who heads the firm's Middle East and Africa Practice, the team also includes new partners **Louise Roman Bernstein**, **Simon Briggs**, **Chris P. Sioufi**, **Gavin B. Watson** and **Nicola Mariani**.

Dechert expanded its energy practice with a new office in Almaty, Kazakhstan and a team of national partners and associates led by partner **Kenneth Mack** in April 2012. Our Almaty team advises numerous major international clients on transactional, regulatory and litigation matters.

## About Dechert LLP

With 26 offices throughout the United States, Europe, Asia and the Middle East, Dechert LLP is an international law firm focused on corporate and securities, business restructuring and reorganization, complex litigation and international arbitration, financial services and asset management, intellectual property, energy, labor and employment, real estate finance and tax law.

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