DEBEVOISE & PLIMPTON
PRIVATE EQUITY REPORT

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You Have the Financials, Right?

Some Challenges in Financing "Carve-Out" Acquisitions

Although a number of private equity sponsors tout their ability to unlock value by rescuing corporate orphans, the job of buying subsidiaries and divisions of larger corporations and unraveling the assets and liabilities of a business from its corporate parent is not for the faint of heart. Most of these carve-out divestitures are complex and bespoke transactions. Among the most challenging issues are those involved in financing the acquisition of a business that is not being run on a stand-alone basis and, therefore, does not often have historical financial statements sufficient for optimal execution of the financing.

Are Financial Statements Even Available?

Historically, companies did not, in most cases, prepare comprehensive financial statements for their component businesses. As a result, when a company decided to divest an operating unit, it was unlikely to have financial statements for the unit on a stand-alone basis. Since the release of FAS 131, segment reporting by public reporting companies with respect to divisions that operate as a separate business has become more stringent and, as a result, public sellers are more likely today than in the past to have comprehensive financial statements for a subsidiary or division being divested. In addition, even where FAS 131 is not applicable, in most well-run auction processes today, historical financial statements will have been completed well in advance of approaching potential buyers.

However, notwithstanding these

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Mark Anderson, Andertoons.com

"As you can see, we had some trouble with the carve-out financials..."

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Letter from the Editor

We feel a little sheepish publishing our winter issue of the *Debevoise & Plimpton Private Equity Report*. First of all, it is a couple days after the official end of winter, and those of us on the east coast of the United States seem to have escaped winter altogether this year. Nevertheless, we have a Winter issue brimming with analysis of legal and market developments impacting the private equity community.

As we go to press, the financing markets are once again vibrant. But, the deals attracting high leverage are those with strong fundamentals and sound financials. Financing carve -out acquisitions of underperforming assets with sufficient leverage to drive expected returns is often challenging even in hot financing markets because of the unavailability of accurate and vetted financial statements to meet market practice for high yield debt offerings. On our cover, we provide some practical guidance to private equity buyers who might need to finance carve-out transactions without the package of financial statements that they would have hoped to have received from the divesting corporate parent.

Also on the financing front, we explore current market practice on the terms of registration rights in over 70 high yield offerings completed in 2011.

The regulatory climate for private equity is, of course, on everyone's radar screen these days. In most cases, the news is frankly not good. We offer practical guidance in this issue on many new developments, including how changes in the UK Takeover Code could make it more difficult in certain cases for private equity buyers to get deals done in the UK and may require enhanced disclosure of sensitive financing terms in bids. We also explain why anticipated rules may reduce the attractiveness of private equity investments to EU insurers and possibly EU pension plans.

Our Guest Column focuses on portfolio valuation, an issue of recent interest to the SEC and to almost everyone in the private equity community. Jesse Reyes, the co-founder of QuartileOne, an analytics firm, reviews the history of valuation practices in the industry and notes the potential impact of too much transparency on returns.

Private equity firms which trade in public securities, directly or indirectly, can unwittingly run afoul of the SEC's new Rule 13h, which requires registration by "large traders." In our article on the topic, we suggest that private equity firms with public portfolio companies or certain public market strategies should consider voluntary filings to avoid inadvertently tripping the rule.

There is, among all of this, some recent good news for private equity coming out of Washington. The JOBs Act is expected to become law soon and will provide some relief from SEC registration requirements for "emerging growth" portfolio companies, will relax the trigger for when a private company effectively becomes public as a result of the number of shareholders and will generally make raising capital easier.

We have been early participants in the attention lavished on private equity investments in the BRIC countries. In this issue, we conclude our series on diligence in these fast-growing emerging markets with a focus on Russia. We also survey the Chinese domestic market for private equity funds.

Although we are already hard at work on the Spring issue, we would welcome your guidance on topics of interest to you and your colleagues. Please feel free to be in touch with any of the members of our Private Equity Group.

Franci J. Blassberg
Editor-in-Chief

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When Size Does Matter:

The SEC's New Rules on Large Trader Registration May Snare Private Equity

As counterintuitive as it may seem for private equity firms to subject themselves voluntarily to SEC reporting regimes, those firms that might otherwise risk inadvertently becoming ensnared in the SEC's new reporting regime for large traders should consider a protective voluntary filing.

The SEC recently adopted Rule 13h-1 (the Rule) under Section 13(h) of the U.S. Securities Exchange Act.[1] The Rule establishes a registration system for "large traders" to assist the SEC in identifying large market participants and monitoring their trading activity. The thresholds are triggered by aggregate trading activity by controlled entities in National Market System securities (basically U.S.-listed stocks and options) in excess of either:

- 2 million shares or $20 million in value in a calendar day, or
- 20 million shares or $200 million in value in a calendar month.

Impact on Private Equity

Private equity fund managers may become large traders for purposes of the Rule under a variety of scenarios. For example, the Rule could be triggered by a block trade or a registered secondary offering of publicly traded securities after an initial public offering by a portfolio company. It could also be triggered by the activities of a private equity firm's capital markets group or the activities of its portfolio companies—*e.g.*, a portfolio company might acquire publicly traded equity securities in connection with an M&A transaction and subsequently sell them. Even if no single such trade implicates the Rule, it may well do so when combined with the trading activity of the entire group, which as discussed below, would include principals who own more than 25% of the GP or manager.

As another example of the potential pitfalls, consider a toehold investment in a public target. The investment might well be below the 5% ownership trigger for reporting under Regulations 13D and 13G, and it may be for passive investment purposes initially. However, Rule 13H makes no distinction based on intentions as to control of the target company. Rule 13H only looks at the size of the transaction. So in this scenario, registration would be required prior to entering the 13D/13G regime. The good news, though, is that the registration and the disclosure of the trading activity is generally not publicly available as is the case with 13D and 13G, so at least there should not be any premature disclosure of the investment to the market, which could jeopardize a subsequent acquisition of the company by the PE firm.

There are also potential issues looking up the ownership chain of the fund manager or GP. For example, if a principal "controls" the fund manager or GP—either in fact or on the basis of presumptions imposed by the Rule (*e.g.*, ownership of 25% or more of the entity)—and if such person has trading activity in NMS securities for his or her own account, that trading activity (as well as the trading activity of the group) would be taken into account for purposes of the Rule when considering thresholds applicable to the controlling person, and such controlling person may end up needing to register as a large trader.

Large Trader Status

The Rule generally requires a person or entity that exercises investment discretion in respect of trading activity in NMS securities to register with the SEC as a "large trader" by filing a Form 13H if trading activity exceeds the stated thresholds.[2] A person or entity may also voluntarily register as a large trader, thereby avoiding the need to actively monitor

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[1] *The Rule became effective on October 3, 2011, and initial Form 13H filings by large traders triggering the Rule's thresholds (on or after October 3, 2011) were due on December 1, 2011.*

[2] *As mentioned above, the Form 13H filing is not publicly available. Subject to limited statutory exceptions, the SEC cannot be compelled to disclose information collected from large traders and registered broker-dealers under a large trader reporting system. Furthermore, the SEC indicated in the adopting release for the Rule that it is committed to protecting the confidentiality of that information to the fullest extent permitted by law.*

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SEC's New Rules on Large Trader Registration (cont. from page 3)

trading levels on an ongoing basis.[3] Upon receipt of a Form 13H filing, the SEC issues a Large Trader Identification Number (LTID), which the large trader is required to provide to registered broker-dealers with whom trades are effected. Broker-dealers, in turn, are required to retain and, in some cases, report to the SEC information concerning large trades and the associated LTIDs.

3 *Although voluntary large trader registration limits the requirement to monitor trading levels on an ongoing basis, a large trader (whether required to file or filing voluntarily) is generally required to make annual and quarterly update filings. Annual update filings are required within 45 days after the end of each calendar year. Quarterly amendment filings are required by the end of a calendar quarter if any information contained in a prior Form 13H filing has become inaccurate (e.g., adding a new broker or forming a new subsidiary that trades NMS securities, but there is no requirement to continually monitor or report trading levels in NMS securities).*

...[I]f a principal "controls" the fund manager or GP—either in fact or on the basis of presumptions imposed by the Rule (e.g., ownership of 25% or more of the entity)—and if such person has trading activity in NMS securities for his or her own account, that trading activity (as well as the trading activity of the group) would be taken into account....

With respect to options, only purchases and sales of options themselves need to be counted; transactions in underlying securities pursuant to exercise or assignment of options need not be counted. For example, when underlying securities are received pursuant to the exercise of a call option, the receipt of the options would not be counted as a purchase when aggregating trading activity in NMS securities. However, a later sale of those same securities would be counted. The volume and value of options purchased or sold is generally determined by reference to the securities underlying each option.

Certain types of transactions are not counted for purposes of determining whether the thresholds are exceeded. These are transactions that the SEC has determined do not warrant scrutiny because they are typically entered into for reasons other than arm's-length trading in the secondary market and are not indicative of an exercise of investment discretion. Although not a complete listing, these include (1) transactions that are part of a (primary) securities offering by or on behalf of an issuer (other than offerings effected through a national securities exchange), (2) transactions effected pursuant to a court order or judgment, (3) transactions to effect an issuer tender offer or other stock buyback, a business combination (including a reclassification, merger, consolidation or tender offer) or a stock loan or equity repurchase agreement, and (4) transactions between an employer and its employees in connection with the award, allocation, sale, grant or exercise of an NMS security, option or other right to acquire securities at a pre-established price pursuant to an employee benefit or incentive program.

To Invest or Not to Invest—Who has Investment Discretion?

The Rule applies to persons or entities that *exercise investment discretion over trading in NMS securities.*

The concept of investment discretion picks up (1) a person who is authorized to determine which securities are to be purchased or sold in a given account and (2) a person who actually makes decisions as to which securities are to be purchased or sold in an account (even though some other person may have ultimate responsibility for such investment decisions).

The Rule indicates explicitly that a person's employees who exercise investment discretion within the scope of their employment are deemed to be doing so on behalf of the employer. So a firm that employs a natural person who, individually or together with others, is a large trader for purposes of the Rule will also be a large trader.

The Trappings of Control

The Rule is focused on the exercise of investment discretion either *directly or indirectly, including through other persons controlled by the large trader*, such as portfolio companies.

Control is defined broadly for this purpose as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract or otherwise. Notably, a presumption of control is placed on any entity or person that has the power, directly or indirectly, to vote or sell 25% or more of any class of an entity's voting securities (or, in the case of a partnership, any entity or person that has contributed—or has the right to receive upon dissolution—25% of the partnership's capital).

Therefore, to determine whether the controlling entity itself needs to register as a large trader, it must aggregate the trading activity of any individuals or

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Registration Rights in High Yield Debt Offerings: A Market Survey

High yield bonds with registration rights have been a fixture of private equity transactions for over thirty years, nothwithstanding changes in law and predictions to the contrary. High yield bonds used to finance private equity transactions or dividend recaps are typically sold in private offerings utilizing Rule 144A with the issuer entering into a registration rights agreement at the time the bonds are initially issued, typically requiring the issuer to conduct a so-called "A/B" exchange offer[1] within a certain time period thereafter. In the A/B exchange offer, the issuer offers bondholders SEC-registered bonds with terms essentially identical to the terms of the bonds sold in the initial 144A offering, in exchange for the initial bond. As a back-up mechanic, the registration rights agreement also generally requires the issuer to file a shelf registration statement to permit SEC-registered resales of the bonds in certain circumstances, which kicks in if the exchange offer mechanic is unavailable due to a change in law or SEC policy, or if a bondholder can't participate in the exchange offer under SEC policy because it is an affiliate of the issuer. The bondholders are entitled to receive additional "penalty" interest[2] if there is a default in these obligations for so long as the registration default continues. Some agreements also contemplate that bondholders may seek specific performance to enforce the issuer's registration obligations. A failure to comply with these registration obligations typically does not result in a default under the bond indenture.

The combination of an initial 144A offering with a subsequent exchange offer requirement gives an issuer the ability to access the high yield markets quickly, while providing assurance to investors that, within designated time periods after issuance, the bonds will be freely tradable for securities law purposes. In addition to SEC registration, though, bonds issued in a Rule 144A offering may become freely tradable simply through the passage of time, as provided in Rule 144 under the Securities Act. The extent and manner in which registration rights agreements take that into account can vary. Some agreements contain "fall away" provisions whereby the registration requirements no longer apply, or additional interest no longer accrues, once the bonds become freely tradable, or after a certain period of time has elapsed after the bonds have been freely tradable. Other agreements contain fall away provisions that apply after a designated period of time has elapsed, rather than tying the fall away to the bonds becoming freely tradable. Some agreements may provide for continuing registration requirements until all the eligible bonds have been traded.

We reviewed a sample of registration rights agreements from over seventy high yield 144A offerings that closed during 2011 to assess the current state of the market with respect to A/B exchange offer deadlines, additional interest rates, specific performance and fall away provisions. The sample focused on private equity sponsor portfolio companies, and included both bonds issued to finance leveraged buyouts and bonds issued by existing sponsor portfolio companies. Our review revealed some interesting findings.

The Continuing Prevalence of Registration Rights

In February 2008, the SEC adopted a number of changes to Rule 144 under the Securities Act, which shortened the holding periods for unregistered, or "restricted," securities. At the time of the 2008 amendments, some commentators predicted that investors in securities sold in Rule 144A offerings would no longer require A/B exchange offers, pointing out that the new holding periods under revised Rule 144 were shorter than the registration deadlines found in many registration rights agreements. A task force convened by the Securities Industry and Financial Markets

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Four years after the adoption of revised Rule 144, it is clear that predictions of the demise of traditional registration rights in high yield debt offerings were greatly exaggerated. Traditional registration rights, providing for an A/B exchange offer and, if an A/B exchange offer is not possible, a shelf registration statement, are still the norm in the U.S. high yield market.

1 *This mechanism is sometimes called an "Exxon Capital" exchange offer, after the first SEC no-action letter approving the A/B exchange procedure. See Exxon Capital Holdings Corp., SEC No-Action Letter, 1988 SEC No-Act. Lexis 682 (May 13, 1988).*

2 *Many agreements structure the additional amount as liquidated damages rather than incremental interest. Those that use the incremental interest construct often characterize the additional interest as liquidated damages.*

Association (SIFMA) proposed an alternative to traditional registration rights that, instead of requiring an A/B exchange offer, would require removal of the restrictive legend from securities after the Rule 144 holding period had run.[3]

Four years after the adoption of revised Rule 144, it is clear that predictions of the demise of traditional registration rights in high yield debt offerings were greatly exaggerated. Traditional registration rights, providing for an A/B exchange offer and, if an A/B exchange offer is not possible, a shelf registration statement, are still the norm in the U.S. high yield market. Only a couple of the agreements in the sample provided for a de-legending alternative along the lines of that proposed by the SIFMA task force, and one of those agreements involved a secured note deal, where registration rights tend to be somewhat less common in large part due to certain compliance requirements imposed on issuers of registered secured notes under the Trust Indenture Act of 1939.

The reason for the resiliency of traditional registration rights in the high yield market is likely two-fold. First, investment guidelines for many high yield investors limit their ability to invest in unregistered securities. For example, an investment fund's formation documents may provide that no more than a certain percentage of the fund's portfolio may consist of unregistered securities. As a result, providing for registration of a high yield debt security may boost the liquidity of that security, even if it is already freely tradable under Rule 144, and providing registration rights generally for high yield offerings may facilitate their marketing as well as overall market liquidity by limiting the time period during which any one bond issue occupies the unregistered securities allocations of investors and freeing up those allocations for new offerings.

Second, many high yield investors want issuers to be subject to SEC reporting requirements. Although the SEC permits certain companies to file Exchange Act reports on a voluntary basis, it has indicated in a staff interpretation that an issuer not previously subject to Exchange Act reporting cannot file Exchange Act reports on a voluntary basis.[4] As a result, for an issuer that is not already an Exchange Act reporting company, traditional registration rights provide the bridge to the bond indenture's SEC reporting requirements. Once a high yield issuer completes an A/B exchange offer or shelf registration, it becomes subject to Exchange Act reporting obligations, and the bond indenture's reporting covenant will typically require the issuer to continue to file SEC reports, even if it is no longer required to do so under SEC rules, so long as those filings are permitted by the SEC.

A/B Exchange Offer Deadlines

Deadlines for A/B exchange offers are negotiated from deal to deal, and may include one or more of (1) a deadline to file a registration statement, (2) a deadline for the registration statement to become effective, and (3) a deadline for the exchange offer to be completed. The most common formulation in the sample provided for a single completion deadline —that is, additional interest would begin to accrue upon failure to complete the

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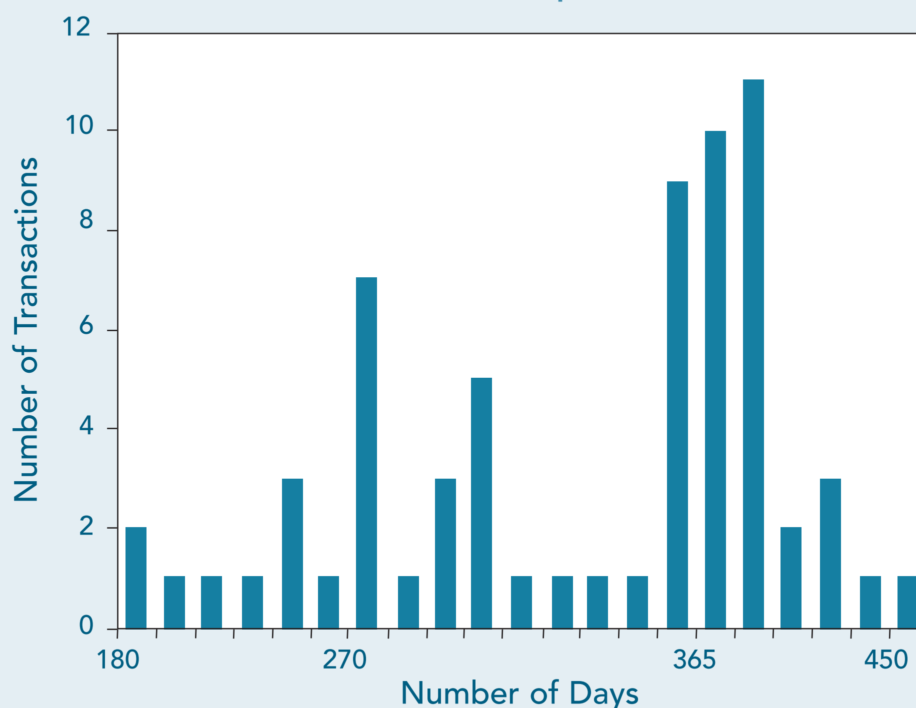
3 *See SIFMA Guidance: Procedures, Covenants, and Remedies in Light of the Revised Rule 144 (October 2008).*

4 *See Compliance and Disclosure Interpretations: Exchange Act Sections (Updated August 14, 2009), Question 116.03, available at http://www.sec.gov/divisions/corpfin/guidance/exchangeactsections-interps.htm.*

Exchange Offer Completion Deadlines



ALERT

Congress Actually Passing Bipartisan Legislation: JOBS Act to Facilitate Access to Capital

There is finally some good news from Washington for the private equity industry and in particular its portfolio companies. It hardly offsets the impact of Dodd-Frank, but at least there is some relief from the SEC registration requirements in sight for "emerging growth" companies looking to go public, a relaxation of the trigger for when a private company is required to become effectively public as a result of the number of its shareholders, as well as some easier ways to raise capital. The goal of the bill, which represents a fairly significant overhaul of some very long-standing rules, is to increase access to the capital markets and spur the growth of smaller businesses.

The legislation is colloquially known as the JOBS Act (which is short for the "Jumpstart Our Business Startups Act) and was passed by the House on March 8, 2012 and by the Senate as we sent to press on March 22nd. The Act, as passed by both houses of Congress, would:

Relax the trigger for public company reporting requirements. The JOBS Act would revise Section 12(g) of the Securities Act such that a private issuer would become a public company subject to the registration and disclosure requirements under the Federal securities laws and the requirements of the Sarbanes-Oxley Act of 2002 if it has $10 million in assets and a class of equity security (other than an exempted security) held of record by either (1) 2,000 persons or (2) 500 persons who are not accredited investors (currently, the 12(g) shareholder threshold is simply 500 persons). Most importantly, employees holding only exempt equity compensation would be excluded from the shareholder calculation. The combination of the increase in the shareholder trigger and the exclusion for employees would provide substantial breathing room for companies that have granted equity deep into their employee ranks (as was the case with Facebook) and would be a significant development in the Federal securities laws, as accredited investors and employees may be the only shareholders in many private companies, or at least may predominate over unaccredited, non-employee investors.

Ease access to the public capital markets for a newly created category of "emerging growth companies." Emerging growth companies, those companies with less than $1 billion in annual gross revenues during their most recently completed fiscal year, would be permitted to utilize scaled and more flexible regulatory requirements (1) during the IPO process (*e.g.*, the IPO registration statement would be required to include only two years of audited financial statements (instead of three) and scaled executive compensation disclosure, including CD&A) and (2) through the end of a transition period, post-IPO (*e.g.*, the disclosure exemptions applicable to the IPO registration statement and exemptions from the auditor attestation requirements of Sarbanes-Oxley 404(b), certain accounting and audit standards and the say-on-pay and say-on-golden-parachute requirements).

Make it easier for private and public issuers of securities to raise capital through certain private offerings. The JOBS Act would amend existing SEC rules to permit the use of general solicitations and general advertising in: (1) Rule 144A offerings so long as the securities are sold only to persons reasonably believed to be Qualified Institutional Buyers or QIBs and (2) Regulation D offers and sales of securities that exceed $5 million to the extent that all purchasers are accredited investors. With the elimination of the existing ban, participants in these types of private offerings would presumably be free to solicit investor interest widely and publicly (*e.g.,* through full-page advertisements in *The New York Times*, blast e-mails or even via Twitter).

Augment the capital raising tools available to issuers. The current Regulation A exemption for small issuances of securities under the Securities Act is of somewhat limited utility given the current $5 million cap on offering size. The JOBS Act would increase to $50 million the aggregate amount of all securities offered and sold in reliance on the exemption within the prior 12-month period. A revamped Regulation A could appeal to companies in need of capital at various stages of their development due to: (1) the ability to test the market prior to filing any offering document with the SEC; (2) more limited disclosure requirements applicable to the offering document (compared to a traditional Securities Act registration statement); and (3) potentially more limited "periodic" disclosure requirements.

* * *

Once the differences between the House version and the Senate version of the Act are resolved, we expect the Act to be signed into law by the President. SEC rulemaking then would follow enactment as many provisions of the Act require or permit the SEC to engage in rulemaking to carry out the changes in law. We expect to report on any further developments, including a summary of any signed bill, in the spring issue of the *Private Equity Report.* ■

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Recent and Upcoming Speaking Engagements

February 8, 2012
Michael P. Harrell
"Rethinking Private Equity Performance in an Era of Increased Scrutiny"
PCRI and Debevoise & Plimpton LLP
New York

February 8, 2012
Alyona N. Kucher
Guy Lewin-Smith
"Structuring M&A Transactions"
Debevoise & Plimpton LLP
Moscow

February 9, 2012
Paul R. Berger
Sean Hecker
Bruce E. Yannett
Steven S. Michaels
FCPA Annual Review Breakfast
Debevoise & Plimpton LLP
New York

February 23, 2012
Jonathan E. Levitsky
"Ethical Issues in Going Private Transactions"
Going Private 2012: Doing the Deal Right
Practising Law Institute
New York

February 23, 2012
Brian F. McKenna
"Developments in Asian Private Equity M&A"
IFLR Asia M&A Forum 2012
IFLR
Hong Kong

March 6, 2012
Thomas M. Britt III
Geoffrey P. Burgess
Andrew M. Ostrognai
"Fund Tax Structuring"
Debevoise & Plimpton LLP and Nishith Desai
Mumbai

March 8-9, 2012
John M. Vasily
"Going Global: International Due Diligence and Other Matters"
Sixteenth Annual Corporate Counsel Institute: Managing Risk in a Global Environment
Georgetown University Law Center
Washington, D.C.

March 12, 2012
Lord Goldsmith QC (moderator)
Mark P. Goodman
Michael P. Harrell
Karolos Seeger
"Litigation and Enforcement Actions by Regulatory and Other Governmental Agencies"
Thirteenth Annual International Conference on Private Investment Funds
International Bar Association
London

March 15, 2012
Marcia L. MacHarg
"U.S. and EU Retail Funds; Key Legal and Regulatory Concepts"
Strategic Issues and Challenges of the CIS Industry Seminar
Brazilian CVM
Rio de Janeiro

March 21, 2012
Thomas M. Britt III
"Recent Developments in Private Equity in Asia"
Asia-Pacific In-house Counsel Summit 2012
Asialaw
Hong Kong

March 21, 2012
Marwan Al-Turki
"Legal Challenges and Concerns Faced by the Players on the Secondaries Market"
Private Equity Secondaries Conference
C5
London

March 22, 2012
Marwan Al-Turki
"How Will New Opportunities Be Created in the Future? Competition, Valuations and Deal Flow"
Private Equity and Venture Capital in the Middle East and North Africa
BVCA and MENA Private Equity Association
London

April 25, 2012
Paul R. Berger
"Enforcement Developments"
Global Capital Markets and the U.S. Securities Laws 2012: Raising Capital in an Evolving Regulatory Environment
Practising Law Institute
New York

May 2, 2012
David A. Brittenham
"Opening Remarks and Introduction"
Leveraged Finance 2012
Practising Law Institute
New York

May 3-4, 2012
Paul R. Berger
"Country Developments—China"
The Foreign Corrupt Practices Act and International Anti-Corruption Developments 2012
Practising Law Institute
New York

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Dealmaking in the UK Has Gotten Tougher: Impact of Takeover Code Reform

The September 2011 changes to the UK City Code on Takeover and Mergers (the "Code") seek to level the playing field between bidders and targets and, in particular, to reduce the effectiveness of "virtual" bids (where a potential bidder announces that it is considering making an offer for a particular target, but does not commit itself to do so). Since the Code was amended, there has been limited M&A activity in the UK and it is still difficult to assess the full impact of the changes. Nevertheless, it is clear that the behaviour of private equity backed bidders will be materially affected by this new regime. There will be an increased focus on maintaining confidentiality, more preparation required before a target is approached, more fulsome disclosure of financing terms and a prohibition, in most circumstances, on deal protection measures such as break fees. It is worth noting that the Code can apply not only to listed companies but also in other situations, including to non-listed public companies and private companies that were listed in the previous 10 years.

Below are a few of the principal changes:

- ***Bidder Identification:*** The Code requires a target company to make an announcement in a number of circumstances, including if there is rumor or speculation about a possible takeover. On the first public announcement of a possible offer, the target must identify all known potential bidders from which it has received an approach or with which it is in talks. The Takeover Panel will only grant a dispensation from this requirement in limited circumstances—principally where a bidder has agreed that it will withdraw, stop work and not actively consider making an offer for the target for six months (known as a "pens down").
- ***Put Up or Shut Up:*** The announcement of a bidder's interest starts the offer timetable. Unless the Takeover Panel grants an extension, a bidder has 28 days from the date when it is first named either to announce a firm intention to make an offer or to announce that it will not make an offer, in which case it is, generally, prevented from bidding for six months.
- ***Deal Protection:*** Subject to limited exceptions, there is a prohibition on inducement fee arrangements and other offer-related arrangements between a bidder and a target, including break fees, no shop restrictions and matching rights.
- ***Disclosure:*** Increased information is required to be disclosed by bidders, including in respect of acquisition financing, financial information and deal fees. Further detail on the acquisition financing changes to the Code can be found below.

It should be noted that some of the changes outlined above do not apply, or apply in a modified form, in certain situations (*e.g.*, where the target has announced an auction process).

Private equity-backed takeovers are still being made and will continue to be made in the UK. However, the changes to the Code, and in particular the new "put up or shut up" rules, mean that careful planning will be critical to maintaining the confidentiality of the potential transaction. ■

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More on the UK Takeover Code: Increased Debt Financing Disclosure

Private equity buyers may be required to disclose more information about their debt financing under the new UK takeover rules, including potentially commercially sensitive information about market flex terms. These requirements were mandated by the changes implemented by the UK Panel on Takeovers and Mergers (the "Panel") to its regulations in the City Code on Takeovers and Mergers (the "Code") on September 19, 2011.

In the past, there were only limited disclosure requirements in the UK applicable to financing matters, which included an obligation to summarize the financing arrangements in the offer document, and the Code did not require full disclosure of all financing documents. For example, customary financing terms documenting the ability of the underwriter to "flex" the pricing and/or other financing terms to facilitate syndication could be kept confidential. However, the Panel has now beefed up the disclosure requirements to include not only a description of how the offer is to be financed and current debt is to be refinanced and the source(s) of the finance, but also details of the new debt facilities, in particular with respect to "*(1) the amount of each facility or instrument; (2) the repayment terms; (3) interest rates, including any "step up" or other variation provided for; (4) any*

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More on the UK Takeover Code (cont. from page 9)

security provided; (5) a summary of the key covenants; (6) the names of the principal financing banks; and (7) if applicable, details of the time by which the offeror will be required to refinance the acquisition facilities and of the consequences of its not doing so by that time" (Rule 24.3(f)). In addition, "*any documents relating to the financing of the offer*" (Rule 26.1(b)) must be published on a website, unless the Panel agrees otherwise.

These changes potentially impact the commercial arrangements between offerors and lenders by requiring the disclosure of ancillary financing documents, including details of financing fees and market flex provisions. Banks have customarily required commercially sensitive information, particularly market flex provisions, to be kept confidential, and keeping this information confidential is also in an offeror's interests. Disclosure of market flex provisions in particular would reveal to the market that the offeror is required in certain circumstances to accept different financing terms, including potentially paying additional fees and higher interest rates. The enhanced bargaining position of prospective lenders may lead to flex terms being invoked, and ultimately could lead to flex provisions being replaced by higher pricing from the outset.

The Panel has, given the particular commercial sensitivity, accepted that details of financing headroom that could be used to increase the offer price need not be disclosed, but has shown little indication that it will allow concessions under the Code to keep market flex terms confidential. The Panel was recently asked to provide guidance in relation to Colfax Corporation's offer for Charter International plc, which serves as a useful case study. In that situation, the Panel allowed the Colfax lenders' market flex rights to be kept confidential, but only based upon the transitional arrangements for implementation of the changes to the Code, and the parties to the Colfax transaction agreed that if the credit agreement were to be amended as a result of the exercise of flex rights, the amended financing terms would be made public. As these concessions were only made under the transitional arrangements, it is not clear whether such concessions to the Code's disclosure rules will be available going forward.

Ultimately, the enhanced disclosure requirements may make it harder for private equity buyers to raise debt financing on desirable terms, which may put them at a disadvantage to strategic buyers not relying on financing or whose financing is not subject to market flex provisions. The challenge will be to find a satisfactory approach to pricing and structuring that minimizes the commercial impact of the new disclosure requirements. ■

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SEC's New Rules on Large Trader Registration (cont. from page 4)

entities over which it has, or is deemed to have, control. There is an exception available, however, if the controlling entity does not conduct trades in NMS securities for its own benefit and any trading entities that it controls have separately identified themselves as large traders to the SEC in compliance with the Rule. The Rule also provides that a controlled entity does not need to obtain its own LTID if the person or entity that controls it has registered with the SEC as a large trader and obtained an LTID. In such cases, all accounts held by a controlled large trader with a broker-dealer would be tagged with the LTID of its controlling person or entity.

Sizing It All Up

In the absence of a voluntary filing, the monitoring requirements alone, particularly with the need to look up and down the chain of ownership, may be quite burdensome for a private equity firm and may require a level of coordination not likely to be in place currently, at least not with this particular focus. Policies and procedures would need to be adopted to track the activity of each member of the control group. Private equity firms may, therefore, instead wish to consider simply filing Form 13H on a voluntary basis in order to avoid inadvertently tripping the Rule and failing to comply with the registration requirements. Although the Rule may not drastically impact private equity firms in a truly substantive way, it is yet a further example of the trend towards increased regulation and monitoring. ■

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GUEST COLUMN

Portfolio Valuation

Once Upon a Time…

I have a seventeen-year-old Lexus with 185,000 miles on it. I bought it used when it was 4 years old for $17,000, which I considered quite a bargain. I recently looked up its residual value because I want to trade it in. Although I'm a bit of a finance geek and should adjust the value of the car periodically, the value of my car wasn't important to me as long as it ran. Why would anyone need to know how much it was worth on a regular basis? The car loan has been paid off for a while, so until I got ready to sell or trade-in, did it really matter?

Once upon a time, the private equity and venture capital industry operated in much the same way. Sponsors who invested in a company kept the value of the company on the books at the original purchase price and didn't adjust it until there was another financing transaction, an exit or some impairment that would make it prudent to update their investors. There wasn't a secondary market at that time—valuations were typically important only when the company was ready to be recapitalized, sold, restructured or taken public. In those days it didn't matter to many limited partners. Investors in private equity funds didn't have sophisticated portfolio management systems, and investment committees were content with far less information with respect to their PE investments.

Fast forward to the present. In late 2011, the SEC sent letters to several GPs as part of an "informal inquiry" into private equity valuation practices. While there was speculation among industry insiders as to what the SEC was really investigating, the SEC's letters led to much introspection and discussion about standard industry practices, the effect of the financial meltdown, and the moves to standardize, regulate, codify, and promulgate valuation standards. From the outside, the SEC concern appears to focus on whether private equity funds use inflated valuations to report an enhanced performance record during fundraising (which is, after all, a securities offering in which misleading information is problematic).

Understanding the route from a conservative or even *laissez-fair* approach towards valuation to an SEC inquiry into valuation of investments requires a bit of a historical redux.

Traditional Cost-Based Valuation

For much of its history, the private equity industry was dominated by a "lower of cost or market" valuation approach. This was generally thought to be in the investor's best interest. Private equity investment was dominated by venture capital in its early years and those investments were typically pre-revenue companies and there was little tangible input available for re-valuation. Therefore, valuations held at lower-of-cost-or-market was considered a conservative approach that minimized the risk of premature overvaluation and the attendant fear of misleading calculations of interim performance of a fund. All industry players seemed to be content with this valuation premise.

Once performance metrics such as the internal rate of return (IRR) became the standard performance metric for the industry, valuation becomes more important since the unrealized value of investments, *i.e.* the net asset value, was a significant component in performance measurement.

Once private equity became a mainstream asset class, appropriate comparisons to the public markets and other asset classes became critical. If a significant portion of an investment was tied up in the unrealized portion of a private equity portfolio, having accurate estimates of valuation became critical to contemporaneous performance metrics. Otherwise, performance measurement based on stale or attenuated valuation due to industry practice could under-value private equity investments and thus make them seem to underperform the public markets. In addition, asset allocation models are typically driven by performance metrics and portfolio values, so contemporaneous valuations in a fast-changing market are critical.

Investors felt that buyout investments,

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Once private equity became a mainstream asset class, appropriate comparisons to the public markets and other asset classes became critical. If a significant portion of an investment was tied up in the unrealized portion of a private equity portfolio, having accurate estimates of valuation became critical to contemporaneous performance metrics.

Guest Column: Portfolio Valuation (cont. from page 11)

which typically involved companies with revenues/profits and free cashflow, demanded more contemporaneous valuations. At a conference in the late 90s, one LP noted: "if they can value a company [with enough rigor] to invest in it, why can't they perform the same process three years later?"

The Push for Standards

There were several attempts in the industry to guide valuation policies. In the late 1980s there was an attempt by several prominent members of the National Venture Capital Association (NVCA) to provide a series of guidelines for their members to follow in reporting the value their venture capital investments. The membership overwhelmingly defeated the proposal, but, ironically, the proposed guidelines were known for years as the "NVCA Valuation Guidelines,, notwithstanding the fact that they didn't formally exist.

The lack of clear procedures to determine fair value, plus the extreme volatility in the markets during the dot.com era forced the accounting profession to revisit fair value. The result of that review was the accounting standard put forth by FAS 157—which provided a more rigorous framework and guidance on techniques and application for determining fair value.

In the early 2000s, the U.S. PE industry finally created a guidelines group (the Private equity Investors Guidelines Group or PEIGG) made up of LPs, GPs and service providers to address valuation guidelines and standards, among other issues. The mandate was to move the industry to a fair value standard instead of the ubiquitous lower-of-cost-or-market approach.

Unlike their U.S. counterparts, industry associations in Europe, which had a more aggressive and rigid regulatory framework, such as the British Venture Capital Association (BVCA) and the European Venture Capital and Private Equity Association (EVCA) were fairly aggressive in trying to codify valuation standards starting in the mid-90s. The European associations operated independently, but eventually the EVCA, BVCA and AFIC (the French Venture Capital Association) together created the International Private Equity Valuations Board (IPEV) which harmonized the various European valuation guidelines with U.S. GAAP and the IFRS. These IPEV guidelines have been "adopted" and endorsed by virtually every country-specific and regional venture capital and private equity association in the world.

Fair Value Is Here

The move to "fair value" was as contentious in the 2000s as it was in the late 1980s. The U.S. PE industry had to comply with U.S. GAAP, which required that private equity funds report the value of their funds on a "fair value" basis. But there were few real procedures under GAAP as how to determine fair value. At the time, fair value (in a definition an accountant at a conference described as "old as dirt") was defined as:

> The amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The procedures that the industry adopted as a result of the PEIGG guidelines used the original investment or most recent transaction as the basis for the valuation of an investment, but also required quarterly estimated valuations that required a contemporaneous valuation. That contemporaneous valuation necessitated using comparable investments, performance multiples, discounted cashflows or industry-specific benchmarking.

Independent of the industry efforts, financial reporting organizations embraced fair value by the mid 2000s, making it all but inevitable that private equity would have to face fair value no matter where they turned. The primary difference between the historical private equity practice and the fair value approach is that the former focused on the "entry" price, while the latter focused on "exit" price.

Enter FAS 157 (ASC Topic 820)

The lack of clear procedures to determine fair value, plus the extreme volatility in the markets during the dot.com era forced the accounting profession to revisit fair value. The result of that review was the accounting standard put forth by FAS 157—which provided a more rigorous framework and guidance on techniques and application for determining fair value.

FAS 157 also brought a refined definition of fair value:

> The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The new standard focused on orderly transactions in "most advantageous"

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Brick by Brick:

A Primer for Due Diligence in the BRICs, Finishing off with Russia

A discussion of due diligence in Russia completes our four-part series on doing due diligence in the BRIC countries, which represent the world's largest emerging markets. Some of the themes applicable to China, Brazil and India, and discussed in our articles in the past three issues, are equally relevant to Russia, including potential FCPA risks, relatively poor record keeping and occasional reluctance on the part of companies and management to share information with outsiders. Russian targets also present a number of specific challenges that may significantly complicate the due diligence process. This stems in part from the fact that the legal framework relating to the ownership and use of land and other real property in Russia, and the proper recording of title to shares and participatory interests in Russian companies, are not yet sufficiently developed. Foreign investments in certain sectors are also subject to multiple and often ambiguous prohibitions and restrictions. And finally, Russian legal and accounting regimes are developing at a very rapid pace, so just keeping up with the changes and figuring out how they might impact an investment is itself a challenging task.

Due Diligence Process

- ***Familiarity with due diligence process and requirements:*** Russian companies' familiarity with the due diligence process and the relevant requirements is considerably dependent on the size, type and location of the relevant company. While most public companies in Russia are well aware of the due diligence process and its importance to investors, on occasion, management may nonetheless be reluctant to share information with outsiders for confidentiality reasons or concerns relating to the impact of a transaction on management's own future or the business as a whole. Private companies are generally even more skittish about sharing information and may need a fair degree of prodding before they will do so.
- ***Internal organization:*** The strength of the internal controls and organization of Russian companies varies greatly, with public companies that are subject to more extensive disclosure requirements and independent audits of their financial statements obviously being better situated than private companies. Most companies have legal departments and in-house counsel; however, decentralization of information and knowledge is a common issue. For example, even public companies may lack a comprehensive internal list or register of licenses and contracts, and documents may be held by various different departments. There is also often a lack of efficient communication between departments and/or affiliates. Another impediment is the lack of standardized documentation and good corporate housekeeping, *e.g.*, minutes of shareholders meetings or board meetings are often not properly maintained.
- ***Publicly available information:*** As a general rule, a search for publicly available information must be conducted at the public authority charged with keeping the particular sort of records sought. Public search resources are still generally underdeveloped, although some, such as the unified register of legal entities or register of rights to real estate, have recently been improved greatly and are now widely used. However, a unified register of court cases is just now being launched. And there is still no unified register of licenses and permits.

  Therefore, in order to make sure a company possesses all requisite licenses and permits, separate requests to numerous licensing bodies is required. To complicate the situation, registers are known regularly to contain errors and omissions. This results in frequent challenges to the veracity of information in state registers, which means that an excerpt from a register is usually not considered dispositive evidence of whatever fact one is trying to verify. Although some resources are available via the internet, the information may well be dated and contain omissions.

Business Due Diligence

- ***Environmental compliance and enforcement:*** Levels of compliance by Russian companies with environmental laws, and the extent of enforcement,

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...Russian legal and accounting regimes are developing at a very rapid pace, so just keeping up with the changes and figuring out how they might impact an investment is itself a challenging task.

Brick by Brick (cont. from page 13)

varies depending on the region and the size of a company's operations. Russian environmental regulations generally establish a "pay-to-pollute" regime administered by federal and local authorities. Payment obligations may also arise under the laws and regulations applicable to water use, air protection, and the handling of waste. If the operations of a company violate environmental laws or otherwise cause harm to the environment or any individual or legal entity, a court action may be brought to limit, suspend or ban such operations and require the company to remedy the effects of the violation. Any company or employee thereof that fails to comply with environmental regulations may be subject to administrative or civil liability, and individuals may, in addition, be held criminally liable (although criminal prosecution to date has been very rare).

The FCPA risk is, not surprisingly, higher in business sectors that operate under governmental concessions and authorizations. In addition, it should be noted that many large companies in Russia are state-owned or controlled, therefore, directors and employees of such companies are deemed to be "government officials" under the FCPA, with the result that payments made to them could run afoul of anti-bribery laws.

- ***Occupational safety and health:*** Russia has rather extensive occupational safety and health laws and regulations, and employers that fail to comply with such laws and regulations are subject to fines and other sanctions. However, the extent of enforcement of these laws and regulations also varies depending on the region and industry sector.
- ***Insurance:*** Many Russian companies do not purchase insurance policies covering such matters as property loss/damage, product liability and third-party liability, other than if explicitly required to be maintained by law (for example, where a company operates hazardous facilities). Therefore, the scope and amount of insurance policies held by a company may well be inadequate in view of the nature of the business conducted by such company.
- ***FCPA:*** Russia is still considered a "high-risk" country from an anti-bribery perspective. The FCPA risk is, not surprisingly, higher in business sectors that operate under governmental concessions and authorizations. In addition, it should be noted that many large companies in Russia are state-owned or controlled, therefore, directors and employees of such companies are deemed to be "government officials" under the FCPA, with the result that payments made to them could run afoul of anti-bribery laws.
- ***Land use issues:*** Russian law recognizes private and state land ownership, as well as other categories of land rights and encumbrances. State ownership is divided into property of the Russian Federation (federal property), property of the various Russian regions and property of municipal entities (municipal property), but for various reasons it is not always clear which governmental body or official has the right to lease or otherwise regulate the use of real property. And Russian companies occasionally use land without proper title. To make matters worse, although title to real property in Russia is subject to state registration, in certain cases land rights are considered valid without such registration. Therefore, it is often difficult to determine with certainty the validity and enforceability of title to real property and the extent to which it is encumbered.

Legal Due Diligence

- ***Regulatory environment:*** Russia's legal system is primarily based on statute. Compared to common law jurisdictions, prior court decisions have limited precedential authority in Russia. That said, in 2010 the Supreme Arbitration Court was granted limited authority to make decisions that may serve as precedents (sometimes, unfortunately, with retroactive effect). Russian laws have undergone substantial development over the past two decades, and continue to progress rapidly. Currently, the Presidential Council is working on substantial changes to the Civil Code, and as a result, Russia may be facing significant reform of its civil and commercial laws in the coming year. Many laws and regulations are relatively new and may contain broad and sometimes

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UPDATE

Another Filing Obligation for Private Equity: Time to Focus on Form PF

Just when private equity firms have finally gotten their registration filings completed, there is another filing challenge that needs attention—possibly sooner rather than later. Many private equity fund managers have just completed the process of filing their Form ADVs and registering with the Securities and Exchange Commission (the "SEC"). In many cases, the managers' compliance teams now will have to turn to completing an even more complicated form.

Last fall, the SEC and the Commodity Futures Trading Commission jointly adopted Form PF, the systemic risk reporting form for private fund advisers mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Form PF is principally designed to assist the Financial Stability Oversight Council in its assessment of systemic risk in the U.S. financial system posed by investment funds that are exempt from registration under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 ("Private Funds"). Only SEC-registered investment advisers ("RIAs") with $150 million or more of Private Fund assets under management ("PFAUM"), including the Private Fund assets managed by certain of its affiliates, are required to file Form PF.

Watch Out for the Hedge Fund Classification

The first filing for most private equity fund sponsors with a fiscal year-end of December 31 will not be due until April 30, 2013. However, if the fund manager is a "large hedge fund manager," the first filing is due 60 days following the end of its first fiscal quarter following June 15, 2012, which could be as early as August 29, 2012. Thus, it is important for managers to promptly confirm that the investment policies of the funds they manage do not inadvertently bring them within the Form PF (and Form ADV) definition of "hedge funds."

A "hedge fund" is any Private Fund that:

- has a performance fee or allocation calculated by taking into account unrealized gains (*i.e.*, a performance fee using mark-to-market values instead of realized gains), other than those that take into account unrealized gains solely for the purpose of reducing a fee or allocation to reflect net unrealized losses;
- *may* borrow an amount in excess of one half of its net asset value (including any committed capital) or *may* have gross notional exposure in excess of twice its net asset value (including any committed capital);
- *may* sell securities or other assets short (other than for the purpose of hedging currency exposure or managing duration of interest rate exposure); or
- is a commodity pool.

The second and third components of the definition could present issues for certain private equity fund managers, since fund organizational documents often do not explicitly limit the ability of the manager to engage in borrowing or hedging activities. However, the SEC has provided guidance making clear that Private Funds falling within either of those two provisions of the definition would nonetheless not be "hedge funds" for purposes of Form PF if (1) they do not actually engage in the relevant activities above the stated thresholds and (2) a reasonable investor would understand, based on the offering documents, that they will not engage in those activities. But we suspect that certain private equity funds will still be considered "hedge funds" due to the fact that they do in fact engage in these activities, with the result that the managers of these funds will be subject to the earlier filing date. For example, a private equity fund may sell short to hedge a position in a publicly traded portfolio company.

Form PF is daunting in length. Among other disclosure requirements, large private equity fund advisers (*i.e.*, RIAs that have $2 billion or more in PFAUM) are required to provide information on (1) the indebtedness of certain "controlled" portfolio companies, including debt-to-equity ratios, (2) any bridge loans, including identification of the lender, (3) the identity of, and financial data concerning, certain portfolio companies that are in the financial services industry and (4) investments by the fund, broken down geographically and by industry).

Frequency of Filing and Due Dates

It is not too early to assemble a team to begin the process of pulling together a firm's first Form PF. The chart on the next page provides the key dates for the firm's first filing, based on a 12/31 fiscal year end.

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Update: Another Filing Obligation for Private Equity (cont. from page 15)

How to File Form PF

Form PF—like Form ADV—will be filed online through the Investment Adviser Registration Depository ("IARD") website. The information provided on Form PF, however, will not be available to the public.

The SEC recently sent a notice to certain advisers that "pre-production testing" of the online Form PF is underway on the IARD website, and advisers may wish to be "test participants" of Form PF before they "go-live" in order to gain a better understanding of the system's features and provide feedback. Further information is available at http://www.iard.com/pfrd/usertesting.asp.

For a more detailed discussion of Form PF and its associated disclosure obligations, please see our November 16, 2011 memo to clients, *SEC and CFTC Adopt Form PF for Registered Investment Advisers to Private Funds* (click here). ■

Type of Private Fund RIA	Frequency of Filing	Filing Date	Initial Filing Date (for FY End 12/31)
Large Hedge Fund Advisers (PFAUM of at least $1.5 billion)	Quarterly	60 days following end of fiscal quarter	— Aug. 29, 2012, if PFAUM is $5 billion or more — Mar. 1, 2013, if PFAUM is less than $5 billion
Large Liquidity Fund (unregulated money market fund) Advisers (PFAUM of at least $1 billion)	Quarterly	15 days following end of fiscal quarter	— Jul. 15, 2012, if PFAUM is $5 billion or more — Jan. 15, 2013, if PFAUM is less than $5 billion
Large Private Equity Fund Advisers (PFAUM of at least $2 billion)	Annually	120 days following end of fiscal year	Apr. 30, 2013
All Other Private Fund RIAs	Annually	120 days following end of fiscal year	Apr. 30, 2013

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What's Ahead in the Year of the Dragon?

More Regulation of the Overheated Fundraising Market in China

How many private equity funds in China are targeted at domestic investors? No one seems to know. *Asia Private Equity Review* reports 472, while the *AVCJ Database* has recorded 1,150. Regardless of the number, however, one thing is clear: the market for domestic Chinese private equity funds is booming. It is but the latest "get rich quick" scheme for a country that has seen many of them over the years. With such rapid growth has come real concerns around the integrity of the domestic market, which regulators are now starting to address.

Domestic Chinese private equity investors have been mostly high net worth individuals (whereas offshore investors have been primarily institutions). Many of these domestic funds seem to be formed by sponsors who have little experience running PE funds. So you have individual investors who may be ill-equipped to police the conduct of the funds and sponsors who may be ill-equipped to operate them using anything resembling best practices. It is a bit of a perfect storm.

According to Chinese news reports, a government official at the National Development and Reform Commission (NDRC), one of the most important Chinese regulatory agencies involved in the regulation of private equity, recently indicated publicly that as many as 1,059 funds are likely involved one way or another in "illegal fundraising." Tianjin, one of China's preeminent fund formation hub cities, has been particularly plagued by a series of private equity-related illegal fundraising cases.

On July 1, 2011, in one of the first high profile cases involving private equity, Huang Hao, a twenty-eight-year old, was sentenced to life in prison for the crime of "illegal fundraising." Huang had apparently raised approximately RMB190 million (~US$30 million) from over 700 Chinese investors by running a ponzi scheme under the guise of a series of private equity investment funds. It seems that the charge of "illegal fundraising" was a bit of euphemism, but there was nothing subtle about the prison term.

Part of the problem to date is that, aside from clearly fraudulent practices such as those apparently engaged in by Huang, there has been no clear guidance on what constitutes "illegal fundraising." The regulators are now stepping in. In early December of last year, the NDRC issued Circular 2864, which formalized the principal rules under a previously announced "pilot program" and provided, for the first time, nationally applicable guidance with respect to private equity fundraising.[1] The NDRC has also posted on its website a series of accompanying "guidelines," including forms and standard documents, setting forth mandatory requirements concerning specific fund documents (such as the offering memorandum and the limited partnership agreement).

While these new regulations do not directly affect sponsors <u>raising money</u> outside of China (even for investment in China), they will be applicable to all sponsors <u>raising money</u> in China—even large, sophisticated international firms that have started to break into the Chinese domestic fund market in the last few years.

Moreover, any fundraising scandals have the potential to tar the entire industry, and the domestic press is unlikely to distinguish much between fly-by-night operations and established and respected global private equity houses.

Manners of Fundraising

Under Circular 2864, private investment funds may be raised only by private offerings to identified and accredited investors who are capable of appreciating and bearing the risks. Fundraising may no longer be conducted through public announcements in the media (including online), putting up notices in community gathering places, distributing booklets or sending text messages to the general public, or using seminars, lectures or other disguised public solicitations (including leaving offering memoranda at the counters of institutions such as banks,

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[1] *Circular 2864 also imposes mandatory registration and filing requirements. Funds raised in China with capital commitments of RMB500 million (~US$79 million) and above must register with the NDRC; all other funds raised in China must register with designated provincial authorities.*

More Regulation of the Overheated Fundraising Market in China (cont. from page 17)

securities firms, trust companies and the like, which has apparently not been an uncommon practice). The sponsor is now required to provide full disclosure of the risks and potential losses associated with the investments, and may not guarantee the return of the investors' invested capital or any fixed rate of returns on such capital.

However, the new rules still do not provide clear standards in certain areas, such as minimum financial tests for accredited investors, or detailed guidance regarding appropriate disclosure. Nonetheless, they are ground-breaking for this young PE industry, and, given some of the questionable fundraising methods that have been employed (for example, solicitation by three-line text message), having even this basic framework is a good start.

...[T]he new rules still do not provide clear standards in certain areas, such as minimum financial tests for accredited investors, or detailed guidance regarding appropriate disclosure. Nonetheless, they are ground-breaking for this young PE industry, and, given some of the questionable fundraising methods that have been employed...having even this basic framework is a good start.

Number of Investors

Under Chinese securities laws, an issuance of securities to more than 200 identified persons in the aggregate requires the approval of an authorized government agency. Circular 2864 re-emphasizes that the number of investors in private equity funds must comply with either the Chinese Company Law (for funds formed as companies, where the limit is either 50 investors for a limited liability company or 200 investors for a joint stock company) or the Chinese Partnership Law (for funds formed as partnerships, where the limit is 50 investors). Circular 2864 goes even further, however, in making it clear that if an investor is a pooled investment trust, partnership or an unincorporated association in other forms (except for a fund of funds), a "look-through" rule shall apply with respect to the qualification and number of the underlying investors. According to market commentary, these rules may have been formulated to curtail the common practice of pooling a large number of investors into one or more trusts which in turn invest directly or indirectly in a fund.

Placement Agents; Funds of Funds; Local Regulations

Placement agents are frequently used in China as intermediaries for fundraising from high net worth individuals. It has been reported that the intermediaries can charge upfront fees as high as 1-2% of the capital commitments raised and then half of the annual management fees and carried interest on the back end. Even well-established general partners sometimes have to live with such exorbitant placement fees due to the scarcity of domestic institutional investors in China. And notwithstanding these high fees, the placement agents tend to assume few risks in acting as intermediaries. For example, many placement agents are not licensed securities firms, and under existing Chinese laws, their fundraising activities are barely regulated, if at all. That said, the situation may change soon as one of the key laws governing securities and investment funds are currently being reviewed and revised, and it is reported that private equity funds and intermediaries will soon be subject to stricter regulations.

Circular 2864 applies not only to direct investment funds, but also to funds of funds. However, the current rules are general and contain few if any provisions that apply specifically to funds of funds. There are credible indications though that further rules specifically governing funds of funds will be issued by the NDRC.

Last but not least, several local authorities, such as Beijing, Shanghai and Tianjin, have all issued their own rules on private equity funds prior to the issuance of Circular 2864, and the local rules may not necessarily work seamlessly with Circular 2864. It will be interesting to see how these rules evolve and how conflicts are addressed, creating yet another moving target in the fast-changing landscape of the private equity market in China. ■

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ALERT

UK/EU Developments: More Disclosure, More Regulation and a Potentially Shrinking Pool of Investors

Tracking the regulatory developments impacting private equity in the UK and EU could be a full time job. In fact, it is for many lawyers, lobbyists and other practitioners. For the rest of you, below is a round up that will keep you up to date on the most important topics. In short, various changes in law now in the pipeline will (1) reduce EU insurers' appetite for allocations to private equity, (2) increase public disclosure by UK private equity firms absent a restructuring of commonly used vehicles and (3) implement an enhanced regulatory framework applicable to EU fund managers.

Solvency II's Impact

Solvency II, a new regulatory framework for EU insurers (and reinsurers) that is scheduled to come into force in January, 2014, is likely to make it less attractive (at least in regulatory capital terms) for EU insurers to invest in private equity than in, say, corporate bonds or sovereign debt. Solvency II requires insurers to calculate and meet a solvency capital ratio ("SCR") using either the "Standard Model" or an "Internal Model" that an insurer develops and agrees upon with its regulator. It is expected that larger insurers will develop internal models whereas smaller insurers will use the standard model. In the standard model, it is proposed that a flat charge (effectively a discount) of 49% should be applied to the value of investment in private equity. This compares with a flat charge under the standard model of 39% for investments in listed equity, 25% for investments in real estate and 2.5% for investments in 3-year AAA bonds. The flat charge for private equity can be modified by up to plus or minus 10%, depending on movements in the public equity markets (*i.e.*, it can vary between 39% and 59%).

Solvency II may also increase the amount of information that EU insurers require from private equity fund GPs in order to enable them to operate any Internal Model they may have agreed upon with their regulator.

Solvency II could also affect pension funds in EU Member States. This is because many occupational pension schemes are set up as insurance contracts. There is no clarity yet on whether the capital requirements of Solvency II will be extended to apply to occupational pension schemes generally. If they are, EU pension fund trustees, like EU insurers, may well find it less attractive to invest in private equity than in some other categories of investments.

In a recent speech at an open hearing on changes to the Pension Funds Directive, Michel Barnier, EU Commissioner for Internal Market and Services, sought to allay industry concern about Solvency II capital requirements being extended to EU pension funds, stating that although the Commission will draw on the approach of Solvency II, it will not be a "copying and pasting" exercise. Nevertheless, industry representatives remain seriously concerned about the proposed rule changes, believing that efforts to harmonize the regulatory regime are based on flawed logic and could have unintended consequences for pension funds and their members.

New Accounting Disclosure Rules for UK Limited Partnerships

Some anticipated rules in the UK are expected to require private equity funds to make more information publicly available (unless they are restructured). In the UK, the most commonly used vehicles for private equity investment funds are limited partnerships registered under the Limited Partnerships Act 1907, which have traditionally been subject only to limited filing and disclosure requirements. A UK limited partnership is only required to prepare and file annual accounts (which would be available for inspection by the public) if the partnership is a "qualifying partnership." UK private equity limited partnerships have been carefully structured so that they are not "qualifying partnerships," which has been accomplished by having at least one partner (typically a limited partner) that is an individual. As a result, it is extremely uncommon for UK private equity limited partnerships to be required to file partnership accounts and have them available for public inspection.

In April, 2010, changes were proposed to these rules because the UK Government decided that the original intention was that a limited partnership's status as a "qualifying partnership" depends not on the status of its limited partners, but only its general partners. That would mean that most private equity limited partnerships would be required to file annual accounts available for inspection by the public unless one of their general partners is neither a limited company, an unlimited company, or a Scottish partnership each of whose members is a limited company. The proposed changes were intended to come into force in late 2010, but for various reasons their implementation was postponed, and they are now expected to be introduced in April or October, 2012.

The new rules will apply to the first

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UK/EU Developments: More Disclosure, More Regulation (cont. from page 19)

accounting period of a UK limited partnership commencing after the introduction of the changes. Unless steps are taken to restructure, many private equity investment funds constituted as UK limited partnerships may soon have to start preparing and filing annual accounts in the same way as UK companies. Therefore, once the form of the new rules is finalized, existing UK limited partnership structures should be reviewed to check whether they now are "qualifying partnerships" required to prepare and file accounts.

Alternative Investment Fund Managers Directive—Update

As almost everyone in the industry knows, the Alternative Investment Fund Managers Directive ("AIFMD") is required to be implemented by EU Member States by July 22, 2013. That means the next fifteen months will be a busy one for legislators and regulators.

We reviewed the AIFMD in detail in our Fall 2010 issue,[1] but here's a "refresher." After July, 2013, all EU-based alternative investment fund managers ("AIFM"), including managers of private equity funds, will need to become authorized (and therefore regulated) under the AIFMD in order to manage alternative investment funds ("AIFs") and market AIFs to professional investors. At that time, a fund "passport" (allowing AIFs to be marketed to professional investors throughout the EU) will be introduced for EU-based AIFM and EU-based AIFs. In 2015, the European Commission will consider whether to extend the passport to AIFM that are not based in the EU and to non-EU AIFs. Non-EU AIFM are likely to be required to be authorized if they wish to manage EU AIFs from 2015, and if they wish to market AIFs (wherever established) to professional investors in the EU from 2018, if the Commission decides to end national private placement regimes in 2018.

The AIFMD is a "framework" directive, which means that it requires detailed implementing measures. These are drawn up by the Commission and adopted under the EU's legislative process. This is the process that is currently under way, and the Commission is expected to publish its draft implementing measures this month (March, 2012), which will then be reviewed for up to three months by the EU Council and the European Parliament. Unless rejected by the Council and the Parliament, the implementing measures are likely to be formally adopted by the EU in July, 2012. Therefore, each Member State will have just twelve months from that time (July 2012) to introduce the AIFMD into its national legislation. The Financial Services Authority has already started this process by publishing a discussion paper on the implementation of the AIFMD in the UK, and has acknowledged that there is a great deal to be done within a tight timeline. Note that not all EU Member States will implement the AIFMD into their legislation at the same time.

Over the next year or so, we can expect a great deal of material to be published as we move from a framework directive to detailed legislation implementing it in each Member State. ■

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1 *See "EU Directive on Alternative Investment Fund Manager: Good News at Last," Debevoise & Plimpton Private Equity Report, Fall 2010. (click here)*

Some Challenges in Financing "Carve-Out" Acquisitions (cont. from page 1)

reporting requirements and market practices, in more cases than one might expect, private equity buyers seeking to finance a carve-out acquisition find themselves in the same position as they might have been 15 or 20 years ago, with insufficient historical financial statements to pursue their desired financing. This may occur because, following negotiations between the buyer and the seller as to the precise scope of the business to be sold, the historical financials produced for the auction process no longer match the actual assets and liabilities that will be acquired. New financial statements can usually be produced, given sufficient time and management attention, but these resources may be in short supply in the context of a fast-moving sale process.

More infrequently, historical financial statements either cannot be produced or cannot be audited, as a practical matter. For example, we have seen a run-of-the-mill carve-out divestiture (if there is such a thing) become much more complicated because the business to be divested had itself recently sold component businesses and the corporate seller had disregarded these earlier dispositions and the related discontinued

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Some Challenges in Financing "Carve-Out" Acquisitions (cont. from page 20)

operation accounting impact for financial reporting purposes. Even worse, it didn't have access to the relevant information necessary to produce audited financials reflecting the impact of the discontinued operations in historical periods because the records had been turned over to the buyers of the assets without a clear obligation to provide access to the corporate seller. In that case, the private equity buyer found itself in a very difficult situation; it needed to finance a carve-out acquisition but the audited financial statements that most financing sources would demand could not be produced because, without the discontinued operations taken into account, the financials did not reflect all of the historic assets and liabilities of the legal entities being audited and, thus, were not GAAP compliant. Ultimately, the buyer had to market the financing using "special purpose financials" and endures a difficult negotiation with the auditors with respect to whether, and to what extent, prospective lenders could rely on the financials.[1]

Are the Financial Statements Sufficient for a High Yield Offering?

The simple fact of life for any private equity buyer is that some combination of historical audited and unaudited financial statements of the target business will be needed in order to obtain debt financing. It is also generally true that the more historical financial statements that are available, the more financing alternatives there will be and, in the end, the more likely that the private equity buyer can pursue the financing structure of its choice.

A marketing of high yield bonds is likely to require as much, if not more, disclosure with respect to historical financial statements as other forms of financing. High yield bonds are usually sold to investors in a transaction exempt from the registration requirements of the Securities Act of 1933, pursuant to the "Rule 144A safe harbor." In order for an offering to be eligible for this safe harbor, an issuer must meet certain informational requirements, including providing investors with the "issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation (the financial statements should be audited to the extent reasonably available)."

Notwithstanding the apparent flexibility of the rule (note that audited financials are required only if they are "reasonably available"), under customary market practice, an offering of high yield bonds under Rule 144A is modeled on a public offering, which would typically be made by way of an offering prospectus including two years of audited balance sheets, three years of audited statements of income, changes in stockholders' equity and cash flows and two additional years of selected financial data (*i.e.*, up to five years of financial statements and data in total), with appropriate comfort from auditors, all as required under Regulations S-X and S-K of the Securities Act of 1933. Market practice does allow for variation from this standard in cases where the full package of historical financials is not available, but it would be very uncommon for disclosure with respect to any high yield offering to include fewer than two years of historical audited financials statements.

In addition, most high yield bonds offered under Rule 144A are accompanied by registration rights for the benefit of investors. In a case where registration rights are offered, an issuer will need financial statements which comply with the requirements of Regulations S-X and S-K by the negotiated deadline for the filing of a registration statement with respect to the A/B exchange offer. This deadline customarily ranges from 45- to 420-days after the closing of the acquisition, with 180 days being the most common.[2]

As a result of market practice, if at least two years of historical audited financial statements and unaudited interim financial statements for the target business cannot be provided within the contemplated time frame for the closing of the transaction, a private equity buyer risks losing the option of tapping the high yield bond market to finance its acquisition, and may instead need to close with a more expensive and less flexible financing. Moreover, even if this limited set of historical financials is available, it is also possible that the historical financial statements necessary for a registered exchange offer will not be available during the 45- to 420-day period for filing a registration statement expected by investors.

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1 *While this article focuses on a private equity buyer's need for historical financial statements of a target in connection with its financing, it should be noted that strategic buyers, including portfolio companies, might have a separate and distinct need for a similar universe of financial statements either because they are public reporting companies or have covenants in their existing financing agreements that contain analogous financial reporting obligations.*

2 *For a detailed market survey of registration rights in 144A offerings, see "Registration Rights in High Yield Debt Offerings – A Market Survey," Debevoise & Plimpton LLP Private Equity Report, Winter 2012. (click here)*

Some Challenges in Financing "Carve-Out" Acquisitions (cont. from page 21)

What Can Be Done if There Are Deficiencies?

In carve-out transactions, it is not uncommon for a private equity buyer to find itself without the historical financial statements necessary to meet market demands with respect to Rule 144A offerings. Here are a few practical solutions that may be available depending on the situation.

- *Push the Seller.* Given the potential impact on a private equity buyer's cost of capital and on the portfolio company's post-closing operating flexibility (each discussed below), before pursuing one of the alternatives below, a buyer should vigorously probe assertions that the necessary financial statements are not available or cannot be produced on an acceptable timeline or that the target's auditors cannot provide necessary comfort, and the issue should be addressed at the earliest possible point in the transaction. The absence of these financial statements and the related auditors' comfort reduces the buyer's flexibility with respect to its financing and there is often a real cost to this loss of optionality. Depending on the dynamics of the sale process, it may be useful to share with the seller the impact of these costs on the value of the target business to the buyer and, as a result, the purchase price that can be offered. In the end, a more costly financing is a shared problem and there can sometimes be a shared solution.

Given the potential impact on a private equity buyer's cost of capital and on the portfolio company's post-closing operating flexibility... before pursuing one of the alternatives below, a buyer should vigorously probe assertions that the necessary financial statements are not available or cannot be produced on an acceptable timeline....In the end, a more costly financing is a shared problem and there can sometimes be a shared solution.

- *Push the Arrangers.* If historical financial statements necessary to meet the bare minimum required for a customary marketing of high yield bonds will not be available on the desired timeline, a private equity buyer should still consider pressing its prospective arrangers to provide bridge commitments supporting the high yield bond offering. As noted above, the Rule 144A safe harbor requirements with respect to historical financial statements are more lenient than customary market practice requires (*i.e.*, at least two years of audited financial statements). Therefore, an offering supported by meaningfully less in the way of financial statement disclosure (*e.g.*, only one year of audited financial statements, if additional audited financials are not "reasonably available"), may still comply with Rule 144A. Given the highly unusual nature of this type of bond offering though, it may be difficult to predict market appetite and, as a result, potential arrangers are likely to be resistant to underwriting a bridge on this basis or, at least, at pricing that would be acceptable to the private equity buyer. However, given the right circumstances, including an attractive credit and a competitive "bake-off," it may be feasible.[3]

- *144A-For-Life and Variations Thereof.* In the more common situation where at least two years of audited financials for the target business are available but a third year of audited statements of income, changes in stockholders' equity and cash flows and/or two additional years of selected financial data will not be available during the customary 45- to 420-day period for filing a registration statement, it is not uncommon for a private equity buyer to obtain bridge commitments supporting a 144A-for-life offering (*i.e.*, an offering without registration rights) or a "modified" 144A offering with long-dated filing periods that will allow the issuer to ultimately satisfy the Regulation S-X and S-K requirements. However, for several reasons, the market for, and liquidity of, these types of bond offerings may be limited. Most importantly, many high yield investors have limits on the percentage of unregistered securities they may hold in their portfolios and the absence of meaningful registration

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3 *As a cautionary note, even if the private equity buyer is confident that it can obtain a bridge to this unique bond offering, it will also need to consider whether the available financial statements, together with other disclosure, will be sufficient to satisfy applicable antifraud rules and regulations applicable to the offering, including Rule 10b-5 of the Securities Exchange Act of 1934.*

Some Challenges in Financing "Carve-Out" Acquisitions (cont. from page 22)

rights under 144A-for-life and "modified" 144A offerings may preclude some investors from participating in the offering. As a result, financing sources are typically less willing to commit to bridges for these types of offerings and, when they do, a private equity buyer can expect to pay accordingly.

- *Mezzanine Financing.* Depending on the size of the financing shortfall, a sponsor could consider a mezzanine or private high yield financing. These types of financings are likely to be more expensive and the related covenants are likely to be more restrictive than could be obtained in a traditional high yield offering. A private equity buyer will need to take into consideration both the direct incremental costs and the potential impact of lost operating flexibility of these financings. Moreover, while the number of financing sources and the magnitude of debt available in this space have both increased significantly over the last several years, supply in this market is still relatively limited, when compared to the high yield market. As a result, this may not be a solution for the largest of large cap deals.

- *Seller Paper.* Whether in the form of debt or equity, seller paper might be considered as a bridge to a time when the necessary financial statements can be produced and a customary 144A offering can be made. Obviously, this option is unlikely to be viewed favorably by the seller but, in many cases, a private equity buyer might reasonably conclude that the seller should bear some responsibility for the lack of requisite financials and play a role in resolving the issue. A private equity buyer will need to consider the dynamics of a given sale process to determine whether this is a reasonable alternative. The cost and flexibility of covenants, if any, in seller paper will depend on the negotiating leverage of the parties and, therefore, will differ on a case-by-case basis.[4]

None of these alternatives is perfect. Each carries its own peculiar cost/benefit analysis. However, when confronted with a carve-out acquisition in which there is a meaningful possibility that customary financials statements will be unavailable when needed for an optimal financing, one of these alternatives might prove to be a workable solution for what otherwise appears to be an intractable problem. ■

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4 *For special considerations regarding seller paper, see "Covering the Capital Structure: The Seller Note," Debevoise & Plimpton Private Equity Report, Fall 2011. (click here)*

Registration Rights in High Yield Debt Offerings: A Market Survey (cont. from page 6)

A/B exchange offer by a specified deadline—with no preceding filing or effectiveness deadline. A significant number of agreements also provided for an effectiveness deadline, or for all three deadlines.

In agreements with a filing deadline, the deadline ranged from 45 to 420 days after issuance, with 180 days being the most common. In agreements with an effectiveness deadline, the deadline ranged from 150 to 510 days after issuance, with 270 and 365 days being the most common. Deadlines for completion of an A/B exchange offer ranged from 180 to 450 days after issuance, with the most common being 360, 365 or 395 days. The longer completion deadlines tend to be found in agreements with no other deadline and agreements with an effectiveness and a completion deadline but no filing deadline. A significant number of agreements did not specify a specific deadline for completion, but rather required that the exchange offer be consummated within a specified period—typically 30 days or 30 business days—after the registration statement became effective; effectiveness deadlines in these agreements ranged from 160 to 510 days after issuance (with 270 and 365 days being the most common). Perhaps not surprisingly, agreements with shorter deadlines tended to be for seasoned issuers that were already SEC registrants with reporting obligations under the Securities Exchange Act of 1934.

Additional Interest Rate

Additional interest provisions in high yield registration rights agreements typically provide for an increasing additional interest rate, subject to a cap. All but a handful of the agreements in the sample contained a starting additional interest rate of 25 basis points (0.25%) per annum. All but two agreements

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Registration Rights in High Yield Debt Offerings: A Market Survey (cont. from page 23)

provided for increasing additional interest over time, typically increasing in 25 basis point increments every 90 days during the continuance of registration default. A majority of the agreements in the sample capped the additional interest rate at 100 basis points (1.0%), although a significant number provided for a cap of 50 basis points (0.5%).

Specific Performance

Over half of the agreements in the sample contemplated that specific performance may be a remedy to a registration default, either by explicitly providing that the bondholders are entitled to specific performance or by providing a waiver by the issuer of certain defenses relating to specific performance. While only a couple agreements expressly provided that specific performance does not apply in the case of a registration default, a significant number were silent about whether specific performance applies.[5]

Fall Away Provisions

Fall away provisions in high yield registration rights agreements provide that the registration requirements under the agreements cease to apply, or additional interest ceases to accrue, after the relevant bonds become freely tradable for securities law purposes, or after a certain period of time has elapsed after the bonds have become freely tradable, or after a certain period of time has elapsed after issuance. In our sample, almost half of the agreements had some sort of fall away provision.

Market practice with respect to fall away provisions has evolved over the past few years in response to the changes in Rule 144 adopted in 2008. Prior to the 2008 amendments, Rule 144 permitted holders who were not affiliates of the issuer to freely resell securities without volume limitations after two years. The 2008 amendments reduced the Rule 144 holding periods, and allow non-affiliates to freely resell securities of Exchange Act reporting companies after a six-month period and to resell freely securities of all companies, regardless of Exchange Act reporting status, after a one-year period.

The change to Rule 144 holding periods has affected the timing reflected in fall away provisions. Prior to the 2008 amendments, it was not uncommon in private equity sponsor transactions for registration rights agreements to provide for a fall away upon the bonds becoming freely tradable without restrictions under Rule 144. A simple fall away upon the bonds becoming freely tradable has become less common following the 2008 amendments. Only a handful of agreements in the sample provided for such a fall away, and nearly all of these had a relatively short, 180-day or 270-day registration completion deadline, inside of the shortened one-year Rule 144 holding period. The most common formulation in the sample provided for a fall away on the second anniversary of the closing date, in effect preserving the fall away construct under the old Rule 144 holding period. A handful of agreements provided for a fall away upon the later of the bonds becoming freely tradable and a specified date ranging from 545 days to 2 years after closing.

The registration regime for high yield bonds has remained remarkably stable through a variety of business cycles and a liberalization of the securities laws. For high yield issuers, the price of admission to the high yield market continues to be offering liquidity through registration rights with an incentive to deliver registered securities within a finite period of time after issuance. ■

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5 *This article does not address whether specific performance would in fact be available as a remedy.*

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markets with assets being held to their "highest and best use." This provided a very precise syntax, but many claimed it was an even more ambiguous framework. As an example of this perceived ambiguity, one interpretative note pointed out that contrary to prior practice, "value" might not necessarily be the same as "price" under the new standard—because price is sometimes determined under duress, and can differ depending on the particular market which may or may not represent the principal market, or the "most advantageous" market.

Remember that prior to FAS 157, the primary difference between PE practice and fair value was the focus on exit versus entry price. FAS 157 created a more problematic distinction for private equity investors. The accounting standard focused on a market-based approach to determining fair value for an investment rather than an entity or company-specific approach. To many professionals, particularly venture investors this distinction led to a concern that these new fair value standards might be wielded like the proverbial hammer where everything looked like a nail. To its credit, FAS 157 also provided detailed guidance and a framework as to where and how to apply the guidelines. Most signficantly, it stratified assets and liabilities into three buckets—so-called levels:

- *Level 1* are those that have an observable input such as a traded market price.
- *Level 2* are those that may not have a direct observable input such as a market price, but have inputs that are based on observable inputs such as market prices.
- *Level 3* (and most applicable to private equity) are those that have no observable inputs.

In addition, there were extremely prescriptive techniques, matrices, and rules on how to apply techniques to determine fair value. PEIGG revised its guidelines to comply with the new FASB 157 guidelines, which were to go into effect on November 15, 2007.

The timing could not have been more auspicious. It was at the very beginning of the financial crisis, and in some circles the financial crisis and its focus on the value of "unvalue-able" assets, such as mortgages, was exacerbated by FAS 157, the fair value premise and its close conceptual cousin "marked-to-market." There was considerable consternation that one unintended effect of FAS 157 was to exacerbate the downward spiraling of Level 3 asset values. Compounding the problem was that analysts, pundits and investors started to view the Level 3 assets as all being bad simply because there was no transparency—thus everything from mortgages, derivatives and other alternatives were painted with the same brush—"problematic," "toxic," "hiding something." Level 3 assets were viewed with suspicion.

Consequences

The move to fair value has been contentious, not because of the concept but because of the unintended consequences and the difficulty of applying a rigorous technique to what some would suggest is art rather than science. In 2009, FASB made an expedient change to FAS 157 that allowed Net Asset Value (NAV) to be used as a basis for Fair Value. To some it appeared to be an acquiescence to the notion that FAS 157 had unintended consequences. Others viewed it as giving bad actors a pass. Still others viewed it as a realization that fair value was a work-in-progress.

As of this writing, FAS 157 has been subsumed within FASB ASC Topic 820. As mentioned above, the timing of the introduction of FAS 157 coincided with the financial crisis, and whether or not there was a casual link, FAS 157 became a polarizing issue. The unheralded renaming of FAS 157 into Topic 820 was observed by some as a simple recognition that fair value was now a *fait accompli* and it was time to move on. Others quipped that renaming it was just a way of removing it from headlines.

What Can Go Wrong?

GPs making "club" investments in a company agree on a valuation of that company when they make the investment. Post-investment, however, the value each investor places on that company may well diverge until there is another arm's-length transaction implying a market value. If the divergence is small, there is no issue, but a material divergence may draw scrutiny from investors. This divergence in valuation has also piqued the interest of the press as it may not make intuitive sense to the casual observer. It may also be this divergence that has attracted the interest of regulators even if it is a natural artifact of independent evaluations.

Fair value assessments in venture investing have a self-correcting mechanism since there may be multiple arm's-length transactions over the life of an investment. Buyout investments, however, generally have only one such transaction, the initial investment, and thus only one real reference point to validate a valuation. Any valuation after that initial transaction involves a subjective appraisal by the general partner. Although buyout transactions have more observable inputs, buyouts have been just

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as resistant to fair value as their venture counterparts. A GP once responded when pressed on using cost as current value: "we've got to eventually sell this company, why would we telegraph what we think this investment is worth to a buyer? Let them tell us." Whether that is actual policy or not, it does reflect the hands-off approach that GPs sometimes feel is in both their own and their investors' best interests.

To go full circle, the irony in the recent SEC interest in overstated valuation is that it is in direct contrast to the accounting and financial reporting industry's concern for the last couple of decades that the private equity industry's historically conservative legacy practice was understating valuations.

In any case, since the financial crisis, there has a been a dramatic change in attitude and widespread adoption of fair value among private equity firms. Between the requirements of the various U.S. and international accounting, industry, and financial performance reporting standards, there is little escape from the fair value regime. In recent years, coordination and sharing of best practices among PE firms, their valuation consultants and auditors have made the process more institutionalized. Many firms appear to be performing valuations on a quarterly basis rather than just at the annual audit and the industry has become more comfortable with the language of fair value—notwithstanding some lingering suspicion of its unintended consequences.

Conclusion

The move to fair value has had many fits and starts, but it is an evolutionary step that is probably necessary in order for investors to have the transparency they require in an era when there is tremendous transparency in other financial markets. That said, some claim that too much transparency in the private equity context is much like killing the goose that laid the golden egg because performance in alternative asset classes is often attained through inefficiencies in market information. They suggest that too much transparency destroys those inefficiencies in ways that will ultimately penalize the investor. Another danger is that GPs may begin to focus too much on short-term performance, a common criticism of the public company structure. In any event, like all evolutionary processes, valuation will continue to be refined with both intended and unintended consequences. ■

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ambiguous provisions. As a result, government authorities and courts end up having broad interpretive and enforcement discretion leading to sometimes unpredictable results.

- ***Foreign investment approvals and restrictions:*** Russian law establishes different regimes for foreign investment in various different sectors, such as a prohibition on foreign investment in TV and radio broadcasting companies that reach more than half of the constituent entities of the Russian Federation or more than half of the general population. In addition to direct prohibitions, Russian law also establishes restrictions on foreign investment in companies whose operations are in an area of strategic importance from a national defense and security perspective. Such restrictions generally take two forms: either a quota is put in place for foreign investment in a certain market (*e.g.*, there is a quota for foreign investment in the Russian insurance sector) or there is a requirement that each particular transaction involving foreign investment in certain strategic companies be cleared by the state. Such areas of strategic importance include certain types of activities relating to radioactive and nuclear facilities, weapons, arms, ammunition, explosive material and military hardware; encryption and covert gathering of information; aviation and aerospace; operations of natural monopolies; and use of subsoil plots of federal importance. In general, no unified set of prohibitions and restrictions on foreign investment exists in Russia. Such prohibitions and restrictions are instead scattered throughout a number of different laws and regulations, often with different definitions, rules and procedures.

- ***Foreign exchange controls:*** Most of the currency control restrictions applicable to currency transactions between Russian residents and non-residents ceased to apply in 2007. However, there still is a prohibition on foreign currency transactions between Russian residents and a requirement to repatriate export-related earnings back into Russia, in each case subject to certain exceptions.

- ***Rights to shares and participatory interests:*** Most Russian commercial entities exist in the form of a a joint stock company or a limited liability company. Joint stock companies having more than 50 shareholders are required to maintain a register of shareholders through an independent registrar (the company may generally choose from among dozens of licensed registrars in the market). Joint stock companies having less than 50 shareholders may maintain their own register (and in such cases the register may not be maintained properly and may need to be updated in connection with a sale). Beginning July 1, 2012, all public companies, even if they have less than 50 shareholders, will be required to maintain their register of shareholders with an independent registrar. A transfer of shares in a joint stock company occurs at the moment of the change to the register. While limited liability companies keep registers of their shareholders (participants), such registers do not definitively evidence ownership of the participatory interest (instead, title passes at the moment of notary certification of the operative transfer document). The above described regime makes determining ownership of and transferring title to equity interests in Russian companies difficult and complicates the due diligence process.

- ***Tax litigation:*** Business entities in Russia are frequently involved in lawsuits and administrative proceedings that challenge the interpretation and application of tax rules and regulations. Because entities within the same industrial sector are often involved in lawsuits and administrative proceedings challenging the same taxes and on the same grounds, it can be useful to attempt to ascertain what tax issues the competitors of a target have faced or are facing, as that will give some

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In general, no unified set of prohibitions and restrictions on foreign investment exists in Russia. Such prohibitions and restrictions are instead scattered throughout a number of different laws and regulations, often with different definitions, rules and procedures.

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indication of the potential issues the target may have in the future.

- *Labor litigation:* Russian laws grant employees extensive social security and labor rights and employee benefits, the costs of which are mostly borne by the employer. Additional rights and benefits may also be established by collective bargaining agreements between labor unions and employers, although unions have recently become more rare.

Financial Due Diligence

- *Accounting records:* Accounting books and financial records of Russian companies are generally less transparent than those of U.S. companies. Russia is currently implementing an electronic filing system aiming to improve the level of monitoring by Russian tax authorities and the transparency of accounting records generally.

Under a new law adopted in July 2010, financial institutions, insurance companies and listed companies are...required to prepare consolidated financial statements in compliance with the IFRS, starting with their annual financial statements for 2012.

- *Financial Audit:* Independent audits of financial statements are only mandatory for public and listed companies, financial institutions, professional participants in securities markets, investment funds, non-governmental pension or other funds, insurance companies, companies whose assets or turnover exceed the statutory thresholds and certain other categories of companies. However, enders often require independent audits of their borrowers regardless of whether they fit within any of the foregoing categories, so private companies with debt facilities outstanding may well have audited financials. Most large Russian companies, whether public or private, are audited by the "big four" auditing firms or a reliable Russian accounting firm. It is worth noting, though, that there are a number of local accounting firms in Russia that are less credible and not always impartial in performing audits.

- *Accounting standards:* As a general rule, Russian companies are required to prepare audited financial statements under Russian Accounting Standards ("RAS"). Under a new law adopted in July 2010, financial institutions, insurance companies and listed companies are also required to prepare consolidated financial statements in compliance with the IFRS, starting with their annual financial statements for 2012. Certain additional companies will be required to prepare such statements starting in 2015. Most publicly listed Russian companies are currently preparing consolidated audited financial statements in compliance with the IFRS or U.S. GAAP, although this is not required by law.

- *Related party transactions:* Private companies in Russia tend to have extensive, and sometimes messy, related-party arrangements or interested party transactions, as they are often called. Failure to approve a transaction as an interested-party transaction may in certain cases result in the invalidation of the transaction upon claims by disinterested shareholders of the company, which is especially important to note for foreign investors since Russia does not always recognize conflict of laws principles, and even a transaction governed by foreign law and containing an arbitration clause in certain cases may be found invalid in Russian courts under Russian law.

* * *

Russia is a large and growing market, full of potential opportunities. But investors must be wary of potential pitfalls and extra vigilant during the due diligence process in order to minimize risks to the greatest extent possible. Guidance from experienced, knowledgeable advisors is crucial to success in this land of still relative uncertainty. ■

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