FundsTalk

September 2013

We are pleased to offer this issue of FundsTalk, Kramer Levin's newsletter devoted to discussing legal issues facing alternative asset managers and funds. The alternative asset market has seen a broad convergence of previously distinct asset classes and strategies, such as private equity, hedge funds, debt and claims trading, etc., into a single class — alternative assets. Extending that theme of convergence, this newsletter focuses on multi-disciplinary themes that affect all asset managers, with particular attention paid to new developments and changes in the legal landscape in which the industry operates. We hope you find the information contained in this newsletter to be helpful and profitable, and welcome your thoughts and suggestions.

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Controlling a U.S. Insurance Company — Key Regulatory Basics That Funds Need To Know

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The last few years have seen increasing private fund activity in the insurance sector, including acquisitions of existing carriers as well as start-ups. Organizations as diverse as Apollo, Harbinger Group, Third Point and Blackstone, and a number of others, have made significant investments in portfolio insurance companies and related businesses. As commentators have observed, insurance companies can be attractive as a source of "permanent capital" in an industry where equity must generally be deployed or returned to investors. Insurance investments also offer risks and rewards that may not be correlated with macroeconomic conditions such as interest rates or price levels. In addition, insurance businesses can take advantage of a variety of nimble hedging mechanisms such as reinsurance and insurance-linked securities to manage exposures. However, in this highly regulated sector, an understanding of some of the basic pillars of insurance law — particularly the oversight by regulators of those who control insurers — is essential for playing in this space. This article focuses on such oversight and what it can mean for acquirers and management. In future editions of *FundsTalk* we will cover related areas such as ancillary transactions (including reinsurance) and statutory determinations of control in the context of fund structures.

Regulating Control over U.S. Insurers

An entity seeking to acquire control of an existing insurer must file a detailed application (known generally as a "Form A") with, and obtain the prior approval of, the domiciliary state regulator. Once acquired, a controlled insurer must report periodically to the regulator on its relationships with its holding company (affiliate transactions, changes in management and similar events), including a requirement under certain circumstances to pre-file affiliate transactions with the regulator.

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Controlling a U.S. Insurance Company — Key Regulatory Basics That Funds Need To Know

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"Enterprise Risk" and "Own Risk Solvency Assessments"

In late 2010, the National Association of Insurance Commissioners ("NAIC") adopted new requirements concerning so-called "enterprise risk," defined broadly as any "activity, circumstance, [or] event…that, if not remedied promptly, is likely to have a material adverse effect upon the financial condition or liquidity of the insurer" or its affiliate group. Form A applicants seeking approval to control an insurer will be required to commit to the regulator in writing that it will comply with these enterprise risk requirements, including annual reporting obligations to the "lead" state of an insurance group. A number of states have already adopted these requirements (including key insurance jurisdictions such as Connecticut, California and Texas); accordingly, some companies will be required to begin filing enterprise risk reports with their principal state regulator as soon as early 2014.

Similarly, the NAIC has formulated rules concerning so-called "Own Risk Solvency Assessments," or "ORSAs." These rules will require insurers or their affiliate groups to conduct self-examinations intended to determine risks to the insurer's current business plan and the sufficiency of capital to support those risks. Summaries must be filed annually with the lead state. An exemption is available for an insurer whose annual premiums are less than $500 million and whose total annual premiums together with those of its affiliates are less than $1 billion. As with the enterprise risk requirements, the new ORSA provisions are in the process of being adopted on a state-by-state basis, with January 1, 2015 being the expected date by which all ORSA requirements should take effect.

Confidentiality Concerns

(i) Document submissions. In most (but not all) states, a Form A is a public document; the Holding Company Act does not shield it from disclosure and, therefore, it falls under typical state-law provisions on open records. Although most states do not post submitted Form As on their insurance department websites, some do, and this can include the underlying legal documentation (such as the purchase and sale agreement) required to be annexed to the Form A.

Notwithstanding these general statutory requirements, regulators will frequently entertain requests to keep materials within a Form A (such as detailed business plans, trade secrets and certain financial disclosures) confidential. However, this willingness varies from state to state, and even a particular state's grant of confidentiality to components of a Form A in a previous deal cannot be regarded as precedential. Information rarely shielded from public disclosure includes basic deal terms and the underlying deal documentation.

By contrast, annual registration statements, notifications of affiliate transactions, enterprise risk reports and ORSA summaries are all accorded confidential treatment.

(ii) Public hearings. In some states, a regulator is permitted or even required to hold a public hearing on the merits of the Form A. Such a hearing can give aggrieved parties (such as employees, competitors, policyholders and other suitors of the target company) an opportunity to attack the transaction and urge the regulator to disapprove it. Where the regulator concludes that such a party would be particularly affected by the transaction, she can permit such party to formally intervene in the proceedings or even grant party status. As a legal matter, this is difficult to achieve, because the regulator is limited to examining the specific criteria set forth in the statute for purposes of reaching a decision on a Form A. Similarly, as a practical matter, regulators generally wish to avoid contentious hearings and will usually try to coax parties toward a consensual outcome prior to any such hearing. As with the other requirements discussed herein, care should be taken in navigating these filing and approval procedures, making appropriate disclosures and communicating with the regulator generally — a fund's ability to enter or compete in the space increasingly depends on it. ■

DGCL § 251(h): Recent Change to Delaware Law Facilitates Two-Step Mergers

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The acquisition of a public company may be structured as a one-step merger, in which shareholders vote to approve the transaction and the target is then merged with the acquiring company or its subsidiary. Alternatively, the acquisition can be structured as a two-step transaction that begins with a tender offer for a majority of the target shares and concludes with a back-end merger in which shares of the non-tendering shareholders are acquired. A recent amendment to the Delaware General Corporation Law ("DGCL") has made the two-step merger transaction for friendly acquisitions more attractive.

A two-step merger transaction that begins with a tender offer is advantageous because it provides a faster path to control over the target than a one-step merger. A tender offer can usually be completed in 30 days from the time it is launched. The SEC staff will review the offer materials, and typically the acquirer can clear all comments, during the pendency of the tender offer. In contrast, parties to a one-step merger transaction cannot mail proxy materials and solicit votes on the merger until after the materials have been filed with the SEC and all comments have been cleared. This could take 30 days or longer, so that the meeting to approve the merger, and the merger itself, typically do not take place until at least 60 days after the proxy materials are first filed with the SEC.[1]

The two-step transaction requires a back-end merger to acquire the non-tendered shares. If, following completion of the tender offer, the acquirer owns a sufficient percentage of the shares to effect a so-called "short-form" merger — 90% of each class of voting shares in Delaware — this is not a problem. A short form merger can be effected without a shareholder vote, often within a few days of completing the tender offer. However, if the acquirer does not have sufficient shares for a short-form merger, it must obtain a shareholder vote to approve the back-end merger. The vote is a foregone conclusion, but the acquirer must still cause the target to file proxy or information materials, clear the SEC comments and wait for a meeting, or the effectiveness of written consents, to approve the merger. The timing advantage of the two-step transaction is lost, and worse, until consummation of the merger, the acquirer cannot use the assets of the target to secure debt it has borrowed to finance the tender offer.

Recently, parties have been incorporating a so-called "top-up option" into merger agreements, allowing an acquirer that falls short of the short-form merger threshold to acquire from the target additional shares to reach the required threshold. However, the target must have sufficient authorized but unissued shares, and the acquirer may be required to have the cash to pay the option price.

DGCL § 251(h), which became effective August 1, 2013, offers a better solution. The new statute provides that, as long as certain conditions are satisfied, no vote of target shareholders is needed to approve a second-step merger following a tender offer if the acquirer owns at least the percentage of each class of target stock required to approve a merger.

There are various conditions to the availability of DGCL § 251(h). Principally —

- The tender offer must be conducted pursuant to the terms of a merger agreement between the acquirer and the target — *i.e.*, the transaction must be friendly.
- The acquirer cannot be an "interested stockholder" (generally defined in DGCL § 203(c) as a 15% stockholder) at the time the target's board approves the transaction.
- The target's shares must be listed on a national securities exchange or held of record by more than 2,000 holders. DGCL § 251(h) will likely not be available for small over-the-counter issuers.
- The consideration in the back-end merger must be the same as in the tender offer.

Where these conditions are satisfied, absent special considerations, DGCL § 251(h) now makes the two-step merger transaction the structure of choice to accomplish a public company acquisition.

Endnote

[1] These timeframes assume that no regulatory approvals, other than routine clearance under the Hart-Scott-Rodino Act, are required. ■

European Derivatives Regulations — Impact on Market Participants (Part 1 of 2)

By Fabien Carruzzo, Associate, Corporate, Derivatives
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The European derivatives regulatory reforms originally adopted in the summer of 2012 and commonly referred to as EMIR are close to full implementation with the entry into force this past spring of technical standards published by the European Securities and Markets Authority ("ESMA").

EMIR enables the EU to deliver on the 2009 commitments regarding over-the-counter ("OTC") derivatives agreed to by the G20 countries that all standardized OTC derivatives be (i) reported to registered trade repositories in an effort to increase market transparency and (ii) cleared with central counterparties (clearinghouses) in order to reduce counterparty credit and operational risks.

This article provides an overview of the main obligations imposed by the regulations on buy-side market participants. In this Part 1 we discuss the scope and application of EMIR and address trade reporting and recordkeeping. Part 2 will focus on clearing and risk mitigation requirements for non-cleared derivatives and EMIR's cross-border application.

Scope and Application of EMIR

Products covered by EMIR. EMIR applies to all derivatives contracts identified in the Market in Financial Instruments Directive and not executed on a regulated market, which is broadly defined to include most options, swaps, forwards and any other derivatives contracts relating to commodities (to the extent cash-settled), securities, currencies, interest rates or indices.

Foreign exchange derivatives contracts (*i.e.*, FX swaps and forwards, exclusive of spot trades) are also within the scope of EMIR, though ESMA still needs to provide guidance as to whether FX derivatives will be subject to the clearing obligation.

Market participants covered by EMIR — Territorial Application. EMIR applies to financial and non-financial counterparties organized in the European Economic Area ("European Area") and to entities established outside the European Area ("Non-European Entities") that would be subject to certain requirements under EMIR if they were established in the European Area.

Financial counterparties include investment firms, banks, insurance companies, registered (UCITS) funds, pension funds and alternative investment funds (such as hedge funds and private equity funds) managed by an alternative fund manager authorized or registered under applicable European regulations. Non-financial counterparties are entities established in the European Area that are not financial counterparties and, within this category, EMIR differentiates entities based on whether they are above or below a specified clearing threshold.

Reporting and Recordkeeping Obligations

EMIR requires all counterparties and clearinghouses to ensure that the details of any derivatives contract subject to the regulations (including non-cleared and intra-group derivatives) are reported to a registered trade repository.

Who reports? Unlike Dodd-Frank, where reporting obligations will mainly be satisfied by execution platforms, clearinghouses or by only one of the counterparties to a trade (primarily registered swap dealers), EMIR imposes reporting obligations on all counterparties and clearinghouses.

In order to avoid reporting inconsistencies, EMIR requires that derivatives contracts are reported without duplication and permits counterparties to delegate the reporting obligation to one of them, a third party or, in the case of cleared derivatives, the clearinghouse. Nonetheless, despite any such delegation, both counterparties remain legally responsible for ensuring that the details of their derivatives contracts are properly reported.

Pursuant to ESMA's cross-border proposals, (i) EMIR reporting requirements will not apply to a transaction between a European Area entity and a Non-European Entity if the Non-European Entity is located in a third

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country for which ESMA has determined there are equivalent reporting requirements and (ii) even if a transaction between two Non-European Entities has a direct, substantial and foreseeable effect within the EU, the Non-European Entities will not be required to comply with EMIR reporting requirements. Clarification and further guidance with respect to the reporting requirements is expected from ESMA.

What must be reported and when? ESMA's technical standards set out the minimum details of data required to be reported to the trade repositories within one working day after derivatives contracts have been concluded, modified or terminated. This includes details regarding the parties to the derivative contract (Legal Entity Identifier, name, domicile, corporate sector) and the main characteristics of the derivatives contract (such as type, underlying asset/metric, maturity, notional value, price, or collateral terms). A main characteristic of the derivatives contract also includes the venue of execution since the reporting obligation extends to both exchange-traded and OTC derivatives contracts.

Backloading — Historical Swaps. Pursuant to EMIR, all derivatives contracts entered into (i) before August 16, 2012 and that were outstanding on that date and (ii) on or after August 16, 2012, will have to be reported to a registered trade repository. Those derivatives contracts that were entered into before August 16, 2012 and are outstanding when reporting obligations begin, must be reported to a trade repository within 90 days of the reporting start date for a particular asset class. Derivatives contracts that were in existence on August 16, 2012, or were entered into on or after that date, but are not outstanding on or after the reporting start date for a particular asset class, must be reported to a trade repository within 3 years of the reporting start date for such asset class.

Timing and Implementation Date. ESMA recently announced that reporting for all five asset classes — interest rate, credit, foreign exchange, commodities and equity — is expected to commence on January 1, 2014. Additionally, ESMA has proposed to distinguish between whether a derivative is exchange-traded or OTC and only require reporting for exchange-traded derivatives beginning January 1, 2015. Although ESMA has indicated the urgency of this matter, the European Commission has 3 months to decide whether to endorse ESMA's recommendation.

Public Dissemination. Trade repositories are required, on a weekly basis, to publish and update certain derivatives contract data reported to them. Such data is required to be made available on a website or an online portal easily accessible by the public and include at least a breakdown, by derivatives class, of aggregate open positions, transaction volumes and values.

Confidentiality obligations. In circumstances where a counterparty or clearinghouse has delegated its reporting obligation to a third party, EMIR provides that the reporting of derivatives contracts in accordance with the regulations will not give rise to a breach of any applicable contractual non-disclosure obligations. Additionally, the ISDA EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol (the "Protocol") includes a confidentiality waiver to help ensure that market participants can comply with their regulatory requirements under EMIR without breaching any confidentiality restrictions that they may be subject to. Specifically, by adhering to the Protocol, market participants will consent to the disclosure of information or the retention of information in accordance with EMIR and related regulations.

Recordkeeping Obligations. EMIR requires counterparties to keep a record of any derivative contract they have concluded and any modification to such contract for at least 5 years following the termination of the contract. ■

Agency Mortgage-Backed Securities Trading — Industry Developments and New Master Agreement

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The Treasury Market Practices Group ("TMPG") of the New York Federal Reserve recently recommended that forward-settling agency MBS transactions be bilaterally margined (*i.e.*, market participants should exchange two-way variation margin) in order for market participants to prudently manage their counterparty exposures. In support of the recommended best practices, the Securities Industry and Financial Markets Association published a new form of Master Securities Forward Transaction Agreement (the "2012 MSFTA") making a number of amendments to the previous form published in 1996 to implement the recommendations.

While the TMPG had initially encouraged dealers to implement these recommendations by early June 2013, it provided some relief earlier this year by recommending that market participants substantially complete the process of margining forward-settling agency MBS exposures by December 31, 2013.

Major dealers have started reaching out to market participants in order to negotiate the 2012 MSFTA and replace the agreements under which these transactions had typically been documented on an uncollateralized basis.

Scope

The TMPG recommends that the bilateral margining practice, at a minimum, apply to four broad categories of agency MBS transactions: collateralized mortgage obligation transactions settling later than T + 3, and To-Be-Announced, specified pool and adjustable-rate mortgage transactions settling later than T + 1.

Delivery Fails Charge

Under the 2012 MSFTA, upon a delivery failure by the seller at settlement, the buyer may elect to require the seller to pay a "fails charge" (under the previous form the only remedy for a delivery failure was termination of the entire facility). The practices allow for the buyer to charge the seller a fee (fails charge) for each day the delivery failure continues and provides a mechanism for fails charge calculations. This financial charge is expected to provide an incentive to sellers to deliver securities in a timely fashion and thereby reduce overall fail levels.

Events of Default and Close-out Mechanism

The 2012 MSFTA provides market participants with greater flexibility to customize termination provisions as follows:

- in case of a delivery failure, the buyer can close-out just the defaulted transaction (as opposed to the entire facility); and
- some events of default have been made optional, some others have been made subject to cure periods and continuity requirements, and automatic early termination for insolvency events can now be made optional through a mere election in the annex.

The liquidation mechanism used in other master agreements for structured products (*e.g.*, ISDA or MRA) has been adopted together with related calculation methodology and standards.

Conclusion

Market participants should carefully review and customize the margining and termination provisions of this new agreement to fit their risk appetite and maximize their flexibility in the event of a default by their counterparty. As with most other financial market transaction agreements, the 2012 MSFTA may also have collateral and cross-default impact on other trading facilities and should be adequately insulated to prevent contagion. ■

Compliance Policy Updates for Funds Relying on Regulation D

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Recently, the SEC adopted amendments to Regulation D under the Securities Act adding (1) new Rule 506(d), which disqualifies issuers from relying on Rule 506 if certain "bad actors" are involved in the offering, and (2) new Rule 506(c), which permits issuers to use "general solicitation and advertising," subject to some conditions. Both rules become effective September 23, 2013. Funds that rely on Regulation D should consider compliance policy updates to ensure that they can comply with the conditions of these new rules.

Bad Actors — Disqualifying Events

Under Rule 506(d) generally, issuers may not rely on Rule 506 if the issuer or "covered persons" involved in the offering have a "disqualifying event" after September 23, 2013, unless the disqualification is waived by the SEC. If an event that occurred prior to September 23, 2013 would have been a disqualifying event had it occurred later, the issuer must disclose the disqualifying event to offerees, and this disclosure must occur within a reasonable time prior to the sale. If an issuer makes sales when there were unknown and undisclosed disqualifying events, the issuer can only rely on Rule 506 if the issuer can demonstrate that it did not know, and in the exercise of reasonable care could not have known, about the disqualifying events.

Amended Rule 506(d) lists the specific participants whose actions could disqualify an issuer from relying on Regulation D, and the specific disqualifying events. Before commencing a Regulation D offering, issuers must conduct internal due diligence to ensure that disqualifying events are disclosed. Issuers need to identify covered persons (including at service providers and among beneficial owners), identify disqualifying events, if any, and prepare mandatory disclosures, if required.

Issuers should also review service provider contracts, including employment agreements and placement agency agreements, to ensure that they contain appropriate provisions requiring notification to the issuer if a disqualifying event occurs. Issuers should also revise policies and procedures to require disclosures by officers, directors and employees and to require covered persons to certify annually that they have disclosed all disqualification events.

Employees, Officers and Directors

Only directors, executive officers or other officers who participate in the offering are covered persons for purposes of Rule 506(d). Whether an officer participates in an offering is based on all of the facts and circumstances, but generally, more than "transitory or incidental" activity is required. Engaging in due diligence activities, drafting or preparing disclosures documents and communicating with the issuer, prospective investors or other offering participants would constitute "participating in the offering."

Issuers need to review their internal policies and procedures, and employment and compliance manuals, to request disclosure of disqualifying events, and add an annual certification requirement.

20% Shareholders

Covered persons include beneficial owners of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power (and not share ownership). For this purpose, securities that offer the ability to control or significantly influence management, such as by electing or removing directors or control persons of the issuer, or approving significant transactions such as acquisitions, dispositions or financings, would be "voting securities." The ability to approve changes to rights and preferences does not by itself make the security a "voting security."

Issuers should revise subscription documentation to include questions about potential disqualifying events and voting agreements among shareholders, and to include provisions requiring large beneficial holders to report disqualifying events. Some investors may be loathe to disclose these matters in responses to questionnaires. Issuers intending to rely on Regulation D should consider what due diligence, if any, should be conducted on major investors to uncover any events that could prevent the Regulation D reliance.

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Compliance Policy Updates for Funds Relying on Regulation D

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Private funds should consider whether to amend operating agreements to expand the fund's ability to cause a mandatory redemption if a beneficial owner's disqualification event could prevent the Fund from relying on Regulation D.

Promoters

Covered persons include promoters that are connected with the issuer in any capacity at the time of a sale of securities offered pursuant to Rule 506. For purposes of Rule 506(d), promoters include any person who, alone or with others:

- directly or indirectly takes initiative in founding or organizing the business or enterprise of an issuer; or
- in connection with the founding or organization of the business or enterprise of an issuer, directly or indirectly receives 10% or more of any class of issuer securities or 10% or more of the proceeds from the sale of any class of issuer securities.

Issuers should also review and modify placement agreements to ensure they receive full and prompt disclosure of disqualifying events, and to add an annual certification requirement.

Timing

For all of these inquiries, issuers need to ensure that they know of events that occurred prior to September 23, 2013 that would have been disqualifying events had they occurred after that date. For sales occurring after September 23, the issuer must disclose these events to prospective investors and this disclosure must be delivered a reasonable time before the sale. The disclosure must describe the matters that would have triggered disqualification if they had occurred after September 23. Failing to make this disclosure when an issuer is required to do so would not constitute an "insignificant deviation" for purposes of Rule 508, and the issuer would lose its ability to rely on Rule 506.

Issuers that are aware of pre-2013 disqualifying events should consider and prepare the necessary pre-offering disclosure.

General Solicitation/Advertising

Rule 506(c) under the Securities Act was recently amended to permit issuers to use general solicitation or advertising. Under Rule 506(c) generally, issuers relying on Regulation D can engage in general solicitation and advertising of their offerings, so long as all investors in the offering are actually accredited, and the issuer has taken steps to reasonably determine that the investors are accredited.

Issuers that intend to use general solicitation or advertising should amend their compliance policies and procedures:

- to specify the type of diligence that the issuer will perform to ensure that investors are accredited;
- to specify a review process for creating, using and retaining general solicitation or advertising materials; and
- to document the processes by which investor qualifications and any solicitation or advertising materials are reviewed.

Fund advisers should be particularly aware of Rule 206(4)-8, which covers misstatements by advisers to pooled investment vehicles, and would apply to general solicitation or advertising materials.

For more information on recent changes to Regulation D, see Kramer Levin's Corporate Alert dated July 11, 2013 which can be found on our website at *www.kramerlevin.com*. ■

SEMINAR

Catch the Trend: Business Development Companies

Date: Thursday, October 3, 2013

The seminar will cover the latest trends in BDC offerings and the advantages of these products (*e.g.*, permanent capital and broadened distribution channels). We will also cover "non-traded" BDCs and their attractiveness. Key regulatory and business considerations will be included. Joining partners George Silfen and Russ Pinilis on the panel are the CFO of MVC Capital, a NYSE-traded BDC, and a JMP investment banker focused on BDC product offerings.

For more information and registration, please contact Jane Silecchia at jsilecchia@kramerlevin.com.

Also, if you have not visited our new resource for public alternative funds, please see *www.PublicAlternativeFunds.com*.