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PIPE Transactions with Insurers and Other Financial Institutions: Understanding the Rules and Current Market Trends

by Paul L. Lee, Gregory V. Gooding, Alexander R. Cochran and Jeremy Rossman

The past eighteen months have seen a number of significant PIPE (private investment in public equity) transactions, many of which involved insurance companies and other financial institutions. Notable transactions involving insurers included Warburg Pincus's investment in MBIA, Berkshire Hathaway's investment in Swiss Re and Allianz's investment in Hartford Financial. In the banking sector, notable PIPE transactions have recently included TPG Capital's investment in Washington Mutual, Corsair's investment in National City Corp, Carlyle's investment in Boston Private Financial and Berkshire Hathaway's investment in Goldman Sachs.

The recent spate of PIPE deals involving financial institutions resulted from a number of factors, including unprecedented funding requirements of large financial institutions, a scarcity of other sources of capital and increasing private equity interest in financial sector investment opportunities. It seems likely that these factors will remain present in 2009 and perhaps beyond, and that we will continue to see large-scale PIPE transactions involving a broad array of financial institutions.

The structuring of PIPE transactions with insurers and other financial institutions involves a number of specialized state and federal regulatory considerations as well as numerous interrelated business, legal and tax issues. Key considerations include the following:

Regulatory Approval Requirements. Equity investments in insurance companies and other financial institutions often require specialized regulatory approvals. For U.S. insurance companies, although a PIPE investment will generally be made at the holding company level, regulatory approvals at the level of the insurance company subsidiaries will often be required from the applicable state insurance departments. Determining the required state insurance regulatory filings depends on a number of factors, including the state of domicile of the insurance company subsidiaries, the states in which the insurance company subsidiaries are licensed to do business and the amount and structure of the proposed equity investment.

An acquisition of 10% or more of an insurance holding company's voting stock will generally be considered a "change of control" transaction. Specific insurance regulatory filings that may be required for investments at or above this 10% threshold include:

- Prior approval of the change of control in the states of domicile of each of the insurance company subsidiaries (Form A approvals) and potentially other states where the insurance company subsidiaries are "commercially domiciled."
- If the investor owns or controls other insurance companies that write overlapping lines of business with the target insurance company subsidiaries, then depending on the combined market share of the investor and such target insurance company subsidiaries, prior notice to certain state insurance departments may be required so that the applicable insurance departments can review the implications of the investment on competition (Form E filings).
- A change of control filing in Texas for any insurance agency subsidiaries licensed in Texas.

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What's Inside

Letter from the Editor

During the second quarter of 2009, some financial institutions found themselves still attempting to gain their footing during a difficult economic time. Although between March 31 and June 30, 2009, the S&P 500 index increased over 15%, the unemployment rate was approximately 9.5% at the end of the same period according to the U.S. Bureau of Labor Statistics, higher than it had been for over 25 years. Amid these tumultuous times, legislators, regulators and others continued to work toward reforming the regulation of financial markets and financial institutions in the wake of the financial crisis.

Most notably, on June 17, 2009, the U.S. Department of Treasury released its white paper entitled "Financial Regulatory Reform: A New Foundation," which proposes sweeping changes to the regulation of all financial institutions, products and markets and will likely cause long-lasting changes. The implications of this white paper for the insurance industry are discussed in this issue of the *Debevoise & Plimpton Financial Institutions Report.*

In this issue we also discuss certain financial regulatory developments in the European Union, developments which are influenced by the changes in the world financial markets. We also explore the potential creation of new markets in the U.S. for renewable energy credits and carbon credits based on the American Clean Energy and Security Act of 2009, which was passed by the U.S. House of Representatives in June 2009.

Because of the sizeable funding requirements of large financial institutions combined with the recent tumult in the financial markets, there also have been a number of PIPE (private investment in public equity) investments in financial institutions in recent months. In the first article in this issue we discuss various issues to be considered in connection with PIPE transactions involving insurance companies and other financial institutions.

As always, we will continue to monitor and report on these and other developments in the *Debevoise & Plimpton Financial Institutions Report* and in Client Updates.

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The Financial Crisis: Implications for U.S. Insurance Regulatory Reform

by Wolcott B. Dunham, Jr., Thomas M. Kelly, John Dembeck and Amit Kataria

On June 17, 2009, President Obama announced his administration's proposals for financial regulatory reform, and the U.S. Department of the Treasury released a comprehensive white paper, entitled "Financial Regulatory Reform: A New Foundation" (the "White Paper"). The White Paper outlines the Obama administration's proposals to reform the ways financial firms, markets, products and services are regulated in the United States, including certain proposed reforms that would directly impact the U.S. insurance industry. While insurance has been regulated by the states since the very inception of insurance regulation in the mid-nineteenth century, there have been intermittent proposals for federal regulation with varied contours, and the current financial crisis has caused a renewed call for changes in the regulation of the U.S. insurance industry. While the White Paper devotes only a small amount of text specifically to the insurance industry, the implications of the proposed reforms for the insurance industry generally are profound. Significantly, while, the White Paper mentions an "optional federal charter" ("OFC") for U.S. insurers, it does not propose it as a component of financial regulatory reform.

This article discusses aspects of the White Paper impacting the insurance industry, focusing on the White Paper in the context of current challenges facing insurance regulation and recent Congressional reform proposals.

President Obama's Proposals for Financial Regulatory Reform

As the title suggests, the White Paper is intended to lay the foundation for significant change in the way that financial firms, markets, products and services are regulated in the United States. The White Paper sets forth five key objectives for financial regulatory reform that affect the U.S. insurance industry: (1) promoting robust supervision and regulation of financial firms; (2) protecting consumers and investors from financial abuse; (3) providing the government with the tools it needs to manage financial crises; (4) regulating over-the-counter derivatives, including credit default swaps; and (5) raising international regulatory standards and improving international cooperation.

Supervision and Regulation of Financial Firms

Insurers are within the scope of the White Paper's proposed legislative reforms relating to supervision and regulation of financial firms. Key aspects of these proposed reforms include the following:

- Introduction of the concept of Tier 1 Financial Holding Companies ("Tier 1 FHCs"), which could include insurance holding companies and insurers (such as mutual life insurers). A Tier 1 FHC is defined in the White Paper as any financial firm whose combination of size, leverage and interconnectedness could pose a threat to financial stability if it failed, regardless of whether it owns an insured depository institution.
- Creation of a new Financial Services Oversight Council ("Council"), which would assist in identifying Tier 1 FHCs and setting material prudential standards for Tier 1 FHCs.
- Expansion of the role of the Federal Reserve as setter of prudential standards for Tier 1 FHCs, as final arbiter of what entities will qualify as Tier 1 FHCs and as regulator and supervisor of Tier 1 FHCs and of thrift holding companies that would become regulated as bank holding companies ("BHCs").
- Consolidation of the supervision of federally chartered banking institutions in a new National Bank Supervisor and elimination of the federal thrift charter.
- Creation of a new Office of National Insurance in the Treasury.
- Creation of a new federal agency, the Consumer Financial Protection Agency dedicated to protecting consumers in the financial products and services markets.

New Office of National Insurance

The White Paper recommends that an office in the Treasury be established called the "Office of National Insurance" ("ONI"). Among the functions of the ONI would be the following: (1) monitor all aspects of the insurance industry; (2) gather information and identify the emergence of any problems or gaps in regulation that could contribute to a future crisis; (3) recommend to the Federal Reserve any insurers that the ONI believes should be supervised as Tier 1 FHCs; and (4) assume Treasury's responsibilities under the Terrorism Risk Insurance Act. In addition, the ONI would be authorized to work with other nations and the International Association of Insurance Supervisors to better represent American interests and have authority to enter into international agreements and increase cooperation on insurance regulation.

The Council would not specifically include a representative of the ONI but it would be chaired by the Secretary of the Treasury, in whose department the ONI would be located. Furthermore, the ONI would not

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have a direct role in identifying insurers that are Tier 1 FHCs – it would make recommendations on this subject to the Federal Reserve which would make that decision. Lastly, if a failing firm includes an insurer, the ONI would not have a direct role in the resolution of the failing firm, but would provide consultation to the Federal Reserve and Federal Deposit Insurance Corporation ("FDIC") boards on insurance specific matters.

Other Potential Implications for Insurance Holding Companies and Insurers

In addition to information requests from the ONI, insurance holding companies and insurers may be subject to the following increased burdens if the White Paper recommendations are implemented:

- Those whose failure would pose a threat to financial stability would become Tier 1 FHCs subject to direct regulation and supervision by the Federal Reserve. Both the Tier 1 FHC holding company and its operating companies would be subject to regular reporting to and examination by the Federal Reserve. Furthermore, an operating company may be subject to more stringent prudential standards imposed by the Federal Reserve than by its primary regulator. Insurance holding companies and insurers that are identified as Tier 1 FHCs would be subject to restrictions on non-financial activities (with five years to conform).
- Both the holding company and operating companies that meet certain size thresholds would be subject to reporting to and examination by the Federal Reserve to help the Federal Reserve determine whether they would be designated Tier 1 FHCs.
- Insurance holding companies and insurers would be subject to information requests from the Council for purposes of monitoring emerging threats that activities in financial markets may pose to financial stability.
- Insurance holding companies that own thrifts would become BHCs (and Financial Holding Companies) and be subject to restrictions on non-financial activities (with five years to conform in the case of new BHCs and Financial Holding Companies).
- U.S. insurance regulation could change depending on the outcome of any treaty negotiations concluded by the ONI. One area of interest to some international reinsurers will be collateral requirements imposed by state law on reinsurance ceded to unauthorized reinsurers.

Current Challenges Facing U.S. Insurance Regulation and Other Recent Reform Proposals

As evidenced by the release of the White Paper, and other recent regulatory reform proposals, crisis conditions draw the attention of lawmakers to the regulatory framework in place and highlight the inefficiencies and weaknesses of the regulatory systems that exist even under normal conditions. These reform proposals, including President Obama's proposal, are best understood in the context of the challenges faced by the U.S. insurance industry and the distinct nature of its regulation.

Going back to the second half of the nineteenth century, a debate has raged over the degree to which uniformity in the regulation of the insurance industry is necessary or desirable. In many ways the challenges facing the insurance industry then remain unchanged today. Insurers wishing to do business in each U.S. state are required to seek licensing approval in every jurisdiction. Likewise, if an insurer wishes to introduce a new financial product it must seek approval from each state regulator and often faces inconsistent standards for approval of such a product which can result in state product variations. In addition, insurers must face market conduct and other examinations, routine administrative rules and regulatory requirements imposed by each separate jurisdiction. All these complications raise the cost of doing business, a cost which is often passed along to the consumer through higher insurance premiums.

At the same time, state insurance regulators face significant barriers in protecting against widespread systemic risks. As the severe financial troubles of American International Group have highlighted, state insurance regulators must deal with a sizeable gap in their authority as they lack the authority to regulate the financial soundness of the parent holding companies of insurers, and in any event may not possess the resources to intervene in the event of financial catastrophe at the holding company level. While banks have a pre-funded system of deposit insurance through the FDIC, with funding raised from banks, policy obligations of failed insurance companies by comparison are funded after the fact through state guaranty fund assessments imposed on solvent insurers.

The globalization of the financial world further complicates the regulatory burden placed on domestic and foreign insurers and regulators alike by adding even more regulatory schemes to the mix. Further to this point, with the absence of a federal insurance regulator of any kind, the United States is the only significant country unable to speak on insurance matters with a single, official voice in international forums.

The financial crisis presents challenges of such magnitude that the laws being proposed, including those proposed in the White Paper, address only certain pieces of the financial regulatory puzzle. With respect

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to insurance regulatory reform, the White Paper proposes federal regulation of insurance holding companies that are Tier 1 FHCs and the establishment of the ONI which, among other things, would coordinate with international insurance regulators. It would, however, leave the current state-based insurance regulatory framework, with its potential for duplicative regulation and lack of uniformity, largely intact.

Other recent legislative proposals have addressed different issues. The following briefly summarizes certain recent legislative proposals, addressing a variety of insurance regulatory issues. While certain of these proposals may change, or be withdrawn, in light of the White Paper or other developments, they provide historical context for both the White Paper and future legislative proposals by the Obama administration and others.

The National Insurance Act of 2007

The United States Senate Committee on Banking, Housing and Urban Affairs held two hearings in July 2006 on insurance regulation reform, where witnesses commented on S. 2509, the "National Insurance Act of 2006." For further consideration the bill was reintroduced as S. 40, the "National Insurance Act of 2007," on May 24, 2007, by Senators Sununu and Johnson (the "NIA"). The NIA was a comprehensive bill that would have authorized a federal regulator, for federally chartered insurers, to regulate federal standards in organization, licensing, financial, product and market regulation, reinsurance, corporate transactions, producers and holding company regulation.

Under the NIA, the federal regulator would have supervised nationally chartered insurers by handling examinations and enforcement actions and would be funded from insurers' assessments and fees. Subject to certain exceptions, a national insurer would not be subject to state insurance laws, while state chartered insurance companies would remain in the state system and not be subject to federal regulation. A state-chartered insurer would be permitted to opt for federal regulation and not be subject to state regulation. As a result, this type of legislation is often referred to as an OFC proposal. The NIA received strong support from industry organizations including the American Council of Life Insurers, the American Insurance Association, the American Bankers Insurance Association and the Council of Insurance Agents & Brokers.

In March 2008, the Treasury released its Blueprint for a Modernized Financial Regulatory Structure (the "Blueprint") in which it endorsed an OFC for insurers. The Blueprint marked the completion of a study began in early 2007, before sub-prime issues and other crises in the credit markets began making headlines. The Blueprint was the first instance in which an administration had supported full federal regulation since the presidency of Theodore Roosevelt. Among other things, the Blueprint specifically recommended that property/casualty insurers operating under a federal charter should not be subject to rate regulation, but that their rates should be governed by free competition. In its recommendation, the Treasury stated, "As a substitute for price controls, a federal regulatory structure should ensure that insurers are financially sound and that consumers are protected from misconduct by competing market participants."

The National Association of Registered Agents and Brokers Reform Act of 2008 and 2009

The "National Association of Registered Agents and Brokers Reform Act of 2008" (H.R. 5611) was designed to address state barriers to non-resident licensing by state insurance producers through the amendment of the Gramm-Leach-Bliley Act to reestablish the National Association of Registered Agents and Brokers as a nonprofit corporation (the "Association"). The primary objective of the Association was to provide a single regulator through which licensing, continuing education and other insurance producer qualification requirements and conditions can be adopted and applied on a multi-state basis, while preserving the right of states to regulate insurance producers and protect their consumers. It provided that Association membership would be the equivalent to a nonresident insurance producer license issued in any state where the member pays the licensing fee. In doing so it also attempted to preserve state consumer protection and market conduct regulation powers not inconsistent with the act. On May 21, 2009 a more recent version, the "National Association of Registered Agents and Brokers Reform Act of 2009" (H.R. 2554), was introduced before the 111th Congress. This version included changes to the manner in which Association board members were selected that appear to be designed to address possible Constitutional defects in the 2008 bill.

The Insurance Information Acts of 2008 and 2009

Another proposal for federal regulation of insurance is the "Insurance Information Act of 2008," introduced as H.R. 5840. The Act seeks to address two issues: (1) the lack of information concerning the United States insurance industry that is obtained by the federal government, and (2) the inability of the federal government to negotiate trade agreements with foreign countries in the face of inconsistent state insurance laws. The bill would establish an Office of Insurance Information ("OII") within the Treasury. The Treasury Secretary would serve as the principal advisor to the President and

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Congress on domestic and international policy issues regarding insurance, while the OII itself would be headed by a Director, within the Treasury. On May 21, 2009 a more recent version, the "Insurance Information Act of 2009" (H.R. 2609), was introduced before the 111th Congress seeking to establish an OII in the Treasury.

Resolution Authority for Systemically Significant Financial Companies Act of 2009

On March 25, 2009, Treasury Secretary Geithner called for new legislation granting the Treasury resolution authority to address systemically significant financial institutions. A draft bill was sent to Congress the same week entitled "Resolution Authority for Systemically Significant Financial Companies Act of 2009." Modeled on the statutory framework that governs the FDIC's exercise of emergency resolution authority with respect to banks, the legislation would authorize the federal government to intervene in order to avert the systemic risks posed by the potential insolvency of a significant financial firm. Citing a need to fill "a significant void in the current financial services regulatory structure," the Treasury proposal would grant the federal government the authority to act as conservator or receiver to sell or transfer the assets or liabilities of a distressed financial institution, to renegotiate or repudiate its contracts and to address any problematic derivatives portfolios.

With respect to insurance companies, the proposed bill would cover holding companies of insurance companies, but specifically excludes the subsidiary insurance companies themselves. The legislation is silent as to preemption of state law. However, in insolvency situations, action taken under this resolution authority would present conflicts with state insurance holding company laws as the states would continue to have authority over the insurance subsidiary of a distressed insurance holding company. If the federal government were to place such a financially significant holding company into conservatorship or receivership, the insurance subsidiary's state of domicile would be concerned about the disposition of the subsidiary or possibly its assets by the federal government. At a hearing on March 26, 2009, several House Financial Services Committee members expressed concern over the possibility that the Treasury's proposal would impair state regulatory authority over insurance.

The National Insurance Consumer Protection Act (2009)

Although OFC bills had been proposed several times prior to the financial crisis, the first such proposal to be introduced since its onset was a bill introduced by Representatives Melissa Bean and Ed Royce called the "National Insurance Consumer Protection Act" (the "Royce-Bean Bill"), introduced as H.R. 1880. Introduced in the House of Representatives on April 2, 2009, the Royce-Bean Bill would establish the ONI within the Treasury. It is similar to pre-financial crisis OFC proposals as it contemplates a National Insurance Commissioner, who would oversee the regulation and supervision of nationally-chartered insurers, as well as oversee the licensing, regulation, and supervision of national insurance producers. The Royce-Bean Bill also grants the National Insurance Commissioner enforcement powers similar to those of federal banking agencies, while allowing for insurers to be subject to examinations every two years. It incorporates the formation of a separate federal guaranty fund for federally regulated insurers, a concept which has been a consistent feature in federal regulatory proposals since the the mid-1960s.

Despite the Royce-Bean Bill's incorporation of older concepts as well as structural similarities with the NIA from 2007, the effect of the financial crisis on the drafting of the Royce-Bean Bill is evident. Several new provisions were added, and one such provision is the addition of a systemic risk regulator. This systemic risk regulator would coordinate with state and federal regulators and make "corrective action recommendations" to the National Insurance Commissioner or state regulator if it determines that certain activities "[are] having or would have, an effect which could result in serious adverse effects on economic conditions or financial stability."

For a detailed discussion of the White Paper's implications for the insurance industry, see our client update *Financial Regulatory Reform: Implications For The Insurance Industry*, dated June 18, 2009, available at www.debevoise.com. For a discussion of the implications of the White Paper for hedge funds, other private funds, futures and derivatives, see our client update *Financial Regulatory Reform: Implications For Hedge Funds And Alternative Investments*, dated June 19, 2009, available at www.debevoise.com. For a discussion of the implications of regulatory reform for private equity funds and advisors, see *What U.S. Regulatory Reform Could Mean for Private Equity*, in the Spring 2009 edition of the *Debevoise & Plimpton Private Equity Report*, available at www.debevoise.com.

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The systemic risk regulator would consult with the National Insurance Commissioner in determining which institutions were systemically important, and subsequently decide whether it should be required to be federally chartered.

Conclusion

As evidenced by the White Paper, regulatory supervision of all financial institutions is undergoing profound change in the United States. While we cannot know the shape supervision will ultimately take, it seems clear that we will see an increased federal role in the regulation of U.S. insurance companies and their holding companies. ■

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Renewal of the EU Insurance Block Exemption Regulation

by Victoria Bostock

The European Commission (the "Commission") is currently debating renewal of the Insurance Block Exemption Regulation (Regulation 358/2003 – OJ 2003 L53/8) (the "BER"), which authorizes certain types of cooperation agreements between insurance companies and provides a limited exemption from the prohibition on anti-competitive practices set forth in Article 81(1) of the Treaty establishing the European Community (the "EC Treaty").

The BER is an exemption regulation specifically implementing in the insurance sector the general exemption provided in Article 81(3) of the EC Treaty. Only a few industries currently benefit from such sector-specified exemption regulations, which have generally assisted in enhancing legal certainty and harmonising the application of EU law across member states.

The current BER replaced the previous exemption introduced in 1992 and will remain in force until 31 March 2010. The continuation of the BER in its current form has been left in some doubt following the Commission's *Business Insurance Sector Inquiry Report* (the "Inquiry Report") in September 2007 and the recent preliminary report presented by the Commission on 24 March 2009 (the "Report"), on whether to renew the BER.

The original aim of the BER was to prevent the need for notification and approval of certain standard industry agreements in order to obtain individual exemption. Since May 2004 and the entry into force of Regulation 1/2003, agreements that satisfy the conditions of Article 81(3) are not prohibited, without need for a prior decision to that effect. Undertakings now are obliged to assess themselves, examining the compatibility of their agreements with Article 81(1) and the applicability of Article 81(3).

The Commission has considered, in depth, the continued role and benefit of the BER. In the Inquiry Report, the Commission asked whether, given the new regime of self-assessment, an industry specific block exemption is necessary, particularly since the general horizontal guidelines and vertical block exemption apply to the insurance sector.

Existing Insurance Block Exemption

The BER grants an exemption to the following cooperation agreements:

1. joint calculations of the average cost of covering a specified risk, mortality tables, tables showing the frequency of illness, accident and invalidity, and the carrying-out of joint studies of the frequency or scale of future claims for given risks;
2. the joint establishment of non-binding standard policy conditions for direct insurance;
3. the joint establishment and management of insurance pools; and
4. the joint testing and acceptance of security devices.

The BER defines those classes of agreements that are exempted up to a certain level of market power and specifies those restrictions that will prevent the application of the block exemption. The BER makes clear that the exemption is only afforded provided that the cooperation does not go beyond what is justified by consumer interest and, in particular, does not concern policy cover, policy terms or premiums.

Joint calculations, tables and studies

Agreements between insurers relating to the exchange of statistical information and the joint calculation of risk premium tariffs are

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exempted under the BER. The Commission recognised that it is necessary that insurers have accurate information about the risks that they insure and therefore, cooperation is essential. The Commission considered that such collaboration would promote competition by assisting smaller insurers and facilitating market entry.

Joint establishment of standard policy conditions

The BER exempts the joint establishment and distribution of non-binding standard policy conditions for direct insurance and non-binding models on profits.

The Commission acknowledged that, in many cases, standard conditions can have positive effects for competition and consumers. However, the Commission was candid in its approach to this exemption by providing a long list of "black clauses" which could not be included.

Insurance pools

Cooperation agreements between insurance undertakings (co-insurance groups) and between insurance and reinsurance undertakings (co-reinsurance) to insure or reinsure a specific category of risk are covered by the block exemption, provided they meet certain conditions. The exemption is based on the premise that such pools may involve restrictions of competition and it is appropriate to lay down the circumstances under which such insurance pools can benefit from the exemption.

Risk-sharing for certain types of risk, such as nuclear and environmental, against which individual companies are reluctant to or unable to insure, is important in order to make sure that those risks do receive cover.

The BER subjects the exemption of pools to thresholds based on the parties' market shares. Pools will be authorised on condition that the combined market shares of their members do not exceed 20% for co-insurance pools and 25% for co-reinsurance pools.

The competition landscape has changed remarkably since the BER was last renewed in 2003. The Commission is going back to first principles in order to check closely what role the BER should play in this new landscape.

Security devices

Agreements between insurers that establish technical specifications and codes of practice in relation to safety equipment, are covered by the BER, as are agreements that establish technical specifications for the installation and maintenance of security devices. In addition, procedures for assessing and approving the compliance of security devices with such specifications are also incorporated. Nevertheless, all such agreements are subject to a number of conditions.

The BER brought the block exemption into line with the harmonised single market rules that apply to security devices. The Commission recognised that insurers have mutual interests in regards to cooperation on security devices since they vigorously seek ways to assist customers to reduce their exposures to insured risks.

Renewal of the block exemption

The Commission had an obligation to submit a Report to the European Parliament and Council on the functioning of the BER by 31 March 2009. Following the Commission's Inquiry Report, in September 2007, and the 2008 review of the insurance block exemption, the Commission has now submitted its Report and published its preliminary views on the renewal of the BER.

The Commission's analysis in the Report addressed three key questions, namely:

- whether the business risks or other issues in the insurance sector make it "special" and different from other sectors such that there is an enhanced need for cooperation amongst insurers;
- if so, whether this enhanced need for cooperation requires a legal instrument such as the block exemption to protect or facilitate it; and
- if so, what is the most appropriate legal instrument (i.e., whether it is the current block exemption or whether partial renewal, amended renewal, or guidance would be more appropriate).

The Commission's view at this stage is that agreements in relation to joint calculations, tables and studies, and insurance pools should continue to be covered by a block exemption. The Commission is not minded to renew the block exemption in regards to security devices and standard conditions, although it points out that this does not necessarily mean that any such agreements will be prohibited.

The Commission announced the following preliminary views, on 24 March 2009, in relation to each of the types of agreement currently falling within the block exemption:

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Joint calculations, tables and studies

The Commission continues to acknowledge that access to statistical data is crucial to the pricing of risk and is particularly beneficial to smaller sized firms. Agreements that increase the number of insurers who can potentially cover a given risk increase market access and competition. The Commission considered that there were good reasons to protect and facilitate cooperation in this area and ardently concluded that any risk that such pro-competitive cooperation may diminish should be avoided.

The Commission did consider alternatives to the block exemption; for example, governments or public authorities could collect and publish the data. However, the Commission concluded that these alternatives would be inefficient and the current block exemption appears to be the most effective avenue.

Joint establishment of standard policy conditions

While agreeing that standard policy conditions have positive effects for competition in the insurance industry, the Commission took the view that they are a feature for other sectors, such as the banking industry, and consequently sector-specific legislation is no longer required.

Many respondents to the consultation process stated that, without the block exemption, there would be increased costs and a corresponding increase in premiums due to a fall in cooperation amongst insurers. The Commission was adamant that the absence of such a framework would not cause tangible difficulties given that it has not done so for the banking sector.

Insurance pools

The Commission agreed with respondents to the consultation process that risk-sharing for certain types of risks is crucial in order to ensure that such risks are covered. The Commission concluded that in this sense the insurance sector is different from other sectors and needs enhanced cooperation.

The Commission concluded that it is appropriate to keep the block exemption in relation to pool agreements, to prevent any risk that insurers would not cooperate in that arena.

The Report does make it clear that if the exemption for this type of agreement is renewed, the Commission will significantly redraft the conditions under which it may be granted. The redrafting will be done to ensure consistency with other general and sector-specific legislation. The Commission has indicated that, in the future, it is likely to take a much firmer approach to insurance pools.

Security devices

The Commission has taken the view that agreements on technical specifications for security devices and their installation fall into the general domain of standard setting, and that this is not unique to the insurance sector. It found that there had been a significant degree of harmonisation in this field across the EU, thus limiting the scope for possible agreements. Although there is a mutuality of interests in the insurance sector, the Commission is doubtful about whether the BER is required to facilitate this type of cooperation between insurers.

Furthermore, the Commission indicated that there are concerns for both competition and the development of the EU's internal market in relation to agreements on security devices. The Commission, therefore, currently favours the option of not renewing this part of the BER.

Next steps

At this point no final decisions have been made regarding the renewal of the BER. A public event was held on 2 June 2009 to allow the Commission to hear final representations on the Report from industry participants and stakeholders prior to determining whether to renew any parts of the block exemption.

The opening keynote speech by Neelie Kroes, European Commissioner for Competition, shed further light on the approach and attitude of the Commission towards the BER. Whilst emphasising the importance of the insurance sector for the European economy and EU citizens as a whole, Neelie Kroes rigorously stressed that the BER is an exceptional instrument and could only be justified if it is providing real benefits to competition and consumers. Significance was placed on the fact that the insurance industry is not operating in a vacuum, but operates alongside many other sectors, most of which do not benefit from a block exemption.

The competition landscape has changed remarkably since the BER was last renewed in 2003. The Commission is going back to first principles in order to check closely what role the BER should play in this new landscape.

Next, the Commission will decide whether to renew or partially renew the BER. If it decides to renew any parts of the BER, the Commission has stipulated that it will consult on a draft regulation. Moreover, if the Commission ultimately decides to not renew any part of the BER a communication will be published to that effect before the end of 2009. ■

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Potential New Markets for Renewable Energy Credits and Carbon Credits

by Sarah A.W. Fitts, Stuart Hammer, Byungkwon Lim and Emilie T. Hsu

On June 26, 2009, the United States House of Representatives passed H.R. 2454, the "American Clean Energy and Security Act of 2009" ("ACES"), which aims to address climate change issues and encourage the use of renewable energy. The bill introduces (i) a federal renewable energy standard requiring utilities to obtain a certain percentage of their electricity from renewable sources and (ii) a cap-and-trade program designed to limit greenhouse gas ("GHG") emissions, which scientists have identified as the likely cause of global climate change. These provisions would create new national markets for both renewable energy credits and so-called "carbon credits." For additional information on ACES, please see our client update titled *House Of Representatives Passes Climate Change And Clean Energy Bill; Senate Is Next Hurdle*, dated July 6, 2009, available at www.debevoise.com.

It is difficult to predict how ACES will be revised after it is debated in the Senate. Nonetheless, whether or not ACES in its current form becomes law, these new commodities markets will, in some form, likely be part of any climate change and clean energy legislation that is ultimately passed by Congress.

Renewable Energy Credits

ACES introduces a federal renewable electricity standard (the "Federal RES"), under which certain utilities would be required to purchase a set amount of electricity from renewable sources. The bill also creates federal renewable energy credits ("Federal RECs"), which generally represent one megawatt hour ("MWh") of energy generation from a renewable source. Under ACES, qualifying renewable sources would include wind, solar and geothermal energy, biomass or landfill gas, hydropower, and marine and hydrokinetic renewable energy.

ACES requires that retail "Electric Suppliers," which include any utility that sold at least four million MWhs of electricity to consumers for purposes other than resale during the preceding year, comply with the Federal RES beginning in 2012. Electric Suppliers must meet their annual obligations by tendering Federal RECs to the Federal Energy Regulatory Commission ("FERC").

ACES mandates that Electric Suppliers obtain 6% of their electricity load from renewable sources and energy efficiency measures by 2012, a target that increases gradually to 20% by 2020. Alternatively, Electric Suppliers will be permitted to make payments of $25 (subject to adjustment for inflation) for each Federal REC that would otherwise be due, with stiffer penalties imposed for non-compliance.

Currently, 29 states and the District of Columbia have implemented mandatory renewable portfolio standards ("RPSs") which, in principal, are similar to the Federal RES, and which would likely remain in effect even if a Federal RES were adopted. Additionally, some states have adopted voluntary RPSs. Each state program is unique and has been implemented to meet state-specific policy objectives, such as diversity of energy supply, to encourage infrastructure investment within a state or promote state environmental concerns. Some of the state programs limit the extent to which credits generated by out-of-state projects can be used to satisfy state requirements. A number of state RPSs allow subject entities to meet their quota using tradable state renewable electricity credits ("State RECs"). Thus, although a Federal REC market is unprecedented in the U.S., active state REC markets already exist.

There is no existing national registry for tracking ownership of State RECs. However, several tracking and accounting entities ensure that State RECs are certified, tracked and not double-counted. Specifically, the State REC markets are increasingly overseen through regional tracking systems such as Western Region Electricity Generation Information System, New England Power Pool, Generation Attribute Tracking System, Electric Reliability Council of Texas, and Midwest Renewable Energy Tracking System. Under ACES, in promulgating regulations to administer the Federal REC program, FERC would rely on existing and emerging state and regional tracking systems in developing federal systems.

Carbon Credits

ACES also establishes a nationwide "cap-and-trade" system, which is a market-based mechanism for reducing GHG emissions. Currently, participation in the carbon market in the U.S. is purely voluntary, with the exception of electricity generators regulated under the Regional Greenhouse Gas Initiative ("RGGI") in the northeastern U.S. Voluntary market participants generally consist of financial firms, buyers with corporate social responsibility motivations and, increasingly, pre-compliance buyers seeking to position themselves for an eventual mandatory cap-and-trade system. ACES would drastically alter the contours of the current market by introducing a wide range of new players into the market and by redefining the rules of the game through federal regulation.

ACES caps the number of GHGs that electricity generators, liquid fuel refiners and blenders, industrial sources, natural gas distribution companies and other "covered sources," which collectively account for approximately 85% of U.S.

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GHG emissions, can emit in a given year. The bill seeks to reduce U.S. GHG emissions to 3% below 2005 levels by 2012, with reductions to 83% below 2005 levels gradually implemented by 2050. To comply with the cap, covered sources could reduce actual emissions by decreasing output, implementing technological or other changes, or purchasing credits on the open market. The market for carbon credits, which represent the right to emit a certain quantity of carbon or other GHGs, would consist of allowances and offsets.

The U.S. Environmental Protection Agency ("EPA") is tasked with promulgating regulations to implement the cap-and-trade system. FERC would regulate market operation and oversight.

Allowances. Emissions allowances are credits that the EPA would distribute to covered emitters via a mix of free allocation and auction. Certain market mechanisms are intended to facilitate compliance under ACES. For example, unused emissions allowances from one year may be "banked" for use in future periods. Allowances may also be "borrowed," or taken from one year into the future for the purpose of covering emissions in the present compliance period. In addition, covered entities may submit an international emission allowance or compensatory allowances in place of a domestic emission allowance, provided that such international allowance meets certain EPA criteria prior to such use. As part of its mandate under ACES, the EPA must establish a system for issuing and tracking allowances.

Offsets. Offsets are created by a reduction in, or avoidance of, GHG emissions by an entity, such as a landfill methane capture project, and sold to a third party, such as a broker or an emitter subject to an emissions cap. As a general rule, offsets must be verifiable and permanent and generated from activities that are "additional," i.e., they go beyond "business as usual." In the voluntary market, a wide variety of standards are currently used to determine what becomes an offset, and there is no single centralized registry that is used for registering and tracking all offsets. Under ACES, the EPA is tasked with establishing regulations that will determine what qualifies as an offset and how offsets are issued.

Certain State RECs can currently be converted into tradable offsets representing avoided GHG emissions. However, this practice is controversial, as it can be difficult to accurately calculate avoided emissions and difficult to ascertain whether such offset credits are truly "additional." A federal offset standard may not allow for such a conversion.

Buying, Selling and Trading

The Current Market. Because the current REC markets are structured differently in each state, market size and liquidity differs greatly among states. Typical contracting practices and prices for RECs also vary widely from state to state.

In 2008, the total global carbon market was estimated at between $120 and $126 billion, with most of that value attributable to the European Union Greenhouse Gas Emission Trading System ("EU-ETS"). The voluntary market accounted for only approximately $700 million of the total worldwide market, with the RGGI market accounting for almost $110 million. Voluntary market trading has increasingly moved from the over-the-counter ("OTC") markets to exchanges over time. The Chicago Climate Exchange ("CCX"), the dominant U.S. exchange, accounted for approximately 56% of the total value transacted in the voluntary carbon market in 2008. CCX operates as an "exempt commercial market" under the Commodity Exchange Act.

A range of derivative REC and carbon products are traded in the OTC market and on exchanges such as the Chicago Climate Futures Exchange ("CCFE"), a subsidiary of CCX. The derivatives market is generally subject only to limited oversight and regulation by the Commodity Futures Trading Commission ("CFTC").

The Market To Come. If ACES or similar legislation becomes law, active trading in these new commodities - Federal RECs, GHG allowances and GHG offsets - and corresponding derivatives instruments will likely develop quickly. Sizeable carbon and derivatives markets developed in the European Union after the creation of EU-ETS.

Financial institutions intending to become market-makers, traders or participants in the new commodities and derivatives instruments will be affected by ACES and any new regulations imposed on commodity-based derivatives. ACES proposes significant increases to CFTC oversight of the OTC market and "exempt commercial markets" and would impose reporting requirements on certain market-participants, and unless an exemption exists, require central clearing of non-customized derivatives and certain position limits.

Further, as lenders, financial institutions will need to evaluate the effect of the new legislation as it applies to those projects having to account for GHG allowances in their cash flow and pricing models, which could affect the terms of any financing that lenders may be willing to offer. As RECs and carbon credits could have value in themselves, such commodities should be included as collateral in any financing. ■

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Recent Changes to the UK Controllers Regime under the Financial Services and Markets Act 2000

By Victoria Bostock

The following article provides a brief overview of the changes to the controllers regime that have resulted from the implementation of Directive 2007/44/EC (the "Acquisitions Directive").

The Acquisitions Directive came into force on 21 September 2007 and the deadline for implementation across the European Union (the "EU") was 21 March 2009. The Acquisitions Directive concerns the prudential assessment procedure and criteria to be applied where there is an acquisition of a substantial holding in a financial services firm.

> **The FSA and HM Treasury have indicated that they believe the new assessment criteria will benefit both the FSA and UK firms, as the supervisory approval process, and the results of this process, will be consistent, transparent and predictable across the EU.**

The Acquisitions Directive aims to improve the process of supervisory approvals for the acquisition of financial services firms by enhancing legal certainty, clarity, transparency and consistency of treatment between different financial sectors.

The Financial Services and Markets Act 2000 (Controllers) Regulations 2009 (the "Regulation") came into force on 21 March 2009 and gives effect to the Acquisitions Directive in the United Kingdom (the "UK") by making various changes to the Financial Services and Markets Act 2000 ("FSMA").

The Regulation amends Part 12 of the FSMA to provide for a new prudential assessment procedure and criteria to be applied by the Financial Services Authority (the "FSA") when considering and, where appropriate, approving the acquisition by a person of a significant holding in a UK financial services firm.

The Financial Services and Markets Act 2000 (Controllers) (Exemption) Order 2009 (the "Exemption Order") came into force on 15 April 2009. The Exemption Order creates exemptions from the obligations to notify the FSA when acquiring, increasing, reducing or ceasing to have control over "relevant UK authorised persons." For purposes of the Exemption Order, a "relevant UK authorised person" means a "UK authorised person" other than: (1) a credit institution authorised under the banking consolidation directive; (2) an investment firm authorised under the markets in financial instruments directive; (3) a management company as defined in Article 1a.2 of the UCITS directive, authorised under that directive; (4) an undertaking pursuing the activity of direct insurance within the meaning of (a) Article 2 of the life assurance consolidation directive, authorised under that directive; or (b) Article 1 of the first non-life insurance directive, authorised under that directive; and (5) an undertaking pursuing the activity of reinsurance within the meaning of Article 2.1(a) of the reinsurance directive, authorised under that directive. A "UK authorised person," is a person who is authorised for the purposes of the FSMA to carry out regulated activity. This term refers to: (1) a person who has a Part IV permission under FSMA to carry on one or more regulated activities; (2) an incoming EEA firm (that is, a European Economic Area firm qualifying for authorisation under Schedule 3 of FSMA); (3) an incoming Treaty firm (that is, an EC Treaty firm qualifying for authorisation under Schedule 4 of FSMA); (4) a UCITS qualifier (such as the operators, trustees or depositories of collective investment schemes that are recognised under Section 264 of FSMA (recognised schemes) or authorised open ended investment schemes); (5) an ICVC (that is, an investment company with variable capital); and (6) the Society of Lloyd's. The Exemption Order is part of the measures to simplify the UK regime relating to controllers of authorised firms.

The Regulation

The key aim of the Acquisitions Directive is to improve the supervisory approval process for mergers and acquisitions in the banking, insurance and securities sector. The Acquisitions Directive aligns the supervisory approval processes for each of the sectors by introducing a maximum harmonised set of rules and prudential evaluation criteria to be followed by all authorities across the EU.

A "copy-out" approach to the Acquisitions Directive has been adopted in order to minimise the possibility of over-implementing the requirements of the Acquisitions Directive.

The Regulation implements the Acquisitions Directive by substituting new provisions into Part 12 of the FSMA (control over authorised persons). A new Chapter 1A of Part 18 of

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the FSMA (control over recognised investment exchanges) has also been added, as have provisions in Section 422 of the FSMA (controller), so that there is consistency with the new Part 12 provisions.

The Acquisitions Directive has modified the following aspects of the controllers regime: (1) definition of who a proposed acquirer is; (2) approval thresholds; (3) assessment process; and (4) assessment criteria.

Proposed acquirer

The Acquisitions Directive revises the definition of who is a proposed acquirer for the purposes of requiring approval before undertaking an acquisition.

A proposed acquirer is now any natural or legal person or such persons acting in concert that has/have taken a decision either to acquire or increase, directly or indirectly, a qualifying holding in a certain type of financial services firm.

The single definition simplifies the current approach taken in the FSMA controllers regime, which sets out eight cases in which control is considered to have been acquired.

The use of the term "acting" in concert now replaces the concept of an "associate" in Section 422(4) of the FSMA.

Nevertheless, the UK government has considered it inappropriate to incorporate the "proposed acquirer" definition into the FSMA, or to retain provisions which might overlap with this concept (such as "associate," as defined in Section 422(4)).

Approval thresholds

The Acquisitions Directive introduced four approval thresholds: 10%, 20%, 30% and 50%. The aim is to permit supervisory authorities to examine proposals at significant stages while trying to avoid placing excessive burdens on firms.

Under the Acquisitions Directive, Member States have the power to impose notification below the 10% threshold. The FSA and HM Treasury are not proposing to exercise this power. The current 33% threshold has been reduced to 30%, although the Acquisitions Directive does allow Member States to keep an approval threshold of 33%.

Assessment process

Modifications to the assessment process have been minor rather than significant. The foremost change that the Acquisitions Directive has introduced is a set time period for assessment.

The Acquisitions Directive shortens the period of time supervisory authorities can take to make an assessment on a proposed acquisition. The 90 calendar day period (equivalent to 65 working days) has been reduced to 60 working days.

Authorities do have the ability to "stop the clock" in order to seek further information, but only once and no later than on the 50th working day of the assessment period. The interruption cannot exceed 20 working days, or 50 working days if the proposed acquirer is not situated in or regulated by the European Community.

Assessment criteria

The current assessment criteria, as set out in the FSMA controllers regime, requires that the person who acquires control must be fit and proper and that the interests of consumers will not be threatened by the acquisition or increase in control.

The Acquisitions Directive now requires supervisory authorities across the EU to assess the suitability of a proposed acquirer and the financial soundness of a proposed acquisition against the following criteria:

- the reputation of the proposed acquirer;
- the reputation and experience of any person who will direct the business of the financial institution as a result of the proposed acquisition;
- the financial soundness of the proposed acquirer, in particular in relation to the type of business pursued and envisaged in the financial institution in which the acquisition is proposed;
- the ability of the financial institution to comply on an ongoing basis with the applicable prudential requirements; and
- whether there are reasonable grounds to suspect that money laundering or terrorist financing is being or has been committed or attempted (or the risk thereof).

The FSA and HM Treasury have indicated that they believe the new assessment criteria will benefit both the FSA and UK firms, as the supervisory approval process, and the results of this process, will be consistent, transparent and predictable across the EU.

The Exemption Order

The Exemption Order is made under a power in Part 12 of the FSMA, as amended by the Regulation. Part 12 of the FSMA imposes obligations to notify the FSA in respect of significant changes of holdings in UK-authorised persons. Part 12 applies to both UK-authorised persons that are authorised under a relevant directive and also those that are not. The Exemption Order provides exemptions from the statutory obligation to notify for those firms that are not regulated under EU law and thereby lessens the regulatory burden on such persons.

Article 4 of the Exemption Order applies a general exemption for non-directive firms. It provides that the obligations to notify apply at the threshold of a 20% holding of shares or voting power, rather than at the thresholds of 10%, 20%, 30% and 50%.

A single 20% threshold will now apply to all FSA-authorised firms not covered by the Acquisitions Directive (e.g., general insurance intermediaries, mortgage intermediaries, some commodities brokers

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and dealers, and advisors who do not hold client money).

Articles 5 and 6 of the Exemption Order contain specific exemptions that apply to building societies and friendly societies, respectively. Regarding authorised building societies, the requirement to notify applies at the threshold of a 20% holding. Relevant friendly societies are wholly exempt.

From a study conducted by the FSA in 2006, it was estimated that each notification cost a firm approximately £2000. Considerable cost savings should be achieved for firms falling outside the scope of Acquisitions Directive by moving from the current notification requirements to a single obligation. It has been estimated that approximately 5% of notifications will no longer be obligatory.

Next steps

The European Commission is expected to undertake a review of the implementation and impact of the Acquisitions Directive by 21 March 2011 and report to the European Parliament and Council. ■

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- Potential change of control or re-licensing filings (often post-closing) in certain other states where the insurance company subsidiaries are licensed such as Colorado, Connecticut, Florida, Michigan and New Hampshire.
- Potential foreign change of control filings in jurisdictions where foreign insurance company subsidiaries are domiciled or licensed.

Looking beyond insurers to other financial institutions, equity investments in domestic bank or thrift holding companies may also require specialized regulatory approvals. In the case of insurance holding companies that are also thrift holding companies, any such regulatory approvals would be in addition to the state insurance law approvals discussed above. Any acquisition of 25% or more of any class of a bank or thrift holding company's voting stock would require prior regulatory approval by the Federal Reserve (for bank holding companies) or the Office of Thrift Supervision (for thrift holding companies) and would result in the investor becoming a bank or thrift holding company itself. In fact, acquisitions of 10% or more of any class of a bank or thrift holding company's voting stock will generally require regulatory clearance and a rebuttal of control agreement to address, among other items, control factors such as board representation. PIPEs transactions are generally structured to avoid triggering any requirement for the investor to become an insurance, bank or thrift holding company and some investors will only acquire 9.9% or less of an insurance, bank or thrift holding company's voting stock to minimize regulatory approval requirements.

Shareholder Approval. In addition to federal and state regulatory approval requirements, large PIPE transactions generally require the approval of the shareholders of the issuer. Assuming the issuer has sufficient authorized capital stock (and, in the case of preferred stock, the issuer's board has blank-check authority), the most likely source of any shareholder approval requirement will be the rules of the stock exchange on which the issuer's securities are listed. If the investment involves the issuance of more than 20% of the issuer's outstanding common stock – either directly or on an as-converted basis – the issuer will need to obtain the approval of its shareholders under NYSE and NASDAQ listing rules. Keep in mind that the 20% limit is measured off of the number of shares outstanding prior to the new investment, and hence the limit on a pro forma basis is only 16 2/3%.

The foregoing threshold is significantly reduced if the PIPE investor is already a "substantial security holder." In that case, any issuance greater than 1% (or, if the sale is for cash and the price is at least the greater of the stock's book and market value, 5%) requires shareholder approval. Issuers and investors must also consider whether the transaction would result in a "change of control," which triggers the requirement for shareholder approval under the NYSE listing rules even if the foregoing objective thresholds are not exceeded.

The need for regulatory and shareholder approvals often conflicts with the issuer's desire to obtain funding quickly and unconditionally. A common solution to this conflict is to structure the investment as a non-voting preferred stock that becomes convertible into common stock only once the requisite regulatory and shareholder approvals are obtained. To protect against the risk that regulatory and shareholder approvals are not obtained, parties have

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agreed to a variety of mechanisms designed to incentivize the issuer (and its shareholders) to obtain the required approvals. These can include increasing the dividend rate and/or decreasing the conversion price of the preferred shares, decreasing the exercise price of issued warrants, triggering a cash payment obligation from the issuer to the investor and providing the holders of the preferred stock with special consent rights to significant transactions. In some transactions, if approval is never obtained and the preferred security cannot be converted into common shares, the security can become mandatorily redeemable at a price that provides the investor the same return it would have had if it had converted into common shares and sold those shares at the prevailing market price on the date of redemption.

Terms of the PIPE Security. PIPE transactions can involve a variety of securities, including straight common, preferred, convertible debt or a combination of the foregoing. Investors sometimes get equity-kickers in the form of warrants in addition to their primary security. Although less common than warrants, investors sometimes receive call options for an incremental investment within a specified period of time. If the PIPE security is a true preferred stock, a key consideration for the investor will be the terms of the dividend. In addition to the coupon itself, the parties must agree on the length of the no-call period, whether or not the dividend is cumulative and whether accumulated dividends compound.

Perhaps the most heavily negotiated issue in recent large PIPE transactions has been the extent to which the investor will be protected if the target company issues new capital on more favorable terms following the closing of the investment. In 2008, PIPE investors were quite successful in achieving such protection, generally lasting for up to 2 years following closing.

Price protection typically covers issuances of common stock or common-linked securities for an implied price per common share less than granted to the investor. Aside from being time limited, protection against offending issuances is sometimes subject to a minimum threshold and often excludes certain anticipated issuances (for example, pursuant to compensation plans or concurrent offerings/placements prior to closing). In addition to new share issuances, price protection has been applied to change of control transactions and liquidations where the implied value of common falls below the price granted to the investors.

On the other hand, regulators and ratings agencies have become increasingly skeptical of price protection covenants. In a number of instances, the Federal Reserve has required modifications to price protection covenants in order to allow bank issuers to treat the investment as Tier 1 capital, and rating agencies often give the issuer a lower level of equity credit for investments that are accompanied by strong price protections. The concern in each case is that these provisions will make issuers more reluctant to raise additional equity in circumstances where the protection would be triggered

Governance. PIPE transactions are typically structured as minority investments. In most cases, an equity stake of around 10% is required to gain the right to designate board members. Above 10%, the number of designees depends upon the specifics of each transaction, the envisioned relationship between the investor and the issuer and in many cases regulatory considerations. The PIPE investors' right to continue to designate representatives to the issuer's board following the initial issuance is typically contingent upon the size of its ownership stake, measured as a percentage of the outstanding equity or as a percentage of the initial purchase.

The committee membership of board designees is also subject to negotiation. Typically, where the investor has the right to designate one representative, the representative is afforded the right to sit on a specified committee and granted observer rights for other committees. As the number of investor designees increases, investor designees are typically afforded proportional representation on all committees, subject to applicable legal and governance requirements.

Standstill and Transfer Restrictions. As PIPE investors have sought greater equity stakes in the issuer, standstill provisions restricting additional share accumulations and "hostile" actions by the investor have become routine. The standstill period typically terminates when the investor owns less than a specified percentage (usually 5%) of the outstanding common stock or voting power of the issuer. In some transactions, the duration of the standstill period is also subject to a fixed time limit, such as 3-5 years after the investment date. The standstill would also typically terminate upon certain extraordinary occurrences (e.g., board approval of a change of control transaction, board recommendation of a tender offer or exchange offer or a significant change to the composition of the issuer's board). All standstill provisions cap the investors' acquisitions at some level above the percentage ownership upon the closing of the PIPE transaction. In transactions involving financial institution issuers, the cap could also be tied to regulatory "control" thresholds. Most standstills also restrict a standard slate of other actions by the investor, including proposals for fundamental transactions, solicitation of proxies or attempts to

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influence or control management (other than through its director designees).

Transfer restrictions in PIPE transactions generally include a lock-up period (typically 1 to 3 years, averaging 18 months) during which no issued shares can be transferred other than to specified permitted transferees, generally including affiliates, limited partners or shareholders. After the lock-up period, transfers generally continue to be subject to distribution limitations, such as caps on the amount transferred in any single transaction or over specified intervals, and the investor often continues to be subject to limitations on transfers to competitors of the issuer or persons who already hold (or in some cases who would hold following the transfer) more than a specified percentage of the issuer's common stock.

Tax Issues. The form of a PIPE transaction can have a material impact on the after-tax returns of the investor, or in the case of private equity investors, the partners of the private equity fund holding the investment. For example, if a PIPE is structured as debt, the coupon will be treated as interest income that is tax exempt to both non-U.S. persons and tax-exempt persons but subject to a 35% tax rate in the hands of a U.S. person. By contrast, if a PIPE is structured as preferred stock, the coupon will typically be treated as a dividend that is tax free to any tax exempt persons, subject to a 30% withholding tax in the case of most non-US persons and eligible for the 15% tax rate in the hands of a U.S. person. Similarly, in many cases the coupon will accumulate, or PIK, rather than be paid in cash. If the PIPE is structured as debt, the PIK interest will give rise to current income to the investor. By contrast, if the PIPE is structured as a preferred stock, it is usually possible to structure the terms of the preferred so that any PIK dividends are not currently taxable.

While the foregoing summarizes a few of the more critical issues that must be addressed to achieve a successful PIPE transaction, there are a variety of additional issues that will need to be faced depending on the specific circumstances of the parties. Closing conditions can be very limited or exceedingly broad, the issuer's commitment can be unconditional or subject to fiduciary outs (and even "go shop" rights). The treatment of the investment by accountants and ratings agencies can vary significantly depending on the terms of the transactions. Although the largest PIPE transactions over the last 18 months established a market for the terms of such investments that is generally quite favorable to the minority investors, we are likely to see some pull back in those terms in the direction of the issuer as the financial markets stabilize and alternative capital sources again become available to financial sector issuers. ■

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