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Consider the QMS

The booming secondaries market may need a new favourite PTP safe harbour

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The secondary market for investors' private equity holdings has developed rapidly over the past several years from a relatively small niche into a vast and permanent fixture of the private equity industry. This expansion has been driven partly by demands for liquidity and a desire for private equity investment diversification. Many expected that the secondary market would grow at a steady rate into the future. The recent upheaval of financial and credit markets, however, has drastically accelerated this expansion beyond expectations.

The unprecedented growth of the secondary market is due to a combination of factors. In some cases, investors are in need of cash or are seeking relief from capital commitments they simply cannot fund. Liquidity needs are also being compounded by the lack of fund distributions, as traditionally self-funding investment programmes are no longer funding themselves. In other cases, the "denominator effect" is forcing some limited partners (LPs) to rebalance their portfolios, as the decline in the public markets has caused them to be overweighted in private equity. As a result, many secondary funds and other organisations in the secondary business are looking forward to a very robust market in 2009. It is anticipated that this market activity will surge throughout most of 2009 and 2010 and, according to some predictions, secondary volume for 2009 may exceed $20 billion in commitments.

This means, however, that general partners (GPs) might be faced with the challenge of balancing investor liquidity needs with their responsibility to prevent their fund from being treated as a "publicly traded partnership" (PTP). Specifically, in order to comply with one of the safe harbours under the US Treasury Regulations, many funds do not permit more than 2 percent of their interests to be transferred in any year. In these funds, if a transfer will cause the fund to exceed 2 percent for a year, the GP will defer the transfer until the subsequent year. The 2 percent limitation has not generally caused any problems for GPs or investors until recently. It has been observed that transfers in some funds are already backed up until 2010. A long-neglected safe harbour under the US Treasury Regulations for a "qualified matching service" however, would increase the limit on transfers in a fund within a taxable year to 10 percent. This may provide a solution to secondary purchasers hoping to take advantage of a buyers' market and GPs hoping to replace delinquent, defaulting or anxious LPs.

Publicly Traded Partnerships and the 2 percent safe harbour

By way of background, under the partnership agreements of most US funds and many non-US funds, GPs are generally prohibited from allowing any transfer that would cause the fund to be treated as a PTP under the US Internal Revenue Code. If a fund were to be treated as a PTP, the partnership generally would be taxed as a corporation rather than a flow-through entity for US tax purposes. This could have catastrophic consequences for funds and their investors.

A partnership will be classified as a PTP under the US Treasury Regulations if interests in the partnership are traded on an "established securities market" or are "readily tradable on a secondary market or the substantial equivalent thereof". An "established securities market" is defined under the Treasury Regulations as a national securities exchange, foreign exchange, regional or local exchange, or an interdealer quotation system that regularly disseminates firm buy or sell quotations. The Treasury Regulations describe, only in very general terms, what it means for partnership interests to be "readily tradable on a secondary market or the substantial equivalent thereof." For instance, the Treasury Regulations provide that interests are "readily tradable on a secondary market or the substantial equivalent thereof" if, based on all of the facts and circumstances, partners are able to buy, sell or exchange their interests in a manner that is comparable, economically, to trading on an established securities market. This general guidance provides little comfort to GPs of funds with frequent transfers. Thus, GPs have become more comfortable relying on certain safe harbours set forth in the US Treasury Regulations.

One safe harbour frequently relied upon provides that interests in a partnership will not be deemed to be readily tradable on a secondary market or the substantial equivalent thereof if the sum of the partnership interests transferred during the taxable year, excluding certain private transfers, do not exceed 2 percent of the total interests in partnership capital or profits. A separate safe harbour is available to certain partnerships that do not have more than 100 partners, subject to certain other requirements and an anti-avoidance rule that may "look through" certain partners that are flow-through entities. In addition, if 90 percent or more of the gross income of a partnership for each taxable year is "qualifying income" (which generally includes passive income such as interest, dividends, and capital gains) the onerous tax consequences described above will not apply. Because it is not always clear whether the 100-partner safe harbour or the "qualifying income" test is satisfied, many GPs prefer the mathematical certainty of the 2 percent safe harbour and will prohibit transfers that exceed this limit. Some of these GPs are facing the decision of changing this policy – and their risk tolerance – in order to accommodate transfers and, in some cases, replace delinquent limited partners.

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Qualified matching service

The qualified matching service (QMS) safe harbour under the Treasury Regulations increases the cap on permitted transfers of partnership interests to 10 percent during a taxable year. Treasury Regulations define a matching service as a computerised or printed listing system that lists bid and/or ask quotes in order to match interested buyers and sellers of partnership interests. It can also, however, be organised as a system that matches buyers with sellers without the bid/ask process.

A matching service will only constitute a QMS, however, if all of the requirements under the Treasury Regulations are met. First, the selling partner cannot enter into a binding agreement to sell the interest until the fifteenth calendar day after the date the information regarding the offering of the interest is made available to potential buyers. The existence of this fifteen-day time period must also be documented in contemporaneous records ordinarily maintained by the operator at a central location. Second, the closing of the sale effected through the service cannot occur prior to the forty-fifth calendar day after the date the information is made available to potential buyers. Again, the existence of this time period must be documented in contemporaneous records. Third, the matching service can only display non-firm price quotes or quotes that express an interest without an accompanying price – the service cannot display firm bid or ask quotes. Fourth, if an interest is listed for sale but remains unsold for 120 days after the date the information is made available, the listing must be removed and must remain de-listed for at least sixty calendar days. Lastly, the sum of partnership interests transferred during the partnership's taxable year, disregarding certain private transfers, cannot exceed 10 percent of partnership capital or profits.

If these requirements are satisfied, transfers through the service are disregarded for purposes of determining whether a partnership is a PTP. Non-QMS transfers, however, would need to be protected under a different safe harbour, such as the 2 percent safe harbour, but would (with the exception of certain private transfers) still count towards the 10 percent limit under the QMS rules.

Potential QMS structures

The QMS safe harbour rules are fairly flexible as to the particular structure and strategy that may be chosen. Moreover, a QMS may be organised by GPs, brokers, and secondary buyers. GPs might consider setting up a QMS to deal with transfers within their own funds. Under this structure, LPs hoping to transfer their interests would submit their information to the QMS where it could then be accessed by potential buyers that are pre-approved by the GP. The pre-approval process may be used by the GP to disqualify buyers that have credit issues or that raise regulatory concerns. Third-party brokers might consider setting up a QMS to facilitate GP approval of their transactions – the QMS operated by NYPPEX is a famous example of such a third party service. GPs, who would not have control or oversight over a third-party service, may want assurances that the requirements of the Treasury Regulations are satisfied. In this regard, a private letter ruling from the IRS may be useful, and certain protections (such as representations from buyers and sellers) should be built into the listing process. Secondary buyers might consider setting up a QMS that would give them a preferred status as a buyer in those funds that may have reached the 2 percent limit. Again, in this case, GPs would likely insist on certain assurances that the QMS is in compliance with the US Treasury Regulations.

The PTP rules and the 2 percent limit on transfers of partnership interests will present a challenge for GPs and a burden for investors as the secondary market continues to grow throughout 2009 and 2010. The QMS safe harbour may be an elegant solution for GPs hoping to stay within the PTP safe harbours and for secondary market investors seeking GP approval of transfers.