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KIRKLANDPEN
Private Equity Newsletter

February 8, 2018

SEC Announces 2018 Examination Priorities

PENpoints

The SEC's 2018 Examination Priorities publication provides a more fulsome discussion of OCIE's underlying concerns than in previous years.

On February 7, 2018, the SEC's Office of Compliance Inspections and Examinations ("OCIE") published its Examination Priorities for 2018. While these priorities are significantly focused on retail investor protection, securities market infrastructure and SRO oversight, some priorities impact private fund advisers, including examining:

- adviser business models that inadequately disclose fees, expenses or other charges, including for private fund advisers with a high concentration of fund investors investing on behalf of retail clients (e.g., pension plans and non-profits);
- fee calculations, which supplements the continued focus on fee and expense disclosure;
- newly registered advisers and other advisers that have never been examined or have not been examined for a long period, all using a risk-based selection;
- management and mitigation of cybersecurity risks, including reviewing an adviser's governance and risk assessment practices, access rights and controls, data loss prevention measures, vendor management, training and incident response;
- implementation of an adviser's AML programs, including examination of customer due diligence processes and the adequacy and timeliness of any required program testing; and
- an adviser's structural controls, disclosures to investors, and other risks related to involvement in cryptocurrency, initial coin offerings, secondary market trading and blockchain.

In announcing these and other priorities, OCIE noted its commitment to a risk-based, data-driven and transparent examination program that embraces technology and innovation. OCIE also noted that the list of priorities is not exhaustive, and OCIE intends to conduct examinations focused on issues that arise from market developments; new information learned from examinations or other sources, including tips, complaints and referrals; and coordination with other regulators, as well as regulatory developments.

The 2018 Examination Priorities publication provides a more fulsome discussion of OCIE's underlying concerns than in previous years and offers useful insight into OCIE's approach to each priority.

INSIDE KIRKLANDPEN

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Final Tax Bill Affects Executive Compensation and Equity-Based Incentive Programs

The 2017 Tax Cuts and Jobs Act (the "Act") will affect the design of management equity incentive programs and other compensation arrangements commonly adopted by private equity-owned portfolio companies ("PCs"). As described in our *Kirkland Alerts* from February 1, 2018, and December 22, 2017, the Act reduces the top corporate tax rate from 35% to 21%, limits the use of net operating losses to 80% of taxable income and prohibits carrybacks of net operating losses (collectively, the "NOL Limits"), significantly expands the overall scope of the $1 million deduction limitation under Internal Revenue Code Section 162(m) ("Section 162(m)"),[1] and expands the types of companies subject to Section 162(m). Highlighted below are some of the potential effects and considerations for private equity sponsors and their portfolio companies:

- **Expanded Scope of Companies Subject to 162(m).** The Act expands the universe of companies subject to Section 162(m) to include private companies with publicly traded debt and certain foreign filers ("newly covered companies"). Previously, only corporations with publicly traded equity securities were subject to Section 162(m). Accordingly, a number of private-equity owned PCs will become subject to the compensation deduction limitations under Section 162(m).
- **Removes Performance-Based Compensation Exemption to Section 162(m).** The Act eliminates the performance-based compensation exemption from Section 162(m) on which public corporations have heavily relied to deduct compensation in excess of the Section 162(m) cap.
- **Decrease in Value of Deductions for Most Companies.** The decreased corporate tax and NOL Limits will generally reduce the value of corporate compensation-based deductions for all entities. Combined with the removal of the widely used performance-based pay exemption, the value of (and ability to take) compensation-related deductions for newly covered companies and publicly traded companies that pay individual executives in excess of $1 million will significantly decrease.
- **Increased Appeal of Profits Interests.** Given the decrease in the availability and scope of corporate tax deductions described above, profits interests could become more appealing to sponsors as an appreciation-based compensation tool for management teams. Unlike options and stock-appreciation rights, which are taxed at ordinary income rates to management and include a corresponding corporate tax deduction, profits interests are often taxed at long-term capital gains rates but are generally not deductible by the company.
- **Effective Date and Transition Rule.** Changes to the corporate tax rate and Section 162(m) are effective for taxable years beginning after December 31, 2017. However, the Section 162(m) changes do not apply to compensation provided pursuant to a written binding contract in effect on November 2, 2017, unless materially modified on or after that date. Accordingly, companies subject to Section 162(m) (including newly covered companies) should be very careful about amending previous arrangements that might otherwise be grandfathered and remain deductible under the old Section 162(m) rules.

1 As described in our prior *Kirkland Alert*, Section 162(m) generally imposes a $1 million cap on a public corporation's federal income tax deduction for compensation paid to certain "covered employees." Previously, "covered employees" included the chief executive officer and each of the next three most highly compensated executive officers, excluding the chief financial officer, but the Act expands the definition to also include chief financial officers.

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Revised Hart-Scott-Rodino Act Thresholds and Civil Penalty Amounts Announced

The Federal Trade Commission ("FTC") recently announced increases to the Hart-Scott-Rodino ("HSR") Act filing thresholds.

Parties to a transaction closing on or after February 28, 2018 must, subject to certain exemptions, file HSR forms when, as a result of an acquisition, the buyer will hold assets, voting securities, and/or non-corporate interests valued in excess of $84.4 million (the "Size-of-Transaction" test) and the transaction involves a buyer or seller with annual net sales or total assets valued at $16.9 million or more and $168.8 million or more, respectively (the "Size-of-Person" test). If the "Size of Transaction" exceeds $337.6 million, the "Size of Person" is, subject to certain exemptions, irrelevant and HSR forms must be submitted.

The chart below summarizes the 2017 and the new thresholds.

HSR Jurisdictional Test	2017 Thresholds	New 2018 Thresholds
Size-of-Transaction	$80.8 million $323 million	$84.4 million $337.6 million
Size-of-Person	$16.2 million $161.5 million	$16.9 million $168.8 million

Filing fees have not changed and apply to the new thresholds as follows:

Transaction Value	Filing Fee
Greater than $84.4 million but less than $168.8 million	$45,000
Greater than or equal to $168.8 million but less than $843.9 million	$125,000
$843.9 million or more	$280,000

The FTC also announced an increase in the maximum civil penalty amounts for HSR violations from $40,654 per day to $41,484 per day, effective January 22, 2018.

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PENbriefs

Landmark Court Opinion Increases Liability Risk Profile for German Portfolio Company Management

A recent decision by the German Supreme Court has tightened the rules for determining when a company is "cash flow insolvent" and, by extension, for determining when a German company must file for bankruptcy. This case is significant because, under the German Insolvency Code (the "German Code"), failure to file for bankruptcy promptly or, at the latest, within 21 days of the occurrence of "cash flow insolvency" can subject directors to civil liability to harmed creditors, civil and criminal fines and, in the worst case, jail time.

Under the German Code, a company is "cash flow insolvent" if it cannot fulfill its due and payable obligations, which courts have interpreted to have occurred whenever a company has a payment shortfall of 10% or more (the "10% Rule"). It has been settled law that, when assessing whether a payment shortfall has occurred, directors must compare the amount of a company's liquid assets plus those it can easily liquidate within three weeks to its payment obligations. Prior to the recent opinion, it was unclear if the payment obligations only included those due on the relevant liquidity testing date, or all liabilities coming due during the following three-week period.

The recent decision is significant because the Court ruled that a company must take into account all liabilities coming due during the following three-week period, increasing the likelihood of a 10% Rule breach. This will have several practical implications, including that it will put pressure on a company engaged in restructuring negotiations, as the obligation to continuously test for cash flow insolvency under the 10% Rule — and to file promptly, no later than 21 days after a 10% Rule breach — remains even if such restructuring negotiations are likely to succeed. To learn more, see our recent *Alert*.

U.S. Department of the Treasury Identifies Russian Political Leadership and Oligarchs, Though Ultimate Implications Remain Forthcoming

The U.S. Department of the Treasury released the *Report on Senior Foreign Political Figures and Oligarchs in the Russian Federation*. For now, Treasury has emphasized that identification in the report does not mean that the named parties are sanctioned or that U.S. persons are now prohibited from doing business with them. However, Treasury Secretary Mnuchin also indicated that those identified could become sanctions targets in the future. Transactions with such parties could also now become subject to closer scrutiny, warranting greater due diligence before engaging in business with them. To learn more, see our recent *Alert*.

Trump Administration Imposes Substantial Tariffs Ushering in *America First* Trade Agenda

President Trump recently acted on recommendations from the U.S. International Trade Commission to impose tariffs on imports of large residential washing machines and solar cells and modules that were the subject of two "safeguard" investigations. These decisions affirm that the Trump administration is prepared to utilize a robust toolkit of remedies when countries are viewed as engaging in unfair trade with the U.S., particularly with respect to China. Companies — and their investors — would be well-advised to examine the international exposure of their enterprise value chains, as the cost of doing business may increase both for inbound transactions as import duties rise and for outbound transactions if trading partners retaliate. To learn more, see our recent *Alert*.

Mexico Signs ICSID Convention

Mexico's Secretary of Economy recently signed the International Centre for Settlement of Investment Disputes (ICSID) Convention. The long-awaited signature was penned amidst growing concerns about the outcome of the upcoming presidential election in Mexico and the prospect of changes to the North American Free Trade Agreement (NAFTA), in order to blunt the effect of these developments. Once ratified by Mexico, parties with investment treaty disputes involving Mexico will be able to arbitrate those disputes with the full protection of the ICSID Convention, including nearly automatic award enforceability. In light of the current climate, clients with relevant interests in Mexico should consider whether to take advantage of available protections for their investments there, which may soon include ICSID protection. To learn more, see our recent *Alert*.

California Court Invalidates Parts of County Ordinance Banning Well Stimulation Treatments and Underground Wastewater Injection

A California state court recently struck down parts of a ballot-initiative measure that sought to prohibit use of land for hydraulic fracturing (i.e., fracking) treatments and oil and gas wastewater injection and impoundment. The outcome may have ripple effects throughout the industry as other municipalities consider similar bans on fracking and wastewater injection. To learn more, see our recent *Alert*.

PENnotes

Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, IL, February 23, 2018

Kirkland is a sponsor of this annual event, which brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year's conference is themed "Remaining Nimble and Achieving Returns While Facing Uncertainty and Volatility." Kirkland partner Robert Wilson will moderate a panel on "Investing within the Changing Healthcare Sector." Click here for more information.

Columbia Business School Private Equity Conference
New York, NY, February 23, 2018

Kirkland will sponsor the 25th annual Columbia Business School Private Equity Conference. The event will focus on the emerging challenges and opportunities facing the private equity and venture capital industries in the coming year. Kirkland partner Srinivas Kaushik will moderate the Leveraged Buyout panel, and partners Stephanie Berdik and David Nemecek will give a lunchtime presentation on "Cracking the Credit Code: Trends in Private Debt." Click here for more information or to register.

13th Annual Stern Private Equity Conference
New York, NY, March 2, 2018

Kirkland will sponsor New York University's Stern School of Business' 13th Annual Stern Private Equity Conference. The conference will provide a forum for industry leaders to discuss the opportunities and risks of today's private equity and venture capital environment, including how tepid global growth, regulatory dynamics, political pressure and financial market conditions are posing challenges to fundraising, deal financing and operations. Kirkland partner Michael Weisser will moderate the Investment Horizons panel, and partner Joshua Sussberg will moderate the Distressed Investing panel. Click here for more information or to register.

Wharton Private Equity & Venture Capital Conference
New York, NY, March 16, 2018

The Wharton School's Private Equity and Venture Capital Conference will showcase several keynote speeches and panel discussions on the state of the private equity and venture capital industries. Kirkland partner Robert Blaustein will moderate the Funds panel, and partner Stephen Hessler will moderate the Distressed Opportunities panel. Click here for more information or to register.

PENnotes

2018 Kellogg Private Equity and Venture Capital Conference
Chicago, IL, April 25, 2018

Kirkland is a sponsor of this annual student-led conference, which brings industry professionals, alumni, students and Kellogg faculty together for a day of discussion on the current state of the industry and its most pressing issues. Kirkland partner Richard Campbell will moderate a panel on "Add-On Acquisitions as a Source of Value." Click here for more information.

Private Debt Investor CFOs & COOs Forum 2018
New York, NY, June 20-21, 2018

Kirkland is a sponsor of this event, which will delve into the complexities of managing the finance and operations of firms that invest across the capital structure, including senior secured loans, subordinated debt, hybrid financing and more. Kirkland partner Stephanie Berdik will address how LPs evaluate private debt and credit funds, and partner Norm Champ will discuss the before and after of an SEC exam. Click here for more information or to register.

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Kirkland & Ellis' nearly 500 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 400 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last seven years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2018 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2017, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2016*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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