PEI Alternative Insight

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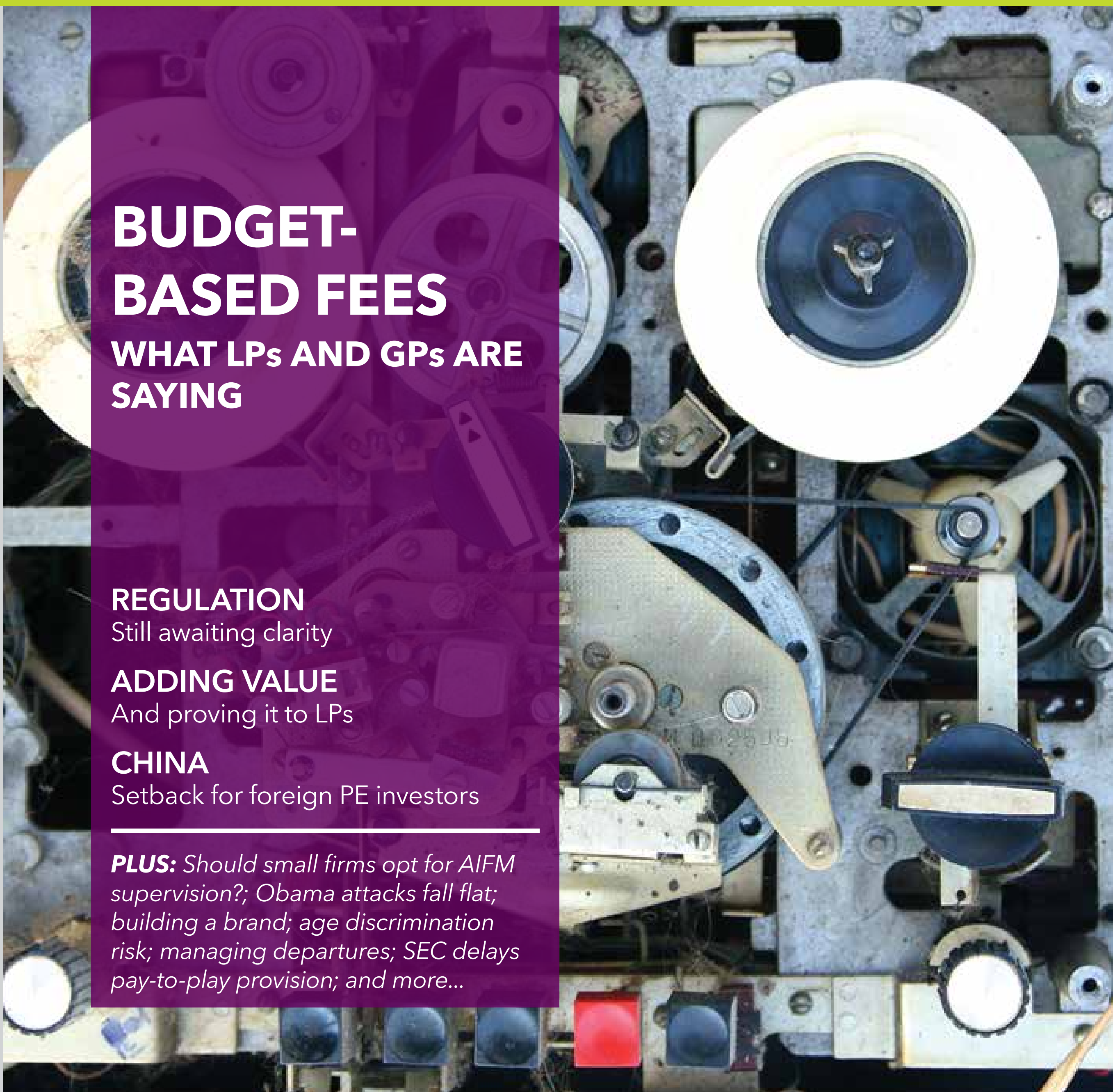
FOR PRIVATE FUND CFOs, COOs AND COMPLIANCE OFFICERS



BUDGET-BASED FEES

WHAT LPs AND GPs ARE SAYING

REGULATION
Still awaiting clarity

ADDING VALUE
And proving it to LPs

CHINA
Setback for foreign PE investors

PLUS: *Should small firms opt for AIFM supervision?; Obama attacks fall flat; building a brand; age discrimination risk; managing departures; SEC delays pay-to-play provision; and more…*

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Regulatory grief

When it comes to regulation the private equity industry could be said to have experienced the five stages of grief.

First came denial: the industry (correctly) declared it had little to do with the financial collapse and to this day does not represent a systemic risk. Leave us be, the message was from GPs, no punishment needed for a sin that was not committed.

Then came anger. As the GPs would have it, misguided politicians attempting to regulate an unfamiliar asset class had predictably drafted a number of draft rules that didn't fit the private equity model. White knuckles began to show in response.

The third stage, bargaining, began with industry trade groups such as the US-focused Private Equity Growth Capital Council and its EU counterpart the European Private Equity and Venture Capital Association (EVCA). This phase is ongoing: on p. 4 we report that the EVCA is now focusing its lobbying efforts against an unwanted depository requirement for the EU's proposed venture capital regime.

The fourth stage, depression or at least perceived lack of control, is perhaps where the industry largely stands today. On p. 16 Thomas Duffell reports that managers are still awaiting clarity on a number of regulations bestowed upon them. From 'Form PF' to the US Foreign Account Tax Compliance Act, many of the new rules crafted post-crisis are inching closer to (or already have reached) their implementation dates. But preparation for these requirements, which in some cases lack clarity, will be outside of GPs' full control until final language is released. In China particularly foreign investors are experiencing this stage of dejection following the recent collapse of the QFLP scheme (see p. 26).

Fortunately the final stage of grief, acceptance, seems where the industry is headed next. In many jurisdictions, final rules are of course expected or already here, and managers are using what they know now to lay the groundwork for compliance. Even GPs that are outside the scope of certain regulations are thinking through the implications. On p. 24 Bovill's Ben Blackett-Ord argues that smaller firms able to escape the EU's AIFM directive have many options to consider from a structuring and regulatory arbitrage perspective.

Throughout the grieving process LPs have looked on aware of the fundamental changes taking place. They too are undergoing their own transformation in a post-Madoff environment; primarily in the form of reduced commitments and a demand for more transparency. We report on p. 20 that more LPs are requesting to see a GP's budget when negotiating management fees. Whether such an arrangement can become the norm remains to be seen. The fact that a growing number of practitioners are discussing it now is further evidence that the private equity industry is maturing in more ways than one.

Enjoy the issue,

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US REGULATION

SEC delays pay-to-play provision

The markets watchdog has pushed back implementation of its 'solicitor restriction' rule while making a technical correction to its definition of 'covered associates'

The Securities and Exchange Commission (SEC) has delayed the "solicitor restriction" aspect of its pay-to-play rules until at least April 2013.

The pay-to-play rules aims to prevent GPs or affiliates from influencing government officials through political contributions by prohibiting them from advising government clients for two years after any contribution.

The "solicitor restriction" provision of these rules stops GPs from using third parties, such as placement agents, to solicit investment from government entities unless the third party is also registered with the SEC and is subject to its own pay-to-play restrictions.

The "solicitor restriction" provision was delayed from its 13 June 2012 implementation date to allow the Financial Industry Regulatory Authority - the placement agent regulator - and the Municipal Securities Rulemaking Board (MSRB) more time to adopt their own pay-to-play rules.

The registration requirement for municipal advisors was created by Dodd-Frank and the SEC has not yet adopted final rules for this provision and the MSRB has said that it won't adopt its own pay-to-play rules until the SEC issues its final municipal adviser registration rule.

The SEC have also made a technical change to the definition of the term "covered associate" within the rule.

"Covered associates" can be general partners, managing members, employees and their supervisors who solicit government entities for the adviser or political committees controlled by the investment adviser or other "covered associates".

In the June 2011 adopting release the SEC specified that the proposed definition of a "covered associate" as a "person" rather than an "individual" was to be ignored.

***SEC:** more time needed to finalise 'pay to play' rules*

This would mean that legal entities - so organisations or companies- and not just individual people could be considered "covered associates".

However in the final text of the rule an error occurred causing the word "person" to replace "individual". The SEC is therefore making this technical amendment to correct the mistake. ■

Definition of 'foreign official' under review

The question of who counts as a foreign official under the FCPA is making its way through the US court system

Private equity firms befuddled as to who counts as a foreign official under US anti-bribery rules should be aware of a recent court case challenging the law's definition of the term.

Currently the FCPA defines a "foreign official" as an officer or employee of a foreign government or any of its "departments" "agencies", or "instrumentalities".

The case challenges the broad scope of the definition of instrumentalities, which has not been clearly defined by the Act but is seen by the US government as a state-owned entity. However, this definition is not always clear cut, argues the law's critics.

The court case, now on appeal, was launched by former Terra Telecommunications executives, Joel Esquenazi and Carlos Rodriguez, after they were convicted under the FCPA of scheming to bribe officials of Haiti's state-owned telecom company – which was deemed an "instrumentality".

The appeal centres on the Haitian government owning shares in a company which does not perform a government function – the definition given to "instrumentalities" by a district court ruling. Defendants argue that "Congress intended the definition of 'foreign official' to apply to traditional government officials, not employees of state-owned enterprises."

At risk for private equity firms and their portfolio companies is the fact that they often engage in a variety of businesses around the world which may directly or indirectly interact with a government or its "instrumentalities". ■

EUROPE/ASIA REGULATION

Depository rule irks VC industry

The EVCA was left frustrated after the European Parliament voted for the adoption of a depository requirement for its venture capital scheme

A proposed pan-EU marketing regime for venture capital funds may come with an unwanted depository requirement following a committee vote from the European Parliament.

In a response statement the European Private Equity and Venture Capital Association (EVCA) called the vote "disappointing", arguing that the financial costs of depositaries – used by GPs to safekeep investors' assets – would make it impossible for smaller venture capital fund managers to enter the voluntary regime.

EVCA secretary general, Dörte Höppner, said the continent was at risk of missing an opportunity to "boost SME financing and growth, an area in which Europe is so desperately running behind the curve", adding there was still time to amend the regulation before the scheme's implementation by July 2013.

A related point made by the industry was that the Alternative Investment Fund Mangers Directive (AIFMD), a regulation designed for private equity and hedge funds operating in the EU, exempts GPs managing less than €500 million from the depositary requirements.

EU policymakers' decision to draft a bespoke venture capital regime rested on the idea that AIFMD was not suitable for venture capital. Consequently," it does not make any sense" to reintroduce certain provisions of the Directive – such as the depositary requirement – to the venture capital scheme, argued EVCA. ■

UK carbon law undergoes reforms

Proposals to the UK's CRC scheme will mean fund managers can more easily separate carbon reduction liabilities amongst portfolio companies, but the bureaucracy of the scheme for complex structures like private equity funds is still leaving room for concern

Proposals to the UK government's Carbon Reduction Commitment Energy Efficiency Scheme (CRC) will benefit fund managers hoping to separate liability between themselves and portfolio companies.

Moreover the proposals mean GPs have been provided greater flexibility in separating portfolio companies' carbon reduction obligations from each other.

The government's Department of Energy and Climate Change opened a consultation period on the scheme earlier this year with the aim to simplify the scheme's operations and design.

Currently firms must aggregate all majority owned portfolio companies into one group when registering with the scheme, and only after then are they able to disaggregate portfolio companies which would qualify for registration in their own right.

The consultation recommends that all portfolio companies, regardless if they were large enough to be captured by the scheme in their own right, should be entitled to disaggregation.

Although this is a welcome break for firms, much of the industry does not think the proposals have gone far enough. "I think there is some disappointment over the criteria being used for qualification," said Angus Evers, partner at law firm SJ Berwin.

He believes private equity firms are aggrieved that all their funds under management must be grouped together for reporting purposes as if they were a traditional corporate group. The concern stems from the UK government electing to use a specific legal definition that does not necessarily work for all organisations captured by the scheme, added Evers.

The industry is also pushing for the scheme to operate on a bottom up basis, meaning that small portfolio companies would be left untouched by the scheme, even if disaggregated as part of a wider GP portfolio.

Michael Coxall, of law firm Clifford Chance, thinks the industry is still concerned with the level of complexity and will want to move toward looking at an alternative, such as the government suggestion of an alternative environmental tax. ■

Carbon reduction: *GPs asked to play their part in monitoring carbon emissions*

India codifies PE rules

To the delight of GPs, India's regulators have unveiled a comprehensive framework for the alternative assets industry

After much anticipation the Securities and Exchange Board of India (SEBI) has laid out clear regulations for private equity and hedge funds that endeavour to provide stability, market efficiency and encourage the formation of new capital pools.

The rules also aim to protect high net worth individuals, a major source of capital for Indian fund managers, from becoming victims of fraud, unfair trade practices and conflicts of interest.

The regulation will require all alternative investment funds (AIFs) to register with SEBI, meaning private equity funds, real estate funds, hedge funds, fund of funds and so on.

Early proposals indicated covered funds would fall into nine different registration categories, but this was later reduced to three following criticisms that too many categories was overly bureaucratic and inflexible.

Despite the reduction there are still concerns within the industry. "This may still impede the ability of a private equity fund, for example, to invest in an early stage venture deal without registering a separate affiliate entity as a venture capital fund," Vijay Sambamurthi, founding partner of Bangalore- and Singapore-based alternative asset-focused law firm, Lexygen, wrote on his firm's blog.

In recent times there has been a marked increase in cases of alternative investment firms preferring to list themselves on stock exchanges, but private equity firms in India were hindered by unclear regulations in this regard, added Sambamurthi.

Mumbai: *clearer rules for PE industry*

India's existing fund legislation, VCF Regulation, which covered only venture capital funds, will be repealed. But existing VCFs shall continue to be regulated by the VCF Regulations till the existing fund or scheme managed by the fund is wound up, said in a statement the SEBI. ■

EU widens scope of VCT scheme

The European Commission has approved measures that will increase the number of companies eligible for the UK's tax friendly Venture Capital Trust scheme

The UK government has received approval from the European Commission to introduce changes to its Venture Capital Trust (VCT) scheme to help promote its growth agenda.

The VCT scheme sets out limitations of what companies a venture capital trust can invest in.

The government can now increase the size of companies which can receive investment from VCTs from assets of £7 million ($11 million; €9 million) to £15 million. It is also expected that companies with a headcount of up to 250 will be able to accept funding of as much as £5 million. Currently only companies with 50 or fewer employees are able to accept investment of up to £2 million.

"Convincing the Commission that VCTs should be able to invest in a wider range of business has been a demanding task," said Ian Sayers, director general the Association of Investment Companies, the trade body of closed-ended investment companies in a statement.

He added that State aid rules set stringent conditions to how much help a government can provide small to medium sized business. State aid stops European countries giving too many incentives to its own companies to ensure fair competition across Europe. The approval will allow the UK to have one of the most generous incentive schemes in Europe.

"The EU and HMT [Her Majesty's Treasury] have created more certainty for investors and increased funding opportunities for a wider group of companies," said Will Fraser-Allen, deputy managing partner at Albion Ventures, in a statement.

The scheme offers certain tax benefits to investors. Those investing are exempt from income tax on dividends received from the VCT and also benefit from income tax relief which is available to be set against any income tax liability. ■

TAX

'Step-up in basis' top GPs' tax concerns

Ensuring portfolio companies can maximise certain tax advantages like amortisation or depreciation deductions is GPs' biggest tax-related concern, according to recent research

When asked which tax issues are most important during the acquisition process, most fund managers cited the ability to readjust a company's value post-acquisition as a way of maximising certain tax advantages, according to McGladrey's 2012 private equity survey.

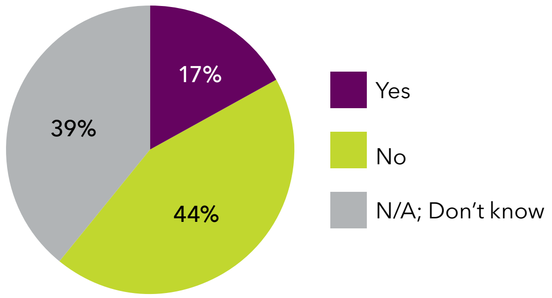
Two-thirds of respondents consider this "step-up in basis" as very or extremely important, according to the survey, while a similar percentage of firms (64 percent) cited the deductibility of interest payments as a crucial tax consideration when buying a target company.

In the context of private equity, a step-up refers to the practice of a firm bringing the basis of the acquired company's assets up to its current fair market value. By doing so, portfolio companies are able to better benefit from certain tax advantages like amortisation or depreciation deductions and amortisation of goodwill, explained Steve Bortnick, a partner in the tax practice group of law firm Pepper Hamilton, in an interview with *PE Manager*.

Further down the list of tax priorities, though still considered either very or extremely important by roughly half of respondents, was federal and state income tax exposure. A lesser amount of fund managers cited the deductibility of transactions costs and the ability to bring allowable tax deductions forward as considerably important, according to the survey.

Perhaps surprisingly, the survey also revealed that only 17 percent of firms feel changes to the tax treatment of carried interest – which Democrats, led by the Obama administration, feel are taxed too generously – will affect their investments and operations. A little under half of respondents (44 percent) said it would have no impact, while the remainder (39 percent) said they were unsure. ■

Would a change to carried interest tax treatment significantly change how you make investments and/or operate your portfolio



Source: McGladrey

Norway clamps down on carry

The Norwegian tax authority will class carried interest as standard income

Norway will tax carried interest as standard income rather than capital gains meaning a tax hike of 20 percent for Norwegian GPs.

Income tax in Norway reflects either income from capital, employment or business, all of which are taxed at different rates. In the past Norway charged carry at the 28 percent capital gains rate but will now charge GPs the 48 percent it charges for income from employment – if that income reaches a certain level.

The source of income is considered based on the circumstances of each case, and is a part of the regular and annual tax assessment performed by the Norwegian tax authority.

The tax administration has the power to change previous tax assessments, for example if the prior information given in the tax return is incomplete or it views the tax assessment to be incorrect.

Norwegian press reported three executives from Norwegian private equity firm Herkules Capital received a claim of nearly NOK 87 million (€11 million; $14 million) and that other GPs had been stung with similar demands. However the tax authority could not comment on specific cases due to confidentiality issues. ■

SWF-friendly tax reforms come with caution

Sovereign wealth funds concerned with losing their tax-exempt status when making certain US private equity investments will find favour with relaxed IRS rules, but that gain may be lost under certain circumstances

It is not clear if sovereign wealth funds that take a position on the advisory board of a private equity fund stand to benefit from relaxed Internal Revenue Service rules designed to encourage foreign investment, warned law firm Pepper Hamilton in a client memo.

As *PE Manager* reported late last year, the US tax office will no longer strip foreign governments of their tax-exempt status should one of their private equity fund investments engage in any "commercial activity". Unusually, the IRS said the proposals could immediately be relied upon even though final rules have not yet been issued.

The industry welcomed the tax revision, with many predicting a rise in private equity investments made by sovereign wealth funds, which collectively manage some $5 trillion in assets, according to the Sovereign Wealth Fund Institute.

However unless the IRS elaborates on its definition of a limited partnership, sovereign wealth funds that take on a relatively active role in the fund may be interpreted as breaking their limited partner status, warned Steve Bortnick, a Pepper Hamilton tax partner, in an interview with *PE Manager*.

IRS: *Not yet clear on how it defines investors' role in a limited partnership*

Concerning co-investment opportunities, Bortnick warned that the burden is on sovereign wealth funds to avoid engaging in any commercial activity, as the more lenient rules applicable to partnership investments do not apply to direct investments. Which non-business activities (for example the receipt of isolated commitment fees) will constitute commercial activities is another area in need of clarity under the proposals, Bortnick elaborated. ■

Sweden closes tax loophole

Sweden will close a tax loophole used by GPs as the Swedish Finance Minister continues his scrutiny of the industry

Sweden's Finance Minister, Anders Borg, will close a perceived loophole that is being used by private equity firms to avoid paying the country tax.

The tax loophole allowed a company in Sweden to borrow money at high rates of interest from a firm in the same group.

Borg: *enforcing a tougher tax regime on the private equity industry*

The Swedish company can then write off the interest costs – reducing its tax bill. The firm, if in a different jurisdiction, can then retain the interest payments and pay little or no tax to Sweden.

The decision comes after media and tax authority investigations put a spotlight on how private equity reduced its tax payments to Sweden while becoming significant investors in healthcare and education in the country.

They were concerned that private equity firms were generating profits in the tax-funded health sector while avoiding paying taxes to the state.

The Swedish Private Equity and Venture Capital Association (SVCA) played down the affect these proposals would have on investments in Sweden. "Investment activity won't be restricted from a private equity perspective," Jonas Rodny, SVCA spokesman, told *PE Manager*.

However Rodny did suggest the industry would be more reluctant to structure deals relying on the deductions because of the lack of clarity surrounding the proposal. The SVCA expressed concern that there is no objective way of knowing who will be granted a reduction.

The rules, due to come into force in January 2013, are expected to increase tax revenues for Sweden by as much as SKr6.3 billion (€707 million; $897 million) as Borg commits to enforcing a tougher tax regime on the private equity industry. ■

GP MANAGEMENT

Full suite systems become industry norm

Larger GPs in particular are finding ways to fully integrate their front and back office systems

Nearly half (41 percent) of GPs now integrate traditional back office systems with their front office work, according to Corgentum Consulting's in-house database seen exclusively by *PE Manager*.

Larger private equity firms in particular (those managing $1 billion or more) are incorporating investor relations, portfolio company information sharing and other front office work with back office functions like reconciliation, settlements and fund accounting. Two-thirds of large GPs have a full suite system in place, according to Corgentum Consulting, which helps LPs inspect GPs' fund administration systems.

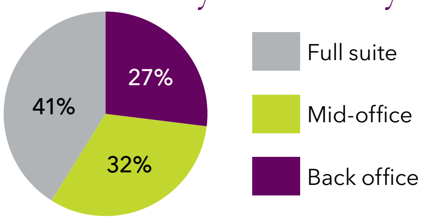
In comparison "middle office systems" are used by 32 percent of GPs, according to Corgentum. Middle office systems feature functions that bridge the gap between the front and back office, including risk management and reporting, record maintenance, compliance oversight and information technology management.

The remainder of firms within the database (27 percent) have systems which are solely focused on traditional back office functions, the data revealed.

Jason Scharfman, a managing partner at Corgentum, noted that there is more of a disparity among the fund administration systems chosen by smaller GPs. In comparison 41 percent of larger GPs now use one of eight fund accounting systems as compared to 36 percent one year earlier.

Scharfman added that 72 percent of larger GPs that have adopted a full suite system still have some legacy systems in place, often because the data from the prior system had not yet fully migrated to the new one. ■

Fund administration systems used by GPs



Source: *Corgentum Consulting*

Carlyle revamps website

The firm's updated website now includes biographies of 600 Carlyle professionals, videos explaining the firm's work and a greater overview of its portfolio investments

Visitors to carlyle.com will be treated with more information about The Carlyle Group's investment philosophy, dealmakers and a new commentary section that features Carlyle executives' media engagements.

The revamped website includes details on the recently listed firm's 94 funds and 63 fund of fund vehicles, biographies on some 600 investment professionals, investment case studies and other transparency measures.

The website was in part designed to provide everyday visitors a clear rundown of what it is that Carlyle does. "We want to give someone in, for example, Montana who may be reading about a Carlyle investment in their hometown, the ability to easily navigate our website and feel assured in our work," said in an interview with *PE Manager* Chris Ullman, Carlyle's head spokesperson.

Other firms too have recently taken a hard look at their websites to meet investors' transparency demands. Earlier this month The Blackstone Group debuted on its website videos describing select investments, and like Carlyle, tweaked their site's architecture for easier navigation.

Ullman said websites in the private equity industry were becoming increasingly sophisticated and that it was important to stay ahead of the curve in how a firm presents itself to investors and the public at large. ■

Carlyle's homepage: *built to assure everyone*

Triago founder launches virtual deal room

Palico is describing itself as the first online marketplace for LPs and GPs to share fundraising, secondaries and co-investment opportunities

Antoine Dréan, founder of placement agent Triago, has launched a first of its kind online marketplace that aims to unite "the fragmented, multi-trillion dollar global private equity fund community", the private equity veteran said in a statement.

Palico – which can be accessed from internet browsers or remotely via smart phones and tablets - goes a step further from its competitors by allowing LPs and GPs to not only engage in secondary transactions, but in fundraising and co-investment opportunities as well, said David Lanchner, a spokesperson for the platform.

For a flat annual subscription fee LPs can search funds or sell and buy existing stakes using an auction service. GPs can in turn discover the identity of potential investors in exchange for giving them access to requested confidential investment documents (such as a private placement memorandum).

In response to some GP criticisms that online platforms were too impersonal for dealmaking, Lanchner said the platform was not intended to replace face to face meetings, but instead provide the industry another channel in cultivating relationships. "This platform recognises that LPs need to freely compare and contrast investment opportunities across a full range of investment fund structures, both online and offline, in order to invest with GPs they are truly comfortable with."

The service is also designed for placement agents to extend the reach of their fundraising and secondary mandates and to allow gatekeepers to discover and select a wider range of investment opportunities for their clients. ■

> *"This platform recognises that LPs need to freely compare and contrast investment opportunities across a full range of investment fund structures, both online and offline, in order to invest with GPs they are truly comfortable with"*

Service update: Latest moves in fund admin

Software provider efront starts its own blog on industry developments while fund administrator Augentius expands to Northern Ireland

Software provider **eFront**, has launched a blog for the alternative investment community. The blog aims to provide insight in helping stressed fund managers understand how to overcome the challenges of a rapidly changing industry, according to eFront. The blog will be authored by eFront and selected industry experts, covering global issues from private equity to real estate.

Phase4 Ventures, a London-based venture capital firm, has appointed Citi to provide document safekeeping and fund administration services. Citi – a global provider of accounting, administration and tax services – has been serving private equity funds and investors for nearly two decades. Phase4 was established in 1999 to manage a portfolio for investment bank, Nomura, but is now independent following a 2010 management buyout.

Fund administration provider **AltResources** has bolstered its team bringing **Joseph Daly**, formerly of Morgan Stanley and Bank of New York, as compliance director. He brings more than 25 years of accounting, compliance and client-service experience in alternative investments, according to a statement.

Fund services provider **Ipes**, has achieved two assurance standards – ISAE 3402 and AAF 01/06 following a six month review by Ernst & Young. The process involved a comprehensive review of Ipes' internal controls with a particular focus on their operating effectiveness.

Augentius Fund Administration is expanding to Belfast. Augentius plans to create an operational centre in the Northern Irish capital, with support from, regional business development agency, Invest Northern Ireland. The Belfast office is expected to create up to 164 jobs by the end of 2014. ■

ACCOUNTING

Deutsche exec appointed to IASB board

A German standard-setter will join the International Accounting Standards Board at a time of convergence with US standards

Martin Edelmann has been appointed to a five year term with the 15-member International Accounting Standards Board (IASB).

The former Deutsche Bank head of group reporting joins at a time when the IASB is currently working to synchronise its standards with its US counterpart, the Financial Accounting Standards Board. The two boards' "convergence project" has recently hit a snag with the US signaling it will retain the right to create tailored rules from any agreed set of standards as it sees fit.

During his 14-year tenure with Deutsche, which ended last year, Edelmann was responsible for transitioning the bank from US accounting standards to international standards. He also served as a member of the German Accounting Standards Board from 2006 until 2011.

Robert Glauber, chairman of the IASB's nominating committee, welcomed Edelmann's appointment, saying in a statement: "Germany is a key constituent of the global economy and [Edelmann's] knowledge and experience of its financial and regulatory systems will prove invaluable to the IASB as it furthers its aim of establishing global accounting standards". ■

LEGAL AFFAIRS

SEC loses top alternatives investigator

The SEC has lost two of its top investigators to the private sector, including Robert Kaplan who co-headed the agency's unit responsible for monitoring private fund managers

Robert Kaplan, co-chief of the US Securities and Exchange Commission's (SEC) unit responsible for investigating private fund managers, is bringing his experiences to Debevoise & Plimpton's Washington DC office.

In similar news, peer law firm BuckleySandler has brought to its Washington DC office Thomas Sporkin, the SEC's top investigator responsible for fielding market fraud tips, including intelligence from the agency's recently crafted whistle-blower programme.

Kaplan: *bringing his SEC experiences to the private sector*

Kaplan, who started his public sector career in 1995 as a SEC staff attorney, is probably best known by private fund managers as co-chief of the SEC's Asset Management Unit, a role he was awarded in early 2010 alongside fellow SEC veteran Bruce Karpati at the time of the unit's creation.

Following Kaplan's departure Julie Riewe and Marshall Sprung have been promoted to deputy chiefs of the Asset Management Unit. Sprung, formerly a litigation associate at Gibson, Dunn & Crutcher, has reportedly worked in the agency's Los Angeles office since 2003. Riewe reportedly joined the SEC in 2005, having previously acted as a litigation associate at Wilmer Cutler Pickering Hale and Dorr.

The unit boasts a team of 75 lawyers and industry experts who were assembled to provide the SEC greater expertise in supervising alternative asset managers. For GPs who complain that some SEC auditors don't understand enough about how private equity is different from other types of investment advisors, the unit sought to ease those concerns.

> *"[Inspectors have been] very fair, competent and balanced in how they approach their examinations"*

When asked what registered firms should expect ahead of an inspection sweep later this fall, Kaplan responded that inspectors are, in his experience, "very fair, competent and balanced in how they approach their examinations".

Kaplan added his work will be largely dedicated to assisting private equity firms who must register with the SEC as mandated by financial reform bill Dodd-Frank. ■

Dewey defectors may come with baggage

A recent court ruling could impact many law firms' bottom line

Law firms that have recruited partners from Dewey & LeBoeuf (see right coverage) may have to account for certain profits the recent hires make from unfinished business at the now defunct law firm, according to a recent New York Federal Court ruling not connected to Dewey's bankruptcy case.

Under the separate federal court ruling, a number of law firms were sued in bankruptcy court by dissolved law firm Coudert Brothers' plan administrator, who claimed the firms must account for any profits derived from unfinished client work that the former Coudert partners had taken on with them to their new employers. The firms argued that because the client work was billed hourly, they were wholly entitled to the profits. The court disagreed, ruling that "although the New York Court of Appeals has not addressed this precise issue, I believe that it would conclude that the method by which the client matters were billed does not alter the nature of Coudert's property interest in them".

The cause of Dewey's own bankruptcy is said to in part stem from paying lavish salaries to high profile lawyers who the firm believed would win them enough business to survive the high debt load, according to court papers filed this Monday. The firm has accrued roughly $300 million in debt, against some $225 million in assets, the court filing revealed.

Dewey will not reemerge from bankruptcy, and will instead liquidate its assets, the firm said in a statement. ■

Legal manoeuvres: PE lawyers' latest moves

More private equity lawyers from defunct law firm Dewey & LeBoeuf continue to find new homes while Morrison & Foerster identifies the head of its New York private equity practice

M&A lawyer **Jonathan Melmed** has left Chadbourne & Park to head up **Morrison & Foerster**'s New York private equity practice.

Goodwin Procter has hired **Thomas Beaudoin** from rival law firm WilmerHale where he was chair of the firm's fund formation practice. Beaudoin, who specialises in venture capital and private equity funds, will sit in Goodwin's Boston office.

Fund formation lawyer **Bradley Mandel** has left Proskauer Rose to join **Winston & Strawn**'s Chicago office.

Schulte Roth & Zabel snagged an 11-strong team of New York-based private equity and real estate lawyers from now defunct law firm Dewey & LeBoeuf. Joining the firm as partners are private equity lawyer **Joseph Smith** and real estate lawyer **Marshall Brozost**.

Moreover **Ilan Nissan** and **Christian Nugent**, two private equity lawyers from the quickly shrinking New York office of Dewey & Lebouf, have defected to **Goodwin**. The embattled New York law firm is reportedly attempting to stave off bankruptcy and is encouraging its partners to find work elsewhere.

Speaking of which, **O'Melveny & Myers** has snagged a team of finance and M&A lawyers from Dewey. **Richard Shutran**, **Junaid Chida**, **Arthur Hazlitt**, **Mark Caterini**, and **Dev Sen** join O'Melveny's New York office as partners.

Meanwhile **Duane Morris** has dipped into the Dewey & Lebouf talent pool, having recruited 16 lawyers from the firm. The recent hires include M&A lawyers **Cameron Macrae** and **Thomas Redekopp** in New York and Boston respectively; and financial services lawyer **Oliver Rust** in New York.

Proskauer too has joined the hunt, having expanded its M&A practice in New York with the addition of former Dewey lawyer **Lorenzo Borgogni**.

Likewise **DLA Piper** has added Dewey lawyers **Joyce Chan**, who specialises in insurance, and M&A lawyer **Heng Loong**, to its Hong Kong office.

Kaye Scholer recently hired Dewey private equity deals lawyer **John Fallon** to its New York office. He brings with him former Dewey associate **John Csuka**.

Ropes & Gray has poached Chicago-based private equity deals lawyer **Matt Richards** from rival law firm Kirkland & Ellis. ■

TERMS & CONDITIONS

Asia GPs top global peers in management fees

Management fees in Asia are generally higher than in other regions, but the fees tend to come with sweeteners

Private equity funds in Asia charged higher management fees than their global competitors despite a tough fundraising climate, according to a recent survey from Squadron Capital.

In Asia, private equity firms are charging management fees at or close to the traditional 2 percent level, which in a global context is at the higher end. Generally, firms in other regions have been more amenable to reducing fees in order to attract investment.

The majority of funds in Asia that are charging annual fees in excess of 2 percent are sub-$200 million funds.

According to Squadron, the higher fees derive from "the combination of smaller average fund sizes in Asia and the fixed costs of fund management irrespective of size". Thus, "GPs might not necessarily be generating annual fee income levels in excess of their likely cost bases", the firm said.

In addition, funds in Asia are increasingly providing concessions for investors to attract funding.

One of the concessions is a "sweetheart deal", where preferential fees are offered to get investors on board early. The proportion of Asia funds giving sweetheart deals grew to 20 percent from 6 percent the previous year, the survey noted. ■

LPs speak out on return strategies

Investors are utilising co-investment opportunities and negotiating better fund terms in the search for higher returns

Limited partners are increasingly targeting better returns by negotiating fee breaks and committing to funds with significant co-investment offerings.

That's according to a panel of LPs who spoke at the Dow Jones Private Equity Analyst conference in New York.

"One thing that we do pay a lot of attention to are the monitoring fees," said Mina Pacheco Nazemi, a director in Credit Suisse's private equity fund of funds business. "We actually model out how much the GP will be taking out in different types of monitoring fees throughout the [fund] life. We track that because at the end of the day we want to have the most alignment with the sponsor."

> "We actually model out how much the GP will be taking out in different types of monitoring fees"

LPs that don't have enough capital to set up separately managed accounts are still negotiating preferential terms with GPs, according to managing director of BAML Capital Access Funds Craig Fowler.

"[LPs] are looking to invest large amounts in single funds to negotiate better terms," he said. "They'll continue to look for a way to enhance returns through fees, better terms and also [by] looking at tweaking strategies, whether that be terms or co-investments."

> "[LPs] are looking to invest large amounts in single funds to negotiate better terms"

While funds offering co-investments have been popular among LPs recently, many LPs only co-invest with GPs to which they've made primary commitments, and some require extensive vetting of co-investment opportunities offered by existing managers.

"It's not just the GP that we're looking at but actually the specific partner on the deal," said Jeffrey Reals, managing director of Performance Equity Management. "If this is a strategy that he or she has employed before that garnered prior success that we can look at, that gives us a whole lot of comfort."

In 2011, Performance Equity Management made 11 co-investments, Reals said, worth a combined $220 million. This year, the firm has participated in five co-invesments.

"I think [co-investment] deal flow has been reasonably good this year," said John Wolak, managing director of Morgan Stanley Alternative Investment Partners. Morgan Stanley has co-invested four times so far in 2012, and in 2011 made 10 co-investments totaling about $250 million. ■

What's your age discrimination risk?

GPs' potential litigation exposure has jumped following reforms to US age discrimination laws. That means more homework needs to be completed before making certain hiring decisions or assigning bonuses

Add employees' ages to the growing list of compliance concerns that need to be addressed by private equity firms with US operations.

Reforms to regulations implementing the 1967 Age Discrimination in Employment Act (which went into effect in late April) call for employers to think more in advance about how their practices might be affecting different age groups. The law now calls for employers (including GPs) to be more aware of what impact, say, a round of bonuses or hiring strategy will have on older workers compared to young. And more importantly, to document what actions had been taken to mitigate any discrimination against the older individuals.

To illustrate what needs to be done, consider a fixed figure bonus payout to staff – one that is probably a higher percentage of a junior employee's base salary compared to a more senior employee. That may not be easy to swallow for the older staff, meaning it needs to be shown that other reasonable factors were at play in the decision or risk an age discrimination lawsuit. Retaining junior talent could be one such reasonable factor, says Stephen Erf, a labour relations attorney at McDermott Will & Emery. Unlike their junior counterparts, senior employees may have a portion of their salary deferred, making it less likely they abruptly leave the firm. A fixed figure bonus therefore can be a tool to keep the younger staff around for another year.

Unfortunately having to study the impact of a bonus round means higher administrative costs for most GPs captured by the law. We would say all, but many firms are unaware of the reforms, according to legal sources, and so will go about their business as usual except now with increased litigation exposure.

What's more is the law applies just as strongly at the portfolio company level: are portfolio company executives aware of the reformed age discrimination rules as well? If you make a representation that they are, perhaps say to a buyer at the time of exit, it should certainly be checked that they are.

Both in the US and abroad the reforms highlight just how regulated the industry has become, for age is but one of many new compliance duties that have been recently added to the private equity rulebook. ■

> *"many firms are unaware of the reforms and so will go about their business as usual except now with increased litigation exposure"*

Obama attacks fall flat

President Obama's first attack on private equity has largely fallen flat. But that's no reason for the industry to ease off on its lobbying efforts

For fund managers in this industry, politics matters. Public perception matters. If the concept of private equity conjures images in the public mind of well-heeled vampires sucking the life out of corporate America, it will make for some uncomfortable conversations with LPs (specifically public pension plans) subject to political pressures.

That said, there was no need for a crystal ball to predict that President Barack Obama

> *"The White House's message – that Bain had overleveraged companies at the cost of honest American jobs – doesn't even seem to have gone down very well with Democrats, his core constituents"*

would campaign against Republican challenger Mitt Romney's private equity past, as part of his bid to secure a second term. But who could have predicted that such a substantial faction of the press would be so critical of the President's framing of the issue?

Sure, the newspapers read by business folk might have been expected to take a positive view of private equity. But what about more left-leaning titles? Well, the Boston Globe recently described Obama's approach (of attacking select Bain investments while trying to avoid a debate about the merits of the industry more broadly) as his "awkward private equity dance". The editorial board of the Washington Post agreed, suggesting that the president "[wanted] it both ways" on the issue.

The White House's message – that Bain had overleveraged companies at the cost of honest American jobs – doesn't even seem to have gone down very well with Democrats, his core constituents. Obama ally Cory Booker, the fast-rising Newark mayor, recently made headlines by slamming the president's strategy as "nauseating". Other centrist Democrats have struck a similar tone.

Not exactly a promising start for the President's campaigning on the issue, then.

But it would be a mistake to think the public perception risk has suddenly gone away. The well-oiled Obama reelection machine will no doubt be considering a change in tactics, given the lacklustre reaction to its anti-private equity message. So it's all the more important for lobby groups like the Private Equity Growth Capital Council – which has, to its credit, ramped up its public defense of the industry in recent months – to redouble their efforts to talk about the positive impact private equity can have. The media may have taken the industry's side this time round, but they might not need much persuading to change gears. ■

Brand conscious

Building a brand can increase visibility with investors, dealmakers and job seekers

Branding may not seem terribly important in an industry built on long lasting personal relationships, but firms with strong and well-communicated reputations can more easily source deals, recruit top talent and attract investors. The more people that are aware of who you are and what your brand represents, the more opportunities arise to discover that next key relationship, be it with a potential investor, employee or target company.

More GPs seem to be reaching that conclusion, according to recent research from public relations firm BackBay Communications, which revealed that a growing number of firms have ramped up their budgets for marketing materials and websites in recent months.

To be clear, no one is suggesting a clever logo, snazzy annual review or comprehensive social media presence is as effective in grabbing investors' attention as solid performance figures (some would argue performance is a factor contributing to an overall brand), but the study suggests more GPs are finding ways to supplement their track record with easy-to-execute branding strategies.

Take a strong logo for example. With all the abbreviations flying around the industry, why not create a distinct image or design that is more capable of leaving a lasting impression with investors than what could be accomplished with the

41

Percentage of GPs who say they use LinkedIn, a professional networking site, as a channel to build their brand, according to Backbay standalone letters that represent the firm's founders?

And at the risk of sounding self-serving, engage the media. Create news releases capable of catching the attention of the press. In fact, create a news section on the firm's website that allows journalists and other curious outsiders an easily accessible window into the firm's accomplishments. And speak with reporters directly, and not necessarily in the expectation of a printed quote – they'll likely remember your name the next time around, or be more sympathetic to your viewpoint when writing unflattering coverage.

“firms with strong and well-communicated reputations can more easily source deals, recruit top talent and attract investors”

Another point to consider is social media. It's a subject we've covered in the past, having reported that while social networking sites can be a liability, they can also be an important tool in the branding kit.

In all, becoming more conscious of your brand identity seems like a simple win-win-win – a way to help stick out from a crowd of GPs all vying for the same LP commitments, deals and human capital. ■

Managing departures

Avoiding an IR nightmare is just one of many factors to consider when parting company with a partner

At some point, most firms will have to manage the departure of a partner – and it won't always be on friendly terms. It's an issue *PE Manager* has explored in the past, offering guidance on what might happen to a leaving partner's slice of carried interest, any stake in the management company and co-investment capital. But of course that's not all that must be considered when a parting of ways becomes necessary...

Friendly fire: When a partner has underperformed or committed some type of misconduct, the firm's disciplinary procedures (if exercised) should clearly outline when a termination is justifiable, to ensure fairness. But in practice, attempting to resolve the matter quietly may be a better option than formal disciplinary proceedings - if only for cosmetic reasons.

“Many firms make the mistake of drafting non-compete clauses that are too broad and restrictive”

Assigning credit: Sometimes, at the time of departure, partners seek the right to share their track records, particularly if they plan to spearhead or join a new fundraising effort. Be sure to negotiate how their track record can be communicated – or risk the firm's successes being overly attributed to an exiting employee.

Right to compete: Create targeted and reasonable non-compete clauses (which prohibit the departing partner from competing with his former firm for a specified period of time). Otherwise they can be difficult to enforce in court, private equity lawyers tell PE Manager, adding many firms make the mistake of drafting non-compete clauses that are too broad and restrictive.

Litigation risk: It's true that every contract is negotiated differently, but all should exhibit clearly delineated rights and obligations set at the time of a partner's arrival. If this is done right, coupled with face-to-face meetings when negotiating any settlement documents, it reduces the likelihood of litigation or disputes post-exit.

Protecting your reputation: In this small, relationship-based industry, people talk. And while it may do little harm if rival firms are snickering at the gripes voiced by a disgruntled employee, LP investment committees communicate too – and they may see a mishandled departure as a cause for concern. Likewise, the press is only too happy to lend its ear to an insider source with a story to tell, making it especially critical to handle any exiting employee with care and respect. ■

REGULATION

Awaiting clarity

From 'Form PF' to FATCA, private equity firms have a seemingly endless stream of regulations by which they soon must comply. How to prepare for these requirements, which in some cases lack final language and clarification, can be a source of concern. Thomas Duffell reports

Some years after the financial crisis that set in in 2008, and after a considerable back and forth lobbying effort, the unprecedented rules and regulations crafted to supervise GPs are inching closer to (or already have reached) their implementation dates. Nonetheless, many private equity firms are still undecided on how to tackle this regulatory challenge.

"The biggest issue is not only the regulation itself but the uncertainty of how the regulation comes out," says Philippe Bucher, chief financial officer of European fund of funds Adveq. When asked to identify which particular provisions or incoming laws are most troubling, Bucher said most were still too undefined at this point in time to name specifics.

A prime example is the US Foreign Accounts Tax Compliance Act (FATCA). Passed by Congress in 2010, FATCA requires foreign firms to provide US tax authorities the name, address, tax identification number, and other key financial details of their US investors or suffer a 30 percent withholding tax on certain US-connected payments.

$2bn

Threshold determining which large firms (measured by AUM) must submit detailed fund information in their Form PF filings

Critics have slammed the law as overstepping its jurisdictional reach, requiring firms to implement new reporting and payment systems to meet US standards and possibly violate local data privacy laws. However the US Internal Revenue Service, which is in the process of revising its reporting forms, still hasn't made clear exactly what information will be required.

Perhaps as a result of this uncertainty firms have yet to complete a huge amount of work to comply with FATCA, noted Ernst & Young partner Ashley Coups in a client memo. Instead firms are likely waiting until the end of the year before they start with any "know your customer" work that would enable them to identify US individuals for reporting purposes.

"The process may be burdensome for a fund manager with many investors, or one who doesn't keep centralised information or have retrieval systems for its existing processes," adds Peter Schuur, a tax partner at law firm Debevoise and Plimpton.

For those without such systems and processes Schuur advises managers start evaluating what information they do have and what systems they can put in place to collect and organise this extra data.

"Perhaps as a result of this uncertainty firms have yet to complete a huge amount of work to comply with FATCA"

Another consideration for managers is whether or not to start gathering extra data from investors now, or whether to wait until the forms have been finalised before potentially annoying investors with extra questions that might not be pertinent.

In Europe the main regulatory priority for GPs has been the Alternative Investment Fund Managers Directive (AIFM), a pan EU-marketing regime for private fund managers that is still in the rulemaking process. However, despite the uncertainty in how the directive will look once it enters effect in July 2013, GPs will not for the most part experience significant stress in complying with its provisions says Sue Woodman, general counsel at Equistone Partners, formerly Barclays Private Equity.

Adveq's Bucher doesn't see much more work to follow if a firm is already regulated within its own jurisdiction. He adds the reporting requirements for the AIFM are not expected to be difficult to file.

"What the directive requires is additional administration that of course can be done," says Woodman.

The real challenge of the AIFM centres on how to set in place an implementation plan, says Coups. He addresses the test of completing a gap analysis which measures where firms are, versus where they need to be – a process made even more difficult by a directive that has yet to be finalised.

There's been a degree of lethargy over the last couple of years concerning the Directive's requirements but with details emerging GPs now appear to be taking the law's implications more seriously, added Coups.

One aspect of the AIFM causing significant concern is the need for EU firms to register their private placement memorandums with their home regulator. Before the memorandum can be issued to potential investors it will have to be sent to the country regulator, such as the Financial Services Authority (FSA) in the UK, who has ten days to approve it before marketing is permitted.

However, terms of the registration are not yet known and questions surround the capacity of regulators to handle the process.

"If they receive several on consecutive days will they have the manpower to do anything meaningful in terms of approval?" wonders Woodman.

Any changes after registration will then have to be notified to the FSA, or other regulator, who will consider the changes. This has led to concerns that the amount of time needed to close commitments on agreed terms

Schuur: *handling FATCA*

> *"The [SEC] can and has brought fraud cases against advisors that have deviated from their valuation policies and procedures"*

will lengthen.

Rules affecting fundraising are also being felt in the US with the Dodd-Frank Act forcing firms to disclose greater information to the Securities and Exchange Commission (SEC).

"SEC examiners will be spending a lot of time reviewing disclosure and marketing materials, especially any material that includes information on prior performance," says Ken Berman, US –based partner at law firm Debevoise & Plimpton.

Another important area for the SEC is how GP's are valuing their portfolio companies. "Valuations are easy if you have realisations, but if certain portfolio positions have not been realised, and the performance numbers are based in part on the current values of unrealised portfolio positions, the SEC is going to want to look at that process used to arrive at those valuations," notes Berman.

And "if you look at the valuation cases that the agency has historically investigated, the staff tend to look at not only if your policies are reasonable but whether you materially deviated from them in arriving at your portfolio valuations" says Rob Kaplan, partner at Debevoise & Plimpton and former co-chief of the SEC's unit responsible for investigating private fund managers.

"The [SEC] can and has brought fraud cases against advisors that have deviated from their valuation policies and procedures, and is of the view that a case doesn't necessarily have to prove that the valuations were materially incorrect, just that the investment advisor made certain representations about their valuation processes to investors, and that those representations proved to be inaccurate," Kaplan adds.

This is not just an issue for US firms

however. Registration with the SEC under the Dodd-Frank Act is a requirement of many overseas firms. There is of course the "private fund adviser exemption", which foreign firms with US investors qualify for, but Woodman argues this is no exemption at all.

"It means that they are exempt from registration under the US Investment Advisers Act but they will not be exempt from, and will have to comply with, the reporting requirements of the SEC which can investigate and check on firms when necessary. So, many UK firms [for example] now fall within the remit of the SEC as well as the FSA – not necessarily a happy position," says Woodman.

Another daunting regulatory challenge for US firms will be Form PF: a rule that requires firms to disclose information on counterparty dealings, leverage and investment so that regulators could spot any brewing systemic risks within the industry.

Smaller firms will escape this challenge but SEC-registered firms with $150 million or more in assets under management (AUM) will be required to file annually starting from next April. Very large private equity firms should be aware, however, of falling foul of the "large hedge fund manager" classification which could come with quarterly filing duties starting as early as this August.

The SEC stated that a private fund would not fall under this classification as long as it doesn't "borrow an amount in excess of one half of its net asset value" or sell securities or other assets short (with an exception for hedging exposure to interest rates or currency risks). But some are still likely to fall within this classification, warn legal sources, who as an example point to firms that sell short to hedge a position in a publicly traded

Berman: *prepare for Form PF*

> *"Many UK firms now fall within the remit of the SEC as well as the FSA – not necessarily a happy position"*

portfolio company.

Some of the daunting filing obligations awaiting private equity firms with more than $2 billion in assets under management include information on the indebtedness of certain portfolio companies. They would also need to break down by location and sector each portfolio company in a fund and provide certain financial data for any portfolio company in the financial services sector.

"They should start the process by considering how they are going to pull all the information together. For private equity firms some of that data is going to have to come from portfolio companies and this may prove difficult to get from some companies on a timely basis," warns Berman.

For those that haven't made inroads into their Form PF preparation Berman advises they first assemble a team from different divisions of the firm. "They need their compliance people, their financial and accounting people, their investor relations people and the people who generate the data for performance reports."

"It is fair to say that advisors need to take Form PF seriously, and that completing the Form accurately and completely may require the advisor to engage a number of employees to assemble the data from multiple sources," adds Kaplan.

Indeed with implementation of many new regulations already here or looming, GPs still without clarity should be regularly keeping track of updates but also reviewing their current information and systems. Preparing for the unknown is difficult but increased focus on the regulations now will put them in the best position to ride what has become a tsunami of new rules. ■

INVESTOR RELATIONS

Budget under review

More LPs seem to be asking for a copy of the budget when negotiating management fees. For GPs this level of transparency may be uncomfortable, but it could also be an opportunity to demonstrate what it actually costs to keep the lights on. Nicholas Donato and Christopher Witkowsky report

Picture if you will, a private equity firm's chief financial officer sitting down with a group of curious investors to discuss budget work. Strewn across the meeting room table are budget projections, expense reports and even the salary figure of the secretary who had just moments prior led the morning visitors to meet the anxious CFO, a reserved individual clearly unaccustomed to sharing such sensitive matters with outsiders.

It's certainly not an everyday scene in the industry, but some variation of it is not unprecedented. A new spin-out has recently been shopping itself to potential limited partners by stressing it will charge management fees based on budget figures rather than fund size. The hope is it will win favour with fee-wary LPs and shorten the marketing period for its debut fund, according to one LP source who declined to provide further details on the fundraise. In recent interviews with *PE Manager* other LPs too have noted seeing similar setups cropping up in the industry.

> *"The fear among LPs is that management fees – will in some cases – turn into a stable, continual source of revenue regardless of manager performance"*

WHAT LPs ARE SAYING

In all LPs stress that management fees were originally intended to help "keep the lights on", or pay salaries and basic operating expenses while the firm waits for carry to roll in. However as fund sizes have grown, the 2-and-20 model has remained largely the same, meaning management fees – in some cases – have turned into a stable, continual source of revenue regardless of manager performance. It also creates incentives for managers to keep raising larger funds.

"It really takes little more money to run a $3 billion fund than a $2 billion fund – let alone a series of overlapping funds," confirms one emerging markets-focused GP.

A recent venture capital study published by long-time LP the Kauffman Foundation makes a similar point, arguing a better option than a flat 2 percent management fee is the budget-based charge, which "offers better alignment between GPs and LPs, gives GPs sufficient capital to operate their firm, and provides LPs with transparency into firm economics".

Despite these concerns most GPs have not been forced to fully reveal their hand with respect to budget costs – however at the same time more LPs are now requesting that they do.

A current middle ground appears to have been reached, at least in some circumstances, says David Fann, head of LP advisory firm TorreyCove Capital Partners. "We always ask GPs for a copy of the budget. But what we usually get in return is an overview of the firm's financials and business economics."

A separate LP source speaking on the condition of anonymity agreed budget requests were being made, but that "very few GPs will actually provide them". The LP added that for those GPs that do, it is usually presented in summary form, and crafted in a way that implies the firm is making very little money off of fees. "But there is no way for us to validate

that without giving us the financial statement."

WHAT GPs ARE SAYING

A significant number of private equity firms, and more directly the CFOs themselves, were invited to comment

"What I'm seeing in the LP community is they follow 100/0 fee sharing religiously, and don't necessarily look at the budget and understand why a GP may need that fee income to cover overhead costs"

for this article on the concept of a budget-based fee model. The vast majority declined comment – a response perhaps underscoring the sensitivity of the subject. Or it may be the case that GPs see little benefit at all in entertaining the idea of an openly shared budget. GPs may feel naked with this level of transparency, or perhaps predict that allowing the subject to become a two-sided conversation would only lead to further reductions in already heavily negotiated management fees.

Then again an open conversation on operating expenses could be the perfect opportunity to show investors why management fees are where they are, says one US-based chief financial officer of a mid-market private equity firm.

"We're about to enter the fundraising cycle and we plan to show our investors how much money drops out of our bottom line with further fee cuts. And then when they see that big negative number, we'll ask 'How do you expect us to generate returns for you?'".

Moreover an interesting psychological dimension to fee negotiations and sharing budget information relates to differences in compensation between LPs and fund managers, notes the CFO. A public pension employee barely pulling in six figures a year may not be sympathetic to the argument that GPs risk losing top talent to competing firms or industries if salaries are reduced from very rich to just rich. And so whether justifiable or not, an open discussion on budget expenses (and thus salary packages) results in some unavoidable frictions between professionals within different income brackets.

The CFO went on to say the compression on management fees is leading GPs to become more creative

0.99

Average fee percentage GPs earned from portfolio companies, based on transaction value in the $500m to $1bn deal range, in the period prior to the financial crisis, according to Dechert

1.24

Average percentage earned post-crisis, a time when LPs were said to experience more bargaining power during management fee negotiations in how they finance their operations. One option has been for GPs to take operating partners off their payrolls and rehire them as outside consultants so that their salary expenses would instead be borne by the portfolio companies benefiting from their services. "The downside of that is you can't guarantee their availability. Their work will go to the highest bidder."

Faced with a downturn in management fees, some firms seem to be trying to compensate by increasing fees charged to their portfolio companies. According to a study released late last year by Dechert, a law firm, transaction fees shot up relative to years immediately before the 2008 banking meltdown. GPs operating in the $500 million to $1 billion deal range, for instance, collected on average a 1.24 percent transaction fee for deals done in 2009-2010 – a noticeably higher figure than the 0.99 percent average charge between 2005 and 2008. Similarly monitoring fees, which GPs bill companies for ongoing advisory services, have also climbed since 2009, according to Dechert.

Of course, it is impossible to know for sure whether GPs are deliberately increasing deal fees as a supplementary source of income in response to management fee concessions, but if so, it may only be a temporary solution. Guided by ILPA guidelines, a key priority for investors today is 100 percent of transaction fees to offset management fees – a departure from the typical 50 to 80 percent figure used in the past.

"What I'm seeing in the LP community is they follow 100/0 fee sharing religiously, and don't necessarily look at the budget and understand why a GP may need that fee income to cover overhead costs," says the anonymous CFO. One New York-based funds formation lawyer notes that deal fees also often finance junior dealmakers annual bonuses. Without it, says the lawyer, retaining talent becomes more difficult for GPs.

In response to criticisms that ILPA's guidelines are encouraging investors to adopt a rigid approach during fee negotiations, ILPA executive director Kathy Jeramaz-Larson said the group's principles were simply meant as "a set of best practices and used in conversations between GPs and LPs". On the matter of all deal fees being returned to the fund, Jeramaz-Larson argued it was a matter of aligning interests "between GPs and LPs for the benefit of all constituents".

The CFO responded to ILPA's defense saying that the "starting point has become religion for many investors" and that carried interest represents the "true alignment of interest". He went on to suggest LPs enter into ad-hoc relationships with fund managers, and avoid drawing lines in the sand around transaction and management fees. "LPs should reject any one size fits all approach and simply focus their efforts on finding the best returns."

If that approach were taken, it would seem, a sit down with investors to discuss budget expenses may not be so uncomfortable after all. ■

"LPs should reject any one-size-fits-all approach and simply focus their efforts on finding the best return"

What ILPA says

An excerpt from the ILPA Private Equity Principles detailing the LP trade body's position on management fees and expenses

- Management fees should be based on reasonable operating expenses and reasonable salaries, as excessive fees create misalignment of interests
- During the formation of a new fund, the GP should provide prospective LPs with a fee model to be used as a guide to analyse and set management fees
- Management fees should take into account the lower levels of expenses generally incident to the formation of a follow-on fund, at the end of the investment period, or if a fund's term is extended
- The management fee should encompass all normal operations of a GP to include, at a minimum, overhead, staff compensation, travel, deal sourcing and other general administrative items as well as interactions with LPs
- The economic arrangement of the GP and its placement agents should be fully disclosed as part of the due diligence materials provided to prospective limited partners. Placement agent fees are often required by law to be an expense borne entirely by the GP

PJ VISCIO
DUFF & PHELPS
MANAGING DIRECTOR

Giving credit where credit is due

When analysing the changes in portfolio company value, most GPs are content to measure changes in EBITDA, valuation multiple, and leverage. But if willing to dig deeper, firms may be able to tell investors a more compelling story around their value-add work

Valuing portfolio companies is hard enough work as it is, so why recommend GPs go beyond the traditional metrics in attributing created value?

Viscio: One of the major points of regularly valuing portfolio companies is to update investors on the performance of the portfolio. But why not show them more? If able to drill down deep enough into a company's financial performance, GPs can better identify where their value-add strategies had actually produced results. A bird's eye view look doesn't necessarily do that.

And as we all know LPs are becoming increasingly more sophisticated in their GP selection process. As part of that they want to clearly separate managers who were in the right place at the right time, or one hit wonders, from those with actual value creation capabilities. A robust value attribution exercise can allow that separation to happen.

So how is it done?

Our approach is to first take the total change in value (typically from the inception of the investment until the present or the date of realisation) and attribute this total change into various factors or components. We then dissect those figures, in quantified amounts, to specific drivers – each of which may or may not have been subject to the GP's actual control or influence. Maybe for instance a growing economy was responsible for some of the company's growth, which the GP shouldn't be able to take credit for.

To be clear, as of now GPs typically perform attribution analyses by looking at changes in EBITDA, valuation multiple, and leverage. But additional effort can produce much more useful detail: further steps can be taken to deconstruct common high level metrics to include factors like revenue growth, margin changes, changes in cost of capital, change in growth profile, and specific balance sheet and capital structure impacts.

The next step is to compare how the portfolio company did against industry benchmarks. This provides a much higher level of transparency to better substantiate evidence of operational value-add and/or GP leadership. Additional visibility can be derived by assessing the impact from specific initiatives (like marketing, cost reduction, etc.) as well as taking into account impacts of acquisitions in order to isolate organic changes in value and attribute those to specific drivers.

Theoretically speaking, could this level of analysis be able to identify which particular deal members deserve credit for value-add contributions?

This was not our original intention, but as we've spoken to more GPs and LPs, it's clear that this potential use is something in which the market has an interest.

Viscio: *More detailed created value attribution will be appreciated by LPs*

We would imagine some less than stellar GPs not being open to this level of review. What has the market reaction been?

GPs have been generally very receptive, particularly founders, investor relations professionals and chief financial officers. Fund raising has become more competitive and top GPs are always interested in market trends that will impact their businesses in the future.

We have heard from a number of GPs that they believe that more transparency to LPs provides a competitive edge. A rigorous detail attribution study enhances transparency into the value creation process. We believe this allows the GP to better tell their story of what they did to create value. ■

EU REGULATION

AIFM: In or out?

Smaller firms able to escape the EU's game changing Alternative Investment Fund Managers Directive have many options to consider from a structuring and regulatory arbitrage perspective, advises Bovill's Ben Blackett-Ord

Bovill: *Exploring the regulatory options for GPs of a smaller scale*

The Alternative Investment Fund Managers Directive (AIFM) is likely to be the most significant shake up of the asset management industry for sometime. Managers of Alternative Investment Funds (AIFs) – which is widely defined to include any collective arrangement that does not fall within the UCITS directive – are likely to be caught. Currently the industry is waiting for detailed rulemaking to occur under so called Level 2 measures, likely to be published by the European Commission later in the summer.

The text of the Directive has now been agreed and accordingly EU supervisors will have relatively little scope to vary from the broad principles enshrined in the Directive. This is not the case in relation to the so called "sub-threshold" managers where national authorities have a number of options open to them and where the provisions of the proposed EU Venture Capital Fund Regime will impact.

Many sub threshold firms are currently subject to the Mifid directive and, depending on how some of the AIFM issues play out, may need to make a decision as to whether to remain in the Mifid camp or opt for the AIFM camp. It appears to be the intention of the Commission to regulate fund and "fund like" activities under UCITS and AIFM and trading and broking activities under Mifid with a clear separation between the two. While one can see some logic to this approach it does not necessarily reflect commercial reality and may lead to some firms having to split their activities between different regulated entities as one firm will not be able to be both a Mifid firm and an AIFMD firm.

FIRMS BELOW THE MARK

A sub threshold firm is an AIFM that manages AIFs whose assets under management, including assets acquired through leverage, do not exceed €100 million or manages AIFs whose assets under management do not exceed €500 million on an unleveraged basis.

Sub-threshold firms cannot benefit from the marketing passport or other benefits under the Directive (unless they decide to opt in to the Directive, in which case it will apply to them in its entirety) and will only be subject to light touch regulation under the Directive. As a minimum this means:

- Registration with (as opposed to authorisation by) their home state regulator;
- A requirement to provide information to their home state regulator about the AIFs that they manage (including providing information on investment strategies employed) and to update competent authorities regularly in relation to instruments traded and principal exposures and concentrations of

the AIFs that they manage (in order to enable regulators to monitor systemic risk).

The precise details of the way in which these requirements will be imposed by the Financial Services Authority (FSA), for example, remains to be seen. However, the overall requirements under the Directive for sub-threshold firms, taken at face value, adds up to considerably less than the regulatory burden that small managers are currently subject to from the FSA. This raises an interesting dilemma for the UK Treasury, should it opt for the Directive minimum, with the effect that many currently FSA authorised managers would, going forward, only be subject to a light touch registration regime, or should it maintain an authorisation requirement for such firms at the risk of being accused of gold plating the provisions of the Directive? In light of a Directive that has been criticised for creating additional regulatory burdens it will be interesting to see how the Treasury responds to a Directive that potentially allows a significant reduction in regulation for sub-threshold firms. Recent consultation from UK policymakers has sought views on this point. Further, might it be the case that firms that have been subject to an authorisation regime in the UK for 25 years might feel a little uncomfortable, or even hard done by, were they to be subject to mere registration?

SELF MANAGED FUNDS

The scope of the Directive is such that as well as impacting on external managers of AIFs it also includes self managed entities (such as VCTs and Investment Trusts) within the definition of an AIF with the effect that the AIF is itself the AIFM for the purposes of the Directive. Such AIFMs are referred to as Internal AIFMs. The inclusion of Internal AIFMs within the scope of the Directive gives firms that provide investment services or advice to VCTs, Investment Trusts and the like an opportunity to influence the way in which the Directive impacts.

Firms that currently provide services to VCTs and investment trusts, or the VCTs or investment trusts themselves, may be able to decide whether the self- managed route is potentially more beneficial from a regulatory perspective than the externally managed alternative. For example, a Mifid firm that currently provides services to a VCT may be better off remaining as a Mifid firm with the VCT itself becoming an Internal AIFM rather than opting to become an AIFM itself and giving up its Mifid authorisation (this may particularly be the case if the firm concerned also undertakes other Mifid activities).

EUROPEAN VENTURE CAPITAL REGIME

A further issue to be considered by some sub-threshold mangers is the impact of the proposed EU Venture Capital Regime. Under this regime, which, if confirmed, will be available to AIFMs with assets under management of less than €500 million that invest at least 70 percent in the equity or quasi equity of "qualifying portfolio undertakings" and are happy to describe themselves as European Venture Capital Funds.

A "Qualifying portfolio undertaking" is an entity that is not listed on a regulated market, employs fewer than 250 people and either has turnover of less than €50 million or a balance sheet total of less than €43 million and which is not itself a collective investment undertaking.

> *"It will be interesting to see how Treasury responds to a Directive that potentially allows a significant reduction in regulation for sub-threshold firms"*

A principal benefit of a European Venture Capital Fund will be the ability to market under a form of EU marketing passport not simply to professional investors (as will be the case under the AIFM Directive) but also to other investors with the proviso that the minimum investment from such investors is €100,000 and subject to certain appropriateness tests. The proposed Regulation imposes a minimum registration (as opposed to authorisation) requirement on managers, a requirement for "sufficient" own funds and light touch reporting to investors and regulators.

CONCLUSION

While the focus for larger AIFMs should remain firmly on the Level 2 arrangements and subsequent FSA requirements, there is much for smaller AIFMs to consider in the meantime from a structuring and regulatory arbitrage perspective.

Ben Blackett-Ord is chief executive of UK-based regulatory consultancy firm Bovill. ■

CHINA

A qualified success?

The recent collapse of the QFLP scheme highlights regulatory tensions in China – but don't bet against it being revived at some point, writes Jeremy Hazlehurst

Private equity may be booming in China – but dollar funds are struggling to compete. In 2007 and 2008, they accounted for over 80 percent of private equity funds raised in China; in 2010 and 2011, only around 50 percent. And part of the reason for this is that foreign firms are getting tangled up in red tape.

There are fundamentally two big problems for foreign private equity firms in China. First, the process of converting money from foreign currencies to renminbi (RMB) is time-consuming and clumsy. And because of the RMB's continued appreciation, the exchange rate causes problems for companies seeking foreign investment. "With deals priced in dollars, the exchange rate has been appreciating enough that the investments are a terrible deal for the company when finally converted to RMB," says Walker Wallace, a Shanghai-based partner at law firm O'Melveny & Myers.

Wallace: *exchange rate has been a problem*

Secondly, foreign funds have to apply for permission for every project that they want to invest in, even if they are in the 'encouraged' category. There are four categories in total – 'encouraged', 'permitted', 'restricted' and 'prohibited' – and industries can move between them, depending on macroeconomic aims. For instance, some categories of real estate are currently prohibited, because the government wants to cool the housing boom.

"For Chinese companies the process of changing ownership is easy, but foreign firms have to jump through a lot more hoops. The system is unnecessarily cumbersome," says Steven Xiang, head of the China practice at law firm Weil, Gotshal & Manges.

That's why the new rule on Qualified Foreign Limited Partners announced last year – which was widely interpreted as a radical liberalisation of private equity in China, potentially opening it up to a serious inflow of funds from overseas – caused so much excitement.

A REGIONAL CLASH

The new regulation, it seemed, would go some way towards clearing up the second problem. Firms would be allowed to become Qualified Foreign Limited Partners, meaning that they would be able to bring money on-shore without specifying where it would be invested. Up to 5 percent of the fund could be foreign money. These funds would also be able to invest just as a domestic renminbi fund does (see box). On the best reading, this meant that foreign money could be quickly invested. Could this be the start of a Chinese private equity gold-rush?

Well, no. In a recent communique from the NDRC, the national regulator (dated 23 April 2012 but only widely circulated two weeks later), it emerged that the new QFLP scheme will not be going ahead after all.

This has been portrayed in some quarters as a real blow for firms operating in China. But according to old hands in the country, it's not such a disaster – and not particularly surprising, either.

"It is in my view a non-event," says Vincent Huang, a partner at private equity firm Pantheon. He points out that the QFLP scheme was actually a trial program carried out by the Shanghai city government. "The central government never agreed to this 5 percent exemption; as far as they are concerned, one dollar of foreign money makes it a foreign fund. Plus, the national government adheres to a strict industry guideline for foreign investments based on a WTO agreement, and never said that it would make an exception for foreign PE investors." The NDRC simply clarified this situation publicly, Huang says.

That might seem odd, but it's a common tale in China. While the regions want to encourage growth, central government often has larger aims – such as controlling


Huang: *cancellation of QFLP a non-event*

THE ABC OF QFLP

The Shanghai Municipal Government announced in 2011 that it would grant Qualified Foreign Limited Partners (QFLP) status to some foreign private equity funds. QFLP funds would be allowed to convert foreign currency into renminbi, while up to 5 percent of the fund's money could be from a foreign source. It could then invest just as a domestic fund does, without asking for permission for each investment.

The Shanghai government issued QFLP licenses to six foreign private equity firms including Blackstone, Carlyle and 3i. Shanghai said it would allow $3bn to be invested through QFLP firms, and allocated quotas to the firms involved. The municipality of Chongqing wants to introduce something similar, as does Beijing.

However, the Shanghai scheme was cancelled in late April by the national regulator. It specifically mentioned that Blackstone's high-profile $800 million fund – which is currently being raised – will not have QFLP status. The scheme will probably be resurrected; but nobody knows when.

inflation nationally – that sometimes clash with regional aims. When this happens, the national regulator outranks the regional ones. But that doesn't stop the regions trying their luck. As David Pierce, the CEO of Squadron Capital who has been involved in China since the 1980s, says: "The pattern in developing the legal system has often been to experiment locally, on a trial basis, in many cases legalising practices that have already started without permission."

In fact, the QFLP issue is part of a larger story. Tension between the central and regional authorities is more intense right now than normal because of the jockeying for position ahead of the once-in-a-decade transfer of power later this year. While the workings of the ruling party are opaque, it's probable that the squashing of QFLP is part of a political play. The toppling of Bo Xiliai, ex-head of the Chongqing province, was all about the centre asserting its power over the regions; it's possible that the QFLP story is also part of that.


Xiang: *current level of control is overkill*

GONE BUT NOT FORGOTTEN

Just to make things more complicated, this actually doesn't mean that new QFLP status is dead. "There are a lot of bottom-up forces in certain locations including Shanghai which wanted to make those changes," says Xiang. "Central government has not made up its mind yet. There are major philosophical issues that the government has been grappling with." For example: how much freedom to give to foreigners operating in China, and how much autonomy to give to the regions.

So what will happen? Offshore private equity money is seen as 'hot' money that will look for short-term returns, which sits uncomfortably with the Chinese government's desire to funnel capital into long-term growth. But there's a widespread belief that the Party will overcome its scepticism and welcome foreign money sooner or later.

As such, QFLP will become a reality eventually, because it's clear that the industry is currently over-regulated. "The government doesn't need control over bringing currency onshore, control over the specific projects, and control over what categories foreigners can invest in; it's overkill," says Xiang. As the currency controls are unlikely to be scrapped any time soon, it's the others that will probably be relaxed.

Despite this setback, private equity clearly has a bright future in China – because on the whole, it is still perceived favourably. "It's a country that favours private equity," says David Pierce.

To outsiders, the tensions between the centre and the regions seem like a tough circle to square. How can it be done? "As the regulatory regime is still a work in progress, issues will arise," Pierce says, "but experience suggests that pragmatic solutions will emerge." ■

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