Compliance

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Historically, private equity General Partners (GPs) and their Limited Partners (LPs) have not paid a great deal of attention to the area of compliance management. This was likely a function of the nature of private equity investing where the focus was on long-term profitability as compared to day-to-day operational considerations potentially impacting the funds, coupled with a less restrictive regulatory environment. Today perspectives on this matter have reversed, and compliance has become one of the fastest growing areas in the private equity space. Mirroring trends from the hedge fund industry, surveys indicate that private equity managers consistently rank compliance as one of the most challenging aspects of their business. Recent studies also indicate that private equity compliance spending has rapidly outpaced other GP operating costs, with estimates indicating that private equity funds increasingly spend larger portions of their operating budgets on this area.

In the forthcoming book Private Equity Compliance: Analyzing Conflicts, Fees, and Risks (Wiley Finance, September 2018) to provide perspective on how we arrived at the current compliance environment an overview of the historical development of the modern private equity compliance environment is discussed. Other key compliance topics covered in the book include:

- Overview of key GP compliance and obligations
- Analysis of GP global regulatory reporting requirements and associated venture capital fund obligations
- Analysis of the impact of emerging regulations on the private equity industry including the General Data Protection Regulation (GDPR), Senior Managers and Certification

Regime (SM&CR), Markets in Financial Instruments Directive II (MiFID II), and the Packaged Retail and Insurance-based Investment Products (PRIIPs)

- Perspectives on the ways in which GPs approach conflicts of interest management
- Analysis of the compliance implications of common private equity practices such as the use of management fee offsets and the compensation of operating partners and advisors
- Examination of the approaches to manage compliance with valuation policies and procedures
- Analysis of the impact of technology on GP compliance management including data management and cybersecurity considerations
- Regulatory case studies in private equity compliance failures

Private Equity Compliance also addresses the ways in which LPs are becoming active participants in engaging with GPs on a variety of investment and operational matters including compliance management. An increasingly popular mechanism to facilitate these conversations between LPs and a GP is through a Limited Partner Advisory Committee (LPAC). The following excerpt from Private Equity Compliance provides background on several of the common duties of LPACs, as well as provides an overview of the importance of GP disclosures to LPACs, and discusses options for LPAC formation:

LPAC's serve as an oversight and governance mechanism on the operations of the fund. They are meant to represent the interest of LPs and provide them with a voice in the management of the fund. While the specific duties of LPAC may differ across private equity funds, traditionally the core duties of an LPAC are often centered around the areas which present may present the greatest risks to LPs. Specifically, key areas LPACs focus on include:

- Conflict of interest oversight -the LPAC may be responsible for overseeing a number of situations in which different conflicts of interest may arise between the actions of the GP, its employees, and the LP. Two of the more common conflicts that LPACs review include:
  - (i) Related party transactions oversight – These are investments where a fund may seek to enter into transaction with individuals or entities related to the GP. Two common related party transactions are for which LPAC provide oversight are:
    - a. Approval of concurrent investments- A concurrent investment generally refers to a situation in which a fund purchases the securities of a portfolio company concurrently with another fund. In practice, the timing of the investments may not be simultaneous, and the two purchases could occur at slightly different times. In these situations, inherent conflicts may arise across a variety of areas including the allocation of securities among the two affiliated funds. Therefore, most funds are structured to submit concurrent investments to the LPAC for review and approval.
    - b. Approval of cross investments – a cross investment refers to a situation where a fund purchases the securities of a company that is a portfolio company of another fund managed by the GP. Due to the dual ownership of both affiliated funds of the investment, the potential for conflicts related to items such as the valuation of the investment may arise either at the time of the initial purchase, throughout the life of the investment or upon sale. In order to provide additional oversight of such conflicts, LPACs typically are required to grant approval on any cross investments.
  - (ii) LP transaction oversight – A fund may also seek to enter into a transaction directly with an LP in addition to their capital commitment to the fund. To oversee these conflicts, the LPAC therefore represents LPs in reviewing and ultimately deciding whether to approve or prevent such transactions.
- Valuation oversight – When disagreements arise between LPs and GPs over the valuation of an asset or group of assets held by a fund, the LPAC typically plays a role in working with the GP, and in some cases third-party appraisers, to determine a valuation.

The duties of LPACs are typically outlined specifically in the fund formation documents. Common LPAC duties include:

- Approving capital calls from investors in certain situations - Approving the issuing of capital calls by the GP in certain instances where they would not otherwise normally be permitted is one common LPAC role. An example of a situation where this could occur, would be if the commitment period for a fund had ended and the GP wanted to issue a special capital call to raise more funds for the purpose of enabling the fund to make additional opportunistic investments in portfolio companies. Typically, since the commitment period had already ended the fund formation documents would outline that LPAC approval was required to issue these new capital calls.
- Approving tax distributions amounts to GPs – Tax distributions are distributions of capital typically made to LPs in order to offset each individual LP's deemed tax liability with respect to their investment in the fund. To be clear the purpose of these

distributions is to provide the LP with money to pay taxes related to their investment in a fund, not to provide them with any sort of profits related to their investment in the fund. These tax distributions are typically paid by funds within 90 days after the end of the fiscal year of a fund. In some instances, a fund's formation documents may set a ceiling limit on the amount of total aggregate tax distributions the fund can pay out to LPs, such as $500,000 USD. If the aggregate contributions were to exceed this ceiling amount, then approval from the LPAC would typically be required to payout a greater amount of tax distributions.

- Override investment limitations – At the time of formation of a private equity fund, there may be a variety of investment limitations placed on a fund. These are also sometimes referred to as investment restrictions. A common example of such a restriction would be a cap on the total investment that may be placed into a single portfolio company. For a variety of reasons, such as a shifting market conditions, a GP may wish to override this cap once the fund actually starts investing capital. In order to breach this cap, LPAC approval would typically be required.
- Approving the advance of GP litigation defense costs – Under certain circumstances a fund may advance an LP money to fund their defense in litigation related to their duties on the LPAC. Similarly, in some cases a fund may advance the GP capital to fund their defense in a lawsuit brought from other LPs. The advance of capital in these situations typically requires LPAC approval prior to disbursement.
- Restricting fund principal's activities and new fund launches – Typically when a private equity fund is in the process of allocating capital, a restriction exists with regards to the principals of the fund (i.e. -the portfolio managers) from working on the management of other funds. Similarly, in order to not cannibalize the opportunity set of the current fund, restrictions also exist on the launching and subsequent closing of new funds by the GP. Any decision to violate these restrictions would require approval from either the LPAC or the majority of interest holders of the fund in most instances.
- Ceasing limited operations mode related to key person events – A key person event refers to a situation that is triggered when a single individual, or multiple persons as the case may be, that are critical to the management of a fund are no longer able to perform their duties. Historically, these provisions were also referred to as key man events. An example of such an individual would be a portfolio manager of a fund. Specifically, the common occurrences that trigger a key person clause include the death of a key person, their incapacitation, if they take bad actions that are determined to constitute items such as fraud or gross negligence, or if they are simply no longer involved in the day-to-day management of the fund for an extended period of time.

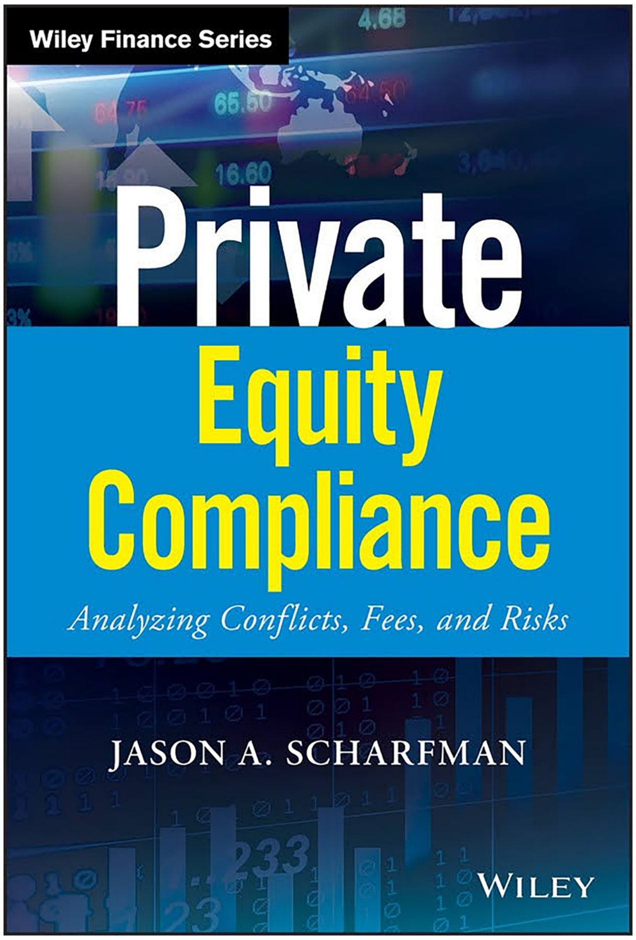
While the specifics of key person clauses vary across private equity funds, once a key person clause is triggered, many private equity funds formation documents contain a provision that the LPs that hold that majority of the fund's interest can vote to place the fund into what is known as a limited operations mode. In this mode, the fund will not make any new investments and will generally only fulfil the funding of previous investment obligations and make follow-on investments into portfolio companies. Depending on the circumstances of the key persons involved in the fund, and the specific investment situation of the fund, its LPs may decide to pull the fund out of limited operations mode and continue normal investment activities. An example of such a situation would be if a portfolio manager of a fund suffered an illness that forced the fund in limited operations mode but had since recovered from the sickness, and the LPs wanted to resume the normal fund operations. Typically, most funds are structured in such a way so that in order to resume normal operations of the fund out of limited operations mode, either a majority-in-interest of the LPs of the fund or the LPAC must approve this transition back to normal fund operations.

- Service provider oversight – In certain instance the fund formation documents may outline that changes to material service providers relationships, such as the auditor of a fund, would require LPAC approval.
- Extensions of a funds term – The term, of a private equity fund refers to the entire period of the fund's existence through to the winding-up and liquidation of the fund. The term of a fund is also sometimes referred to as the life of a fund. A common fund term would be 10 years from the date of the initial fund closing however, they may be longer or shorter. Generally, extensions of a fund's term require approval by the LPAC.
- Other matters the GP deems important – Many fund formation documents contain a provision such as this, "The General Partner may consult with, or seek the approval of the LPAC regarding any other matter determined by the GP for any other matter as determined by the GP in its sole and absolute discretion." This means that there may be other situations or potential investments that were not specifically contemplated at the time the original fund formation documents were drafted that have subsequently arisen that the GP feels is a good idea to run past the LPAC.

However, as these clauses are typically written the other types of items the GP brings to the LPAC is in the GP's complete discretion. So how should a GP, or an LPAC for that matter, determine what other items that should be raised to the LPACs attention? This determination is typically related to a concept known as a good faith effort. The general standard outlined in fund formation documents is that the GP makes what is known as a good faith effort to bring items to the LPACs attention and provide them with enough material facts so that they can make an informed determination of the merits of the proposed GP action. This good faith effort is also related to the issue of GP disclosures.

GP Disclosures to LPACs

When capital is first committed by LPs to a private equity fund the issue of disclosures by the GP is one that has come under increased scrutiny by private equity regulators. In particular, one of the key areas of focus relates to disclosures, is their completeness. In some cases, a GP may make disclosures of relevant information that are too limited in nature, or on the other hand a GP that makes very broad disclosures that do not specifically address important information material to LPs at the time capital is being committed. Once the initial capital commitments have been made by LPs, similar issues related to GP disclosures to LPs arise in the context of ongoing disclosures that should be made throughout a fund's term.



Disclosures of material information cannot be made by General Partners selectively, especially to LPACs who may be tasked with reviewing potential conflicts. Representatives of private equity regulators including the US SEC have highlighted that LPAC's decision making ability has been impaired in many cases by GP's failure to provide the LPACs with sufficient disclosures to make informed determinations over areas such as conflicts of interest, which are particularly important based on the nature of private equity investing. Regulators have observed the incompleteness of these disclosures was particularly noteworthy, as it related to the disclosures centered around the potential conflicts surrounding the practice of GP representatives taking board seats on underlying portfolio companies.

LPAC Formation Considerations

Although not a technical requirement, due to the increased input and oversight it affords LPs, today most private equity funds maintain an LPAC. Once a decision has been made to implement an LPAC, there are a number of initial questions facing GPs regarding the structure, membership and duties of the LPAC.

Determining Which LPs Can Serve on an LPAC?

After a determination has been made as to how many seats there will be on the LPAC, often the next question facing a GP is which investors will be invited to sit on the committee. Often to keep their larger investors happy, a GP will invite the larger investors in a fund to serve on an LPAC. These larger investors are sometimes referred to as seed investors or anchor investors.

It should be noted that certain seed investors may require a seat on the LPAC as part of their own investing process. In these cases, therefore, their committing of capital to the fund is predicated on their receiving a seat on the LPAC. From a legal perspective, this agreement between the GP and LP is often outlined in a supplemental document to the fund formation documents known as a side letter. A side letter is a separate agreement applicable to a specific LP, as opposed to the entire pool of LPs. Side letters typically outline certain specific rights available to LPs and unique obligations the GP has to a specific LP, such as a requirement to offer them a seat on the LPAC.

How Many LPs Can Serve on an LPAC?

One of the first questions a GP must determine is how many LP members the LPAC will have. There are no bright line legislative or regulatory rules with regards to specific minimum or maximum requirements. In practice, many GPs decide to keep the number of LPs to a manageable size. The actual number of LP seats on the committee may vary according to a number of factors including the actual size (i.e. – assets committed) of the specific fund, and the total number of investors in the fund.

For example, a larger private equity fund would likely have a greater number of large investors and therefore, the GP may feel obligated to create an LPAC board with more investors represented as compared to a smaller fund. In general, the minimum size for most LPACs is three LPs.

In order to provide further current advice on the applications of private equity compliance in practice the book also features interviews with private equity compliance practitioners. Additionally, the book features examples of key private equity compliance documentation including a compliance manual, code of ethics and relevant sections of private equity offering memorandums. Private Equity Compliance: Analyzing Conflicts, Fees, and Risks is currently available for pre-order from booksellers worldwide including Amazon.

Author Bio

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Jason Scharfman is the Managing Partner of Corgentum Consulting, a specialist consulting firm that performs operational due diligence reviews and background investigations of fund managers of all types, including hedge funds, private equity, real estate, and long-only funds on behalf of institutional investors, including pensions, endowments, foundations, fund of funds, family offices, and high-net-worth individuals.

He is recognized as one of the leading experts in the field of due diligence and is the author of several publications including Hedge Fund Compliance: Risks, Regulation and Management (Wiley Finance, 2016), Hedge Fund Governance: Evaluating Oversight, Independence, and Conflicts (Academic Press, 2014) Private Equity Operational Due Diligence: Tools to Evaluate Liquidity, Valuation, and Documentation (Wiley Finance, 2012), and Hedge Fund Operational Due Diligence: Understanding the Risks and (Wiley Finance, 2008). Mr. Scharfman has also contributed to the Chartered Alternative Investment Analyst (CAIA) curriculum on due diligence, has served on the organization's Due Diligence, Risk Management and Regulation Committee and is a CAIA charterholder.

Before founding Corgentum, he previously oversaw the operational due diligence function for a $6 billion alternative investment allocation group called Graystone Research at Morgan Stanley. While at Morgan Stanley, Mr. Scharfman was also a senior member of a team which oversaw all of Morgan Stanley's hedge fund operational due diligence efforts allocating in excess of $13 billion to a firm-wide platform of over 300 hedge fund managers across multiple investment strategies. Prior to joining Morgan Stanley, he held positions which primarily focused on due diligence and risk management within the alternative investment sector at Lazard Asset Management, SPARX Investments and Research and Thomson Financial.

Mr. Scharfman received a B.S. in Finance with an additional major in Japanese from Carnegie Mellon University, an MBA in finance from Baruch College's Zicklin School of Business, and a JD from St. John's University School of Law. He is admitted to the practice of law in New York and New Jersey. Additionally, he holds the Certified Fraud Examiner (CFE), and Certified in Risk and Information Systems Control (CRISC) credentials.

Mr. Scharfman's additional experience includes consulting with the U.S. House of Representatives Judiciary Committee on the subject of hedge fund regulation. and providing training to financial regulators on the subject of hedge fund due diligence. He has also served as a consultant and testifying expert on hedge funds and due diligence practices in litigation and arbitration proceedings. Additionally, he has lectured on the subject of hedge fund operations and operational risk as an adjunct professor at New York University. Mr. Scharfman is a member of several industry organizations including the Information Systems Audit and Control Association (ISACA), the American Bar Association, the New York State Bar Association and the New Jersey State Bar Association. He has written extensively on the subject of due diligence and travels and speaks worldwide on due diligence and operational risks.