



ICLG

The International Comparative Legal Guide to:

Alternative Investment Funds 2015

3rd Edition

A practical cross-border insight into Alternative Investment Funds work

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Fundraising in 2015: Continuing Evolution

Skadden, Arps, Slate, Meagher & Flom LLP
and Affiliates

Stephen G. Sims



Introduction

The fundraising market for Alternative Investment Fund Managers in 2015 shows increasing stratification. Managers of illiquid funds are looking to the future with some optimism, with a significant number of well-known private equity fund managers gearing up for their latest fundraising rounds. Hedge fund managers, recently the subject of attention over fee structures, are generally positive, with a majority expecting assets under management to increase in the near term according to a recent study, and the favourable financing environment continues to be seen as attractive to private equity real estate fund managers and investors. However there are many variations, some relating to the regulatory environment, or the political winds, and investors and managers have reasons both for optimism and complaint.

Transparency and Reporting: Be Careful What You Wish For

A number of years ago, in the aftermath of the Global Financial Crisis, I listened to a regulator talk about the challenges being faced by regulators in the new environment. The prevailing view was that information, or big data, was the solution to many of the world's ills. Had the regulators been possessed of sufficient information, they would have been able to discern, sufficiently in advance, the build-up of excess leverage; the increase in maturity transformation issues at lenders and investors; deleveraging gaining in pace; and subsequent falls in asset prices.

The regulator's concern at the time was that there would be an exponential increase in the amount and types of information being provided by market participants to regulators, but regulators were not seeing sufficient increases in their budgets to be able to claim with any confidence that they could parse the reams of information to discern anything valuable, or more to the point, that would allow them to prevent the next Global Financial Crisis.

Nevertheless, the provision of information to investors and regulators continues to be a key theme in both the European Union and the United States, two key markets for Alternative Investment Fund Managers.

In addition to the question of whether regulators need additional information, lawmakers have determined that investors need more information in order to make informed choices about the funds in which they are considering investing, and perhaps more importantly the funds in which they have invested.

The Alternative Investment Fund Managers Directive has now been fully in force for almost a year (ignoring the transitional period)

and it has increased significantly the reporting and recordkeeping requirements imposed on fund managers seeking to do business in the European Union. The question is whether the enhanced cost and compliance burden has outweighed the benefit and it is likely that we will need to get further into the reporting season before investors are able to weigh in on the issue.

Clearly, though, the information prescribed to be provided pursuant to the Alternative Investment Fund Managers Directive is at best a very limited improvement. In certain circumstances it might serve to put investment funds, and also their investors, at a disadvantage as compared with other industry players, in particular with the requirements that private equity firms, but not trade buyers, disclose certain potentially sensitive information in relation to target companies (and also refrain from extracting value in the initial years post acquisition). In any event, what investors are calling for is consistency in the provision of information rather than increases in its volume. A recent survey found that, by choosing between industry databases and reference years, over three quarters of firms are able to claim that they are top quartile performers. Various industry bodies prefer to address the issue themselves rather than wait for regulators to demand change. The Institutional Limited Partners Association, having brought about changes to the field of play with its Principles released after the Global Financial Crisis and focused on alignment of interest, governance and transparency, is looking at ways to improve and standardise reporting to fund investors. This follows other initiatives such as the Walker Guidelines on Transparency and Disclosure, to some extent overtaken by the Alternative Investment Fund Managers Directive, and the Hedge Fund Standards.

In the United States, the regulators have taken a different approach, deciding to focus on specific issues to determine compliance by firms. The Securities and Exchange Commission conducted examinations into some 400 private equity firms and found violations of the governing agreements of approximately half of those firms in the area of fees and expenses charged to investors in funds managed by them. Interestingly, the Securities and Exchange Commission did not focus on whether the governing agreements themselves were fair, instead choosing to focus on compliance with those agreements. Its concern is that while investors are sophisticated, and represented by experienced counsel, at the time of entry into the arrangements, their ability to monitor ongoing compliance is lower at least partly as a result of the considered opacity of some fund structures and the broad discretions given to managers to implement agreements. This raises the issue of potential conflicts of interests and the regulator appears to be seeking to ensure that the treatment of fees and expenses is consistent with the disclosure surrounding them. A number of high-profile managers have made changes to their regulatory filings or fees and expenses procedures following

this investigation, and the regulator's involvement in this area has been generally welcomed by investors, in comparison with many investors' views of the impact of the Alternative Investment Fund Managers Directive whether in relation to reporting or the more substantive provisions.

Fortress Europe: Protecting Investors or Managers?

The Alternative Investment Fund Managers Directive was intended to harmonise the marketing and management of Alternative Investment Funds throughout Europe, and to protect investors from perceived excesses and abuses by fund managers, particularly those of non-European Union origin. But it is difficult to see how the process has been harmonised for non-European Union managers, reliant as they are on each Member State's individual private placement regime to market to investors in that jurisdiction, or potentially on "reverse solicitation". Many managers have turned their backs on the European Union, and its investors, instead focusing increasingly on other jurisdictions. Given the other requirements of the legislation, which should ensure that foreign managers are appropriately regulated in their own jurisdictions, it is difficult to see how investors are well served by legislation that limits their choice to invest with attractive foreign managers.

The question, then, is who does the legislation serve? Managers who, together with their funds, are based in the European Union, benefit from a marketing "passport" that enables them to market freely to professional investors within the European Union, admittedly after having agreed to comply with costly requirements relating to custody, as well as awkward provisions relating to remuneration. The European Securities and Markets Authority is currently engaged in a review to determine whether the passport should be made available to non-European Union managers, and a vociferous minority of European Union-based managers (and their trade body representatives) has suggested that the passport should not be available because it would create an uneven playing field favouring the non-European Union managers who benefit from perceived economies of scale, and lax regulation, which would see them make inroads into the domestic managers' investor base. Never mind that the purpose of the legislation is ostensibly aimed at protecting investors, who generally favour enhanced choice, or that many European Union managers welcome the competition and fear the end results of protectionism as likely to restrict their own ability to access other, larger, markets for investors.

Political Concerns

In many countries the effects of austerity programmes have resulted in civil unrest or unease. A number of countries have introduced, or their political parties have threatened to introduce, legislation that could impact on fund managers and their investments.

Taking the United Kingdom as an example, legislation has been introduced targeting managers who are seeking to have management

fees taxed as capital gains in their hands, rather than ordinary income, and one political party has proposed rules to tax carried interest as income where the executives, rather than having "skin in the game", have "DNA in the game", in other words where the authorities consider that the executives do not have sufficiently large amounts of their own capital at risk. Managers targeting investments that seek to do business with the National Health Service, or in the healthcare sector generally, or in the residential sector where rent controls have been proposed, are watching political developments with a keen eye.

Fund Terms: Ongoing Evolution

Many column inches have been devoted to the subject of fees and expenses, but in reality these should be of limited concern and investors should focus on selecting the best, rather than the cheapest, managers. Fund terms continue to evolve slowly, with investors seeking to tighten the ability of managers to exercise discretion, at least in circumstances where there are perceived conflicts of interests.

Managers and investors have yet to crack the problem of side letters: the successful closing of a private equity fund is marred by the circulation, typically a few days later, of vast quantities of often irrelevant side letter provisions which are sometimes not quite repetitive of each other and the ability of other investors to elect their benefit is becoming an increasingly elaborate and obscure process. Managers and their counsel should focus on ways to improve efficiency in this area, whether by incorporating the principal terms into the governing documents of the funds themselves or otherwise seeking to curtail the side letter explosion.

Fund Managers

A number of fund managers with successful track records have failed to raise new funds, and there appear to be two reasons why this is the case. The first is where performance is positive but erratic: investors are unwilling to jump on the rollercoaster for another ride. The second relates to succession: where managers have not put in place credible succession planning, investors are concerned as to the performance of the next generation. This could be due to a failure to promote the next generation or disagreements over strategy, but investors are keen to ensure stability in the managers they back.

All in all, managers and investors appear to be stepping in the right direction and generally in time with each other. Regulatory and political intervention is generally, but not always, unwelcome, and it is to be hoped that regulators and politicians alike will do what they can to create an environment where the best fund managers can access the best investors, regardless of their respective domiciles, that regulation will be both proportionate and relevant, and that politicians will create environments where good managers can make good investments without undue interference.

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Mr. Sims is recommended as a leading lawyer in Who's Who Legal and Chambers UK. He was also recommended as one of the top 40 lawyers under 40 in Financial News in 2013.

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