



# Issues in Current Fundraising Environment

## *Illinois Venture Capital Association*

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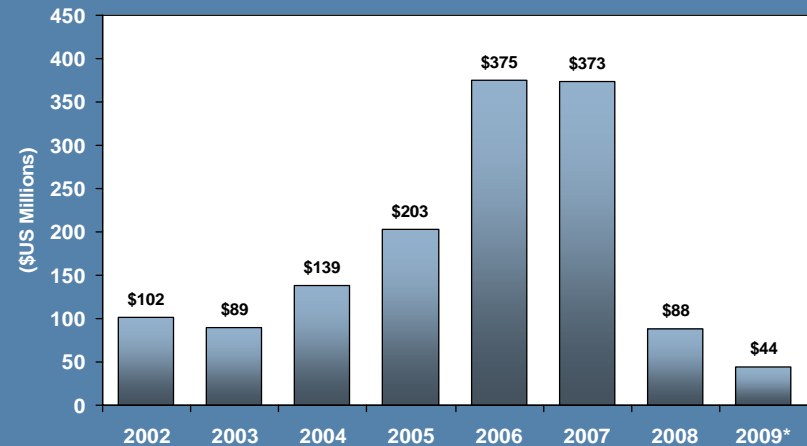
# State of the Primary Market



# State of Private Equity Industry – Deal Activity

- **Value and number of announced LBOs plunged in the first three quarters of 2009:**
  - Global: 78% decline in value from same period in 2008 to \$26.9B; number of deals fell 48% to 617
  - U.S.: 81% decline in value from same period in 2008 to \$6.6B; number of deals fell 53% to 199
  
- **Smaller deals**
  - Global: Deals < \$50 million represented 85% of deals (1,259) in 2008 and 90% of deals (555) during the first three quarters of 2009

Average LBO Deal Value by Year



\*Through 9/30/2009

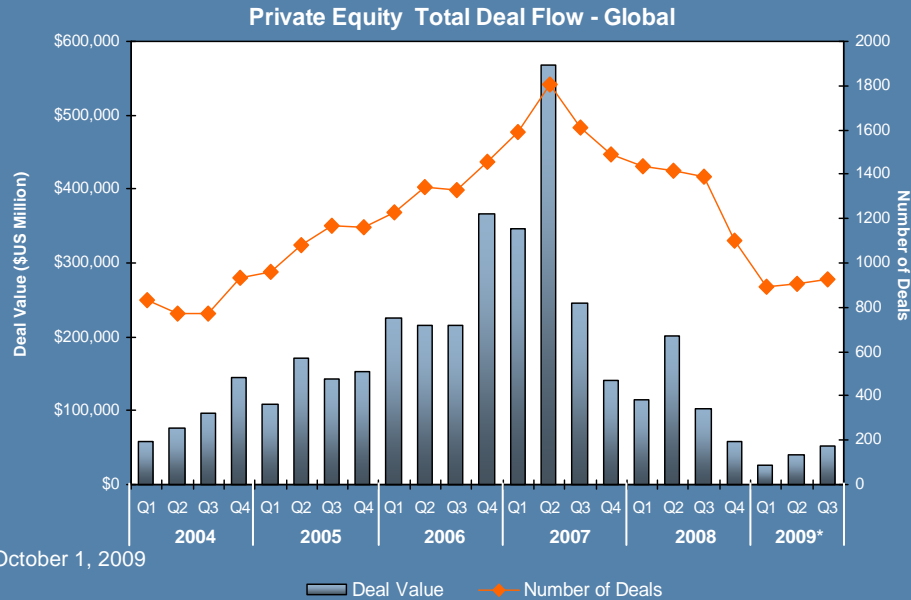
Source: Thomson Financial data as of October 1, 2009; Global values are for all leveraged buyouts by announcement date; U.S. values are all leveraged buyouts involving U.S. targets by announcement date



# State of Private Equity Industry – Deal Activity

(cont'd)

Total Value of All Private Equity Transactions by Transaction Size – Global (\$US Millions)								
	2002	2003	2004	2005	2006	2007	2008	2009*
<\$50M	8,032.25	10,839.62	12,981.96	16,155.45	16,893.40	18,474.09	15,495.96	8,660.62
\$50M – \$250M	26,986.30	37,463.65	50,003.29	64,339.54	72,874.36	76,992.55	59,061.08	24,647.33
\$250M – \$500M	26,059.04	29,136.28	51,750.82	67,140.84	73,804.28	81,631.96	48,856.49	20,561.15
\$500M – \$1B	36,282.93	38,841.23	58,767.76	83,780.19	96,489.59	129,852.57	66,268.16	17,201.48
\$1B – \$2.5B	35,001.62	42,054.77	88,105.57	142,216.94	165,408.37	221,363.20	99,093.64	34,938.47
>\$2.5B	23,182.69	41,454.62	116,778.19	208,370.59	604,124.87	780,500.24	192,952.60	16,957.96
<b>Total</b>	<b>153,044.83</b>	<b>199,490.17</b>	<b>374,537.57</b>	<b>578,353.55</b>	<b>1,023,244.88</b>	<b>1,300,314.61</b>	<b>477,427.94</b>	<b>119,467.01</b>
<b>% Change in Total from Prior Yr</b>	NA	30.3%	87.7%	54.4%	76.9%	27.1%	-63.3%	NA



Source: Thomson Financial data as of October 1, 2009

\*Through 9/30/2009

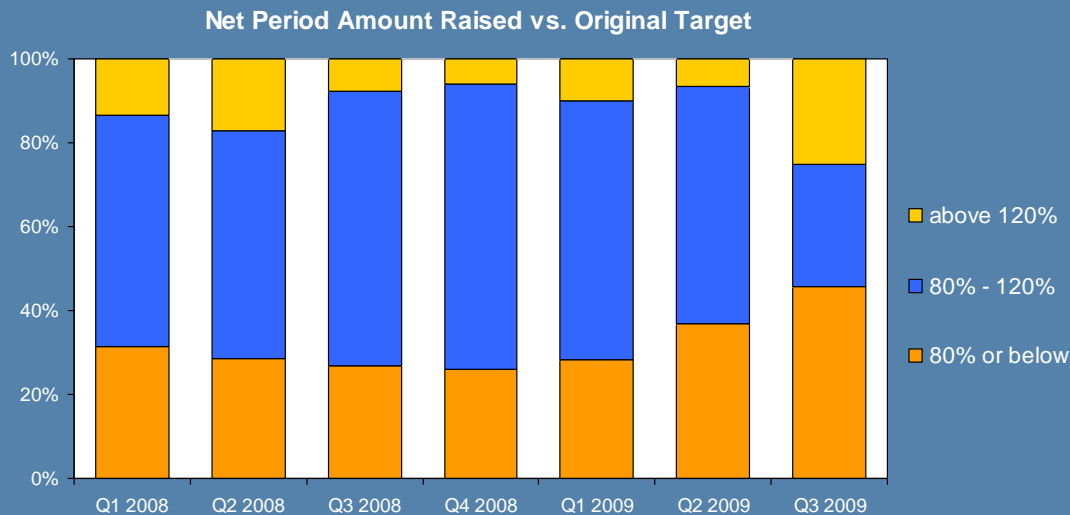
■ Deal Value    ◆ Number of Deals



# State of Private Equity Industry – Fundraising

## ■ The fundraising environment remains difficult

- Few funds with first closings in 2009 – most represent “final closes” from 2008 efforts
- Fund managers have struggled to hit their target fundraising amounts
  - ◆ E.g., while a quarter of all final closings in Q3 2009 beat their subscription targets by more than 20%, nearly half closed at less than 80% of their targeted amount.



Source: Thomson Financial data as of October 1, 2009; Includes all funds with final closings



# State of Private Equity Industry – Fundraising

## (cont'd)

- Fundraising slowed in 2008, especially in Q4, and has declined significantly in 2009
- Continuing weakness in Q3 2009 came despite a lift in public markets that provided some respite to LPs' liquidity issues
  - Lowest overall private equity fundraising quarter since Q4 2003
- Global numbers:

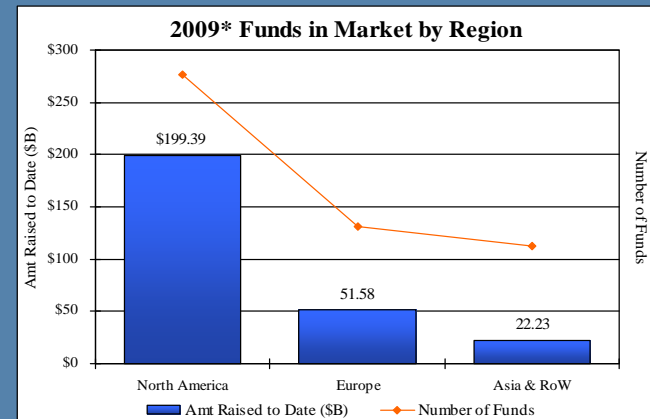
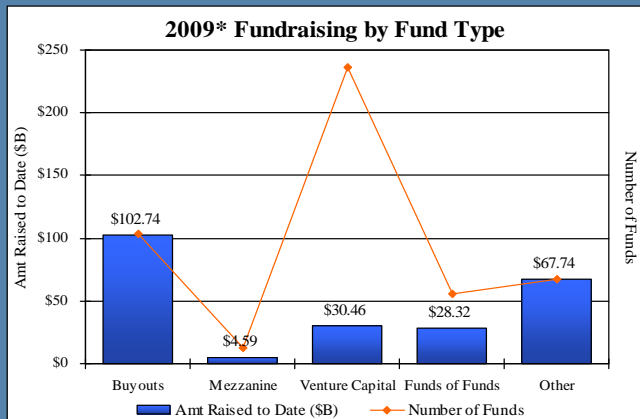
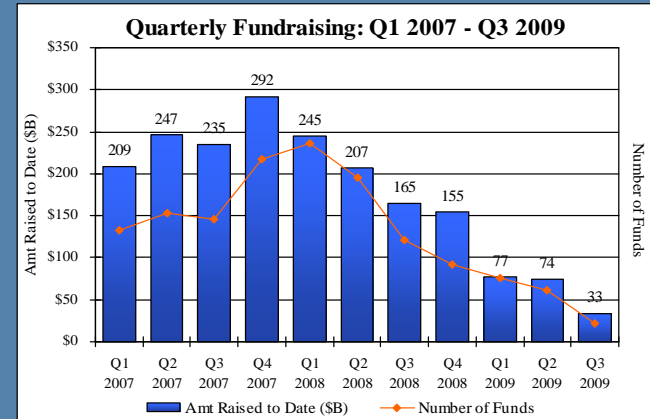
Period	Q4 2007; Q1 – Q3 2008		Q4 2008; Q1 – Q3 2009		% Change in Capital Raised
	No. of Funds	Amounts (billions)	No. of Funds	Amounts (billions)	
<u>Q4</u>	292	\$217.67	155	\$91.22	-58.1%
<u>Q1</u>	245	\$236.26	77	\$75.40	-68.1%
<u>Q2</u>	207	\$195.03	74	\$60.95	-68.7%
<u>Q3</u>	165	\$120.48	33	\$21.36	-82.3%
<b>Annual</b>	<b>909</b>	<b>\$769.43</b>	<b>339</b>	<b>\$248.93</b>	<b>-67.6%</b>

Source: Thomson Financial data as of October 1, 2009; Includes all funds with final closings; "Private Equity Fundraising Plummets to Lowest Levels Since 2003," Preqin Press Release, 10/1/09



# State of Private Equity Industry – Fundraising (cont'd)

- Fundraising (as measured by funds that reached final close) declined significantly in late 2008 and has continued to decline throughout 2009
- Buyout funds raised the biggest portion of overall capital
- North American fund activity continues to dominate the global PE industry among funds in market (i.e., funds currently on the road)



Source: Thomson Financial data as of October 2, 2009 ; Includes all funds with final closings; \*Through 9/30/2009  
 Venture Capital = Balanced Stage, Development, Early Stage, Expansion, Later Stage, Seed Stage Other = Distressed Debt, Energy, Other Private Equity, Generalist, Secondary Funds, Turnaround  
 Other = Distressed Debt, Energy, Other Private Equity, Generalist, Real Estate, Recap, Secondary Funds, Turnaround



# State of Private Equity Industry – Fundraising

## (cont'd)

- **Significant decline in U.S. PE fundraising:**
  - In Q3 2009, 46 U.S.-based funds raised \$13.3B, which is a drop of 83.1% from the \$79.0B raised by 168 funds in Q3 2008

Fund Type	2007		2008		2007 to 2008 % Change in Capital Raised	2009*	
	Number of Funds w/ Final Closings	Net Period Amount Raised (USD Mil)	Number of Funds w/ Final Closings	Net Period Amount Raised (USD Mil)		Number of Funds w/ Final Closings	Net Period Amount Raised (USD Mil)
Buyouts	178	\$192,509.20	161	\$162,293.00	-16%	56	\$27,861.00
Mezzanine	29	\$11,882.00	23	\$22,886.90	93%	7	\$1,662.60
Venture Capital	248	\$36,046.30	224	\$28,604.60	-21%	88	\$8,427.80
Funds of Funds	104	\$23,032.00	99	\$28,268.80	23%	42	\$13,527.00
Other	117	\$93,596.80	94	\$80,544.50	-14%	48	\$29,831.00
<b>Total</b>	<b>676</b>	<b>\$357,066.30</b>	<b>601</b>	<b>\$322,597.80</b>	<b>-10%</b>	<b>241</b>	<b>\$81,309.40</b>

Source: Thomson Financial data as of October 2, 2009 ; Includes all funds with final closings; \*Through 9/30/2009

Venture Capital = Balanced Stage, Development, Early Stage, Expansion, Later Stage, Seed Stage Other = Distressed Debt, Energy, Other Private Equity, Generalist, Secondary Funds, Turnaround

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# State of Private Equity Industry – Fundraising

## (cont'd)

- **Fund-raising in Q3 2009 fell even further off its year-earlier pace as the third quarter came to a close**
  - However, greater supply of funds likely in 2010
- **Approximately 100 firms' fundraising efforts were called off without a first close**
  - Fundraising toughest for firms without a strong record
  - Supply is outstripping demand
    - ◆ Amount of capital available for new investments is down significantly
    - ◆ Institutions remain reluctant to commit
- **New funds commitments often partly funded by distributions from previous deals**
  - Difficult deal-side exit markets slow distributions, compounding difficulty for institutional investors to make new investments
  - If deal flow continues to pick up, funds raised may increase as well
- **Large swathe of significant LPs readying themselves to re-enter the market in Q4 2009 and into 2010**

Source: "PE Fundraising Plummet in Q3 2009", 10/1/09, [globalpensions.com](#); "Fundraising Weakness Continued Through Q3", Dow Jones *Private Equity Analyst*, 10/8/09; "Private Equity Fundraising Plummet to Lowest Levels Since 2003," Preqin Press Release, 10/1/09



# Market Trends – Private Equity Fund Terms

- **Management Fees**
  - General downward pressure on management fees, especially for large funds with scale
  - Reluctance to pay fees on undrawn capital in light of questions about fund size and/or PE sponsor's ability to successfully deploy capital in challenging deal environment; possible use of "side-car" funds to address this issue
- **Management Fee Offsets**
  - Increased pressure on anything other than 80% or 100% offset for all fee income
  - Scrutiny of any exceptions to definition of fee income
- **Capital Call Limitations**
  - Limitations on the amount of capital that may be called per year (e.g., over the first year, the first two years or in any calendar year)
- **Size and Composition of GP's Capital Commitment**
  - Increasing to at least 2% and up to 5% preferred (as opposed to 1%)
  - More focus on cash vs. fee waiver in light of future uncertainty in tax treatment of fee waiver
- **Distribution Waterfall**
  - Increased pressure for full payout model (or close thereto)
  - Increased pressure for interim GP clawbacks
  - Increased focus on tax distribution exception to GP clawback cap



# Market Trends – Private Equity Fund Terms

## (cont'd)

- **Termination Triggers**
  - Increased pressure for no fault termination of the investment period and scrutiny of voting thresholds
  - Increased pressure for no fault divorce termination of the fund provisions
  - Increased scrutiny of key man provisions, including pressure for automatic suspension of investment activity (as opposed to an affirmative vote to suspend)
  - Focus on payments to GP following the trigger of a no fault termination of investment period, no fault termination of fund and no fault divorce – specifically management fees and carried interest
- **Conflicts**
  - Increased focus on how PE sponsors are allocating investment opportunities and resources among multiple products
  - Push-back against the “serialization” of PE sponsors and allocation of opportunities away from flagship fund into specialist funds
- **No “Strategy Drift”**
  - Push back on public equity, PIPEs and debt investments by buyout funds
- **Ownership of the GP**
  - Limitations with respect to selling stakes to third parties
  - Focus on potential impact on and/or conflicts with interests of LPs



# Market Trends – Private Equity Fund Terms

## *(cont'd)*

- **Renewed Focus on GP's Fiduciary Duties**
  - Transparency, accountability and reputation concerns post-Madoff
- **Partnership Expenses**
  - Scrutiny of what expenses are borne by the fund, rather than by the management company (e.g., outside reporting services, operational experts, consultants, conferences)
- **Transfer Provisions**
  - Emphasis on reduced GP consent provisions
  - Focus on relaxing publicly traded partnership restrictions on transfers
- **Expansion of Baskets for Emerging Markets and Other Non-Core Regions**
  - More room for Asia/MENA investments
  - Way to gain sector exposure without raising and investing specialist fund
- **ERISA Compliance**
  - More funds now have the flexibility to rely on the “under 25% test” as opposed to being required to achieve VCOC status
- **September 2009, Institutional Limited Partners Association (the “ILPA”) released its “Private Equity Principles”**
  - 3 Overarching Principles: Alignment of Interests, Governance and Transparency



# Market Trends – Global Market Conditions

## ■ First Closing Issues

- First closings have a smaller percentage of LP target base than in the past
- Many LPs not willing to commit until final closing
- Increased LP emphasis on minimum first closing size
- Pressure by large LPs to restrict their fund ownership percentage, making it more difficult to meet minimum first closing size

## ■ Extended Offering Period

- Increasingly have fundraising period of 18 months (instead of 12) plus possible extensions

## ■ Reductions in Fund Commitments (either at GP discretion or following investor request/consent)

- For example, in Sep. 2009, French buyout firm PAI Partners told investors that it was willing to reduce its fund size by 50%, or about €2B (\$2.94B) following the recent departure of two key persons but LPs appear to be demanding an even greater reduction

## ■ Newest Trend – Extending Investment Period

- For funds that are unlikely to be fully invested
- In lieu of raising new fund at such time

## ■ Scrutiny of Default Mechanisms (such as forfeiture, sale, commitment reductions and GP's ability to purchase)

## ■ Deeper Dive on Due Diligence

## ■ Dry Powder Overhang on Industry



# Market Trends – Global Market Conditions *(cont'd)*

## ■ Liquidity Provisions/Solutions to Capital Scarcity

- Extending Investment Period
- Extending Time for Post-Investment Period Follow-on Investments
- Increasing Percentage Cap for Post-Investment Period Follow-on Investments (generally or on a deal-specific basis)
- Recalling/Recycling Existing Capital
- Top Up/Annex Funds
- Borrowing
- Issuing Preferred Interests
- Management Fee Waiver/Deferral
- Cross-Fund Investing
- Reopening of Fund for New Commitments

## ■ Extraordinary Transactions

- Bracing for wave of consolidations, spinouts, mergers, SPACs, etc.
- Opportunistic Additions of Select Investment Professionals – Departures from investment banks present opportunities for PE sponsors, especially in select target geographies (e.g., Asia).

## ■ Greater Transparency/Possible Limitations Regarding the Use of Placement Agents

- Response to public pension scandals involving finders' fees



## Market Trends – Global Market Conditions *(cont'd)*

- **Focusing on Emerging Markets (Central America, South America, Caribbean, Eastern Europe, Africa, Pacific, Asia, Middle East)**
  - PE fundraising in emerging markets rose by 23% in 2008 despite fall across the rest of the world (Source: Thomson Financial data as of May 21, 2009)
  - \$12.5B raised for Asia-focused funds in Q3 2008, surpassing amount raised for European funds in same quarter (\$11.9B) for the first time in history (Source: *Financial Times*, 10/7/08)
  - More Middle East and Eastern Europe (ex-Russia) focused funds
  - Bigger baskets for Asia/MENA deals in global LBO funds
  - However, interest in Russia and Eastern Europe has waned recently and China fundraising and deals fell sharply in Q1 2009 (Source: Thomson Financial data as of May 21, 2009)
  
- **Focusing on Alternative Strategies (Senior Debt, Distressed Debt, Energy, Clean-Tech, Turnaround)**



# Market Trends – Global Market Conditions *(cont'd)*

## ■ Increased LP Negotiating Leverage

- In September 2009, the ILPA released its “Private Equity Principles”
  - ♦ The ILPA represents more than 200 private equity investors worldwide, and its executive leadership and board includes CalPERS, OMERS, CPPIB, Ontario Teachers, State of Florida, Mass PRIM and University of California
  - ♦ 3 Overarching Principles: Alignment of Interests, Governance and Transparency
  - ♦ ILPA Principles are a “wish list” of items that LPs have long sought but have historically not always been successful in getting (e.g., 100% fee offset, management fee reduction, full payout waterfall, joint and several guarantees)
  - ♦ ILPA Principles are consistent with other recent media reports that certain groups of LPs are working together to stake out positions on terms and “drive the market”
- Small LPs are emboldened by market dynamics to attempt to impact fund terms
- Reports of requests for term changes even in closed funds, particularly when amendments are proposed



# Market Trends – Changing Regulatory Environment

## ■ Potential Changes to Regulatory Regimes

- U.S. federal and state restrictions on use of private placement agents and pressure to disclose specifics of placement agent arrangements
- Broader U.S. federal and state restrictions and disclosure requirements related to political contributions
- Potential U.S. legislation that would require registration of PE sponsors with the SEC under the Investment Advisers Act
- Potential U.S. legislation that would require limited registration of PE funds with the SEC under the Investment Company Act
- Broader and more specific anti-money laundering regulations (e.g., Know Your Customer (KYC) requirements)
- EU Commission's proposed Directive regarding extensive regulation of alternative investment fund managers



# State of the Secondary Market



# Secondary Market Trends

- **Unprecedented Growth of Secondary Market in Recent Years**
- **What is causing the growth?**
  - **For Sellers:**
    - ◆ Record number of private equity funds raised in 2005-2008
    - ◆ PE funds are traditionally illiquid, long-term investments with no redemption rights
    - ◆ Reduced level of distributions from PE funds put pressure on liquidity-challenged investors
    - ◆ Inability by LPs to meet commitment obligations and significant penalties for default
    - ◆ Desire by LPs to reduce unfunded liabilities
    - ◆ “Denominator Effect” – many LPs have become “over-allocated” in private equity
  - **For Buyers:**
    - ◆ Favorable pricing of secondary interests and decline in secondary market bid spreads
    - ◆ Opportunity to access premier funds that may have been over-allocated during the primary offering
    - ◆ Opportunity to invest further along the J-curve
    - ◆ Sophisticated secondary market intermediaries matching buyers and sellers of interests
    - ◆ Tremendous growth of dedicated secondary funds raised and structured secondary transactions



## Secondary Market Trends *(cont'd)*

- **What types of funds are LPs selling?**
  - Primarily buyout and venture capital interests
  - Real Estate
  - Energy/Infrastructure
  - Distressed and Special Situations
  - Other (e.g., timber)
  
- **Secondary Market Outlook**
  - Recent decline in secondary transaction volume in 2009 due to large pricing discounts and slow down in capital calls from funds
  - Long term growth expected to continue
  - Structured solutions expected to become more common



# Certain Limited Partner Issues



# Institutional Limited Partners Association Private Equity Principles



# Who/What is ILPA?

- **Institutional Limited Partners Association**
- **Global trade association for LPs**
- **“not-for-profit association committed to serving Limited Partner investors in the global private equity industry by providing a forum for:**
  - Facilitating value-added communication
  - Enhancing education in the asset class
  - Promoting research and standards in the private equity industry”
- **Founded in early 1990s [[www.ilpa.org](http://www.ilpa.org)]**
- **220 member organizations from 10 countries**
- **Members manage >\$1 trillion of PE capital**
- **Members must be active/own account PE investors (GPs not allowed)**



# Purpose of Private Equity Principles

- Suggested best practices
- Basis for continued GP-LP discussion
- To:
  - Correctly align interests between GP and LP
  - Enhance fund governance
  - Provide greater transparency to investors
- Referred to as “laundry list,” “wish list,” etc.
- “Strongly endorsed” by CALPers (which chairs ILPA)



# Alignment of Interests

## ■ Carried Interest:

- Best practice = whole fund distribution waterfall
- Recognizes deal-by-deal but
  - ◆ all fees and expenses to be returned
  - ◆ no credit for value uplifts of unrealized investments
  - ◆ 30%+ to be escrowed
- Recaps to return 100% of cost base prior to carried interest
- No carried interest on income
- No gross-up for withheld taxes
- Clawback to be:
  - ◆ gross of tax
  - ◆ joint and several liability



## Alignment of Interests *(cont'd)*

### ■ Management Fees:

- Management fees to be based on “reasonable operating expenses”
- Step-down on successor fund/end Investment Period
- Limited Partner Advisory Committee oversight
- 100% fee off-sets

### ■ General Partner:

- “Substantial” co-investment, cash not waiver and restrictions on transfer
- Key person devotion of time and exclusivity
- No cherry-picking co-invest
- Fees and carried interest to be directed to fund executives



# Governance

## ■ Fiduciary Duty:

- Avoid contracting out of fiduciary duties
- All conflicts to be approved by Limited Partner Advisory Committee
- “Cause” removal on court of first instance finding; no cure by terminating malfeasor
- No indemnification for ‘cause’ acts; all indemnification payments to be capped

## ■ Strategy:

- Super majority approval to amend narrow investment strategy
- Consider annual caps to achieve time diversification
- Cap debt, public equity and “pooled” investments

## ■ Termination:

- No fault suspension/termination of commitment period on majority vote
- No fault GP removal/dissolution on  $2/3$  investor vote
- Automatic suspension of commitment period on keyman event; 180 days cure on  $2/3$  LP vote



# Transparency

- **Additional auditor confirmations**
- **Limited Partner Advisory Committee access to independent counsel**
- **Disclosure of internal GP affairs (including carried interest, co-invest and profit share)**
- **Enhanced financial reporting**
- **LP contact list on closing**
- **Limited Partner Advisory Committee meeting protocol**



# Defaulting Partner Issues



# Defaulting Partner Issues

- **Bankrupt Defaulting Partners**
  - Notice of late payment
  - Notice of default
  - Automatic default provisions
  
- **Treating Limited Partners Differently**
  - Delaware
  - Cayman



# Certain Regulatory Changes



# Upcoming U.S. and EU Fund Manager Regulation and its Cross Border Impact



# Registration Requirements Under Current U.S. Law

## ■ Two Principal Investment Adviser Registration Schemes

- Federal: Investment Advisers Act of 1940 (“Advisers Act”)
  - ◆ Regulates investment advisers, including private fund managers (e.g., GPs and management companies)
  - ◆ Requires SEC registration for larger advisers (based on number of clients and AUM)
  - ◆ SEC registration preempts state registration
- States: “Blue Sky” state securities laws
  - ◆ Almost all states regulate investment advisers (other than SEC-registered advisers) with a place of business in the state
  - ◆ Require registration for smaller advisers (based on AUM)
  - ◆ Exemptions from registration may exist but vary by state
  - ◆ States retain full jurisdiction to investigate and enforce violations of state anti-fraud laws



# Registration Requirements Under Current U.S. Law *(cont'd)*

- **IAs Not Required To Register Under the Advisers Act**
  - Private IA fewer-than-15-client exemption (§203(b)(3)): Typical private fund manager exemption
    - ◆ Fewer than 15 clients during 12-month period (generally each entity (e.g., private fund) counts as one client)
    - ◆ Not publicly held out as IA (broadly interpreted by SEC)
      - Public statements (e.g., press releases, Web sites) should be crafted to not constitute “holding out” as an IA
      - Private fund private placement is not “holding out” as an IA
    - ◆ Not an IA to fund registered under Investment Company Act (“1940 Act”) or a “Business Development Company” under 1940 Act



# New Proposed Legislation

- **U.S. Private Fund Investment Advisers Registration Act of 2009 (7/15/09) (the “Registration Act”)**
  - Proposed by Obama administration to Congress and expected to be part of a larger financial services regulatory overhaul
  - Eliminates the fewer-than-15-client exemption under the Investment Advisers Act for U.S.-based fund managers and *limits the exemption for non-U.S. fund managers*
  - Timing is uncertain, but most expect that the new legislation will be acted upon at the end of this year or early 2010 and will be effective sometime in 2010
  - October 1, 2009 House bill would allow the SEC to exempt “venture capital funds” from the Registration Act requirements and eliminates private fund managers from “Tier 1” financial holding company statutes
  - Without a specific exemption (e.g., fewer-than-15-client exemption), almost all private fund managers would have to register



# New Proposed Legislation (*cont'd*)

## ■ Registration Act (*cont'd*)

- Recordkeeping requirements and reporting to SEC of information regarding any “private fund” advised by an IA, including:
  - ♦ AUM
  - ♦ Use of leverage (including off-balance sheet)
  - ♦ Counterparty credit risk exposures
  - ♦ Trading and investment positions
  - ♦ Trading practices
- “Private fund” defined as:
  - ♦ Any fund relying on 1940 Act § 3(c)(1)/3(c)(7) (e.g., private equity, hedge and certain real estate funds), and
  - ♦ Organized under U.S. law or has 10% or more securities owned by U.S. persons



# New Proposed Legislation (*cont'd*)

## ■ Registration Act (*cont'd*)

- SEC required to share with the Federal Reserve and the Financial Services Oversight Council information regarding private funds as deemed necessary to assess systemic risk; Federal Reserve and Council to keep information confidential
- SEC generally authorized to keep information confidential
- Private fund records of IA subject to periodic and surprise SEC examinations
- SEC given rulemaking authority to mandate disclosures to current/prospective investors, counterparties, and creditors
  - ◆ Comments by SEC Chairman Mary Schapiro (9/18/09) suggest the SEC may require some level of public disclosure regarding private funds should legislation be passed requiring registration of private fund managers



# Related Regulatory Proposals

- **Treasury’s Financial Regulatory Reform white paper (6/17/09) calls for creation of a Financial Services Oversight Council to monitor systemic risk, coordinate financial regulation, and in consultation with the Federal Reserve, designate certain firms to be regulated as “Tier 1” financial holding companies**
  - Under the the proposed Private Fund Investment Advisers Registration Act of 2009, private fund information provided by the SEC to the Federal Reserve and the Council could result in Tier 1 designation
- **In Senate testimony (7/15/09), Andrew J. Donohue, director of the SEC’s Division of Investment Management, suggested the Senate may wish to consider registration of private funds under the 1940 Act or condition the use of 1940 Act § 3(c)(1)/3(c)(7) on SEC rules\***
  - This would allow the SEC to further regulate the activity of private funds and perhaps impose certain mutual fund type regulation on these funds

\* See page 42 for similar Senate bill



# Other U.S. Legislative Proposals to Require Registration

## ■ Senate

- Private Fund Transparency Act of 2009 (introduced 7/16/09)
  - ◆ Would require private fund managers to register with SEC by eliminating IA fewer-than-15-client exemption for managers with place of business in U.S. and \$30M or more AUM and narrow the exemption for “foreign private advisers”\*

\* Act is consistent with the U.S. Private Fund Investment Advisers Registration Act of 2009 described on pages 37-39



# Other U.S. Legislative Proposals to Require Registration *(cont'd)*

## ■ Senate

- Hedge Fund Transparency Act of 2009 (introduced 1/29/09)
  - ◆ Could effectively require registration of private fund managers by requiring limited registration under 1940 Act of § 3(c)(1)/3(c)(7) funds with \$50M or more of assets or commitments
  - ◆ Would require such funds to submit to SEC information requests and exams, make certain disclosures (including ownership structure and current value of fund assets) adopt AML programs, and report suspicious transactions
  - ◆ Would apply to all § 3(c)(1)/3(c)(7) funds, not only to hedge funds as the title of the bill implies
  - ◆ Not likely to become law



# Changing Regulatory Landscape

## ■ State Proposals to Require Registration

- There have been other proposals at the state level (e.g., Connecticut) that appear to be deferred pending action regarding private fund/manager regulation at the federal level

## ■ Reaction of Industry Groups

- The Private Equity Council generally indicated support for requiring SEC registration of IAs to private funds as contemplated by the Private Funds Transparency Act\*
- MFA (a hedge fund industry trade group) also supports IA registration with a *de minimis* AUM threshold to exempt small advisers\*

## ■ Likely Outcome

- Repeal of fewer-than-15-client exemption from registration, and/or
- Managers of 3(c)(1)/3(c)(7) funds with threshold AUM would be required to register as IAs with the SEC

\* Subject to reservations on regulation as financial holding companies for systemic risks



# Key Points For Non-U.S. Fund Managers Under Proposed Legislation

- To remain exempt from Investment Advisers Act registration, non-U.S. Fund managers must:
  - Have no place of business in the U.S.;
  - Have fewer than 15 U.S. domiciled funds and/or other U.S. clients (e.g., managed accounts, AIVs etc.);
  - Have less than \$25M AUM **attributable** to U.S. clients (probably means U.S. fund investors); and
  - Not advise U.S. registered funds (e.g., mutual funds) or business development companies



## What Next?

- **The proposed Registration Act would have to be passed and then the SEC would draft proposed rules to implement the new regulations**
- **After a comment period on the proposed rules the SEC will make the rules final and likely provide a transition period to allow fund managers to register with the SEC**
- **Based on the current draft, it is very likely that a non-U.S. manager managing a private fund with significant U.S. investors will trigger registration**



# Implications of SEC Registration

- **Summary of Key Regulatory Requirements for Registered IAs**
  - Restrictions on carried interest for certain funds
  - No unilateral changes of control of fund sponsor
  - Restrictions on marketing materials/pitch books
  - Required reporting of personal securities transactions and compliance with code of ethics
  - Appointment of CCO and maintenance of detailed compliance program and specified books and records
  - Subject to periodic and possible surprise SEC inspections for compliance with federal securities laws, including Advisers Act



# Implications of SEC Registration (*cont'd*)

## ■ Advisory Contracts

- Performance fees/carried interest generally prohibited, except:
  - ♦ 3(c)(1) funds – may charge investors performance fee/carried interest if either (1) investor has \$1.5M net worth or (2) investor invests \$750,000 or more with private fund
  - ♦ 3(c)(7) funds may charge performance fee/carried interest (all QPs)
  - ♦ Non-U.S. investors may pay performance fees/carried interest
  - ♦ BDCs may charge performance fee
  - ♦ Advisable to test fund investors in advance of likely registration requirement
  - ♦ Can waive for non-qualifying investors under rule
- Advisory contract (LPA/management contract) may not be “assigned” without client consent
- Private fund manager may not have direct or indirect change of control without client consent
- 25% or more ownership change may trigger change of control issue (unless dominant 50% or more owner)
- What is consent?
  - ♦ LPs and vote required
  - ♦ Advisory boards
  - ♦ What about GP?



# Implications of SEC Registration *(cont'd)*

## ■ Advertising Restrictions

- Presentation of performance data
  - ◆ Hot button issue for SEC examination staff
  - ◆ Permissible for private fund managers to use (e.g., PPM, pitch book) but subject to numerous restrictions under Advisers Act rules and SEC interpretations
    - Special requirements/restrictions for IRRs
      - IRRs must be shown net of fees/carried interest
      - May show gross IRR with net IRR (equal prominence)
      - Gross IRRs only for 1-on-1 presentations with footnote example
        - Difficult to meet 1-on-1 test
    - Prior “team” performance subject to restrictions
    - Need supporting records and required disclaimers and format
- Past specific recommendations
  - ◆ If cited generally must include at least 1 year of all investments
- No testimonials
- LP reports/diligence
  - ◆ May not be advertising, but still subject to antifraud rules



# Implications of SEC Registration *(cont'd)*

- **Compliance Programs, Code of Ethics/Insider Trading**
  - Must adopt and implement tailored written compliance policies and procedures reasonably designed to prevent violation of the Advisers Act by fund manager and supervised persons
  - Must designate a CCO responsible for administering policies and procedures
  - Annual review and risk assessment
  - Must adopt written code of ethics
    - Requires personnel to report personal securities holdings initially and annually and transactions quarterly
    - Preclearance of all IPOs and private placements purchased by manager personnel
  - Must have formal insider trading policy
- **Books and Records Requirements**
  - Detailed recordkeeping requirements
  - General corporate, accounting books and records
  - Information relating to investments made on behalf of clients
  - Quarterly reports of all personal securities transactions by fund manager and employees
  - Email retention required, including search capabilities
- **Disaster Recovery Plan**



# Implications of SEC Registration *(cont'd)*

## ■ Other Advisers Act Requirements

- Disclosure of solicitation/placement agent fees where payment is solely to compensate person for soliciting investors (or referring investors) to invest in fund managed by adviser
- Rule 206(4)-3 requirements apply where compensation paid includes referrals of prospective investment advisory clients (e.g., individual accounts) in addition to fund investors
  - ◆ Written agreement
  - ◆ Specific disclosure and acknowledgement
  - ◆ “Bad boy” disqualifications
- Custody requirements for cash and securities
  - ◆ Bank/broker custody
  - ◆ GAAP audited financials for funds – 120 days from FYE; 180 for FOF
  - ◆ Proposed amendment to custody rule would require:
    - Annual surprise examination of fund manager by independent public accountant
    - If client accounts maintained by qualified custodian affiliated with adviser, SAS 70 report from independent public accountant
- Proxy voting policy
- Financial/disciplinary event disclosure



## Implications of SEC Registration *(cont'd)*

- **Other Required or “Best Practices” Policies and Procedures**
  - AML
  - Privacy
  - Gifts/political contributions
  - Allocation
  - Best execution/soft dollars
  - Valuation
  - Marketing
  - Use of placement agents and intermediaries



# Implications of SEC Registration (*cont'd*)

## ■ SEC Inspection

- Examination Process
  - ♦ Routine – first year of registration and every few years thereafter
  - ♦ Sweeps – SEC focuses on specific issue and does across the board examination of firms
  - ♦ For “cause”
- Typical current examination cycle first year of registration and every few years thereafter depending on factors such as:
  - ♦ Size
  - ♦ Organizational structure
  - ♦ Quality of risk management/compliance systems (as assessed by SEC)



# EU Directive Overview

- **European legislation – if enacted in Europe, UK and all other European Union countries will be required to implement it into domestic legislation**
- **Draft was published on April 30, 2009 – badly drafted, even unworkable in some areas**
- **Consensus that a Directive will be enacted, although expected to be subject to considerable amendment**
- **Timing – uncertain**
  - Directive adopted mid-2010?
  - Implementation Europe-wide 2012?
- **Transitional provisions – not yet clear**



# Key Points for U.S. Fund Managers

- **Cannot market to EU investors unless:**
  - Fund manager is regulated in the EU under the Alternative Investment Fund Managers Directive;

or

  - Fund manager is subject to “equivalent regulation” in a non-EU jurisdiction;
  - and
  - Fund manager obtains a marketing authorisation from an EU regulator (e.g., Financial Services Authority)
  
- **Widely thought that the equivalence requirements set by Europe will not be met by the U.S.**



# Key Issues

- **As currently drafted, once Directive is implemented:**
  - U.S.-based fund managers will not be permitted to market to European investors
  - UK (or other EU) sub-advisors will not be able to advise funds managed by U.S.-based fund managers
- **It is acknowledged that the Directive will need substantial revision**
- **Key Points Under Review Are:**
  - The threshold at which fund managers will become subject to the Directive
  - Marketing of third country funds (and a rather concerning suggestion that “marketing” as currently defined could restrict deal activity)
  - Depositary and independent valuation requirements
  - Use of leverage (as defined, currently more relevant to hedge funds)
  - Reporting obligations (particularly notes anti-competitive concerns regarding PE portfolio companies)
  - Interaction with other EU legislation (including Markets in Financial Instruments Directive)



## Next Steps

- Intense lobbying occurring – both industry and politicians
- Proposals not supported by UK Government, but that may not be sufficient to block them
- Date for European Parliament vote on Directive delayed – indicative of the lobbying that is taking place
- Difficult to structure for Directive until proposals are more certain



# Current State of Placement Agent Investigations



# Overview

- **Current State of Placement Agent Investigations**
- **Proposed SEC “Pay-to-Play” Rule**
- **Public Pension Fund Reform Code of Conduct**



# Current State of Placement Agent Investigations

- Placement agent\* arrangements are under increased scrutiny by state and federal law enforcement and regulatory agencies, as well as public pension funds
- The burgeoning federal and multi-state actions are led by the SEC and State of New York
- **Federal Government:**
  - SEC issued proposed “pay-to-play” rule that would prohibit use of placement agents to solicit public plans and limit political contributions by investment managers
  - SEC coordinating its federal civil and criminal investigations with NY State Attorney General
  - SEC filed civil charges against six people involved in NY state probe
  - FBI questioned New Mexico investment fund officials and federal prosecutors served subpoenas on NM’s two largest public pension plans
- **New York:**
  - As a result of NY AG’s two year investigation into alleged “pay-to-play” schemes:
  - State Comptroller issued bans on use of placement agents for NYSCRF and on NYSCRF doing business with money managers who contribute to candidates for Office of the State Comptroller
  - PE Firms – Carlyle Group, Riverstone Holdings LLC, Pacific Corporate Group Holdings LLC and several others – have agreed to an aggregate \$56.9M in “pay-to-play” settlements with NY AG

\* As used in this presentation, “placement agent” includes persons or entities who refer to themselves as “finders”



# Current State of Placement Agent Investigations (*cont'd*)

## ■ **New York: (*cont'd*)**

- NY AG indicted or garnered guilty pleas from six people involved with designated “placement agents” securing investments by NYSCRF and other public plans into private funds
- NYC public pension plans and NY State Teachers Retirement System have also taken similar actions to NYSCRF
- NY AG issued more than 100 subpoenas to private fund sponsors and other industry participants regarding use of placement agents and investments by NYSCRF, New York City pension plans and other public plans
- NY AG and three NYS Senators announced plans to introduce NY laws to replace NYSCRF’s sole trustee system with a 13-member board of trustees, as well as implement new disclosure and reporting requirements
- NYS Assembly’s proposed bill that includes a prohibition on the use of placement agents by managers doing business with NYSCRF is currently tabled

## ■ **Placement Agent Response:**

- Placement agents organizing new coalitions to lobby against placement agent bans and working through existing industry groups to lobby and inform public/media dialogue



# Proposed SEC “Pay-to-Play” Rule

- **On August 3, 2009, SEC published proposed rule to proscribe “pay-to-play” practices by investment advisers (whether or not registered under the Investment Advisers Act)**
- **Proposed rule would effectively prohibit a private fund’s GP/management entities, principals and most employees from:**
  - Paying a placement agent to solicit a governmental agency to invest in the private fund
  - Making a political contribution to a government official/candidate who could influence a governmental agency to invest in the private fund
  - Soliciting a political contribution for such a government official/candidate
- **Public comment period ended October 6, 2009 and SEC suggesting that final rule may be in place in early 2010**
- **More than 230 comment letters have been posted on the SEC’s Web site, a number of which are from pension plans, leading placement agent firms, private equity firms and U.S. institutional investors objecting in writing to the proposed placement agent ban**



# Proposed SEC “Pay-to-Play” Rule (cont’d)

- **The specific prohibitions of the proposed rule include:**
- **Using placement agents. Private fund advisers prohibited from paying third-party placement agent, solicitor, finder or similar party to solicit a governmental agency**
  - Prohibition breached if private fund pays a success fee to a third party based on all money raised for the private fund (including from governmental agencies) and the third party communicates with a governmental agency for purpose of raising money
  - May permit third party to receive fee based on all money raised so long as third party did not communicate with any governmental agency for purpose of raising money
- **Making and soliciting political contributions – two year rule. Private fund is prohibited from receiving carried interest, management fees or other compensation from governmental plan or state university endowment for two years after GP/management entity, principal or other employee (even if made by principal/employee while employed at a predecessor firm):**
  - contributed to a prohibited government official or candidate or
  - solicited a contribution or coordinated solicitation of contributions to a prohibited government official or candidate



# Public Pension Fund Reform Code of Conduct

- **PPF Reform Code of Conduct proposed by NY AG to govern “future conduct” in connection with all direct and indirect transactions between the private funds\* that have adopted the PPF Reform Code of Conduct and a public pension fund in the United States**
  
- **Five key categories of conduct addressed:**
  - Bans use of third-party intermediaries by investment firms to influence investment decision-making at public pension funds (applies to all plans of U.S. federal, state, local governments, and their agents/instrumentalities)
  - Bans campaign contributions above \$300 by investment firms, their principals, agents, employees and immediate family members to officials of public pension funds that are being solicited for business or have an investment in such firm
  - Requires disclosure of any conflicts of interest of the investment firm, actual or apparent, to the public pension fund and, in some cases, to the AG’s office or appropriate law enforcement official in public pension fund’s jurisdiction
  - Requires disclosure of campaign contributions, investment fund personnel and payment to third-parties relating to the interaction between the investment firm and the public pension fund
  - Bans engaging in “revolving door” employment practices, misusing confidential information, and providing improper gifts to employees of public pension funds

\* As of 9/18/09, Carlyle, Riverstone, PCG, HM, Levine Leichtman, Access, and Falconhead have adopted PPF Reform Code of Conduct



# Changes to New York Power of Attorney Law



# Overview

- **New York law governing use of powers of attorney by “individuals”<sup>1</sup> amended effective September 1, 2009<sup>2</sup>**
- **Stated intent relates to gift/tax/estate planning context – “Statutory Short Form and Other Powers of Attorney for Financial Estate Planning”**
  - Nonetheless statute does not exempt POAs used in other contexts (e.g., commercial transaction)
- **Imposes new requirements for creation of valid POA and other new rules for principals and agents**
- **Scope of Amendment**
  - Applies only to individuals executing POAs on or after 9/1/2009 within New York State under New York State governing law
  - POAs executed outside New York State are valid under New York law if in compliance with the laws of that state
    - Silent on POAs executed within New York State purporting to be governed by law of foreign jurisdiction
- **POAs executed before 9/1/2009 are not invalid**

<sup>1</sup> The statute does not bar the use of different forms of POAs by a person “other than an individual;” however it is unclear whether this would be applied to IRAs and certain alter ego trusts. The initial consensus in the market is that this would not apply to “individuals” signing in their capacity as corporate officers or directors.

<sup>2</sup> Title 15 of Article 5 of the New York General Obligations Law was amended on 1/27/2009, with an effective date of 3/31/2009, later postponed to 9/1/2009.



# POAs in the Fund Context

- **POAs are standard in many fund operating, subscription, transfer and related documents**
  - Often the POA authorizes a fund's GP to sign the fund's operating documents on behalf of its LPs or make certain representations on their behalf
  - Consider effects of *Mercury* case on UK and Cayman funds
- **LPAs usually include a POA authorizing the fund's GP to take certain actions and execute certain documents on behalf of LPs (e.g., AIVs, amendments)**
- **In registered investment companies, members of senior management or board of directors may, for example, execute a POA designating members to sign and file a registration statement**



# Key Provisions of Amendment

- **POAs must now include cautionary statements**
  - Principal (in fund formation case, the LP) given notice of the powers it is granting
  - Agent (sponsor) warned of consequences of violating duties
- **POAs must now be in 12 point font, dated, countersigned by agent and notarized (principal and agent signatures)**
  - Additional step for closing process
  - POA has effect from the date of later of two signatures
- **Automatic revocation of all prior powers of attorney executed by principal, unless the POA specifies otherwise**
  - Could lead to irrational results (e.g., if the LP invests in another fund at a later date)



## Key Provisions *(cont'd)*

- **Establishes that agent acting under POA owes a statutory fiduciary duty to the principal and sets forth the agent's fiduciary obligations**
  - Effective retroactive to pre-9/1/09 POAs
- **Codification of agent's common law fiduciary duties:**
  - Prudent person standard when dealing with principal's property
  - Must act according to principal's instructions and, absent instructions, in principal's best interests and without conflicts of interests
  - Segregate property of the principal from that of agent's other property
  - Proper recordkeeping
- **Position that fiduciary duty is only implicated with respect to actions directly taken as attorney-in fact (e.g., execution of certain documents)**
  - *Ordinary course transactions are effectuated pursuant to the LPA (not the POA) itself and with the partnership's property (not the LPs')*



# Possible Further Amendments

- **Multiple pending amendments**
  - Key change would be to avoid automatic revocation of prior POAs when new POA executed
    - ◆ Certain additional clarifying changes on procedures for revocation
  - Although this change would benefit private funds and other commercial entities relying on POAs, current amendments do not narrow scope of the proposed amendment
  - Unclear when amendments would be adopted and/or effective



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