

# Private Equity Strategist

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## Cash or carry

By Mel Schwarz, Partner, National Tax Practice

*There is renewed interest in carried interest. More specifically, treating carried interest as ordinary income. This time around, calls for change are coming not only from Capitol Hill, but from the White House as well. Legislation has been introduced, and it's likely we'll see additional proposals, offering a variety of approaches, and lively debate. It's a discussion in which private equity firms will want to be fully engaged.*

June 22, 2007. The first session of the 110th Congress. Representative Sander Levin of Michigan, a member of the House Ways and Means Committee, introduces H.R. 2834, legislation that would “amend the Internal Revenue Code of 1986 to treat income received by partners for performing investment management services as ordinary income received for the performance of services.”

Provisions of the Levin bill are included in legislation approved by Ways and Means and passed by the House. The Senate, however, does not concur. Levin's proposal is not included in the Senate version of legislation or in the conference agreement passed by Congress and signed into law by President Bush on December 26, 2007. Thus the failure of Congress' first attempt to change the tax treatment of carried interest.

April 3, 2009. The first session of the 111th Congress. Representative Levin introduces H.R. 1935, legislation that would “amend the Internal Revenue Code of 1986 to provide for the treatment of partnership interests held by partners providing services.”

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This time the outcome may be different.

In 2007, various developments prompted introduction of the Levin bill. Several prominent private equity firms announced plans to go public. Academic papers suggesting carried interest should be taxed as ordinary income came to light, drawing interest on Capitol Hill. And public displays of conspicuous consumption by some private equity professionals drew the scorn of many.

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## Cash or carry (continued)

Today, of course, we have a painful recession, rising unemployment across all segments of the economy and a populist movement to rein in what many consider garish executive compensation, particularly on Wall Street. We also have an Administration with an ambitious agenda and fully in support of changing the tax treatment of carried interest. President Obama has endorsed taxing such earnings as ordinary income in his FY2010 budget, estimating it would generate \$24 billion over the next nine years.

Today, as in 2007, unions, lawmakers and others promoting a change in the tax law frame it as a matter of equality. As congressman Levin stated in his April 3, 2009 press release:

“This is a basic issue of fairness. Fund managers are receiving compensation for managing their investors’ money. They should not pay the 15% capital gains rate on their compensation when millions of other hard-working Americans, many of whose income is performance-based, pay ordinary rates of up to 35%. The President’s budget recognizes that this is unfair. The House of Representatives has recognized that it is unfair, and this year I hope we can act to change the law.”

Fairness notwithstanding, what will truly drive passage of a carried interest tax bill will be the need for revenue offsets. And there could be quite a need. Given the distressed economy, prolific stimulus spending and myriad initiatives proposed by Congress and the administration, lawmakers will almost certainly be looking for new sources of revenue this year. Passage of health care legislation, and extension of the research credit or other tax provisions that would otherwise expire, are some developments that could trigger the call for offsets.

**Unlike the Levin bill of 2007, which did not impose a tax on carried interest until some income recognition event, the current proposal triggers a tax payment at the date of grant.**

More than any time in the past, there is a real possibility of a change in the tax treatment of carried interest being enacted. It could happen this year. If the private equity industry is to have input in shaping the legislation and defining those changes, it needs to be fully and immediately engaged in that process.

Exactly what form a final bill would have is unclear. H.R. 1935 adheres to the principle that compensation for services should be treated as ordinary income. Backers of the bill assert that carried interest represents a performance-based fee that investors are paying to fund managers for their services and that it should be taxed accordingly. The bill would affect any investment management firm that takes a share of an investment fund’s profits as compensation, regardless of the type of assets the firm is managing, its investment strategy or the amount of compensation involved.

Unlike the Levin bill of 2007, which did not impose a tax on carried interest until some income recognition event, the current proposal triggers a tax payment at the date of grant. Specifically, the bill states that in the case of a transfer of interest in a partnership, the fair market value of the interest would be taxed immediately in the amount the partner would receive for the transferred interest if the partnership sold all its assets at the time of transfer and distributed the proceeds to the partners.

While H.R. 1935 provides a basis for debate, what may ultimately emerge from Congress could be quite different from what Rep. Levin has proposed. The Obama administration did not provide a recommended structure for a bill in its FY2010 budget.

The industry is split on how best to respond. Some see no point in negotiating and will lobby and lobby heavily to have any proposal defeated. Others realize this is primarily revenue-raising and not a tax policy exercise, and advocate active dialogue, believing legislators would prefer to put forth a bill the private equity industry has signaled it can live with, and one that will therefore have an easier path to enactment. They feel such an approach could result in a solution more acceptable than the Levin bill.

Any bill will need to consider the compensation elements and return-on-investment elements of carried interest, as well as the timing for assigning a value. The Levin bill simply treats all carry as compensation. As noted, it mandates valuation and payment of tax at the time the carried interest is granted, regardless of whether any funds are available to pay the tax. Having to value the assets of a partnership immediately would make the law exceedingly difficult to administer. And some argue that by requiring general partners to pay the income tax upfront, such a law would eliminate a GP’s incentive, provided by the current “2 and 20” structure, to grow the partnership.

An alternative structure might allow taxation to be deferred until the interest is disposed of and then assigned fixed percentages to compensation and ROI, taxed as ordinary income and capital gains, respectively. Such a structure would provide a greater degree of certainty as to the value of carried interest and would certainly be easier to administer. •

# Not-so-private equity

By Steven Goldberg, Principal

*Spurred by a national and global financial crisis, the Obama administration and Congress are seeking to revamp the country's financial oversight system. Central to that effort is imposing regulatory requirements on private equity, hedge funds and other pools of private capital. The changes could be the most sweeping in the history of private investment funds. How likely is it that new regulations will come to pass? And what will that mean for middle-market private equity?*

“One of the key lessons of the current crisis is that destabilizing dangers can come from financial institutions beyond banks, but our current regulatory system provides few ways to deal with these risks.”

Those were the words of Treasury Secretary Timothy Geithner, speaking earlier this year of the administration's plan to reform the financial system.

While the spotlight in the early days of the financial crisis was solely on the largest institutions, the “too-big-to-fail” banks and insurance companies, and their often disastrous business practices, now private equity, along with its hedge fund brethren, has come under increased scrutiny. Many have stated that these unregulated pools of capital are too opaque, that they pose a risk to the health of the financial system and that they require greater transparency and oversight.



At its April meeting in London, the G 20, many of whose members have pointed an accusatory finger at the U.S. for precipitating the worldwide financial crisis, pledged to “extend regulation and oversight to all systemically important financial institutions, instruments and markets.”

And this clarion call is coming not just from Washington. At its April meeting in London, the G 20, many of whose members have pointed an accusatory finger at the U.S. for precipitating the worldwide financial crisis, pledged to “extend regulation and oversight to all systemically important financial institutions, instruments and markets.”

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Of course, despite the often negative characterizations, legislators, regulators and the administration recognize the very significant role private equity and hedge funds may play in the market's recovery. A central element of President Obama's plan to restore health to the financial system is the public-private partnership designed to remove up to \$1 trillion in “toxic” assets weighing down the books of financial institutions. The participation of private investment funds will be critical to the program's success.

That said, with the electorate's backing and the geopolitical imperative in mind, President Obama has urged Congress to enact legislation that would give the government new and sweeping oversight power of private investment funds. In March, the administration outlined four broad components of comprehensive regulatory reform: addressing systemic risk; protecting consumers and investors; eliminating gaps in regulatory structure, and fostering international coordination.

To address systemic risk, the administration has called for a single independent regulator with responsibility over systemically important firms. Consensus is that this duty may fall to the Federal Reserve. Such a “regulator-in-chief” would be responsible for oversight, and, if necessary, would assume control of large non-bank entities such as private equity firms, if it's determined their failure could upend the U.S. banking system.

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## Not-so-private equity (continued)

While pledging to work with Congress to define “systemically important,” the administration believes the characteristics of such an organization should include: the financial system’s interdependence with the firm; the firm’s size, leverage and degree of reliance on short-term funding; and its importance as a source of credit for households, businesses, and governments, and as a source of liquidity for the financial system.

Central to the administration’s efforts to address risk is the registration of sources of private capital.

With approximately 50% of hedge funds (representing over 70% of hedge fund assets) already voluntarily registered with the SEC, any new registration requirement would primarily impact the private equity community. While no individual private equity firm or hedge fund would seem to pose a true danger to the health of the financial system, the administration’s concern is that each industry collectively represents a potential systemic risk. An equally important impetus in calling for registration is investor protection. While noting the voluntary registration by hedge funds, the Treasury stated that for private capital overall there “is no reliable, comprehensive data available to assess whether such funds individually or collectively pose a threat to financial stability. The Madoff episode is just one more reminder that, in order to protect investors, we must close gaps and weaknesses in the regulation and enforcement of broker-dealers, investment advisors and the funds they manage.”

Specifically, the administration’s proposal calls for:

- advisors to private pools of capital whose assets under management exceed a certain threshold to register with the SEC;
- the funds to be subject to investor and counterparty disclosure requirements and regulatory reporting requirements;
- the funds to report, on a confidential basis, information necessary to assess whether the fund or fund family is so large or highly leveraged that it poses a threat to financial stability, and
- the SEC to share funds’ reports with the systemic risk regulator, which would then determine whether the funds could pose a risk.

Meanwhile, financial overhaul bills have been introduced in both houses of Congress. In the Senate, Chuck Grassley, R-Iowa, and Carl Levin, D-Mich., in January introduced the Hedge Fund Transparency Act, which would “clarify current law to remove any doubt” that the SEC has the authority to require private equity funds, hedge funds, venture capital funds and similar pools of capital to register with the commission. The bill would amend the Investment Company Act of 1940, to make clear that private investment funds that trade or hold securities as a significant part of their assets are indeed investment companies under the act, and the SEC can require those funds to register and disclose their size and the identities of their investors. The funds would also be required to establish anti-money laundering programs and report suspicious transactions.

Specifically, the Grassley/Levin bill would require private investment funds with more than \$50 million in assets under management to disclose to the SEC:

- the names of the companies and natural individuals who are the beneficial owners of the fund and an explanation of the ownership structure;
- the names of any financial institutions with which the fund is affiliated;
- the minimum investment commitment required from an investor;
- the total number of investors in the fund;
- the name of the fund’s primary accountant and broker, and
- the current value of the fund’s assets and assets under management.

In the House, Reps. Michael Capuano, D-Mass. and Michael Castle, R-Del. introduced in January the Hedge Fund Advisor Registration Act of 2009. The bill would eliminate the private advisor exemption used by many advisors to private investment funds to avoid registering with the SEC. Under current law, an advisor is exempt from registration if it has fewer than 15 clients in any 12-month period and does not hold itself out generally to the public as an investment advisor.



While no individual private equity firm or hedge fund would seem to pose a true danger to the health of the financial system, the administration’s concern is that each industry collectively represents a potential systemic risk.

Of course, legislation put forth by the House and Senate, and the administration's proposals, would have to be reconciled before a bill is ready for the president's signature. Of the provisions announced to date, the Senate's is considered by many in the private equity and hedge fund communities to be the most onerous in terms of disclosure, given its call for registration by the actual fund, not the fund's advisor. Some feel progress on a bill may be easier in the House, where a clearer agenda has been outlined and Democrats have firm control. In the more closely divided Senate, financial regulation reform could come in the form of a single, large bill, which could take many months to come to a vote. That said, it is likely a bill will be presented to President Obama sometime this year, probably in the fourth quarter.

What provisions will a final bill contain? Requiring registration with the SEC is a near certainty. The precise nature of that requirement is more difficult to determine, but most likely the SEC would have the authority to examine private equity and hedge funds to the extent the commission deems appropriate and necessary. Any and all manner of information related to a fund could be subject to review, including detailed information on general partners, limited partners and investment performance. What is of greater importance of course is what, if anything, the SEC would choose to make public. It should be noted that while the SEC is in favor of registration, according to Chairman Mary Schapiro, the agency does not have the resources to examine thousands of private investment funds. Most likely, accounting firms would be recruited to conduct regulatory audits of the funds.

It seems unlikely that some of the more onerous disclosure requirements, such as making public detailed limited partner information, would be included in final legislation. As noted, private equity and hedge funds will play a central role in the public-private partnership designed to buy up "toxic" assets and distressed businesses. The administration is keenly aware that any bill may have to cede ground on what many private investors consider heavy-handed restrictions, including disclosure requirements and executive compensation limits, in order to attract investors to the bank rescue plan.

Oversight will of course come at a cost for private equity firms and hedge funds. The funds will be subject not only to examination but also to reporting requirements. To meet those requirements, private investment funds will need to have a compliance infrastructure in place. They will need to ensure that operationally they have systems in place to generate the types of records and financial reports the SEC will be seeking. The funds will need enhanced policies and procedures around risk management, as well as the ability to identify and test key financial and operational controls.

### Conclusion

There is near-universal agreement that private investment funds will soon be less private. The precise nature and scope of the oversight is yet to be determined. Ultimately, funds will have to recognize that compliance will be another cost of doing business. The ability to shoulder those costs and to operate effectively in this new regulatory environment will be key to survival. •

## Grant Thornton in the news

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“Every time you enter into a subjective situation like fair value you are going to get differences. Is it more transparent than the traditional cost approach it replaced? Yes. At least it attempts with some structure to provide what the company and the auditors believe are the fair values for those companies.”

### Neil Beaton

National partner-in-charge, Valuation Services  
*Reuters*  
March 4, 2009

“There is plenty of demand for [minority investments]. We've got a lot of inquiries from private equity firms.”

### Stephen McGee

Executive director, Grant Thornton Corporate Finance LLC  
*Dow Jones*  
March 30, 2009

# Marking to the middle market

By **Harris Smith**, National managing partner,  
Private Equity

*In a deeply troubled economy, with few willing buyers and sellers, the application of FAS 157 is often resulting in more write-downs than write-ups. With clenched teeth, large buyout firms have cut values significantly, while airing their grievances with the accounting rule's requirements. How should middle market firms address compliance with FAS 157? How will marking down investments impact a firm's ability to retain LPs and attract new ones? Are there lessons to be learned from the experiences of the big players, or does the middle market need its own approach?*

Financial Accounting Statement 157 defines fair value as the price that would be received to sell an asset or be paid to transfer a liability in an orderly transaction between market participants at the measurement date.

For large buyout firms, carrying investments at fair value has come at a cost, in many cases a substantial one. Firms such as Blackstone, Carlyle, KKR and TPG have reported significant write-downs of their private equity investments. According to Reuters, TPG marked down its latest buyout fund by 29% for 2008, while Blackstone lowered its five funds by an average of 31%. An affiliate fund of KKR wrote down the value of its investments by 30% and Carlyle by 13.8% for the last quarter of 2008.

**“Middle market firms often have fewer dollars and less of the resources required of FAS 157 compliance.”**

**Steve Brady**

Midwest partner-in-charge, Transaction Advisory Services  
Grant Thornton LLP

These buyout shops have not been pleased with having to comply with FAS 157. While they have cited the economic malaise as a reason for their portfolios declining in value, they have also in many cases pointed a disapproving finger at the accounting rule. According to the firms, FAS 157 has forced them to provide a quarterly snapshot of hard-to-price holdings that does not reflect the true long-term value of the businesses. Henry Kravis, co-founder of KKR, reportedly stated in March that while the value of a number of investments in a KKR fund had been reduced, many of the companies had in fact improved profits. Blackstone told investors that had FAS 157 been applied to an older Blackstone fund during a previous recession, the portfolio would have been valued at just 0.3 times cost. When the investments were actually sold, they provided a more than 2x return on investment.

Complaints notwithstanding, for many of the firms, the poor numbers have not put a hold on fundraising. While many have lowered their original targets, they have managed to raise substantial sums. For example, Blackstone is currently raising its sixth buyout fund, Blackstone Capital Partners VI, which is said to have a target of \$10 billion.

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Earlier this year, The Carlyle Group concluded fundraising for Carlyle Partners V, securing \$13.7 billion in commitments, and it was reported the firm had secured \$1 billion of a planned \$3 billion fund to invest in financial assets.

## The middle market

Of course, while the large firms have received significant press regarding their portfolio valuations, or more specifically their write-downs, middle market firms have been conducting their own mark-to-market valuations. With the accounting rule effective for fiscal years beginning after November 15, 2007, there has been near-universal adoption of FAS 157, and most middle market firms have had at least a couple of reporting periods in which they were required to comply. That said, many believe the middle market has been slower than the larger firms in adopting FAS 157.

“Middle market firms often have fewer dollars and less of the resources required of FAS 157 compliance,” said Steve Brady, Midwest partner-in-charge, Transaction Advisory Services, Grant Thornton LLP. “In addition, there has been greater scrutiny of the larger funds, given their visibility and the comparability of their investments to declines in the public markets.”



## “Private equity firms of all sizes believe FAS 157 is an unnecessary expense. In their eyes it’s a process that does not provide much value.”

### **Massimo Messina**

Partner-in-charge, Midwest Region Valuation Services  
Grant Thornton LLP

“Private equity firms of all sizes believe FAS 157 is an unnecessary expense,” said Massimo Messina, partner-in-charge, Midwest Region Valuation Services, Grant Thornton LLP. “In their eyes it’s a process that does not provide much value. Middle market firms feel particularly strong about the requirement, given the lower level of resources they can dedicate to this.”

Of course, most middle market firms are savvy and sophisticated, and while they may not like or entirely agree with FAS 157, they know compliance is a must. “Middle market firms realize FAS 157 is here to stay,” said Mike Bernstein, Financial Services partner, Grant Thornton LLP. “They want to provide their investors with the highest degree of comfort. They know these limited partners often invest in large funds, are accustomed to a certain level of disclosure and will ultimately judge a general partner on what they realize from their investments.”

While all middle market firms are complying with the accounting rules, there appears to be wide latitude in how they are developing fair value measurements.

Neil Beaton, national partner-in-charge, Valuation Services, Grant Thornton LLP, who characterized middle market compliance as “reluctant acceptance,” believes there is a great deal of inconsistency in practice. “Many middle market firms are determined to do things their way. What one firm uses as a fair value may be different from what another firm uses.”

Of course, for mid-market firms it is often more difficult to find market comparables for the smaller private companies in which they typically invest. “Many middle market PE firms argue there is not enough recent transaction volume to establish a market value,” said Mike Ryan, Southeast partner-in-charge, Transaction Advisory Services, Grant Thornton LLP.

“If you’re a large buyout firm trying to value your investment in a major cruise line, it’s very easy to find another cruise line,” added Ken Meuser, Financial Services partner, Grant Thornton LLP. “If you’re a middle market firm seeking fair market value for a small niche manufacturer, the process is much more difficult. You have to adjust for differences. It takes a great deal of time and judgment.”

Some believe the overall experience of middle market firms will be much like that of the larger players when it comes to portfolio valuations. “There has been a quite a discrepancy among the large firms, quite a range of results, and I think the middle market will mirror that,” said Meuser. “I can’t say we expect middle market firms to be better or worse. It is more dependent on the types of investments, the industries, the amount of leverage.”

That said, some feel the nature of middle market investments may prove advantageous when it comes to applying FAS 157 in today’s market. FAS 157 analysis utilizes Level 1, 2 or 3 inputs. Level 1 refers to quoted prices for identical assets in active markets. Level 2 inputs are quoted prices for similar assets in markets that are active, or quoted

prices for identical assets in inactive markets, or are wholly derived from inputs that are observable. Level 3 inputs have no external market and rely on analysis of fair value and information that is not observable by outside parties.

Consensus is that middle market firms are primarily using Level 3, given the difficulty of finding any type of observable data for the small private companies in which they typically invest. Many large firms, however, with stakes in more sizeable businesses, are mainly employing Level 2, and in some cases, Level 1 inputs. In a recessionary environment, such observable market prices are often deeply distressed. Level 3 inputs, therefore, could result in higher valuations vis-à-vis current market conditions.

“If a private equity firm has a stake in a public company’s equity or debt securities, you simply can’t get away from Level 1 inputs,” said Messina. “You are completely at the mercy of the markets.”

While they may possibly fare better than the large buyout shops, anecdotal evidence suggests many middle market firms substantially wrote down the value of their portfolios at year-end. If so, that may lessen the severity of future write-downs.

“I know of many firms that were aggressive in their write-downs at the end of 2008,” said Beaton. “Anticipating the market would continue to decline, they wanted to avoid having to take additional substantial write-downs in the future. We will probably see further declines in first quarter reporting, but I don’t believe to the same degree.”

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## Marking to the middle market (continued)

Beaton believes there could be another six to 12 months of write-downs but expressed some confidence that “we have seen the worst of it.”

### Mark-to-market impact

Most middle market practitioners would acknowledge it’s a somewhat difficult fundraising environment. However, as noted, despite the high-profile declines in their portfolios, many of the largest firms don’t seem to have been noticeably stalled in their efforts to attract capital. The same could hold true for the middle market, given that falling portfolio values have become almost universal among private equity firms of all sizes.

“In this market there is a presumption that values have declined,” said Ryan. “There is not a stigma associated with write-downs. In fact, in many cases, a write-up would be viewed with suspicion and likely be scrutinized.”

One benefit of a slower fundraising and dealmaking environment is the ability to focus on growing portfolio companies in preparation for the market’s eventual return. Middle market firms may be particularly advantaged in this regard.

“With a smaller number of investments, middle market firms can focus more closely on helping portfolio companies improve operations, renegotiate with banks and refocus business plans,” said Messina. “It’s a unique dynamic that might make the middle market firms more resilient.”

There’s also a common sentiment that sophisticated investors, such as the LPs that invest in middle market firms, will not abandon funds in the face of substantial declines in portfolio value. What may impact LP retention and fundraising to a greater degree, and is not at all associated with FAS 157, is the need among LPs to reduce their private equity commitments in the face of the “denominator effect,” which has left some over-allocated in the asset class.

“There have been situations where successful, well-established middle market firms have had some LPs sell their interests on the secondary market for 50 cents on the dollar,” said Brady. “This was not because of a poor relationship with the firm, poor fund performance or any type of fallout from FAS 157. The LPs simply needed to reallocate their capital.”

Some have stated that FAS 157 is undermining the government’s attempts to stabilize the financial system and exacerbating the market’s boom and bust cycles. They point to the market’s positive reaction to FASB’s early April easing of some rules, which will primarily allow banks to limit losses, as evidence that mark-to-market is a drain on recovery. And some within private equity believe it has introduced more volatility and is impacting the market to a greater degree than cost-based accounting.

That said, while acknowledging the seeming disconnect between private equity’s long-term investment horizon and the “snapshot” nature of FAS 157, many see the accounting standard not as a detriment but as a true benefit to the industry. No one can determine the length and severity of the market downturn, they say. In the meantime, investors want and need an assessment of the portfolio as it stands today, even if a sale date is far in the future.

“Marking to market will be viewed much more favorably once a recovery is under way,” said Messina. “In the meantime, private equity firms will be well served to embrace FAS 157. By providing transparency and clear accounting standards, the firms will be better positioned to retain limited partners, and compete for finite investor capital.” •

### Questions?

Grant Thornton LLP professionals understand the unique needs and strategies of private equity firms and their professionals. Throughout the life cycle of a fund, we deliver timely value through our audit, tax, transaction and other specialty services. For more information on how you can benefit from Grant Thornton’s private equity services, contact:

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