Private Fund Update

January 6, 2014

NOTE: Webinar on Volcker Rule January 16: On January 16, I will be participating in a webinar on the Volcker Rule entitled "The Volcker Rule and its Impact on Private Equity." The webinar will include an overview of the final rule and its compliance requirements, the impact of the rule on private equity funds and other "covered funds," and exclusions to the rule, including SBICs and most BDCs. Please feel free to register.

Scott E. Gluck, Esq.
Venable LLP

Washington, DC Office:
t 202.344.4426
c 540.454.4820

Los Angeles Office:
t 310.229.9900
c 540.454.4820

sgluck@Venable.com
www.Venable.com

The Association for Corporate Growth will have its 2014 Middle-Market Public Policy Summit on Wednesday, February 5 in Washington, DC. The event is a great opportunity to hear from legislators and regulators, and learn more about policy issues that impact the middle market. To register for the Summit, click here (ACG Members only).

Instead of the typical update, this email contains the top ten (in my opinion) legislative and regulatory issues that could impact the private equity community. As always, I welcome your feedback.

Ten Legislative and Regulatory Items to Watch

1. *Sun Capital Partners* Decision

In June, the U.S. Court of Appeals for the First Circuit ruled that a private equity fund constituted a "trade or business" under the Employee Retirement Income Security Act (ERISA), and was therefore potentially liable for the ERISA withdrawal liabilities of the fund's portfolio company. The court highlighted the fund's active involvement in the day-to-day operations of the portfolio company, finding that the fund "sufficiently operated and managed the company" to be considered more than a mere passive investor.

The facts of *Sun Capital Partners* may be distinguishable from other private equity investments due to the highly active role the fund played in the management of the portfolio company. In addition, under the ERISA statute an 80% common ownership is required before ERISA liability attaches. Nevertheless, the *Sun Capital Partners* case bears close watching not only because it represents a potential expansion of ERISA liability for private equity funds, but also because some commentators have argued that the court's interpretation of a "trade or business" should also apply to the U.S. tax code (despite the fact that the court's opinion expressly states that its ruling doesn't apply to the tax code), which would have significant implications for the private equity industry.

Sun Capital has filed a petition for certiorari on this case, and the Private Equity Growth Capital Council recently filed an amicus brief in support of the cert. petition. It remains to be seen whether the Supreme Court will agree to hear the case.

2. Legislation to Exempt PE Fund Advisers from IAA Registration

In December 2013, the House of Representatives voted 254-159 to approve H.R. 1105, the Small Business Capital Access and Job Preservation Act, which exempts private equity investment advisers from having to register under the Investment Advisers Act of 1940.

The legislation faces a much tougher road in the Democrat-controlled Senate and President Obama's senior advisors have indicated that they would recommend a veto of the legislation, but this bill could be included in a JOBS Act 2.0 legislative package.

3. Mergers and Acquisition Brokers Legislation

In November 2013, the House Financial Services Committee voted 57-0 to pass H.R. 2274, the "Small Business Mergers, Acquisitions, Sales, and Brokerage Simplification Act." The legislation would exempt M&A brokers from having to register as broker-dealers under the Securities Exchange Act of 1934, and instead create a simplified reporting regime for brokers who qualify for the exemption. The exemption only applies to companies with gross revenues of less than $250 million and/or EBITDA of less than $25 million; and private equity funds themselves may not qualify for the exemption, as one of the requirements stipulates that the broker may not receive, hold, transmit, or have custody of the funds or securities to be exchanged in the transaction.

M&A brokers are a vital source of deal flow for many funds and there has been considerable market confusion as to what the registration obligations of M&A brokers are. H.R. 2274 could help eliminate ambiguity and help facilitate deal flow for private equity funds.

4. Broker-Dealer Registration for Private Equity Funds

In April 2013, David Blass, Chief Counsel for the Security and Exchange Commission's Division of Trading and Management, gave a speech in which he said that private equity investment advisers need to consider whether their activities might require them to register as broker-dealers under the Securities Exchange Act of 1934. The issue arises in two separate areas: (i) with respect to fundraising activities by fund personnel and (ii) when a fund charges a portfolio company transaction fees in connection with a securities-based transaction.

With respect to fundraising, the SEC's primary concern is unregistered in-house employees receiving a commission or other compensation directly tied to the success of the fund's marketing activities. The SEC has been examining this issue for some time, and is expected to issue guidance on this issue.

With respect to charging portfolio companies transaction fees, the SEC is still in its fact-finding stage and guidance is not expected for some time. It should be noted (i) the broker-dealer issue only arises with respect to transaction-based fees and not other fees, such as monitoring fees, and also (ii) in his speech Blass stated his belief that if 100% of the fees charged are offset against management fees, no issue arises.

Blass has backed away from some elements of his April speech in subsequent remarks, but this clearly remains an issue of which fund professionals should be aware.

5. General Solicitation Rulemaking

In 2011, Congress passed the Jumpstart Our Businesses Now (JOBS) Act to help facilitate capital formation. Among other things, the legislation eliminated the ban on general solicitations, thereby allowing private equity and other private funds to market themselves to the general public, provided that those who actually purchase fund interests are accredited investors. The SEC's final rule implementing Congress's mandate that the ban be lifted requires that private equity funds conduct a general solicitation to take several actions, including taking reasonable steps to ensure that all purchasers are accredited investors.

Simultaneous with the final rule, the SEC also proposed new rules which would impose numerous burdensome restrictions on the ability of private equity funds to conduct general solicitations. The proposed rule also asks for comments on whether the definition of an "accredited investor" should be changed – something which could have a significant impact on smaller funds. Several organizations, including the Association for Corporate Growth, the Private Equity Growth Capital Council and Small Business Investor Alliance submitted comments to the proposed rules urging the SEC to withdraw these new proposed rules.

As a practical matter, the final rules promulgated by the SEC will ultimately determine whether private equity funds conduct general solicitations.

6. Financial Stability Oversight Council

One of the cornerstones of the 2010 Dodd-Frank Act is the creation of the Financial Stability Oversight Council, a body consisting of fifteen federal and state regulators charged with identifying and responding to risks to the financial stability of the United States. FSOC has the ability to designate nonbank financial companies as Systemically Important Financial Institutions (SIFI), thereby subjecting them to enhanced prudential standards and supervision by the Federal Reserve. To date, three nonbank companies have been designated: AIG, GE Capital, and Prudential Financial.

The OFR Study was not focused specifically on the private equity industry, but in September the Office of Financial Research issued a report on the asset management industry that some believe could be a precursor to the designation of asset management companies as SIFIs. If FSOC begins developing additional metrics to assess various types of asset managers for SIFI designation, private equity firms will want to watch closely to ensure that they are not swept up in the process._Firms must have at least $50 billion in total consolidated assets in order to be considered for SIFI designation, so this issue applies to larger funds.

7. Small Business Investment Company Reform

The U.S. Small Business Administration's SBIC program provides federal loans (leverage) to private investment funds that are then required to invest those funds in U.S. small businesses. The program is an excellent way for private equity funds to get access to low-cost capital and thereby improve returns for the fund and investors.

Congress has sought to increase the size of the SBIC program from $3 billion in FY 2013 to $4 billion in FY 2014 to help promote small business' access to capital. In addition, the Senate Small Business & Entrepreneurship Committee has passed legislation that increases the maximum amount of federal leverage for a family of funds from $225 million to $350 million and also requires the public posting of certain fund performance data on the SBA website.

The SBIC program is already a good arrangement for many private equity funds. An expansion of the program at the federal level, combined with increased interest in SBICs by banks due to the Volcker Rule (see below) could result in a significant increase in the number and size of SBICs in the near future.

8. Volcker Rule

Last month five federal agencies approved the Volcker Rule, which in addition to banning proprietary trading by banks, also severely restricts the ability of banks to invest in private funds. Under the rule, banks will be prohibited from investing more than 3% of their tier-one capital in "covered funds," which includes private equity funds, hedge funds, and venture capital funds. In addition, banks are prohibited from owning more than 3% of any individual covered fund. However, investments in SBICs are exempt from the rule, as are investments in business development companies (BDCs), provided that the bank owns or controls less than 25% of the company's voting stock.

The final Volcker Rule included other positive changes for private equity and other covered funds due in part to three sets of comments submitted by the Private Equity Growth Capital Council. For example, insurance company general and separate accounts are not subject to restrictions on investing in private funds. In addition, the final Volcker Rule clarifies that a banking entity is not subject to the restrictions where the banking entity is acting in a fiduciary or similar capacity on behalf of its customers. The final Volcker Rule also preserves the ability of a U.S. private equity firm to sponsor non-U.S. funds with investors that include non-U.S. banking entities and appears to preserve the flexibility of U.S. private equity firms to include such non-U.S. funds in parallel fund structures.

The general conformance period on the final Volcker Rule will conclude on July 21, 2015, one year later than originally anticipated. The American Bankers Association has filed a lawsuit challenging certain provisions of the rule relating to collateralized debt obligations, and further legal challenges are possible. Assuming that the rule stays largely in place, which is likely, it will be interesting to see the extent to which the rule leads to an increased demand for SBICs and/or BDCs.

9. Guidance on IAA Regulations

In 2013, the SEC issued guidance on two issues that was favorable to the private equity industry. In August, the SEC's Division of Investment Management issued guidance on the custody rule (Rule 206(4)-2), which confirms that investment advisers to private funds do not need to maintain private stock certificates with a qualified custodian, provided that certain criteria are met. Then, in December, the Division of Corporate Finance issued favorable "Compliance and Disclosure Interpretations" (CDIs) regarding certain key provisions of the new "bad actor" rules governing Rule 506 offerings (Rule 506(d)). Perhaps most relevant for private funds is the clarification in Question 260.16 that for purposes of this rule, an "affiliated issuer" does not include every affiliate of the issuer but rather only those affiliates that are issuing securities in the same offering. As a practical matter, this means portfolio companies are not "affiliated issuers" of private equity funds for purposes of the rule.

The private equity industry is seeking additional guidance from the SEC on several requirements under the Investment Advisers Act. It will be interesting to see if guidance on these issues is as favorable for the industry as the previous guidance.

10. Tax Reform

Comprehensive tax reform – which involves simplifying the tax code by eliminating or reducing tax expenditures (sometimes referred to as "loopholes") and potentially changing fundamental provisions in the tax code that are not expenditures – is something that will impact every private equity fund and portfolio company.

At the fund level, for years the Obama Administration has sought to change the tax treatment of carried interest from capital gains to ordinary income, and this will continue to be a priority for the administration in any tax reform package. Fund managers also need to be mindful of proposals to change the tax structure for pass-through entities, such as partnerships and limited liability companies.

Comprehensive tax reform will also impact portfolio companies regardless of the business they are in. Proposals that fund managers should pay particular attention to involve reducing or eliminating the deductibility of interest on corporate debt, slowing down the rules for depreciation of assets and limitations on the deductibility of advertising expenses.

Although tax reform is unlikely to occur this Congress given the recent announcement that Senate Finance Committee Chairman Max Baucus is resigning from the Senate to become U.S. Ambassador to China, it is something that Congress has been working on for years, and could very well happen in the years ahead.

If you would like to opt out of receiving this communication, just let me know.