FundsTalk

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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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Incentive Equity Compensation Survey: Private Equity Firm Portfolio Companies

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Kramer Levin has prepared the 2013 Private Equity ("PE") Portfolio Company Incentive Equity Compensation Survey (the "KL Survey"). The KL Survey analyzes key terms in incentive equity compensation programs offered by private equity firm portfolio companies. In particular, the KL Survey:

- analyzes key variables in the incentive equity compensation programs of 31 PE-sponsored companies represented by Kramer Levin, where the compensation program was implemented in 2008 or thereafter;
- compares our findings to those set forth in a similar study conducted by PricewaterhouseCoopers (the "PwC Survey"); the PwC Survey analyzed the incentive compensation programs of 32 PE-sponsored companies, where the compensation program was implemented between January 1, 2006 through April 30, 2008; and
- illustrates trends and market developments since 2008 in structuring incentive equity compensation programs in the privately-held PE-sponsored portfolio company.

The findings in the KL Survey highlight the following developments and trends:

1. **The Rise of Profits Interests.** Profits interests have become more prevalent and are now widely used to effect incentive equity grants. In the PwC Survey, 81% of the grants were stock options, while in the KL Survey, 75% of the grants were profits interests. The growth in popularity of profits interests since 2008 is directly correlated with the increased use of (and familiarity with) limited liability companies. Limited liability companies are very flexible vehicles that are designed to give effect to the parties' contractual goals, including the manner in which the members participate in current distributions and distributions upon sale or

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Acquisitions of U.S. Insurance Businesses — Executing Ancillary Transactions

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In last month's edition, we examined some of the threshold regulatory issues involved in acquiring a U.S.-based insurance company. We turn now to the related topic of ancillary transactions that may be integral to the main M&A transaction and constitute part of the underlying motivation for the acquirer's investment. While an exhaustive discussion of the issues arising from these arrangements is beyond the scope of this article, what follows is an overview of the main deal considerations that funds should be alert to when entering into insurance company acquisitions or divestitures that have an ancillary component.

Two prime examples of such arrangements are (i) investment management or similar service agreements and (ii) reinsurance agreements. As to the first, an acquirer may intend that the target insurer enter into agreements with the acquirer for the provision of certain services in exchange for compensation. In the second example, an acquirer may wish to cede some of the target company's in-force risks to an affiliate of the acquirer. In other reinsurance cases, an acquirer may wish to monetize redundant reserves (in the case of a life insurer) at the target company by ceding them to a new captive reinsurer funded in part by third-party investors. In each of these hypothetical cases, it is critical to the acquirer that these ancillary transactions be in place immediately at the closing of the acquisition; without these components of the transaction, the entire deal's objective from the acquirer's standpoint could be frustrated.

In addition to regulating acquisitions, the Insurance Holding Company Act (the National Association of Insurance Commissioners, or "NAIC," model law that we examined in our last issue) places restrictions on the ability of insurers to transact business with affiliates. The Act as in effect in any given state may vary from the NAIC model, but in general all states impose some version of these restrictions. For example, any transaction between an insurer and an affiliate must be "fair and reasonable." In addition, certain types of affiliated transactions over a certain size must be submitted to the regulator 30 days before they become effective. These include all "management agreements, service contracts…and all cost-sharing arrangements."

Consequently, for a private fund to acquire an insurer and then seek to provide services to the insurer in exchange for fees (such as brokerage or investment management services), the fund will need to navigate the Holding Company Act requirements concerning affiliate transactions insofar as these will be affiliated relationships from and after the closing of the sale. For instance, if the fund wishes for such an arrangement to be in place immediately upon closing, it will typically not be sufficient to file the service agreement with the regulator on the day of closing. Under the Act, 30 days' prior notice to the regulator will have to be given. Even beyond that, however, because the service arrangement is contemplated as part of the acquisition, the fund would be well-advised to refer to this proposed arrangement in the Form A and, ideally, submit the proposed form of service agreement at such earlier time. In other words, the fund should undertake to obtain the regulator's approval of the service agreement as part of the Form A approval. If this is not done, the regulator may take the view that he is approving the acquisition alone and may therefore require a Form D filing concerning the service agreement to be made upon closing. This would delay, potentially, the effectiveness of the service arrangement and also carry regulatory risk. The regulator might take this view anyway, even if the affiliate agreement is submitted at the time of the Form A. However, in this event the fund can at least build approval of that agreement into the regulatory closing condition of the contract (about which more below), thus applying some leverage on the regulator to approve the agreement.

Turning to reinsurance, an acquirer may intend for the target insurer, upon closing, to cede risk to an affiliate insurer already owned (or newly established) by the acquirer. This may be attractive in order to relieve capital strain, to balance portfolios as between legal entities,

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to monetize excess reserves, to maximize risk-based capital ratios or for other reasons. Recent years have seen funds and other acquirers propose novel securitization and similar transactions as part of acquisitions of life insurance companies in order to achieve one or more of these objectives. Key to these efforts often is the use of special-purpose captive reinsurers to absorb these risks and accept funding from third parties, a practice that has drawn regulatory scrutiny in recent transactions.

In order to maximize the likelihood that the regulator considers the entire transaction as a whole, the acquirer should indicate to the regulator the importance of the ancillary transactions to the success of the deal. Critically, this must include (i) a substantiated narrative and quantitative argument as to why the transaction is fair to policyholders and (ii) particularly in the case of services, a discussion of rates being charged by arms' length parties for similar services in the marketplace for purposes of comparative analysis. Another key factor that will affect execution is the allocation of risk between the parties (as set forth in the transaction documents) associated with the approval. A buyer will typically not be required under a contract to close if regulatory approval is meaningfully conditioned such that the basic terms of the deal are frustrated. However, a seller can, of course, seek to limit the buyer's optionality by negotiating a "burdensome condition" threshold that attaches at the highest point possible. Exactly how much conditionality the buyer should be compelled to accept, and still be required to close, can be a major point of contention in negotiations. Once finalized, of course, the allocation of this risk, as memorialized in the contract, will be fully visible to the regulator, which can in turn affect the dynamics of the regulatory process itself. ■

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liquidation. Profits interests are more tax efficient than stock options from the grantee's perspective; profits interests enable a holder to participate in future appreciation in the issuer's equity value after the grant date without contributing capital and without recognizing tax upon receipt or vesting of the interests. Profits interests also allow the holder to potentially receive capital gains treatment upon disposition and to be eligible to participate in current distributions. The ability to participate in current distributions has become more important to management teams as leveraged dividends have increased in popularity recently.

2. **Increased Pool Allocation.** In the PwC Survey, a majority of the compensation programs had an allocation between 6-10% of outstanding capital, while the KL Survey shows that a majority of compensation programs fell in the 11-20% range.

3. **Vesting Criteria.** In the KL Survey, 69% of the compensation programs provide for only time-based vesting and 31% provide for a combination of time and performance-based vesting. The PwC Survey had a higher frequency of time and performance-based vesting at 75% of the compensation plans in that survey.

   The KL Survey shows that vesting periods are usually four or five years (52% and 34% of the programs in the KL Survey, respectively), typically with annual vesting (66%); most of the incentive equity programs provide for automatic and full acceleration of vesting upon a change of control of the issuer.

4. **Participation in Distributions for Unvested Incentive Equity.** In the KL Survey, we found that over a majority of the compensation programs permitted holders of unvested incentive equity interests to participate in current distributions by the issuer. The distributions are typically placed in a set-aside or escrow account for the benefit of the holder and amounts are released to the holder when the corresponding incentive equity interests vest. In 67% of the cases where there is a set-aside or

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

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Part 1 appeared in the September 2013 issue of FundsTalk, *which can be found at* www.kramerlevin.com *or by contacting one of the authors or editors.*

The European derivatives regulatory reforms originally adopted in the summer of 2012 and commonly referred to as EMIR are closer to full implementation with the entry into force of technical standards published by the European Securities and Markets Authority ("ESMA") and the recent September 15th effective date for certain risk mitigation requirements.

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

Clearing Obligation

Derivatives Contracts Subject to Mandatory Clearing

Derivatives contracts that a clearinghouse has been authorized or recognized to clear and that ESMA has determined should be cleared will be subject to the mandatory clearing requirement under EMIR. Additionally, while the mandatory clearing obligation under EMIR will not apply to exchange-traded contracts, proposed revisions to the Markets in Financial Instruments Directive (the so-called MiFID II) include a mandatory clearing requirement for those contracts.

Mandatory Clearing Determination Process

In determining whether a derivatives contract should be subject to the clearing obligation, ESMA can follow one of two approaches:

- A "bottom-up" approach, where national regulators notify ESMA of any authorized existing clearing services for derivatives contracts in their jurisdictions (essentially upon the initiative of the relevant clearinghouse), following which ESMA is required to make a mandatory clearing determination within six months based on a number of factors; or
- A "top-down" approach, where ESMA can mandate clearing with respect to certain derivatives contracts even though no clearinghouse is offering the contract for clearing.

EMIR requires national authorities to notify ESMA of any existing clearing requirements for derivatives contracts in their jurisdictions so that ESMA can assess which products should be cleared.

ESMA will establish and maintain a public register of derivatives contracts subject to mandatory clearing on its website indicating the date when the clearing obligation will become effective for such contracts and any phase-in by categories of counterparties.

Mandatory Clearing for Historical Swaps?

Trades entered into before EMIR's entry into force (August 16, 2012) are not subject to the mandatory clearing requirement and counterparties can keep them purely OTC. Trades entered into after a national regulator has notified ESMA of any authorized existing clearing services but before a mandatory clearing determination becomes effective with respect to such trades, may need to be cleared under the so-called "frontloading" principle. This will likely pose a number of pricing and collateral issues for counterparties and ESMA may need to adjust its approach in that respect.

Counterparties Subject to Mandatory Clearing

The clearing obligation applies to transactions between two entities that are either financial counterparties or non-financial counterparties exceeding the clearing threshold (see box on page 5) (an "NFC+").

Transactions between a financial counterparty, an NFC+ or a non-EU jurisdiction entity (a "Third-Country Entity") that would be subject to the clearing obligation if it were established in the EU will be subject to the clearing obligation.

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Non-Financial Counterparty Clearing Thresholds

(i) Credit derivatives contracts: € 1 billion
(ii) Equity derivatives contracts: € 1 billion
(iii) Interest rate derivatives contracts: € 3 billion
(iv) Foreign exchange derivatives contracts: € 3 billion
(v) Commodity derivatives contracts and other derivatives contracts not specified in (i) through (iv) above: € 3 billion

As a result, non-European mutual funds and private funds trading with European dealers will likely be subject to the mandatory clearing requirement under EMIR because they will qualify as alternative investment funds under the AIFMD.

When does a non-financial counterparty become obligated to clear?

A non-financial counterparty becomes an NFC+ when the rolling average of its derivatives contracts positions (gross notional value), exclusive of derivatives contracts related to hedging, exceeds the applicable clearing threshold during any 30 working day period.

Once these conditions are satisfied, an NFC+ is required to notify ESMA and its local regulator that it has exceeded the clearing threshold. Similarly, when an NFC+ moves below the clearing threshold, it will no longer be required to comply with mandatory clearing once it has notified its local regulator that it does not exceed the clearing threshold.

Implementation Timing

Before clearing obligations can be implemented, ESMA must first designate contracts subject to mandatory clearing, and draft standards for approval by the European Commission, European Parliament and Council. In that respect, in July 2013 ESMA published a discussion paper in which it sought market participants' views on proposed standards implementing the clearing obligation.

Risk Mitigation Obligation

Non-cleared Derivatives Contracts

Financial and non-financial counterparties entering into derivatives contracts not cleared by a clearinghouse or exchange-traded are required to ensure that appropriate procedures and arrangements are in place to measure, monitor and mitigate operational and counterparty credit risks.

Applicable Requirements

Market participants are required to timely confirm (by electronic means where available) the terms of their non-cleared derivatives contracts and develop processes in order to reconcile portfolios, manage associated risk, quickly identify and resolve disputes between parties, and monitor the value of outstanding contracts. Financial counterparties are also required to hold appropriate and proportionate amounts of capital to manage the risks not covered by an exchange of margin.

With respect to risk mitigation requirements, EMIR is broader in scope than Dodd-Frank because some risk mitigation rules (for instance with respect to confirmations, reconciliation, compression and dispute resolution) apply to all market participants and requirements to carry out daily valuations and exchange collateral apply to all financial counterparties and NFC+. Under Dodd-Frank, business conduct rules and similar risk mitigation requirements are mainly imposed on dealers and major swap participants and other market participants are only indirectly impacted.

In early September, ESMA determined that Dodd-Frank rules on timely confirmation, portfolio reconciliation and portfolio compression (but not dispute resolution) were equivalent to EU technical standards. Once the European Commission approves ESMA's submissions, market participants may choose to comply with either Dodd-Frank or EMIR risk mitigation techniques in that respect.

Implementation Timing

As of September 15th, all of EMIR's risk mitigation techniques became effective and EU entities were

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required to ensure that they have procedures in place to achieve portfolio reconciliation and compression, as well as procedures for dispute resolution. To aid market participants in meeting these requirements, ISDA developed the 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol as well as the ISDA March DF Protocol Extension Agreement for market participants who have adhered to the ISDA March 2013 DF Protocol.

Cross-Border Application

EMIR mandates that a transaction between two Third Country Entities that would be subject to clearing and risk mitigation techniques if the Third Country Entities were established in the EU will be subject to such requirements to the extent that the transaction has a direct, substantial and foreseeable effect within the EU or where such an obligation is necessary or appropriate to prevent the evasion of any provision of EMIR.

EMIR tasks ESMA with clarifying these principles and in July 2013 ESMA published a consultation paper on draft regulatory technical standards seeking public input.

ESMA is proposing that clearing and risk mitigation requirements, but not the reporting obligation, apply to transactions between two Third Country Entities when rules in those counterparties' jurisdictions have not been determined to be equivalent to EMIR and either: (a) one of the counterparties is guaranteed (above certain thresholds) by an EU financial counterparty; or (b) both counterparties execute the transaction via their EU branches.

Also, in order to implement the anti-evasion principles of EMIR, the consultation paper would treat any "artificial" transaction as being structured to avoid EMIR's application. A transaction is artificial where it lacks commercial substance or relevant economic justification in itself and ESMA specified certain criteria that would guide their determination.

This past month, the European Commission extended the deadline for ESMA to draft related technical standards until November 15, 2013 so that ESMA could fully analyze and take into account the results of its public consultation.

Penalties

EU member states are required to provide penalties relating to the infringement of regulatory requirements under EMIR, as well as take all measures necessary to ensure that EMIR is implemented in their jurisdiction. Penalties must be effective, proportionate and dissuasive, and include at least administrative fines. In certain instances, local regulators may disclose every penalty imposed on financial counterparties and, where appropriate, non-financial counterparties for certain infringements.

Infringement of EMIR's rules, however, will not affect the validity of a derivatives contract or the parties' ability to enforce the provisions of a derivatives contract, nor will a party to a derivatives contract be entitled to any compensation as a result of its counterparty's infringement of EMIR.

Conclusion

Market participants will need to take a number of actions to adjust to the new regulatory environment. Those actions include implementing procedures to ensure compliance with reporting and recordkeeping obligations (see Part 1 of this article), checking which products ESMA determines are required to be cleared, and when the clearing mandate will begin, and implementing risk mitigation procedures, including in certain instances adhering to protocol agreements.

Market participants will need to open reporting lines with trade repositories or enter into agreements with third-party service providers, counterparties or clearinghouses to satisfy their reporting obligations. Those required to clear will need to set up clearing capabilities with one or more clearinghouses and negotiate applicable clearing documentation with clearing brokers. Also, market participants should understand how clearing will impact their funding needs, business operations, and relationships with trading counterparties, prime brokers and custodians.

Non-financial counterparties will need to monitor their use of derivatives contracts in light of the clearing threshold and make appropriate notifications to their regulators when they pass the threshold.

Market participants, especially those established in non-EU jurisdictions, should pay careful attention to final technical standards setting forth EMIR's extraterritorial reach and determine whether some of EMIR's requirements apply to them and if substituted compliance with another regime (such as Dodd-Frank) is sufficient to discharge their obligations under EMIR. ■

The Latest Trend in Private Equity Funding of IP Monetization

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Prompted by the ever-increasing efforts to monetize intellectual property ("IP") by both practicing and non-practicing entities, a recent trend has developed where private equity firms ("PEFs") have made funds available to companies and law firms to assist in these monetization efforts. Under the new approach, the PEF makes available an amount of funds with a pre-set return for a portfolio of IP monetization efforts, whether through licensing programs, litigation or a combination of both. Because the portfolio includes multiple IP monetization efforts, the opportunities for financial success increase and the corresponding risk is diversified.

For decades, IP monetization has been the business model for so-called patent trolls, also referred to as non-practicing entities ("NPEs") or patent assertion entities ("PAEs"). These entities do not manufacture, use or sell products or services embodying their patented invention, but instead only seek royalties for their patents either through licensing programs or patent infringement lawsuits. Despite the call for legislative reform and a Presidential commission on the issue, the financial success of this model has attracted investors to join and/or invest in this business model. The traditional model has been for investors to make funds available for a specific monetization effort, such as a single patent infringement lawsuit.

More recently, operating companies have turned their attention to IP monetization by exploiting the company's existing IP or through strategic acquisitions, such as Google's acquisition of Motorola's mobile business arm. A number of these practicing entities with sizeable patent portfolios have determined that selling or licensing their existing IP may be a source of additional revenue either through licensing, sale or enforcement, particularly where the company continues to burden the ever increasing "maintenance fees" to the U.S. Patent Office to sustain the life of their IP. Indeed, a number of these operating companies have established business divisions or separate subsidiary companies focused on these IP monetization efforts.

One monetization approach has been to license or sell patents owned by the practicing entity that relates to its non-core technology. For example, an entity may decide that its business has turned its focus away from certain business initiatives, making the IP less valuable to the company, but potentially valuable to others. As a result, the company will sell that IP—most likely patents directed to that now non-core technology area.

A more profitable monetization approach has been to enforce a company's patents against competitors in litigation to gain market share through injunctions (*i.e.*, excluding a competitor from selling a product in the U.S. that infringes the company's patent(s)) or reap large monetary damages from companies that utilize the operating company's patented technology. One of the primary examples of this approach is the so-called "Smart Phone Wars."

Whichever approach is followed, companies (whether operating or non-operating) sometimes do not have, or are unwilling to make, the resources available to pursue a licensing and/or an enforcement program that will yield a sufficient financial gain to justify the investment. This is particularly true where business distraction costs combined with outside counsel's legal fees could potentially dwarf the revenues generated. A number of PEFs have responded to this issue by offering funds to companies and law firms to help pay for the investment needed (*e.g.*, expertise of outside counsel) to pursue these IP monetization efforts.

One of the most recent trends involves a PEF establishing a fund for the law firm to pay for a certain percentage of legal fees and disbursements associated with IP monetization efforts in exchange for a pre-negotiated return based on the amount of funds used by the firm. This allows the firm to offer companies substantial discounts on their fees in exchange for the company giving up some of the upside in the event of a financial recovery. For example, a monetary recovery would be split among the PEF, client and law firm based on their respective pre-set negotiated percentages. The PEF gets paid a pre-set amount out of the law firm's percentage. This arrangement is ultimately a win-win-win for all parties who took an interest and risk in the IP monetization opportunity.

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Of course, should the monetization efforts fail, the PEF would lose its investment, the law firm's compensation would be substantially reduced, and the client would have lost the cost of disbursements as well as costs relating to business distractions. While this adverse scenario is possible, it is unlikely, and this approach works best when all the parties participating in the IP monetization effort have skin in the game — *i.e.*, the PEF having invested its capital, the client having invested the funds to cover disbursements, and the law firm having risked losing a large percentage of its legal fees. In order to minimize the risk, each of these parties will have evaluated and conducted their respective due diligence on the strength of the IP monetization efforts and have concluded that it is worth pursuing. With such due diligence in place, the likelihood of an adverse outcome should be well within an acceptable degree of risk.

The elegance of this model, from the perspective of the PEF, is that the risk, similar to other investments, is diversified and not tied to a single company, licensing effort or litigation, as was the case in past models. Instead, the risk is spread across several matters and IP monetization efforts such that a single monetization effort within the portfolio could by itself pay for the investment. For example, if there are three monetization efforts underway, two of those efforts could yield no revenues, but one could be large enough to cover the costs of the other two. Under this scenario, the PEF would obtain its expected return.

Such an outcome is not atypical, particularly where the appropriate cases are selected for investment based on the due diligence. In sum, this emerging business model affords PEFs with another avenue for investment with acceptable risk, while at the same time affording companies the ability to pursue additional revenue streams with reduced risk and investment. We expect this trend to continue and expand in the coming years. ■

Incentive Equity Compensation Survey: Private Equity Firm Portfolio Companies *continued from page 3*

escrow account, interest accrues on the amounts that were subject to hold-back.

5. **Repurchase Rights; Put Rights.** In both Surveys, a company call right with respect to vested equity upon termination of service applies in almost all incentive equity compensation plans. A put right in favor of the employee is much less prevalent — appearing in roughly 20% of the compensation plans and often is limited to "good" leavers. The repurchase price paid by the issuer is usually a function of the reason for termination, with a bad leaver (for-cause termination; resignation without good reason) often receiving less than fair market value (100% in the case of for-cause termination, but only 32% in the case of resignation without good reason) and a good leaver (termination without cause; resignation with good reason) often receiving fair market value for the vested equity interests. The employee put is usually at fair market value (71% in the KL Survey). In most cases, unvested equity interests are forfeited upon termination of service regardless of the reason for termination. If the equity interests are not repurchased by the issuer upon termination of service, in a majority of the compensation programs, the equity interests convert into passive economic interests resulting in a forfeiture of non-economic rights, such as voting rights, preemptive rights and tag-along rights.

We would be pleased to meet with you to discuss the KL Survey in more detail. Please contact Howard Spilko at 212.715.9267, *hspilko@kramerlevin.com* or Michael Andrescavage at 212.715.9476, *mandrescavage@kramerlevin.com* if you would like a copy of the KL Survey. ■