SEWARD & KISSEL LLP

PRIVATE EQUITY FUNDS REPORT

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This newsletter highlights selected key developments in US securities laws and regulations and other developments affecting private equity sponsors and their funds. If you know of anyone who may be interested in receiving this newsletter, please notify Royce Akiva (akiva@sewkis.com).

I. SEC Registration Requirement for Private Equity Fund Advisers

A. Overview.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") imposes new Securities and Exchange Commission ("SEC") registration requirements under the Investment Advisers Act of 1940, as amended (the "Advisers Act") that generally will require most advisers to private equity funds ("PE Sponsors") with over $150 million in total AUM to register with the SEC as investment advisers. As of the printing of this newsletter, July 21, 2011 is the registration deadline, however, the SEC has indicated that it may extend such date to the first quarter 2012.

B. The Big Picture: What Registration Means in Practice.

The paperwork to be completed as part of the registration application under the SEC's Form ADV is fairly extensive and an adviser should budget at least a month to complete and file the Form ADV. The SEC has 45 days to approve the registration once the Form ADV has been filed. During the pre-filing period, the PE Sponsor should also (if it hasn't already done so) run background checks on all employees who will be covered in the Form ADV.

PE Sponsors must also realize that registration means more than completing the required paperwork and submitting to periodic SEC exams. PE Sponsors need to make sure that they are getting ready to operate their business in a regulated environment.

Perhaps most significantly, PE Sponsors registering with the SEC will need to (i) adopt and implement written compliance policies and procedures designed to detect and prevent violations of the Advisers Act, (ii) review these policies and procedures at least annually, and (iii) designate a chief compliance officer ("CCO") to implement, maintain, administer and test the compliance policies and procedures. These procedures must be finalized by the time the SEC approves the Form ADV registration application. A registered PE Sponsor's compliance manual should address, among other areas:

- Portfolio management processes (e.g., allocation of investment opportunities among clients and adherence to established portfolio guidelines as applicable).
- Proprietary trading of the adviser and personal trading of its employees.
- Accuracy of disclosure to clients (including advertisements).
- Safeguarding client assets from conversion or inappropriate use by advisory personnel.
- Accurate creation and appropriate maintenance of required records.
- Procedures to value client holdings and assess fees.
- Trading practices (e.g., best execution, soft dollars and allocation of aggregated trades as applicable).
- Safeguards for the protection of client records and information.
- Business continuity plans.
- Political contributions.

Many PE Sponsors currently address at least some of the compliance program elements in their current business

practices. However, in most cases, these policies and procedures are less formal than those the SEC would expect and often deviate from the specific substantive requirements that the SEC has promulgated for registered advisers. Moreover, some PE Sponsors will want to conduct mock audits in anticipation of registration and the regulatory oversight that comes with it.

C. Key Compliance Areas for PE Sponsors to Consider.

Highlighted below are a number of key areas that PE Sponsors will need to review and consider in connection with the registration process and establishing their compliance programs.

Carried Interest

The Advisers Act generally prohibits registered advisers from charging investors advisory fees based on a share of the capital gains or appreciation of the investor's assets (i.e., taking a "carried interest"). The Advisers Act contains exceptions from this prohibition for "Qualified Clients" as defined in the Advisers Act (generally investors who have a net worth exceeding $1.5 million, or who, with certain exceptions, are "Qualified Purchasers" within the meaning of Section 2(a)(51) of the Investment Company Act of 1940, as amended) and investors that are not U.S. residents. PE Sponsors who have funds that permit investment by U.S. persons who are not "Qualified Purchasers" (i.e., Section 3(c)(1) funds) will need to confirm that all investors in these funds are "Qualified Clients" to the extent that they have not done so in the investor's original subscription agreement. It is unclear whether there will be a grandfathering of those who were clients of the adviser before its registration.

Trade Allocation

An adviser is a fiduciary and therefore must always serve the interests of its advisory clients (including fund investors). Based on this duty, the SEC expects advisers to treat all clients in an equitable manner with respect to its allocation of investment opportunities so that no one group of investors is disadvantaged. The typical standard is a "fair and equitable" allocation over time, subject to certain exceptions. PE Sponsors that manage multiple vehicles will need to have polices for allocating deal flow and exit opportunities.

Side Letters

In essence, side letters are documents outlining preferential terms offered to select investors, such as increased transparency, rights to co-invest, limits on default penalties, reduced fees or similar rights. While some side letter provisions, such as separately negotiated fees, are generally viewed as innocuous, others, such as those limiting the penalties in the event the investor defaults on its capital commitment, may raise concerns. The SEC expects advisers to provide disclosure to clients regarding such arrangements, and in some cases could view the preferential treatment as inconsistent with the adviser's fiduciary duty.

Performance Advertising

The term "advertisement" is broadly defined to include any communication that offers an advisory service to more than one person. This definition may encompass statements made on websites or in connection with social media. Under the antifraud provisions of the Advisers Act, the SEC regulates the content of marketing materials and, in particular, the presentation of performance results by advisers. PE Sponsors will need to review their offering documents and other marketing materials to ensure that their presentations comply with SEC guidelines. Important points to note are:

- The SEC generally prohibits testimonials, "cherry-picking" (i.e., showing some but not all investments made or accounts managed) and false or misleading statements — the latter ultimately being a question of the particular facts and circumstances involved.
- Performance, as a general matter, must be shown net of all fees and carried interests. Under certain conditions, gross performance figures are permissible in one-on-one presentations. Those provisions are very fact-specific, however, and it's critical to refer back to the relevant SEC guidance.
- Following registration, advisers must retain all performance reports and supporting documents for

the entire measuring period portrayed for at least five years from when the reports were last used.

Code of Ethics

Registered advisers must also adopt and enforce a Code of Ethics as part of their compliance program. The Code of Ethics must, among other things, address personal trading and require the reporting of personal holdings by employees. While the rule is fairly broad and provides a fair degree of latitude, it does require that advisers adopt certain procedures to promote and enforce ethical behavior. Note that under the Advisers Act, a "covered person" may not acquire any beneficial ownership in any securities through a private placement of securities or investment opportunity of limited availability, unless the CCO has given express prior written approval.

Custody of Assets

Under the Advisers Act, assets generally must be properly custodied with a "qualified custodian" and account statements are required to be sent to clients. In addition, advisers may be required to undergo annual surprise exams of client assets by an independent public accountant. PE Sponsors should review the exceptions afforded in the case of certain privately offered securities held by their funds and with respect to funds that provide certain annual audited financials to investors within 120 days of each fiscal year end.

Political Contributions

The Advisers Act prohibits an adviser from receiving compensation for providing advisory services to a government pension (through a fund or otherwise) for two years following any contribution, other than certain de minimis contributions, made on or after March 14, 2011 by the adviser or its covered associates to an official of the government entity who is or will be in a position to influence the award of advisory business. In addition, an adviser is prohibited from coordinating, or soliciting others to make, on or after March 14, 2011, contributions for an official of a government entity to which the adviser is providing or seeking to provide advisory services. There are also "look-backs" in certain cases.

General Recordkeeping; E-mail Retention

The Advisers Act requires a registered adviser to make, maintain, and preserve certain books and records covering its own activities. The SEC staff has made clear that an adviser must retain all records, including e-mails and instant messages containing information or communications covered by such requirements. Although the e-mail retention obligation strictly applies only to e-mails that include information the adviser must otherwise retain under the Advisers Act, the SEC frequently requests prompt production of either all firm e-mails for a certain time period or all e-mails to or from certain individuals. The challenge is then how to identify and retain only those e-mails containing required information. Moreover, instant messaging, personal e-mail addresses and social network communications would also be subject to retention to the extent they include information the adviser must otherwise retain under the Advisers Act. In general, PE Sponsors should take steps to adopt an electronic communications policy to address the various issues that can arise in this context.

D. Conclusion.

In sum, becoming an SEC-registered investment adviser requires significant preparation and an extensive commitment of time and resources; however, it is a challenge that can be dealt with through proper planning and ongoing execution.

Further, we note that additional regulatory changes for PE Sponsors remain a possibility. In particular, recent legislative proposals have been offered that would exempt most PE Sponsors from the new registration requirements.[1] While it remains too early to predict the ultimate outcome of such proposals, there is a strong lobbying push underway to make this change.

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[1] On March 16, 2011, the Capital Markets Subcommittee of the House Financial Services Committee held hearings on draft legislation that would exempt advisers to private equity funds from the Dodd-Frank Act registration requirements. Information pertaining to the hearing is available on the Financial Services Committee website at: http://financialservices.house.gov/News/DocumentSingle.aspx?DocumentID=239799

II. The Volcker Rule

A. Overview.

Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule," regulates the proprietary trading activities of certain banking entities and non-bank financial companies and their relationships with private equity and hedge funds. Specifically, the Volcker Rule generally prohibits covered entities from engaging in proprietary trading, as well as sponsoring or investing in private equity and hedge funds. Importantly, the Volcker Rule provides certain significant exceptions to these prohibitions, provided that, among other things, required capital and quantitative limits are not violated.

Banking Entities. The Volcker Rule prohibitions apply to "banking entities," which it defines as any insured depository institution, and any company that controls an insured depository institution or that is treated as a bank holding company for purposes of the International Banking Act of 1978, as amended. All subsidiaries and affiliates of banking entities are also subject to the Volcker Rule.

Private Equity Fund/Hedge Fund. The terms "private equity fund" and "hedge fund" are generally defined to mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940, as amended, but for the exclusions contained in Sections 3(c)(1) and 3(c)(7) of that Act. The appropriate federal banking agencies, the SEC and the Commodity Futures Trading Commission also have the authority to issue regulations identifying other types of funds that will be included within the definition of private equity fund or hedge fund.

B. General Prohibitions Relating to Private Equity Funds.

The Volcker Rule prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, any private equity fund, subject to certain exceptions and a transition period. The prohibitions against sponsoring a fund will prevent a bank entity from serving as a general partner, managing partner, or trustee of a fund, or selecting or controlling a majority of directors, trustees or management of a fund. Additionally, a banking entity cannot share the same name, or a variation of the same name, with a fund for marketing, promotional or other purposes. However, these basic prohibitions are subject to certain exceptions designated as "permitted activities."

C. Permitted Activities.

The Volcker Rule will permit a banking entity to organize and offer a private equity fund, provided that certain conditions specified in the rule are met. In addition, these activities may be subject to certain other limits and requirements that regulators will have the authority to impose.

In order for a banking entity to engage in the permitted activities with respect to private equity funds in the U.S., it must comply with all of the following conditions:

- The banking entity must provide bona fide investment advisory, trust or fiduciary services;
- The fund must be organized and offered only in connection with the advisory services, and even then only to customers of such advisory services;
- The banking entity cannot acquire an equity interest or ownership interest in the fund beyond a de minimis investment (see below);
- The banking entity must comply with certain limitations imposed on relationships with private equity funds;
- The banking entity must not guarantee performance of the private equity fund;
- The banking entity must not share the same name or a variation of the same name with the private equity fund;
- No director or employee of the banking entity, may hold an interest in the private equity fund; and
- The banking entity must provide adequate disclosure to prospective and actual investors.

De minimis Investments. In order to meet the de minimis investment standard, the banking entity's

investment in the private equity fund cannot exceed 3% of the total ownership interests of the fund beginning not later than one year after the private equity fund's establishment (which period may be extended up to two additional years upon application to and approval by an appropriate banking regulator). Additionally, the aggregate investments of the banking entity and its affiliates in private equity funds and hedge funds must be immaterial (as determined under rules to be adopted) and cannot exceed 3% of the banking entity's Tier 1 capital. The banking entity must also actively seek to have unaffiliated investors in the fund in order to reduce or dilute its investment.

Other Potential Limitations. In addition to these specific requirements, the Volcker Rule provides that no transaction, class of transactions or activity may be deemed to be a "permitted activity" if it would: (i) involve or result in a "material" conflict of interest, to be defined by rule, between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a "material" exposure to high risk assets or high risk trading strategies, to be defined by rule; (iii) pose a threat to the safety and soundness of such banking entity; or (iv) pose a threat to U.S. financial stability.

D. Implementation.

While the Volcker Rule sets forth the basic limitations on the private equity fund activities of banking entities, like much of the Dodd-Frank Act, many details must be implemented through rule making, studies, and further regulatory actions.

The Volcker Rule is being implemented in tiers. The Financial Stability Oversight Council has completed a multifaceted study regarding the implementation of the Volcker Rule and provided its recommendations regarding implementation that are to be used by the regulatory agencies in connection with their rulemaking. Within nine months of receiving the recommendations from the Financial Stability Oversight Council, the regulatory agencies must complete the rule making process. After the final rules are promulgated, banking entities will have two years to bring themselves into compliance with the Volcker Rule. The two year compliance grace period can be extended an additional three years, by way of one year increments upon application to and approval by an appropriate banking regulator.

III. 2010 – A Year of Varied Exits

A. Overview.

The 2008 financial crisis and the subsequent market collapse that continued throughout 2009 dramatically disrupted the life cycle of many private equity investment funds, making it extremely challenging for PE Sponsors to profitably realize value from their portfolio investments during that period. As a result, lengthened portfolio company holding periods became necessary both to enable the portfolio companies to weather the economic storm and to allow the PE Sponsors to wait for a recovery from the depressed market level of business valuations. In 2010, improved conditions in the equity capital, debt and M&A markets and the general business environment allowed many PE Sponsors to take action and proceed with exit transactions involving their portfolio companies. Limited partners of private equity funds were anxious to realize returns on their investments and pressured PE Sponsors to act, with additional motivation provided by the anticipated 2011 increase in capital gains tax rates (being that the two year extension of current tax rates was not settled until well into December 2010, the expectation of a tax rate increase impacted most 2010 business planning). PE Sponsors were once again able to engage in a wide variety of exit strategies, as strategic corporate acquirers had substantial available cash on their balance sheets to make acquisitions and secured and mezzanine lenders were again willing to provide debt financing. Other PE Sponsors were sitting on large sums of "dry powder" in the form of limited partner capital commitments available to invest in businesses that were rebounding with the improved economy. The capital markets were also favorable, with the "IPO window" opening to allow initial public offerings for some companies. Depending on market conditions during the course of the year, factors specific to the portfolio

businesses, and capital/debt structures of the portfolio companies to be disposed, PE Sponsors proceeded on all fronts to secure gains on their investments in 2010.

B. Discussion of Exit Strategies.

PE-Backed IPOs

When stock market multiples are strong and investors are receptive to new issuers, a portfolio company IPO can be a home run for the PE Sponsor. During parts of 2010, for portfolio companies in the right industries, the IPO exit strategy reemerged, led by the announcement of the largest private equity-backed IPO in history: Bain Capital and KKR's $4.6 billion IPO of hospital operator HCA. Other notable private equity-backed companies that completed or announced IPOs in 2010 included Toys"R"Us, Neilson, GNC Holdings, and AMC Entertainment. In some instances, the PE Sponsors were able to sell large portions of their equity position to the public; while in others, there was no secondary offering of PE Sponsor shares, but future liquidity was achieved through the public listing of the portfolio company's stock (and, in some cases, through the use of offering proceeds to reduce portfolio company debt burdens). Once a public market for a portfolio company's shares has developed, PE Sponsors have established means to subsequently complete their exit through registered secondary offerings, unregistered resales of shares under Rule 144 of the Securities Act of 1933, as amended, or in-kind distributions of the portfolio company's shares to the private equity fund's limited partners.

Secondary Buyouts

Another significant trend seen in 2010 was the secondary buyout transaction, whereby a private equity portfolio company is sold to a fund managed by another PE Sponsor. Unfavorable market conditions, which prevented PE Sponsors from making any new investments for a lengthy period, made many PE Sponsors eager to put their committed capital to work before the end of their fund's investment period. This eagerness to invest, combined with restored access to debt financing, made secondary buyouts an appealing alternative to other exit strategies, as bids from these new PE Sponsors with capital commitments they need to put to work in many cases resulted in higher purchase offers for auctioned portfolio companies than were made by strategic buyers. For instance, KRG Capital purchased Fort Deerborn from Genstar Capital for $520 million, which was financed with 60% debt and 40% equity and generated a 7.8 times return on Genstar's four year investment. Other secondary buyouts completed or announced publicly in 2010 included Welsh Carson's $600 million purchase of Smile Brands from funds managed by PE Sponsor Freeman Spogli, HarbourVest's injection of $300 million into five portfolio companies of Arcapita Bank, and KKR's $1.5 billion acquisition of Pets at Home from funds managed by Bridgeport Capital.

Dual Track Sales Processes

The uncertainty of the M&A and IPO markets in 2010 frequently led PE Sponsors seeking an exit transaction to employ a dual track sales process. To utilize that process, the PE Sponsor conducts an auction to sell the business while simultaneously making SEC filings and preparing for an IPO of the portfolio company. While burdensome, this dual track process allows the PE Sponsor to determine which exit strategy will yield a better valuation or other favorable outcome, and thus, the opportunity to act accordingly. This was particularly useful in 2010 because the IPO market was not a consistently favorable option throughout the year. In August 2010, a consortium of PE Sponsors led by Bruckman Rosser successfully sold LRI Holdings Inc., the parent company of Logan's Roadhouse Inc., to Kelso & Co. for an estimated eight times EBITDA, after pursuing a $200 million IPO and an auction. Similarly, Bridgeport Capital auctioned its portfolio company, Pets at Home, while simultaneously preparing it for a public offering. It ultimately sold the business to KKR for approximately $1.5 billion, producing an 8 times return for Bridgeport. The sale of Smile Brands by Freeman Spogli to Welsh Carson also came at the conclusion of Freeman Spogli's pursuit of an IPO of Smile Brands.

Dividend Recapitalizations

Dividend recapitalizations are another means PE Sponsors used to realize gains on portfolio investments without exiting. A wave of these transactions took place in

2010, fueled by the willingness of lenders and the high yield debt markets to allow companies to increase their leverage. Deals that occurred during tight debt markets resulted in equity-heavy capital structures and were natural candidates to be refinanced with more debt. The proceeds of the refinancing were then used to provide liquidity and returns to private equity investors through the declaration of portfolio company dividends. Standard & Poor's data for 2010 suggests there were at least sixty-six (66) private equity-sponsored dividend recapitalizations initiated through October 2010. Some of these deals occurred after the portfolio companies had unsuccessfully pursued auctions, IPOs or dual track exit strategies. There was also speculation that taking gains in 2010 through dividend recapitalizations was at least in part a result of the desire to beat the anticipated increase in capital gains tax rates. These factors pressed PE Sponsors to take advantage of the thawing credit markets and made dividend recapitalization one of the noteworthy developments of 2010. Some of the larger recapitalizations of 2010 included Dunkin Brands Inc., Getty Images Inc., and Petco Animal Supplies Inc.

C. What's Next for 2011?

Which strategies PE Sponsors will find most attractive to exit their portfolio companies in 2011 remains to be seen. Much speculation is focused on an expectation of a bigger volume of PE-backed portfolio company IPOs this year. Market conditions also seem primed for sales of businesses to cash-rich strategic corporate buyers. Surely, as was the case in 2010, PE Sponsors will continue to test the waters and proceed with the strategies that promise the biggest returns for their investors. In the wake of the bleak economic conditions of 2008-2009, it's certainly a relief that there are now options available to consider.

IV. Continued Evolution of the ILPA Principles

A. Overview.

In January 2011, the Institutional Limited Partners Association ("ILPA"), a not-for-profit organization serving the interests of institutional investors in private equity, issued Version 2.0 of its Private Equity Principles ("Version 2.0"). Version 2.0 clarifies and expands on ILPA's original September 2009 report entitled "Private Equity Principles" (the "Original Report"). ILPA issued Version 2.0 to further its goal of establishing a universal set of industry guidelines to more closely align the interests of PE Sponsors and their investors. The Original Report was divided into sections according to three basic principles: (i) Alignment of Interest; (ii) Governance; and (iii) Transparency. Each section outlined a series of best practices and recommended fund terms that ILPA believes will improve the private equity industry for the long-term benefit of all its participants.

Version 2.0 is organized according to the same three principles as the Original Report and reiterates many of the same recommended fund terms. Representing the preferred terms of significant limited partners, the Original Report understandably suggested significant terms that many PE Sponsors viewed as more favorable to limited partners than what they would consider industry standard.

Version 2.0 expands on the Original Report by incorporating feedback from PE Sponsors, limited partners and industry third parties in an effort to increase the Report's "focus, clarity and practicality." Version 2.0 further clarifies each of the three original guiding principles and expands on some of the best practices with respect to each. Version 2.0 also includes new appendices that outline best practices regarding financial reporting (including a Capital Call and Distribution Template, the first of several recommended Standardized Reporting Templates that ILPA is currently developing), and "carry

clawback" situations. In the future, ILPA expects to provide additional appendices in order to address similar topics as industry best practices continue to evolve.

B. Alignment of Interests.

Distribution/Waterfall

Version 2.0 generally follows the Original Report which outlined the following preferred terms with respect to the Carry/Waterfall as follows:

- "European-style" waterfall (i.e., full return of all-contributions-plus-preferred-return prior to payment of any carried interest).
- If using a "deal-by-deal" waterfall structure:
  - require carry escrow accounts with significant reserves (at least 30% of the carried interests).
  - unrealized investments should be valued at the lesser of cost or market.
  - Return of all realized cost for given investment with continuous makeup of partial impairments and write-offs, and return of all fees and expenses to date.
- Clawback liabilities, if any, should be determined and clearly disclosed to limited partners as of the end of every reporting period and should include disclosures accompanied by a plan by the general partner to resolve the clawback.
- Clawback amounts should be gross of taxes paid by the general partner and paid back within two years following recognition of the liability.

Version 2.0 underscores the importance of having defined mechanisms to ensure satisfaction of clawback obligations such as joint and several liability of individual general partner members or, alternatively, several liability coupled with a creditworthy guarantee of the entire clawback repayment from a substantial parent company, the PE Sponsor's principals, or some sub-group of such principals.

ILPA reversed course with respect to its position on general partner clawback taxation and now suggests that general partner clawbacks may be net of taxes actually paid by the general partner members (rather than taxes based on an assumed tax rate) taking into account the members' actual tax rates, loss carryforwards and carrybacks, the character of the fund income and state tax payments.

Additionally, ILPA no longer suggests disclosing clawback liabilities at the end of every reporting period and instead advises making such disclosures on an annual basis.

Management Fees and Expenses

The Original Report outlined the following preferred terms with respect to management fees and expenses:

- Management fees should be based on reasonable operating expenses and reasonable salaries to ensure that fees are not excessive.
- The management fee should encompass all normal operations including, at a minimum, overhead, staff compensation, travel, and other general administrative items as well as interactions with limited partners.
- Placement agent fees and costs arising from general partnership insurance should be borne entirely by the general partner.
- All transaction, monitoring, directory, advisory, and exit fees charged to portfolio companies by the general partner should accrue 100% to the benefit of the fund.

ILPA's guidance with respect to management fees and expenses remains largely unchanged in Version 2.0. ILPA continues to take the position that management fees should be based on reasonable operating expenses. Regarding expenses, while the Original Report recommended that general partnership insurance should be an expense borne entirely by the general partner, Version 2.0 is silent on this point. ILPA continues to advocate for fee income offsets and has expanded its recommendations to include fee offsets for any consideration charged by the general partner. Unlike the Original Report, however, which recommended a 100% offset to the benefit of the Fund, Version 2.0 makes no specific offset percentage recommendation.

Term of the Fund

The Original Report stated that extensions of the term of a Fund should be permitted in one year increments only.

Version 2.0 also provides that such extensions should be approved by a majority of the limited partners. Version 2.0 further clarifies that in the absence of limited partner consent, the general partner should fully liquidate the fund within one year following expiration of the fund term.

General Partner Commitment

The Original Report outlined the following preferred terms with respect to the general partner's capital commitment to a fund:

- The general partner should have a substantial equity interest in the fund to maintain a strong alignment of interest with the limited partners.
- A high percentage of the general partner's commitment should be in cash as opposed to being contributed through the waiver of management fees.
- Principals should be restricted from transferring their interest in the general partner in order to ensure alignment with the limited partners.

Version 2.0 expands on the recommendations regarding general partner commitments by suggesting that general partners not be allowed to co-invest in select underlying deals and instead should be required to maintain their equity interest through a pooled fund vehicle. Version 2.0 also provides that fees generated by an affiliate of the general partner should be reviewed and approved by a majority of the Limited Partner Advisory Committee (the "LPAC").

C. Governance.

No Fault Rights

Whereas the Original Report recommended a majority vote of the interest of the Limited Partners to exercise a "no fault" right to suspend or terminate the commitment period, Version 2.0 recommends a two thirds interest vote by the limited partners. Similarly, while the Original Report called for a three quarters in interest vote of the limited partners for a "no fault" right to remove the general partner or dissolve the fund, Version 2.0 suggests a two thirds in interest vote in each case.

Key Man Provisions

The Original Report outlined the following preferred terms with respect to Key Man Provisions:

- Automatic suspension of investment period, which will become permanent unless two thirds of limited partners in interest vote to re-instate the investment period within 180 days upon key man event or for cause.

While the Original Report suggested requiring a two thirds in interest vote to reinstate the investment period after a key man event is triggered or for cause (i.e., fraud, gross negligence), Version 2.0 recommends only a "defined super-majority" vote. Version 2.0 also notes that changes to key man provisions should be approved by a majority of the limited partners or the LPAC, a relaxed standard from the two thirds in interest vote recommended by the Original Report.

Amendments of the Fund's Documents

While the Original Report recommended that a super majority vote of the limited partners generally be required for all amendments to the fund's limited partnership agreement, Version 2.0 recommends that only a simple majority in interest should be required for most amendments to the partnership agreement, with supermajority votes or individual partner consents being recommended for special cases.

Limited Partner Givebacks

The Original Report proposed that a limited partner's obligation to return distributions to the Fund to satisfy its indemnification obligations be capped at a percentage of the partner's capital commitments. Version 2.0 contemplates an all-partner giveback to satisfy indemnification obligations subject to an aggregate cap of 25% of total capital commitments and a time limit of two years after the applicable distribution.

LPAC

Where the Original Report promoted standardization of LPAC practices to remedy the "lack of uniformity" of private equity funds, Version 2.0's LPAC proposals are intended "to provide a model" while acknowledging "that

one standard might not fit every situation." For example, while both the Original Report and Version 2.0 list a variety of specific situations where the LPAC should be consulted, the Version 2.0 list recommends that the LPAC provides for "an open forum for discussion of matters of interest and concern to the partnership" while recognizing that the LPAC's functions "may evolve." Finally, Version 2.0 appears to recognize that the interests of the fund and the interests of the LPAC may not be perfectly aligned by cautioning that each LPAC member should "consider whether they have any potential conflict of interest" and disclose actual conflicts to the other LPAC members.

D. Transparency.

Management and Other Fees

The Original Report stated that all fees generated by the general partner should be periodically disclosed and classified in each audited financial report and with each capital call and distribution notice.

Version 2.0 expands on the recommendations from the Original Report by suggesting that not only should all fees generated by the general partner be disclosed and classified in each audited financial report, but that the same also be true of all fees charged by an affiliate of the general partner.

Capital Calls and Distribution Notices

The Original Report outlined the following preferred terms with respect to Capital Calls and Distribution Notices:

- With each distribution, the general partner should disclose the exact amount of carry and provide build-up to carry calculation.
- General partners should provide greater detail on all capital calls (including percentages for each limited partner) and with respect to the calculation of management fees (including offsets).

Version 2.0 recommends that capital calls and distributions provide information consistent with ILPA's Standardized Reporting Format and also include estimates of quarterly projections on capital calls and distributions.

Financial Information

The Original Report outlined the following preferred terms with respect to Financial Information:

- Funds should provide annual reports within 75 days of year-end and quarterly reports within 45 days of the end of the quarter.

Version 2.0 adjusts the timeline for the delivery of annual reports to investors from 75 days after year end, as provided for in the Original Report, to 90 days after year end.

V. Update on Status of Carried Interest Tax Legislation

The most significant legislation introduced in 2010 that would have affected the taxation of PE Sponsors of private investment funds treated as partnerships for federal income tax purposes ("Funds") was the bill passed by the House of Representatives in May 2010 as part of the American Jobs and Closing Loopholes Tax Act of 2010, to revise the rules for taxing the "carried interest" derived by Fund Sponsors.[2] Notably, the House of Representatives had passed similar legislation in both 2007 and 2009.

Subject to a phase-in period beginning in 2011,[3] the House Bill would have (i) treated "carried interest" allocated

[2] Despite the fact that "carried interests" are received by PE Sponsors in consideration for their managerial and advisory services to the Fund, under current tax laws the income attributable to carried interests is characterized for tax purposes at the Fund level with the result that any portion of the "carried interest" that is long-term capital gain income at the Fund level could "flow-through" and be taxed to the Fund Sponsor with the same character.

[3] The House Bill would have phased in the new tax rules concerning carried interests at a blended rate. Until 2013, 50% of a PE Sponsor's carried interest would have been taxed as ordinary income and the remaining 50% taxed under current rules (i.e., as a "pass-through" of the character of the Fund's income determined at the Fund level). Beginning in 2013, 75% of carried interest would have been taxed under the House Bill as ordinary income and the remaining 25% would have been taxed under the current tax rules.

to a PE Sponsor as ordinary income subject to the maximum federal income tax rates, regardless of the tax character of the income derived by the Fund (e.g., capital gains, dividends, interest, rents, etc.) and as "self-employment income" subject to the additional "Medicare tax" (currently imposed at a rate of 2.9%), and (ii) taxed as ordinary income, rather than as capital gain, the gain derived by a PE Sponsor upon the direct or indirect sale of the PE Sponsor's equity interest in Funds unless such equity interest had identical terms to the equity interests held in the Fund by investors or non-service providers.

Following the passage of the House Bill by the House of Representatives in the summer of 2010, the Senate had considered several modified versions of the "carried interest" provisions of the House Bill (the "Senate Substitutes"), but did not pass a similar bill. The Senate Substitutes did not provide for a phase-in period with respect to the proposed change in the tax rules. Rather, the blended rate would have taxed 75% of the carried interest derived from assets held by a Fund for five years or less as ordinary income and taxed the remaining 25 % under the current tax rules. For assets held by a Fund for at least five years, the Senate Substitutes would have taxed 50% of the carried interest as ordinary income and the remaining 50% under the current rules.

Prior to the Congressional elections in November 2010, passage of the House Bill or the Senate Substitutes (or some modified version of these tax proposals) seemed very likely. However, with the elections resulting in the Republicans assuming control of the House of Representatives and increasing their representation in the Senate, no legislation relating to "carried interests" was enacted in 2010 and Congress ultimately enacted legislation retaining the current tax rate structure for the 2011 and 2012 taxable years. The prospects for the passage of any change to the taxation of carried interest currently are very uncertain. President Obama's budget for fiscal year 2012 (the "Budget Proposal") contains a new proposal to tax carried interest as ordinary income. Unlike the House Bill and the Senate Substitutes, the Budget Proposal would not provide any phase-in or blended rates and would immediately tax all carried interest as ordinary income. It currently seems unlikely that a Republican-controlled House of Representatives will support this proposal as Republicans have consistently rejected similar bills and proposals during the past few years. However, given significant budgetary concerns and increased focus on the country's deficits, it is likely that Congress will at some future time refocus on the taxation of carried interest.[4]

While it is likely that any future carried interest tax proposals will contain provisions similar to those contained in the House Bill or the Budget Proposal, many PE Sponsors have so far decided to forego any significant pro-active tax planning to address any changes in the taxation of carried interest until it becomes clearer regarding whether and when such legislation will be re-introduced in Congress and the terms of any such proposed legislation are defined.

VI. Impact of FATCA on Private Equity Funds

A. Introduction.

In March 2010, the Hiring Incentives to Restore Employment ("HIRE") Act was enacted to provide payroll tax breaks and general credits to incentivize businesses to hire unemployed workers. As an offset to the lost tax revenues relating to those benefits, the HIRE Act contained provisions designed to prevent offshore tax evasion by U.S. taxpayers by forcing certain types of non-U.S. entities ("Foreign Financial Institutions") to disclose certain identifying information about their "United States accounts" or be subject to a new 30% United States withholding tax on "withholdable payments." These provisions, collectively known as the Foreign Account Tax Compliance Act or FATCA, are designed to prevent tax

[4] In this regard, it is interesting to note that the Budget Proposal estimated that its proposed change in the taxation of carried interest would raise $10 billion of additional revenues for 2012 through 2016 and an estimated $14.8 billion of additional reserves through 2021.

evasion by U.S. persons through the use of offshore financial accounts and offshore entities. Unless the IRS exercises its discretionary authority to modify the applicability of the FATCA requirements for private equity funds, FATCA will have a significant compliance impact on private equity funds organized both within and outside of the U.S.

For FATCA purposes, a Foreign Financial Institution (an "FFI") includes a foreign entity engaged primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest (including a futures or forward contract or option) in such assets.[5] A private equity fund formed under the laws of a jurisdiction other than the U.S. clearly constitutes an FFI and foreign "feeder funds" of U.S. private equity funds, non-U.S. "parallel funds" and foreign "alternative investment vehicles" of U.S. investment funds should also constitute "FFIs." Each of these foreign entities are collectively referred to herein as a "Foreign Fund."

For FATCA purposes, a "withholdable payment" means U.S. source income including, but not limited to, interest, dividends, rents and, significantly, the gross proceeds from the sale or other disposition of property that could produce U.S. source interest or dividends (e.g., stock of a "U.S. corporation") and the gross proceeds from the repayment of debt. Therefore, if an FFI fails to satisfy the FATCA reporting requirements, a 30% withholding tax would be imposed on the entire amount of the gross proceeds derived by the FFI from the sale of the stock of a U.S. corporation. It should be noted that otherwise applicable income tax treaty provisions will not reduce or eliminate the obligation of a U.S. person to withhold tax on "withholdable payments" to an FFI. An FFI entitled to the benefits of a tax treaty will need to either file a refund claim with the Internal Revenue Service (the "IRS") or claim a credit against federal income taxes otherwise payable by the FFI. An FFI that is organized in a non-treaty foreign jurisdiction is expressly not permitted any credits or refunds of withheld FATCA payments.

For FATCA purposes, a "United States account" includes any financial account held by one or more "specified United States persons" or a foreign entity that has "substantial U.S. owners" (i.e., specified United States persons that own directly or indirectly, more than 10% of the equity of the foreign entity)[6] (a "U.S. Owned Foreign Entity"). A "specified United States person" means any U.S. person other than publicly-traded corporations, banks, tax-exempt organizations, individual retirement accounts, federal, state and local governments, REITs, RICs and common trust funds.

The provisions of FATCA concerning FFIs generally are applied to withholdable payments made after December 31, 2012. However, a special "grandfathering rule" exempts payments made under "obligations" that are outstanding before March 18, 2012 and any gross proceeds received after that date resulting from the dispositions of such obligations.

B. Operation of FATCA.

The operative provisions of FATCA require a "withholding agent"[7] to deduct and withhold a tax equal to 30% on any withholdable payment to an FFI if the FFI does not satisfy certain reporting requirements. An FFI will not be subject to this withholding tax if it enters into an agreement with the IRS (an "FFI Agreement") whereby the FFI agrees to:

[5] An FFI includes virtually all foreign investment vehicles regardless of whether they are offered or traded publicly and there is no de minimis rule for such vehicles measured in any manner (e.g., gross or net assets or number of owners).

[6] For foreign corporations, "substantial" means more than 10% of either the vote as value of its stock and for a foreign partnership, more than 10% of either its profits or capital interests. However, in the case of a foreign entity that is an investment vehicle, ownership of any interest in such entity by a U.S. person is treated as "substantial."

[7] Withholding agents include any person who has control or custody of a "withholdable payment." Prime brokers, in particular will need to implement compliance programs to determine whether FFIs have entered into an FFI Agreement (as defined below).

- Obtain information from each holder of each account maintained by an FFI to determine which accounts are "United States accounts;"
- Comply with any IRS-mandated verification and due diligence procedures designated to identify United States accounts;
- Report annually to the Treasury certain identifying information regarding its United States accounts;
- Deduct and withhold 30% from any withholdable payments made to either other FFIs that are not compliant with the FATCA reporting requirements or to a "recalcitrant" account holder (i.e., an account holder that fails to comply with reasonable requests for information from the FFI to determine if the account is associated with a U.S. taxpayer);
- Comply with requests by the IRS for additional information relating to its United States accounts; and
- Attempt to obtain a waiver of any foreign law that would otherwise prohibit the FFI from disclosing the above-described information regarding any United States accounts and to close the account if such a waiver is not obtained from an account holder within a reasonable period of time.

An FFI that is a member of an affiliated group and that does not itself enter into its own FFI Agreement must comply with an FFI Agreement entered into by another member of the group. A "non-contracting" member is therefore not excused from FATCA's reporting requirements and can cause a compliance failure for the affiliated group.

The IRS is authorized to issue guidance under which an FFI may be deemed to enter into an FFI Agreement if (i) the FFI complies with IRS procedures to ensure that the FFI does not maintain United States accounts and meets certain other requirements prescribed with respect to accounts of other FFIs, or (ii) the FFI is a member of a class of institutions which the IRS has determined poses a low risk of taxation. In this regard, in November 2010, the Managed Funds Association has requested that the IRS consider exempting foreign funds from the requirement of entering into an FFI Agreement because of their satisfaction of the above-described requirements. The IRS has not yet responded to this request.

Under a separate but related provision of FATCA, a 30% withholding tax is imposed on any withholdable payment made to a non-financial foreign entity (an "NFFE") if the beneficial owner of the NFFE does not provide the withholding agent with either a certification that the NFFE does not have a "substantial U.S. owner" or provides the withholding agent with the name, address and taxpayer identification number of each substantial U.S. owner. As with respect to FFIs, U.S. individuals and privately-held U.S. taxable entities will be subject to information reporting by NFFEs, while U.S. tax-exempt entities, publicly-held corporations and other regulated entities will be excluded.

C. Preliminary IRS Guidance.

Implementation of FATCA will require detailed and comprehensive guidance issued by the IRS regarding the many compliance provisions of the legislation. While FATCA's withholding and reporting provisions relating to FFIs do not become effective until 2013, last year the IRS issued a Notice (Notice 2010-60) (the "First Notice") in an effort to provide all parties affected by these provisions with preliminary guidance regarding such implementation. The major topics addressed in the First Notice are (i) the definition of an FFI, (ii) a description of the compliance obligations for FFIs and NFFEs, including detailed procedures for gathering information and identifying United States accounts, and (iii) the "grandfather rule," exempting obligations issued prior to March 18, 2012 from potential withholding under FATCA. The Notice states that the Treasury Department and the IRS intend to issue proposed regulations based upon the framework and the special guidance contained in the First Notice.

On April 8, 2011, the IRS issued a second Notice (Notice 2011-34) (the "Second Notice") providing further guidance on priority issues regarding the implementation of FATCA. The Second Notice supplements the First Notice and responds to concerns identified by commentators following its publication.

The Second Notice provides guidance on, among other issues, (i) the procedures to be followed by participating FFIs in identifying United States Accounts among their preexisting individual accounts, (ii) certain categories of FFIs that will be deemed to have entered into FFI Agreements, and (iii) the obligation of participating FFIs to report with respect to United States Accounts. The Second Notice provides that FFI Agreements will become effective on the later of (i) the effective date of FATCA, or (ii) the date they are executed. As with respect to the First Notice, the Treasury Department and the IRS intend to issue Treasury Regulations incorporating the guidance described in the Second Notice.

D. Complying with FATCA.

Disclosure Requirements by Foreign Funds

A private equity fund structured as a U.S. limited partnership that has either an FFI or an NFFE as a limited partner will be a withholding agent under FATCA with respect to any U.S. source income it derives that is allocable to such foreign partner. In order to avoid FATCA withholding, an FFI limited partner must enter into, and comply with, an FFI Agreement and a NFFE should certify to the private equity fund regarding its "substantial U.S. owners." A private equity fund organized under foreign law is itself an FFI and will be subject to FATCA withholding if it has not entered into, and complies with, an FFI Agreement. Further, if a controlling ownership interest in such Foreign Fund is owned by a foreign corporate "feeder fund," then the "feeder fund" and the Foreign Fund will comprise an affiliated group and the "feeder fund" will also need to comply with an FFI Agreement to avoid FATCA withholding.

A Foreign Fund will have to make detailed factual determinations in order to comply with the FFI Agreement requirements. In order to ensure that a Foreign Fund can enter into and comply with an FFI Agreement, such funds should consider requiring their investors to provide any information ultimately required by future evidence to be disclosed to the IRS. With respect to Foreign Funds that are now being formed, consideration should be given to adding additional provisions in the Foreign Fund's governing documents and/or subscription agreements that will enable the Foreign Fund to obtain the required information from its investors and to implement appropriate procedures if an investor fails to provide the Foreign Fund with such information. Already existing Foreign Funds should review their governing documents to determine their ability to obtain the requisite information from their investors. Further, Foreign Funds should make sure that their governing documents permit special allocations of any FATCA withholding imposed on the Foreign Fund to its "recalcitrant account holders."

While additional significant guidance with respect to the operation of FATCA will be forthcoming from the IRS, private equity fund sponsors should immediately begin the process of reviewing their organizational structure, including its U.S. funds, Foreign Funds and portfolio and holding companies, to assess the impact of FATCA to both foreign investors and U.S. entities and be prepared to implement systems, procedures and investor communications in response to such guidance.

Payments to FFIs or NFFEs Under Credit Agreements

Payments under credit agreements involving U.S. borrowers and foreign lenders will require additional certification and information from the lenders in order to avoid the imposition of the new FATCA withholding tax on interest and principal payments. The issue applies principally to U.S. portfolio companies of private equity funds that borrow funds from a Foreign Fund or unrelated foreign lenders. Since U.S. loan documentation often includes a U.S. withholding tax "gross up" designed to ensure that a lender receives the same amount net of withholding taxes as the gross amount if no withholding taxes had been imposed, Foreign Funds that are lenders should ensure that any such "gross up" payments exclude FATCA withholding taxes.

As noted above, "obligations" outstanding before March 18, 2012 generally are exempt from the FATCA withholding tax provisions. The Notice provides that

forthcoming Treasury regulations will provide that the term "obligations" for purposes of this grandfather exemption does not include any instrument treated as equity for federal income tax purposes or any legal agreement that does not have a definitive expiration or term. Further, any material modifications of an "obligation" outstanding on March 18, 2012 will cause the obligation to be treated as being reissued on the date of such modification with the result that the obligation will thereafter cease to be exempt from FATCA withholding taxes. We note that the Notice does not address the applicability of the "grandfather" exemption to revolving credit facilities.

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