Proskauer

Private Funds In Focus

Winter 2013

New Year's Resolutions – Annual Filing Obligations and Compliance Matters for Private Fund Managers

As the new year begins, private fund managers should take some time to consider various action items that are potentially applicable to private fund managers, some of which may be new for many managers in 2013. For a quick summary of many of these items, see the chart on pages 6-8.

Section 13

Under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 (the Exchange Act), any person or "group" of persons that directly or indirectly acquires beneficial ownership of more than 5% of any class of equity voting securities that is traded on a U.S. exchange (including Nasdaq) may be required to file a Schedule 13D or Schedule 13G. If one or more of a manager's funds currently holds, or at any time in 2012 held, in the aggregate more than 5% of such publicly traded securities, the fund or funds may be required to file an initial or amended Schedule 13D or Schedule 13G with the Securities and Exchange Commission (SEC). If the securities were acquired before a newly public issuer became publicly listed (and in certain other cases), the initial Schedule 13G filing with respect to that issuer generally is due on February 14, 2013. (Schedule 13D filings and Schedule 13G filings in certain other cases are due throughout the year as transactions occur rather than on a set date.) If there have been any changes during 2012 to the information included in a previously filed Schedule 13G, an amendment that updates such information generally must be filed by February 14, 2013 as well.

Under Section 13(f) of the Exchange Act, managers with investment discretion over $100 million or more of U.S. publicly traded securities generally must file a Form 13F with the SEC disclosing such holdings. Managers that exercised investment discretion over $100 million of such securities as of the end of any month during 2012 generally must file Form 13F with the SEC no later than February 14, 2013 (with quarterly filing obligations thereafter for the remainder of 2013).

Fund managers that have previously filed a Form 13H (principally certain large traders of U.S. equities) must file an annual amendment by February 14, 2013.

SEC-Registered Investment Advisers and Exempt Reporting Advisers

SEC-registered investment advisers should keep in mind several key registration documents that must be updated and filed with the SEC on an annual basis. For many investment advisers that registered during 2012 as a result of the Dodd-Frank Act, the first annual update will be due in the first quarter of 2013. Updates to Form ADV Part 1 and Part 2A (the brochure) must be filed within 90 days after an adviser's fiscal year-end. An updated Part 2A (or summary of changes) must be delivered to an adviser's clients within 120 days after the adviser's fiscal year-end. Although investors in a private fund technically are not clients of an adviser, it is often considered best practice to provide the updated Part 2A (or summary of changes) to investors in the fund within such 120-day period.

SEC-registered investment advisers are required to conduct a review of their compliance program on an annual basis. SEC examiners expect to see documents reflecting the annual review.

Many SEC-registered investment advisers also will be required to file Form PF for the first time in 2013. Form PF is applicable to advisers with at least $150 million in gross assets under management attributable to private funds. The frequency and timing of the Form PF reporting obligation and the amount of information that must be reported on Form PF will vary depending on the size and type of private funds managed by the adviser. See our separate report on Form PF below: *Form PF: What You Need to Know*.

While exempt from most annual filing requirements, an exempt reporting adviser (e.g., an adviser to private funds with less than $150 million in assets under management or solely to venture capital funds) must file an update to the portions of Form ADV Part 1 that an exempt reporting adviser is required to complete. The update must be filed within 90 days after the adviser's fiscal year-end.

CFTC-Registered and Exempt CPOs and CTAs

Commodity Futures Trading Commission (CFTC)-registered and exempt firms face several new filing obligations in 2013. Advisers relying on an exemption from CPO registration under Rule 4.13(a)(3) or an exemption from CTA registration under Rule 4.14(a)(8) must make a simple filing reaffirming the exemption within 60 days after the end of each calendar year. NFA rules that are scheduled to become effective on February 15, 2013 have expanded the reporting obligations of CFTC-registered CPOs and CTAs. Under the new NFA rules, registered CPOs must file an annual report on Form CPO-PQR with respect to each fund they manage within 90 days after the end of each calendar year and a quarterly report on Form CPO-PQR within 60 days after the end of each calendar quarter. Registered CTAs must file Form CTA-PR within 45 days after the end of each calendar quarter.

Form D Amendment

A fund manager that has filed a Form D with the SEC with respect to an offering of interests in a fund must file an amendment annually for so long as the offering is ongoing. The amendments are due on the anniversary date of the original Form D filing.

Privacy Laws

Federal law generally requires a fund manager to distribute its privacy policy, or a notice summarizing the policy, to all natural persons, 401(k) and IRA investors before such investors acquire an interest in any of the manager's funds, and annually thereafter. There is no specific deadline for distribution of the privacy notice, but many fund managers choose to distribute it with year-end reports. Relevant rules do not permit email or website distribution unless the recipient has consented in advance in writing. Federal regulators prepared a model privacy notice that falls into a "safe harbor" with regard to the content requirements for privacy notices, but fund managers may continue to use other types and forms of notice so long as they comply with the relevant rules.

In addition to federal requirements, a growing number of states restrict the use of sensitive personal information thata fund manager collects. For example, Massachusetts regulations require businesses that store personal information of that state's residents to (i) implement a privacy policy which includes, "to the extent technically feasible," encryption of data and (ii) assess, "at least annually," the scope of their data security measures.

Fund and Investor-Specific Matters

Fund managers should consider reviewing the governing agreements of their funds (along with side letters with investors) for any obligations to provide certain information to investors on an annual basis. Such agreements often require annual reporting with regard to ERISA status, compliance with certain material terms of a fund's governing agreements, and similar matters. Fund managers also should consider whether any fund term or investment period expiration dates are on the horizon and plan accordingly.

Certain Annual Tax Elections and Filings

U.S. Tax Elections

Certain U.S. federal income tax elections that are common in the private investment fund context are filed with the electing person's U.S. federal income tax return. Two common elections are the "electing investment partnership" and "qualified electing fund" elections:

- "*Electing Investment Partnership*" *Election*. Internal Revenue Code Section 743 permits an opt-out of mandatory basis adjustment rules (which generally impose significant record keeping burdens when partnership interests are transferred) for funds that are taxable as partnerships for U.S. tax purposes and meet certain other criteria. An election by a fund to be an electing investment partnership is filed with the IRS by attaching the election to the fund’s tax return for the first taxable year in which the election is intended to be effective. In general, the first year in which there is a transfer of an interest in a partnership is the first year for which the partnership should consider whether it is advisable to make an election to be an electing investment partnership.

- "*Qualified Electing Fund*" *Election*. In order to mitigate potential adverse U.S. tax consequences, U.S. funds which have invested in non-U.S. portfolio companies, and U.S. investors that have invested in non-U.S. funds that have invested in non-U.S. portfolio companies, may elect to have such non-U.S. portfolio companies treated as "qualified electing funds" (commonly referred to as a QEF election). A QEF election is applicable where the non-U.S. portfolio company is (or could be) classified as a "passive foreign investment company" (PFIC). A QEF election with respect to a PFIC is filed with the IRS by attaching the election to the U.S. fund’s or the U.S. investor’s (as the case may be) U.S. federal income tax return. In most cases, it is important for a QEF election to be made in respect of the year in which the PFIC stock was acquired. Side letters for some funds may obligate a manager to

make or seek to make QEF elections, investigate whether making QEF elections is advisable, or provide information to investors in connection with QEF elections.

Section 83(b) Elections

If a person filed a Section 83(b) election with the IRS during the year (e.g., such election was filed by a person who acquired an interest subject to vesting in a general partner entity), such person must attach a copy of the Section 83(b) election that was filed to his or her U.S. federal income tax return for the taxable year in which the interest was acquired. (Note that the Section 83(b) election itself must be filed with the IRS within 30 days of acquiring the property that is the subject of the election.)

U.S. Tax Filings with Respect to Non-U.S. Entities

A private investment fund and its investors should consider on an annual basis whether any U.S. tax filing requirements must be satisfied with respect to any non-U.S. entities in which the fund invests. Such filing requirements are generally applicable to U.S. persons (which may include a fund formed under U.S. law or a U.S. investor – including U.S. fund managers – in a fund formed under the laws of any jurisdiction) that own (directly or indirectly) more than a certain threshold interest in the non-U.S. entity or engage in certain transactions with such entity. The filing requirements are generally satisfied by attaching the appropriate IRS forms to the U.S. person's U.S. federal income tax return. The IRS forms which may be applicable include, among others, IRS Form 5471 (with respect to certain non-U.S. corporations, including a non-U.S. corporation that is a "controlled foreign corporation" with respect to the U.S. person), IRS Form 926 (with respect to certain contributions of property to a non-U.S. corporation), IRS Form 8621 (with respect to certain non-U.S. corporations that are PFICs), IRS Form 8865 (with respect to certain non-U.S. partnerships), IRS Form 8858 (with respect to certain non-U.S. disregarded entities) and IRS Form 8938 (with respect to certain foreign financial assets).

Tax Side Letter Undertakings

A manager may have agreed in side letters to cause a fund to satisfy certain annual tax reporting obligations, notify investors if the fund has engaged in certain types of transactions, or provide certain tax information to investors on an annual basis that relate to an investor's unique tax status.

State Taxes

State franchise taxes are not due until June 1st for limited partnerships and limited liability companies in Delaware. Filing requirements and deadlines for state franchise taxes (and potential annual report filings) in any other states or foreign jurisdictions may vary.

Report of Foreign Bank and Financial Accounts

With very limited exceptions, the Report of Foreign Bank and Financial Accounts (FBAR) requires a U.S. person who has a financial interest in, or signature authority over, one or more financial accounts in a foreign country to report those accounts annually if the aggregate value of all such U.S. person's foreign financial accounts exceeds $10,000 at any time during the calendar year. The FBAR must be received by the U.S. Department of The Treasury on or before June 28, 2013 (not merely postmarked by that date) rather than June 30, 2013, because June 30, 2013 is a Sunday. Under the rules, an individual has "signature or other authority" only if such individual has the authority (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account "by direct communication (whether in writing or otherwise) to the person with whom the financial account is maintained." While there continues to be no general FBAR filing requirement for most owners of hedge fund and private equity fund interests, a hedge fund or private equity fund itself may have a filing obligation under certain circumstances, as well as officers and employees with signature authority for such funds and any owner of such funds with a controlling interest. For example, a U.S. fund may be required to file an FBAR if it owns directly or indirectly a foreign bank account, and an officer may be required to file an FBAR with respect to his or her signature authority over the foreign bank accounts owned directly or indirectly by the fund or a portfolio company.

In 2011, the Financial Crimes Enforcement Network (FinCEN) released guidance (FinCEN Notice 2011-1 and FinCEN Notice 2011-2) that provided an extension of time to file FBARs for officers and employees of certain entities who had signature authority over, but no financial interest in, certain foreign financial accounts. Last year, pursuant to FinCEN Notice 2012-1, this deadline was extended for reports for 2011 and prior years from June 30, 2012 to June 30, 2013. This deadline was extended again recently for reports for 2012 and prior years to June 30, 2014 pursuant to FinCEN Notice 2012-2. Among the limited categories of individuals covered by these notices are officers and employees of investment advisers registered with the SEC with signature or other authority over the foreign financial accounts of entities that are not registered investment companies (officers and employees with signature or other authority over the foreign financial accounts of registered investment companies generally are exempt from filing the FBAR).

Summary of Certain Upcoming U.S. Regulatory and Filing Deadlines

The list below briefly summarizes various reporting obligations and filing deadlines for private fund managers under U.S. rules, many of which are discussed in more detail above.

What to Do?	Who Must Do It?	Deadline
File updated Form ADV Part 1	SEC-registered advisers and (for certain portions) exempt reporting advisers	90 days after adviser's fiscal year-end
File updated Form ADV Part 2A	SEC-registered investment advisers	90 days after adviser's fiscal year-end
Deliver updated Form ADV Part 2A (or summary of changes) to clients	SEC-registered investment advisers	120 days after adviser's fiscal year-end

What to Do?	Who Must Do It?	Deadline
Annual compliance review	SEC-registered advisers	Annually
File Schedule 13G	Beneficial owner of 5% or more of a class of voting equity of U.S. public company	February 14, 2013 in many cases
File Schedule 13F	Manager of $100 million or more in U.S. listed securities	February 14, 2013
File Form 13H	Large trader of U.S. listed equities who trades 2 million shares or $20 million on any day or 20 million shares or $200 million in any month[1]	Amendment due February 14, 2013 if there are any changes to report
Send annual privacy notice to certain investors	Most advisers	Annually
File Form SLT	U.S. adviser to report at least $1 billion (i) of securities issued by U.S. clients to non-U.S. investors plus (ii) non-U.S. securities owned by U.S. clients[2]	Monthly

What to Do?	Who Must Do It?	Deadline
File Form PF	SEC-registered advisers managing at least $150 million in gross assets under management (AUM) attributable to private funds[3]	*Hedge fund advisers* with at least $1.5 billion in gross AUM must begin quarterly reporting within 60 days after the end of their first fiscal quarter to end after 12/15/12[4] *Private liquidity fund advisers* with at least $1.5 billion in gross AUM must begin quarterly reporting within 15 days after the end of their first fiscal quarter to end after 12/15/12.[5] *All other private fund advisers* with at least $150 million in gross AUM must begin reporting annually within 120 days after the end of their first fiscal year to end after 12/15/12.[6]
File Form D Amendment	Funds that have an ongoing offering of interests more than a year after the initial Form D filing	Anniversary date of the original Form D filing

What to Do?	Who Must Do It?	Deadline
File FBAR	U.S. person with interest in or signature power over non-U.S. bank account with greater than $10,000. In general, there currently is no FBAR filing requirement in respect of hedge fund and private equity fund interests, although there may be such a requirement in the future	June 28, 2013
CFTC Rule 4.13(a)(3) annual affirmation filing	Any adviser continuing to rely on the exemption under CFTC Rule 4.13(a)(3)	Annual filing within 60 days of the end of each calendar year (Note: 4.13(a)(3) filings made after December 3, 2012 may automatically be deemed to be affirmed in 2013)
CFTC Rule 4.14(a)(8) annual reaffirmation filing	Any adviser continuing to rely on the exemption under CFTC Rule 4.14(a)(8)	Annual filing within 60 days of the end of each calendar year

What to Do?	Who Must Do It?	Deadline
CFTC Form CPO-PQR	Any CFTC-registered CPO	Within 60 days after the end of each calendar quarter and within 90 days after the end of each calendar year
CFTC Form CTA-PR	Any CFTC-registered CTA	Within 45 days after the end of each calendar quarter

Conclusion

As with any new year, 2013 brings a number of annual filings and other obligations for private fund managers. The foregoing list is illustrative in nature and by no means exhaustive. Given the complexity of many of the regulations and the individual circumstances applicable to any fund, fund managers should discuss all of these matters with their various legal and tax advisors.

Form PF: What You Need to Know

Gregory T. Merz

The deadline for completing an initial filing on Form PF is fast approaching for many investment advisers to private funds. Hedge fund firms with between $1.5 and $5 billion in gross assets under management must submit their first quarterly report on Form PF by March 1, 2013, while private equity firms with a fiscal year ending on December 31 and smaller hedge fund firms with between $150 million and $1.5 billion in gross assets under management must file their first annual report on Form PF by April 30, 2013.

Form PF is a complicated form that, depending on how large and diverse a private fund adviser's business is, can require a very significant coordinated effort from a firm's financial, compliance, administrative and legal support functions. To avoid wasting time and effort, it is necessary to begin the process by answering several key interpretive questions in order to determine which sections of the Form apply and how the data required by the Form should be presented. Unfortunately, the technical requirements of Form PF are not necessarily consistent with an intuitive understanding of a private fund adviser's business. As such, it is important to conduct this analysis carefully so as to avoid issues down the road.

Background

Form PF requires all registered investment advisers with more than $150 million in gross assets under management attributable to private funds to submit extensive financial data regarding their private fund investment activities to the SEC on a quarterly or annual basis (depending on the size and type of private funds that the firm manages). The stated purpose of this massive data-gathering exercise is to enable the Financial Services Oversight Counsel (FSOC) to monitor "systemic risks" to the U.S. financial system.

In general, any registered investment adviser that advises one or more private funds and has at least $150 million in gross assets under management attributable to those private funds (a Reporting Adviser) will be required to complete Form PF and file it with the SEC on an annual basis. However, the reporting requirements for certain large Reporting Advisers will be more frequent and/or more extensive. In particular:

- Reporting Advisers with at least $1.5 billion in gross assets under management attributable to hedge funds (Large Hedge Fund Advisers) will be subject to more comprehensive quarterly reporting requirements regarding the investment activities of their hedge funds as a whole, as well as the investment activities of any individual “qualifying hedge funds” (those with more than $500 million in gross assets under management).

- Reporting Advisers with at least $1.0 billion in gross assets under management attributable to private liquidity funds and registered money market funds (Large Liquidity Fund Advisers) will be subject to more comprehensive quarterly reporting requirements regarding their private liquidity fund investment activities.

- Reporting Advisers with at least $2.0 billion in gross assets under management attributable to private equity funds (Large Private Equity Fund Advisers) will be subject to more comprehensive annual reporting requirements relating to their private equity fund investment activities.

Key Preliminary Interpretive Questions

Given the structure of Form PF, there are two key preliminary interpretive questions that must be resolved before a Reporting Adviser can begin gathering the data necessary to complete its Form PF reporting obligations: First, the Reporting Adviser's private funds that are subject to Form PF reporting requirements must be identified, and the categories each private fund falls into for reporting purposes must be determined. Second, the Reporting Adviser must determine how the firm's gross assets under management must be aggregated, both for the purpose of determining which reporting thresholds apply and for the purpose of determining how to answer the applicable sections of the Form.

Private Fund Categories

The first step in the analysis is to identify a Reporting Adviser's "private funds." For Form PF reporting purposes, a "private fund" is defined as any fund that is exempt from registration under the Investment Company Act of 1940 in reliance on either section 3(c)(1) (privately offered funds with no more than 100 beneficial owners in the fund) or section 3(c)(7) (privately offered funds whose securities are owned exclusively by "qualified purchasers"). Most private funds that are marketed to U.S. investors fall within the scope of this definition, but there are several key exclusions. These include real estate funds that are able to rely on the section 3(c)(5)(C) exemption from registration under the Investment Company Act and offshore funds that are exempt from the Investment Company Act because they are neither offered to nor held by U.S. investors.

Once a Reporting Adviser's inventory of private funds has been identified, the next step is to determine into which categories each of these private funds fall for Form PF reporting purposes. There are seven potential categories that may apply: (i) hedge fund, (ii) securitized asset fund, (iii) liquidity fund, (iv) private equity fund, (v) real estate fund, (vi) venture capital fund, and (vii) other private fund.

Of these categories, the definition of a "hedge fund" is the first and most important to understand and apply. A "hedge fund" is defined very broadly under Form PF as any fund, other than a securitized asset fund (discussed below), that:

- pays a performance fee or allocation, the calculation of which may take into account unrealized gains;

- may borrow an amount in excess of 50% of its net asset value (including any uncalled committed capital) or which may have a gross notional exposure in excess of twice its net asset value (including any uncalled committed capital); or

- may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration).

The extremely broad scope of this definition, which has been interpreted quite rigidly by the SEC, can lead to some surprising results. In particular, the element of this definition that essentially defines a hedge fund as any fund that has the potential to engage in short sale activities has proven to be particularly controversial. In the adopting release for Form PF, the SEC considered but expressly rejected requests to apply the hedge fund definition based on actual or contemplated use of shorting strategies, rather than potential use.[7] Consistent with this position, the SEC has issued interpretive guidance stating that private equity funds whose governing documents allow the fund to engage in short sales should be categorized as hedge funds, even if the fund does not engage in short sale activities and has no intention of engaging in such activities. The SEC also has advised that venture capital funds that may on occasion use short sales to hedge positions in publicly-traded securities in the fund's portfolio (for example, as part of an exit strategy for a successful investment) must be classified as hedge funds for Form PF reporting purposes, even if the venture capital fund meets all of the requirements to be treated as a venture capital fund pursuant to Rule 203(l)-1 under the Investment Advisers Act.[8]

Once a Reporting Adviser's hedge and non-hedge private funds have been indentified, the next step is to analyze which other categories of private funds may apply. For funds that have already been classified as hedge funds, it is necessary to determine whether the fund also may fall into the securitized asset fund or liquidity fund category. A "securitized asset fund" is defined as any private fund whose primary purpose is to issue asset-backed securities and whose investors are primarily debt holders. Securitized asset funds are excluded from the definition of a hedge fund and need not be reported on Form PF as such. On the other hand, the definition of liquidity fund is not mutually exclusive from the definition of a hedge fund. Consequently, the SEC has advised that a hedge fund that also meets the definition of a liquidity fund must complete all sections of the Form that apply to both types of private funds. [9]

For those funds that do not fall into the hedge fund classification, the next step is to analyze which of the following five categories apply. For purposes of this analysis:

- A "liquidity fund" is defined 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.

- A "real estate fund" is defined as any private fund that is not a "hedge fund," that does not provide investors with redemption rights in the ordinary course, and that invests primarily in real estate and real estate-related assets.

- A "venture capital fund" is defined as any private fund meeting the definition of a venture capital fund under Rule 203(1)-1 under the Investment Advisers Act.

- A "private equity fund" is defined as any private fund (i) that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund, and (ii) that does not offer redemption rights in the ordinary course.

- "Other Private Fund" is defined as any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund, venture capital fund or private equity fund.

Aggregation of Assets

The next step in the analysis is to determine how the Reporting Adviser's gross assets under management attributable to its private funds must be aggregated for purposes of determining which reporting thresholds under Form PF apply.

Form PF provides that an adviser must calculate its gross assets under management attributable to private funds in accordance with the requirements for calculating "regulatory assets under management" under Part 1A of Form ADV. In general, this requires advisers to include as assets under management the gross value of all assets in a private fund (regardless of the nature of those assets), plus any uncalled capital commitments to the fund. In addition, Form PF requires a Reporting Adviser to aggregate its private fund assets under management with the private fund assets of all of its "related persons," unless such related person is "separately operated."[10] Related persons whose assets under management must be aggregated for Form PF reporting purposes have the option of submitting a single Form PF covering multiple related persons or filing separately. If such related persons elect to file separately, however, they must complete each section of the Form that applies based on their aggregated assets under management. Thus, for example, if the hedge fund assets attributable to a group of related persons exceed the $1.5 billion threshold for reporting as a Large Hedge Fund Adviser, then each related person in the group must complete Section 2 of the Form, even if the assets attributable to an individual member of the group would not exceed the $1.5 billion threshold.

For purposes of Form PF, various types of private fund structures also must be aggregated together for purposes of determining the applicable reporting thresholds. In particular, a Reporting Adviser generally must aggregate the assets of any parallel fund structures (including any "dependent managed parallel accounts"[11]) and master-feeder fund arrangements. However, private fund assets invested in other private funds may be disregarded for this purpose. In addition, a Reporting Adviser whose principal office and place of business is located outside the United States generally may disregard any private fund that during the last fiscal year was not: (i) a U.S. person, (ii) offered to a U.S. person, or (iii) beneficially owned by a U.S. person. Finally, fund-of-fund assets count towards determining whether a Reporting Adviser's assets under management exceed the initial $150 million reporting threshold, but generally may be disregarded for all other purposes under the Form.

One final principle to keep in mind when applying these aggregation rules under Form PF is that, with the exception of determining whether a private fund adviser exceeds the initial $150 million filing threshold, each of the reporting thresholds applies on a category-by-category basis. Thus, it is not necessary for a Reporting Adviser to aggregate assets across private fund categories in order to apply the large fund adviser reporting thresholds. For example, if a Reporting Adviser manages $1.4 billion in hedge fund assets and $1.9 billion in private equity fund assets, the Reporting Adviser will not be subject to either the Large Hedge Fund Adviser or the Large Private Equity Fund Adviser reporting obligations, even though the firm's total assets under management exceeds both large fund adviser reporting thresholds.

Conclusion

Completing Form PF is an exercise for which it definitely will pay to "measure twice and cut once." As such, it is important to resolve the preliminary interpretive questions carefully in order to determine accurately which sections of Form PF will apply and how the data required by the Form should be presented. There are, of course, many other issues that Reporting Advisers will encounter as they work through the process of gathering the data and completing each of the specific items under the Form. Nevertheless, getting these initial questions right early in the process will help to avoid wasting time and effort.

American Taxpayer Relief Act of 2012

On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012 (2012 Tax Act), confirming the expectation that individual U.S. federal income tax rates for high-income taxpayers would rise in 2013. Considerable uncertainty continues to exist regarding whether the taxation of carried interest will change.

The 2012 Tax Act resulted from well-publicized negotiations regarding the tax aspects of the "fiscal cliff," a term used to describe the expiration of certain tax rates and tax incentives, along with the introduction of certain spending cuts.

The 2012 Tax Act covers a broad range of tax law provisions affecting both individuals and business entities. Following are some highlights of the new law:

- Tax brackets for individuals with annual income less than $400,000 have been made permanent, while the rate for those with income above that level is increased

permanently to 39.6%.

- The capital gains tax rate is permanently increased from 15% to 20% for those individuals with annual income above $400,000. In addition, the provision including qualified dividend income in the calculation of capital gains has been made permanent.

- For individuals with annual income above $250,000, a phase-out mechanism on personal exemptions and a limitation on itemized deductions are reinstated, after having been suspended in 2011 and 2012.

- The 100% exclusion from gain of proceeds from the sale of "qualified small business stock" (as defined in the Internal Revenue of Code) applicable to stock acquired after September 27, 2010 is extended for stock acquired before January 1, 2014, at which point, absent further action, the exclusion will return to 50%.

- Look-through treatment of payments between related controlled foreign corporations (CFCs) under the foreign personal holding company rules has been extended through 2012 and 2013. This allows for deferral for certain payments between commonly controlled CFCs.

The 2012 Tax Act also includes a variety of energy tax extenders, as well as an extension of the availability of a tax credit for certain research expenses.

FATCA Update

On January 17, 2013, the Internal Revenue Service (IRS) and Treasury Department issued long-awaited final Treasury Regulations (Final Regulations) under FATCA. To avoid a 30% withholding tax on "withholdable payments," FATCA will require certain foreign financial institutions (FFIs) to identify U.S. account holders and report that information to the IRS. "Withholdable payments" generally include U.S.-source dividends, interest and certain other income, as well as gross proceeds from the disposition of property that can produce U.S.-source interest or dividends.

The Final Regulations extended the deadline for FFI registration from June 30, 2013 to October 25, 2013, in order to be exempt by January 1, 2014. This registration will be done through an online IRS portal.

The Final Regulations also extended some of the FATCA withholding deadlines for pre-existing investors:

- For U.S.-source dividends, interest and certain other income,
- January 1, 2014 for investors admitted on or after January 1, 2014.
- July 1, 2014 for investors admitted before January 1, 2014 who are "prima facie" FFIs.
- January 1, 2016 for all other investors admitted before January 1, 2014.
- For gross proceeds from the disposition of property that can produce U.S.-source interest or dividends, January 1, 2017.

In addition, the Final Regulations clarify the interaction between FATCA Intergovernmental Agreements and the regulations. They also provide more detail on the information that must be provided to the IRS under an FFI agreement, and establish a procedure for an investment fund manager to consolidate FATCA compliance for all FFIs that it manages.

Please see our client alert for a more detailed summary of the Final Regulations.

Due Diligence Guidance to Avoid Foreign Corrupt Practices Act Issues in Acquisitions and Investments

Mark J. Biros

In November 2012 the Criminal Division of the U.S. Department of Justice (DOJ) and the Enforcement Division of the U.S. Securities and Exchange Commission (SEC) released "*A Resource Guide*" clarifying, among other things, their approach to successor liability under the Foreign Corrupt Practices Act (FCPA) in the mergers and acquisitions context. See http://www.justice.gov/criminal/fraud/fcpa/guidance. The Resource Guide provides helpful guidance on the due diligence procedures acquirers can conduct to better evaluate potential post-acquisition liability of, and minimize the likelihood of a criminal or civil enforcement action being filed against, an acquired entity or the acquirer (under the theory of successor liability),[12] in connection with violations of the FCPA.

As noted in the Resource Guide, due diligence relating to the FCPA has four potential benefits:

First, due diligence helps an acquiring company to accurately value the target company. Contracts obtained through bribes may be legally unenforceable, business obtained illegally may be lost when bribe payments are stopped, there may be liability for prior illegal conduct, and the prior corrupt acts may harm the acquiring company's reputation and future business prospects. Identifying these issues before an acquisition allows companies to better evaluate any potential post-acquisition liability and thus properly assess the target's value.

Second, due diligence reduces the risk that the acquired company will continue to pay bribes. Proper pre-acquisition due diligence can identify business and regional risks and also can lay the foundation for a swift and successful post-acquisition integration into the acquiring company's corporate control and compliance environment.

Third, the consequences of potential violations uncovered through due diligence can be handled by the parties in an orderly and efficient manner through negotiation of the costs and responsibilities for the investigation and remediation.

Finally, comprehensive due diligence demonstrates a genuine commitment to uncovering and preventing FCPA violations.

The Resource Guide notes that the government will be lenient if the acquiring company:

- conducts sufficient and appropriate pre- and post-acquisition due diligence;
- quickly takes corrective action to remedy any conduct that violates the FCPA; and
- reports the inappropriate conduct to the authorities.

It is important to note that the Resource Guide only reflects the views of the DOJ and SEC, and applies only to the FCPA. Acquirers also should consider any similar laws that are potentially applicable to such transactions (e.g., the UK Bribery Act).

While the Resource Guide addresses FCPA issues in the context of an acquisition, its suggestions are equally helpful where a private investment fund or other investor is about to make any significant equity investment.

The Resource Guide recommends a risk-based approach to due diligence focusing on anticorruption issues, which should include at least the following:

- legal, accounting and compliance review of the target's sales and financial data, customer contracts and third-party distributor agreements;
- risk-based analysis of the target's customer base;
- audit of selected transactions;
- interviews with the target's general counsel, compliance and audit personnel, and executives in charge of sales to discuss corruption-related matters; and
- analysis of the target's anticorruption training to identify shortfalls.

If pre-acquisition due diligence reveals FCPA issues, then remedial action, some taken pre-closing and some taken post-closing, may include any or all of the following:

- ensure improper behavior has ceased;
- require the target to terminate, suspend, or reprimand employees or agents responsible for the improper conduct;
- disclose the improper conduct to the DOJ and the SEC;
- require the target's distributors and other agents to sign anticorruption certificates, complete anticorruption training in their language, and sign new contracts that incorporate FCPA anticorruption warranties, representations and audit rights;
- integrate the target into the acquirer's internal compliance and training programs; and
- communicate the acquirer's compliance policies and procedures to the target's employees and agents.

Acquisition of a target does not create retroactive jurisdiction for the pre-acquisition misconduct of a target that was not previously subject to FCPA jurisdiction. However, post-acquisition misconduct can trigger FCPA liability. As a result, acquirers should not eschew pre-acquisition due diligence simply because the target, prior to acquisition, is not subject to FCPA penalties.

FCPA violations discovered during pre-acquisition due diligence need not derail a transaction. As the Resource Guide notes,

[I]n a significant number of instances, DOJ and SEC have declined to take action against companies that voluntarily disclosed and remediated conduct and cooperated with DOJ and SEC in the merger and acquisition context. And DOJ and SEC have only taken action against successor companies in limited circumstances, generally in cases involving egregious and sustained violations or where the successor company directly participated in the violations or failed to stop the misconduct from continuing after the acquisition.

For example, in 2004 a Connecticut-based acquirer discovered FCPA violations by its target. The target and the acquirer disclosed the conduct to the DOJ and the SEC. The target paid $1.1 million in disgorgement, pre-judgment interest and civil penalties. The acquirer proceeded with the acquisition and entered into an agreement with the government to ensure the target's full compliance with its non-prosecution agreement.

These pre- and post-acquisition due diligence steps are important to ensure that any FCPA-related issues are identified and addressed quickly.

Corporate Governance Trends for 2013

Ori Solomon

Entering 2013, companies find themselves in a climate of uncertainty, highlighted by precarious debt crises (both at home and abroad), sociopolitical unrest in various regions around the globe, and unpredictable economic growth. While difficult to predict the full impact of these and other external pressures, highlighted below are certain key issues trending in corporate governance that private investment funds and the boards of directors of their portfolio companies should be aware of in planning for 2013 and beyond.

Board Composition

The election of director candidates will become increasingly scrutinized in 2013. Not only will directors be expected to have industry and financial expertise, the evolving marketplace requires that directors be well-equipped to oversee IT and international risks. In addition, highly publicized demand for diversity in the boardroom is increasing, especially in the area of gender imbalance. Companies are faced with the very difficult challenge of shifting board composition in favor of these new highly sought characteristics while weighing the importance of continuity. Discussions altering the makeup of the board should be candid and collegial; it may be helpful to focus discussion on a list of actual director candidates emphasizing, the board's aspirational characteristics.

Succession Planning

Recent developments reinforce the importance of the board's role in developing a detailed CEO succession plan. In 2010, the SEC restricted the ability of companies to exclude from proxies shareholder proposals seeking information relating to CEO succession plans as well as the board's role in doing so. Compounding the issue are higher CEO turnover rates and increasing incidents of CEO incapacity, as well as the top-heaviness of 43% of S&P 500 CEOs serving as board chairs. Even more than in 2012, boards should seek to develop transparent and fulsome succession plans with the active participation of current CEOs.

Executive Compensation

Say-on-Pay. As *say-on-pay* enters its third proxy season allowing shareholders to vote on executive compensation policies, the two-year exemption from reporting for smaller reporting companies (public float of less than $75 million) will no longer be available as of January 21, 2013. In addition, proxy advisor Institutional Shareholder Services ("ISS") in its 2013 U.S. voting guidelines (i) refined its *say-on-pay* analysis on peer group selection methodology; (ii) extended the say-on-golden-parachute analysis to new, existing, renewed or legacy arrangements; and (iii) assessed shareholder proposals to link executive compensation to external metrics (*e.g.,* environmental and social). Boards of smaller reporting companies who previously relied on the two-year exemption should be informed as to ISS guidelines and other guidance on *say-on-pay*.

Pending Dodd-Frank Regulations. Although the SEC is behind in rule making since the Dodd-Frank Act went into effect three years ago, there is speculation that it may finalize new rules for executive compensation clawback policies and executive/worker pay ratio.

Directors should consider a company's compensation policies (including both director and officer's compensation) in anticipation of the aforementioned regulatory and shareholder risks. Companies should consider developing policies to communicate potentially controversial compensation issues both internally and externally.

Board Advisors

Directors should continue to monitor material relationships and activities of advisors to boards of directors very closely. Recent opinions by Delaware courts have criticized directors for failing, early in the engagement of an advisor, to become aware of conflicts of interests and to analyze the impact of such conflicts and protective measures in the best interests of the company. Conflicts should be treated on a case-by-case basis with due regard for each situation's nature, business context and relevant legal case law; in failing to do so, a board potentially could overlook interested transactions or invalidate a transaction that otherwise might have been approved by the courts.

Health Care Reform

On January 1, 2014, the *play-or-pay* provisions of the Patient Protection and Affordable Care Act of 2010 (health care reform) will go into effect. Generally, employers of 50 or more full-time employees will have to pay a penalty if (i) they do not offer health coverage to their full-time employees or (ii) they offer health coverage but the coverage does not meet affordability or minimum value requirements. The penalty varies depending on which failure happens. If no coverage is offered to at least 95% of an employer's full-time employees, and one or more of the employees enrolls in a state insurance exchange and receives a federal government subsidy, the employer will be required to pay $2,000 a year for each full-time employee (minus 30 full-time employees). If the coverage offered is not affordable or does not provide minimum value, the penalty is $3,000 a year for each full-time employee who receives the federal subsidy (but not more than the "no coverage" penalty). This year boards will need to weigh whether to *play-or-pay*, and in that analysis consider the costs of offering health coverage, paying the applicable (non-deductible) penalties, and the actions of the company's competitors. If an employer decides to pay, the board will need to understand the company's obligations under the Act as well as the impact the elimination (or reduction) of employer-provided health benefits will have on employee morale.

FCPA

On November 14, 2012, the SEC and Department of Justice released a 120-page guide providing a detailed analysis of the Foreign Corrupt Practices Act, including guidance on definitions of foreign officials, improper gifts, travel and entertainment expenses, and how successor liability applies in the M&A context. Directors should be keenly aware of the restrictions and related laws that prohibit U.S. companies and citizens from making improper payments to foreign government officials. Companies should consider developing or enhancing protocols, compliance and deterrence programs or other processes to monitor such activity.

Digital Security

Several high-profile data breaches cost companies millions in 2012. It is reported that President Obama may issue an executive order to combat the rise in breaches in the private sector with hopes of securing the nation's digital infrastructure. More than in years past, board discussions have focused on data security in the context of overall company risk assessment. The rapid development of cloud computing and mobile technology would only seem to support that trend.

Recent Client Alerts

The following recent Proskauer Client Alerts addressed topics relevant to the private investment funds community.

Federal Trade Commission Announces 2013 Threshold Revisions for HSR Act and for Clayton Act Section 8 Prohibition on Interlocking Directorates (1/14/13)

The U.S. Federal Trade Commission announced that it has increased (to $70.9 million and $283.6 million) the thresholds that determine whether companies are required to notify federal antitrust authorities about a transaction under the Hart-Scott-Rodino (HSR) Antitrust Improvements Act. The alert examines the latest revisions to these filing thresholds, which are required to be adjusted annually to keep pace with the change in the level of the gross national product.

Final Rule on New Iranian Sanctions Published (12/28/12)

On December 26, 2012, the U.S. Department of The Treasury's Office of Foreign Assets Control published a final rule amending the Iranian Transactions and Sanctions Regulations to implement section 218 of the Iran Threat Reduction and Syria Human Rights Act of 2012, and sections of two 2012 Executive Orders. The alert provides an overview of the final rule, which could affect private funds and their portfolio companies.

The European Commission Adopts AIFMD Implementing Regulation and ESMA Consults on Key Concepts Relating to AIFs and AIFMs under the AIFMD (12/20/12)

On December 19, 2012, the European Commission adopted implementing rules (the Regulation) for the Alternative Investment Fund Managers Directive (AIFMD). The Regulation supplements certain elements of the AIFMD and contains implementing rules which will have direct effect in EU member states on application without the need for national implementing legislation. Also on December 19, 2012, the European Securities and Markets Authority (ESMA) published two consultation papers regarding the AIFMD, with the purpose of ensuring common, uniform and consistent application of the AIFMD across the EU.

While the published rules are extensive, the alert highlights some of the key points coming out of the Regulation and the ESMA consultation papers.

Cooperation Arrangement Would Permit Swiss Alternative Investment Funds to Access EU Market (12/5/12)

On December 3, 2012, the European Securities and Markets Authority approved a cooperation arrangement between the Swiss Financial Market Supervisory Authority (FINMA) and regulators in the EU member states for the supervision of Swiss-managed alternative investment funds, including hedge funds, venture capital funds, private equity funds and real estate funds. This arrangement is the first of its kind under the AIFMD. The alert describes the arrangement in more detail.

UK FSA Issues First Consultation on AIFMD Implementation (11/16/12)

On November 14, 2012, the UK Financial Services Authority published Part I (CP1) of its two-part consultation paper series on implementation of the AIFMD in the UK. The alert provides a summary of CP1, which covers: the prudential regime for all types of alternative investment fund managers; matters relating to depositaries; and the requirements on AIFMs contained within the AIFMD, including organizational matters, duties in relation to management of alternative investment funds and transparency obligations towards investors and regulators.

Foreign Exchange Forwards and Swaps Exempt from CFTC Regulation; CFTC Also Grants Relief to Family Offices and Funds-of-Funds (12/4/12)

On November 16, 2012, the U.S. Department of The Treasury issued a Final Determination exempting both foreign exchange forward contracts (FX Forwards) and foreign exchange swaps (FX Swaps) from the definition of "swap" under the Commodity Exchange Act. Managers of private funds that trade FX Forwards and FX Swaps, but that do not trade other instruments that qualify as commodity interests under CFTC rules, will not be required to either register with the CFTC as a commodity pool operator (CPO) or file for an exemption before the end of 2012.

In addition, on November 30, 2012, the CFTC issued no-action letters providing relief to family offices and fund-of-funds managers. The alert takes a closer look at these two developments.

Investment Funds Not Liable for Portfolio Company's Underfunded Pension Liability under Federal Court Ruling (12/3/12)

In *Sun Capital Partners III, LP v. New England Teamsters and Trucking Industry Pension Fund*, Civ. Action No. 10-10921-DPW (D. Mass. Oct. 18, 2012), the U.S. District Court for the District of Massachusetts ruled that two private equity investment funds managed by Sun Capital Partners, Inc. were not liable for their bankrupt portfolio company's multiemployer pension plan withdrawal liability. The alert examines this ruling, which comes as welcome news to private equity funds that (either together or through related funds) own 80% or more of a portfolio company with underfunded pension liabilities or withdrawal liability, and is a matter of concern for the Pension Benefit Guaranty Corporation and multiemployer pension plans seeking to assert liability on these funds.

United Kingdom and United States Conclude FATCA Intergovernmental Agreement (9/25/12)

On September 12, 2012, the United Kingdom became the first government to enter into an agreement with the United States regarding the U.S. withholding tax regime commonly referred to as the Foreign Account Tax Compliance Act (FATCA). The agreement is based on the model "reciprocal" intergovernmental agreement published on July 26, 2012. The alert describes the agreement and its principal effects.

Events

Proskauer is pleased to be sponsoring or speaking at the following upcoming events:

Real Deals UK Mid-Market

February 6, 2013 (London)

Proskauer Breakfast Seminar: Back to the Future – Proskauer's Review of 2012 and Our Predictions for 2013 for Private Funds

February 13, 2013 (London)

Please contact PIF@Proskauer.com to register. Note that space is limited.

Proskauer AIFMD Webinar Series

- Understanding the European Alternative Investment Fund Managers Directive: Non-EU Managers of Venture Capital, Private Equity and Hedge Funds February 21, 2013

Please contact PIF@Proskauer.com to register.

Proskauer Seminar & Cocktails: Hot Topics for Insurance and Private Investment Firms: A Panel Discussion among Legal and Insurance Experts

March 5, 2013 (New York)

Please contact PIF@Proskauer.com to register.

The Women's Private Equity Summit

March 14-15, 2013 (Half Moon Bay, CA)

EVCA's Certificate in Institutional Private Equity Investing Program

April 15-18, 2013 (Oxford, United Kingdom)

Regulatory Compliance Association Spring Symposium: Regulation, Operations & Compliance

April 18, 2013 (New York)

NVCA VentureScape

May 14-15, 2013 (San Francisco)

Publications

Proskauer recently worked with The PEI Media Group Ltd. to publish a new book on limited partnership agreements, featuring contributions from 17 Proskauer corporate and tax lawyers in the firm's Private Investment Funds Group in Boston, London and New York. The book – *The LPA Anatomised*– is a first-of-its kind publication, addressing the needs of general partners, limited partners, placement agents, lawyers, fund administrators, accountants and tax advisers. Edited by Proskauer London Partner Nigel van Zyl, the book explores the complexities of limited partnership agreements and analyzes key fund terms in private equity, identifies their purpose and explores critical negotiating points.

* * *

[1] See our prior client alert at http://www.proskauer.com/publications/client-alert/sec-adopts-large-trader-reporting-requirement/.

[2] See our prior client alert at http://www.proskauer.com/publications/client-alert/new-us-treasury-form-slt-applicable-to-investment-advisers/. Other Treasury and Bureau of Economic Analysis forms may be required, but generally only if notice is received from the relevant agency.

[3] See our prior client alert at http://www.proskauer.com/publications/client-alert/sec-adopts-private-fund-risk-reporting/.

[4] Hedge fund advisers managing at least $5 billion in gross AUM were required to begin quarterly reporting within 60 days after the end of their first fiscal quarter to end after 6/15/12.

[5] Private liquidity fund advisers managing at least $5 billion in gross AUM were required to begin quarterly reporting within 15 days after the end of their first fiscal quarter to end after 6/15/12.

[6] Private equity fund advisers with at least $5 billion in gross AUM were required to begin annual reporting within 120 days after the end of their first fiscal year to end after 6/15/12.

[7] At the same time, however, the SEC stated that funds whose organizational documents failed to expressly prohibit short sale activities could still avoid being classified as hedge funds so long as the fund did not engage in such activities and a reasonable investor would understand that, based on the fund's offering documents, the fund would not engage in such activities.

[8] Note that since Form PF only applies to registered investment advisers, this interpretive position will not impact venture capital firms that are exempt from registration because their business is limited solely to advising qualified "venture capital funds" under Rule 203(l)-1.

[9] Like the definition of a "liquidity fund," the definition of a "venture capital fund" is not mutually exclusive from the definition of a "hedge fund," and, as noted above, the SEC has advised that a venture capital fund that also falls within the definition of a hedge fund must be treated as a hedge fund for Form PF reporting purposes. In contrast, the definitions of "private equity fund," "real estate fund" or "other private fund," are, by their terms, mutually exclusive from the definition of a hedge fund. As such, for Form PF reporting purposes, a private fund cannot be treated as both a hedge fund and a private equity fund, real estate fund or other private fund.

[10] A related person will only be considered to be "separately operated" if (i) the Reporting Adviser has no business dealings with the related person in connection with the advisory services the Reporting Adviser provides to its clients, (ii) the Reporting Adviser does not conduct shared operations with the related person, (iii) the Reporting Adviser and the related person do not refer clients or business to each other, (iv) the Reporting Adviser and the related person do not share personnel with each other, and (v) the Reporting Adviser has no reason to believe that its relationship with the related person otherwise creates a conflict of interest with its clients.

[11] A "dependent managed parallel account" is defined as any managed account or other pool of assets managed by the applicable Reporting Adviser that pursues substantially the same investment objective and strategy, and invests side-by-side in substantially the same positions as the identified private fund (other than a managed parallel account or group of accounts whose gross value is greater than the identified private fund or group of parallel private funds). According to the SEC, this exception for managed parallel accounts whose value exceeds the value of the referenced private funds is intended to prevent an adviser with a relatively small amount of private fund assets from becoming subject to the reporting requirements under Form PF simply because it manages a large number of separate accounts that pursue the same investment strategy as the adviser's private fund(s).

[12] The FCPA does not expand the circumstances under which successor liability will apply. As the Resource Guide notes, "[s]uccessor liability is an integral component of corporate law. Successor liability applies to all kinds of civil and criminal liabilities, and FCPA violations are no exception. Whether successor liability applies to a particular corporate transaction depends on the facts and the applicable state, federal, and foreign law."

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