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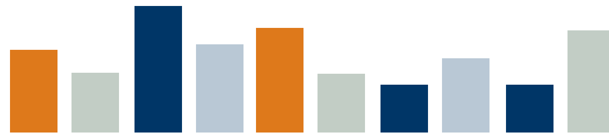

Investment Management Hot Topics

# Private Equity Fund Managers: Developments in Marketing, Compliance and SEC Exams

November 28, 2012


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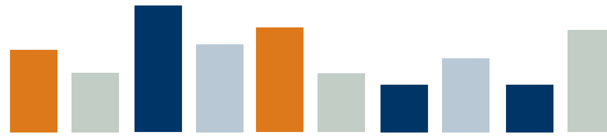



# 1. About the Speakers

**Stephanie R. Breslow**
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Stephanie R. Breslow is co-head of Schulte Roth & Zabel's Investment Management Group and a member of the firm's Executive Committee. Her practice includes investment management, partnerships and securities, with a focus on the formation of liquid-securities funds (hedge funds, hybrid funds) and private equity funds (LBO, mezzanine, distressed, real estate, venture), as well as providing regulatory advice to investment managers and broker-dealers. She also represents fund sponsors and institutional investors in connection with seed capital investments in fund managers and acquisitions of interests in investment management businesses, and represents funds of funds and other institutional investors in connection with their investment activities.

Stephanie is a sought-after speaker on fund formation and operation and compliance issues, and also regularly publishes books and articles on the latest trends in these areas. She co-authored *Private Equity Funds: Formation and Operation* published by the Practising Law Institute (2009–2012), contributed a chapter on "Hedge Funds in Private Equity" for inclusion in *Private Equity 2005–2006* (PLC Cross-border Handbooks) and co-wrote *New York and Delaware Business Entities: Choice, Formation, Operation, Financing and Acquisitions* and *New York Limited Liability Companies: A Guide to Law and Practice*, both published by West Publishing Co.

Recently named Vice-Chair of the Private Investment Funds Subcommittee of the International Bar Association, Stephanie is a founding member and former chair of the Private Investment Fund Forum, a member of the Advisory Board of Third Way Capital Markets Initiative, a former member of the Steering Committee of the Wall Street Fund Forum, and a member of the Board of Directors of 100 Women in Hedge Funds.

Stephanie was named one of *The Hedge Fund Journal*'s 50 Leading Women in Hedge Funds and the *Euromoney Legal Media Group*'s "Best in Investment Funds" at the inaugural Americas Women in Business Law Awards. She is also listed in *Chambers USA*, *Chambers Global*, *The Legal 500 United States*, *Best Lawyers in America*, *America's Leading Lawyers*, *Who's Who Legal: The International Who's Who of Business Lawyers* (which ranked her one of the world's "Top Ten Private Equity Lawyers"), *IFLR Best of the Best USA (Investment Funds)*, *IFLR Guide to the World's Leading Investment Funds Lawyers*, *IFLR Guide to the World's Leading Women in Business Law* (Investment Funds), *IFLR Guide to the World's Leading Private Equity Lawyers, and PLC Cross-border Private Equity Handbook*, among other leading directories. Additionally, Stephanie was recognized by the Girl Scouts of Greater New York as one of 2012's Women of Distinction.

Stephanie earned her J.D. from Columbia University School of Law, where she was a Harlan Fiske Stone Scholar, and her B.A., *cum laude*, from Harvard University.

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Brad L. Caswell focuses his practice on counseling hedge and private equity funds on operational, regulatory and compliance matters. He provides guidance to clients on a broad range of issues, including those related to the U.S. Investment Advisers Act, other federal, state and self-regulatory organization requirements, and securities trading rules in the United States. Brad also provides guidance to clients with operations in Hong Kong, Japan and other markets throughout Asia and the U.K. with respect to regulatory, compliance, trading and operations.

Prior to joining SRZ, Brad served for 12 years in various in-house roles, including as general counsel and chief compliance officer of investment advisers ranging from multi-billion dollar funds to start-ups, and as a member in the asset management group of a leading investment bank. This in-house experience, coupled with his results-oriented approach to legal problem solving, enables Brad to offer clients a valuable perspective on investment management operations and compliance issues.

Brad is also a frequent speaker and writer on the topics of fund operations and regulatory compliance. He recently spoke on the “New Private Placement Rules Under the JOBS Act” for a Financial Executives Alliance forum, and co-authored the columns “The Long View: How Hedge Fund Advertising Has Been Impacted by the JOBS Act” and “The Long View: U.S. Regulation of Private Fund Managers, Beyond Dodd-Frank” for *HFMWeek*.

Brad received his J.D., *cum laude*, from Boston College Law School and his B.A., *magna cum laude*, from Georgetown University.

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Marc E. Elovitz is chair of Schulte Roth & Zabel's Investment Management Regulatory & Compliance Group and advises hedge funds, private equity funds and funds of funds on compliance with the Investment Advisers Act of 1940 and other federal, state and self-regulatory organization requirements, including establishing compliance programs, registering with the SEC and handling SEC examinations. Marc provides guidance to clients on securities trading matters and represents them in regulatory investigations and enforcement actions, arbitrations and civil litigation.

Recently, Marc has been leading macro-level compliance infrastructure reviews with fund managers, identifying the material risks specific to each particular firm and evaluating the compliance programs in place to address those risks. He also regularly leads training sessions for portfolio managers and analysts on complying with insider trading and market manipulation laws.

Marc is a frequent speaker at hedge fund industry conferences and seminars and recently discussed "Increasing Demands for Transparency: Form PF, OPERA, AIFMD" at Deutsche Bank's Global Prime Finance Hedge Fund Conference  and related topics at the Goldman Sachs Annual Hedge Fund Conference. He also addressed "Securities Law Compliance — Insider Trading" at Columbia Business School's Private Equity Program and "The SEC Exam Process and Compliance Concerns" for the Managed Funds Association's SEC Compliance Priorities Seminar. Marc wrote the chapter on "The Legal Basis of Investment Management in the U.S." for the Oxford University Press book *The Law of Investment Management* and co-authored the chapter on "Market Manipulation" in the Matthew Bender treatise *The Securities Exchange Act of 1934*. In addition, he recently co-authored numerous columns for *HFMWeek* and a chapter on "Protecting Your Firm Through Policies and Procedures, Training and Testing" for the *Insider Trading Law and Compliance Answer Book*, published by Practising Law Institute.

Marc is a member of the Steering Committee of the Managed Funds Association's Outside Counsel Forum, the Private Investment Funds Committee of the New York City Bar Association and the American Bar Association's Hedge Funds Subcommittee.

Marc received his J.D. from New York University School of Law and received his B.A., with honors, from Wesleyan University.

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Omoz Osayimwese focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. Omoz has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed capital transactions, and advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees.

Omoz's recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz's recent speaking engagements include "Leverage for Investment Funds" at SRZ's Private Investment Funds Seminar and "Evolving Terms of Private Equity Funds" at the firm's Investment Management Hot Topics seminar, as well as participating in a roundtable discussion at the AIFEA meeting regarding investment advisor registration for private equity firms and addressing "Emerging Managers: Raising a Hedge Fund in a Bear Market" at the Hedgeworld Webinar.

Omoz received his B.A., with highest honors, from Michigan State University and his J.D. from University of Michigan Law School.

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Russel Perkins focuses his practice on the structuring, formation and negotiation of private equity funds and hedge funds. He has represented a wide variety of fund sponsors, asset managers and institutional investors in all stages of private equity funds, real estate funds, secondaries funds, funds of funds and other alternative asset classes, both domestically and internationally. Russel deals regularly with issues relating to the Securities Act, the Investment Company Act, the Investment Advisers Act and ERISA. He also has significant private equity, venture capital and mergers and acquisitions transactional experience.

Recognized as a leading practitioner in his area of expertise by *The Legal 500 United States*, Russel has represented investment funds sponsored by, among others, Arcis Group, Coller Capital, DRA Advisors, GE Asset Management, Harbert Management Corporation, The Praedium Group, Ram Realty Services, VCFA Group and Westport Capital Partners. He also represents institutional investors such as DuPont Pension Trust and General Electric Pension Trust.

Russel received his J.D. from the University of Virginia School of Law and his A.B., *cum laude*, from Harvard University.

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Phyllis A. Schwartz focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds, real estate funds and small business investment companies. Phyllis represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements and the creation of internal investment vehicles, she has extensive experience with institutional investors and regularly advises on the acquisition and disposition of partnership interests and market terms of investment funds. Phyllis also represents private equity funds in connection with their investments in, and disposition of, portfolio companies.

A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed "Fine Tuning the Nuances of Performance Reporting Standards" at FRA's third annual Private Investment Funds Tax Master Class and presented on the "State of the Industry" at FRA's Private Equity C-Level Summit. She is co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute, 2009-2012), which is considered the leading treatise on the subject.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Best Lawyers in America*, *The International Who's Who of Private Funds Lawyers*, the *IFLR Guide to the World's Leading Investment Funds Lawyers*, the *IFLR Guide to the World's Leading Private Equity Lawyers* and the *IFLR Guide to the World's Leading Women in Business Law* (Investment Funds).

Phyllis received her A.B. from Smith College and her J.D. from Columbia University School of Law.

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Joseph A. Smith represents private equity fund sponsors and institutional investors in connection with fund formation, the acquisition of portfolio investments and the implementation of exit strategies. In this capacity, Joe advises clients on securities, governance, ERISA, Investment Advisers Act and structural issues. He has extensive experience with all alternative asset classes, including venture capital and later-stage growth equity investments, leveraged buyouts, mezzanine investments, real estate ventures and opportunity funds, secondary investments, funds-of-funds and hedge funds. Joe has also represented many fund managers in connection with spin-offs and consolidations.

In addition to domestic representations, Joe has advised private equity clients in connection with the acquisition and structuring of portfolio company investments throughout Europe, Latin America and Asia. His representation of asset managers in the real estate sector includes advice concerning REIT offerings and privatizations, partnership roll-ups and cross-border investments. Joe's clients include Arcis Group, DRA Advisors, DuPont Capital Management, FirstMark Capital, GE Asset Management, Harbert Management Corporation, Hemisfério Sul Investimentos, Intel, Kotak Mahindra Group, The Praedium Group, Prosperitas Capital S.A., Ram Realty Services, REAL Infrastructure Partners, Royalton Partners, The Silverfern Group, Top Tier Capital Partners, Value4Capital, VCFA Group and Westport Capital Partners.

Joe has been recognized as a leading practitioner by *Chambers USA*, *The Legal 500 United States* and *The Legal Media Group Guide to the World's Leading Private Equity Lawyers*.

Joe received his A.B. from Columbia University and his J.D. from New York University School of Law.

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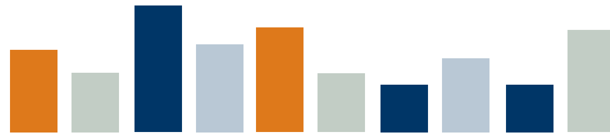

Investment Management Hot Topics

# 2. PowerPoint Presentation

# Marketing

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## Notes:

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# The Offering Memorandum

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# Other Marketing Documents — Pitch Books and DDQs

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# Sharing Information Through Data Rooms

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# Marketing Under the JOBS Act

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# Compliance

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# Conflicts of Interest

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Fees and Expenses

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# Valuation

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# Side Letters

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# Investor Complaints

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# Custody Rule Compliance

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# Record Keeping and Retention

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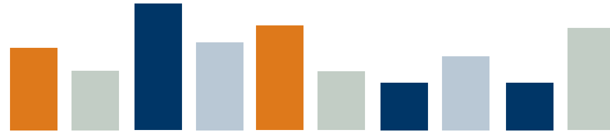

Investment Management Hot Topics

# 3. Marketing Outline

# Marketing

## I. Introduction

A. Marketing is the life-line of a private equity fund. Since reinvesting deal proceeds is permitted only in narrow circumstances under partnership documents, managers must raise new funds to continue their private equity fund businesses. Permanent capital vehicles are successfully raised from time to time, but they represent a very small part of the private equity industry and are not likely to replace funds with defined terms and investment periods. In the broadest stroke, marketing involves descriptions of a new fund's investment program through a summary of the manager's past relevant experiences. These descriptions, wherever contained, may not contain misleading statements to prospective investors

B. Securities laws create liability arising out of a fund's material misstatements in its marketing materials. SEC registration and compliance with the Investment Advisers Act for old and new registrants has created heightened awareness of marketing practices

C. Investor fraud is a pervasive fear in the current investment management world. The post-Madoff era has made investors, auditors and the SEC extremely attentive to the type and accuracy of information shared with prospective investors. Investors are testing the accuracy of information, particularly during their diligence of a manager

D. Investors have also expanded the amount of information required to be provided to them while they hold an investment. Delivery of ongoing information provides a bridge from marketing one fund to the next. In particular, ongoing information reports give investors an idea of what to investigate when deciding to commit to a successor fund. Not surprisingly, the SEC may look at current reports as marketing materials. In short, private equity fund managers are always marketing, whether officially or not

## II. The Offering Memorandum

A. The offering memorandum (the "PPM") should contain the information material to an investor's decision to commit to a fund

B. The PPM includes disclosure of track record, which is essential in achieving marketing success. Investors are expected to pick and to stay with managers who have demonstrated successful investment results. Understandably, this creates pressure between a desire to put forward track record in the best light possible and providing non-misleading information

1. Track records are presented in different ways, but IRRs and cash-on-cash returns are most typical

2. Presentation of gross returns vs. net returns is being revisited as an issue due to registration of managers. Investors care about data reflecting the returns they would have received had they been an investor in a prior fund, after management fees and carried interest, as opposed to what the fund recognizes

(a) SEC guidance requires net returns to be provided in most circumstances. Occasionally, it is just not possible to present net data. For instance, if performance from a pre-fund period is being included, there were likely no fees or carried interest charged in respect of the investments. Some managers will nevertheless use hypothetical management fees and carried interest

(b) Many PPMs include gross and net returns. Ideally, net returns should be as visible as gross returns. Footnoting net information is not as desirable as including the information in the body of the PPM

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(c) In the case of a multiple fund history, net returns are generally calculated and presented based on each individual fund's actual fee/carry structure. A manager may wish to present net returns based on the compensation methodology of the fund being marketed. This approach should be carefully footnoted to avoid investor confusion

3. Where funds have different compensation structures for investors (i.e., larger investors may be charged lower management fees), the track record should be presented using the highest fee structure

4. Cumulative vs. fund-by-fund performance may be useful for investors who have remained with a single manager over many funds

    (a) Cumulative and fund-by-fund performance track records are permitted; however, many investors are not likely to have participated in all funds, and therefore, the manager should include performance breakdowns for each fund

    (b) The manager should consider whether cumulative track record is reasonable and balanced. For instance, if a prior fund does not follow the same strategy, its record should not be blended with another fund's results

5. Track record information in PPMs for private equity funds includes both realized and unrealized returns as of a recent date

    (a) In order to present unrealized returns, the manager uses its valuations for unrealized investments. The SEC may question valuations in audit procedures given how important the track record is to investors. A disclaimer that actual performance results of unrealized investments will not necessarily match valuations of investments is not likely to protect managers

6. The manager should update track record information in supplements to its PPM. Investors care about knowing that the information is both accurate and current

7. Projected returns of unrealized investments are to be avoided

    (a) If a placement agent is being used, any type of projection, hypothetical, model return is prohibited

    (b) Unlike valuations, a manager should not predict the price at which a fund will actually dispose of an investment. Similarly, a manager needs to be careful about projecting a portfolio company's future results, such as predicting EBITDA growth, increases to customer base and reductions to operating costs. It would be customary to address steps being taken to achieve such desired goals

8. Target returns should be used only in conjunction with a "sound basis" for such target. FINRA has adopted this approach where a placement agent is marketing the fund and requires marketing materials to state the "sound basis" upon which such targets have been calculated in marketing materials. FINRA has not yet defined, however, what a "sound basis" is

    (a) Real estate and mezzanine funds tend to use target returns more than other types of private equity funds

9. Selective disclosure

    (a) If selective deal summaries are included, the PPM should cross-refer to the performance chart covering all prior investments, and the selection should be based on objective criteria. A performance chart showing all investments should be included in the materials

    (b) Performance covering limited time periods should be based on objective criteria

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(i) Pre-fund investments can be disclosed if the persons primarily responsible for managing the fund being marketed also were responsible for the pre-fund investments. Performance from prior place of employment is difficult to include in an offering document

(c) Carryforward of track record from prior employers

(i) The individual needs to have been primarily responsible for the investments at the prior employer

(ii) The PPM must include all funds/accounts managed previously. The PPM cannot omit — i.e., cherry pick — prior bad performance

(iii) Track records should only be included for prior funds and investment experience at prior employers that cover substantially similar investment strategies of the fund being marketed. Verification of track records from prior employers presents issues. Investors will want to check with a prior employer about the information, and the employer is unlikely to be helpful. It may therefore be possible to include only broad, publicly available information, such as the individual serving on the board of a public company

(iv) Disclosure of an experience with a prior employer is likely to be covered by non-disclosure agreements. In that case, the prior employer could be deemed to own the track record, making it impossible to carry forward without consent

## III. Other Marketing Documents — Pitch Books and DDQs

A. Pitch books are abbreviated versions of the PPM. They are typically drafted in the form of PowerPoints or slides and therefore not always thought of as “legal” documents. Pitch books should be reviewed by the chief compliance officer and counsel

1. Pitch books need to be consistent with the PPM. If information is presented in a pitch book and not in the PPM, the manager should evaluate whether the information is of such a material nature that it should be added to the PPM

2. Although a firm may use several different pitch books when marketing a fund, the pitch books should also be consistent with each other. In order to protect a firm during its marketing process, to the maximum extent possible a person should be designated as the point person for all marketing materials, including pitch books, and to discuss issues with counsel

3. If a placement agent is being used, the pitch book needs to include risk factors

B. Due diligence questionnaires include performance and non-performance details, including background on litigation and regulatory proceedings and investigations

1. Investors can receive information in response to unsolicited inquiries that are not provided to all investors. Therefore, there may be more flexibility in providing information in the DDQ and not the PPM

2. Many institutions have their own form of DDQs, but managers may prepare their own DDQs in advance of requests for such informational documents. If the manager prepares its own DDQ, it may not be deemed to have provided information on an unsolicited basis

## IV. Sharing Information Through Data Rooms

A. Like many DDQs, the data room is assembled in advance of due diligence requests for information. Managers are anticipating documents that investors will request in connection with conducting diligence on the fund

B. The best practice for managers is to advise all investors about their data room to avoid the appearance of selective disclosure

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C. The data room should be kept current. The person in charge of marketing should be overseeing the removal of outdated materials

## V. Marketing Under the JOBS Act

A. The JOBS Act eliminates the ban on general solicitation and general advertising under Regulation D. This Act represents a new paradigm in private equity fund advertising

B. Under the JOBS Act, public solicitation of investors in private funds will be permitted provided that the fund sells only to accredited investors

C. The rules to be adopted under this Act are still not finalized, but managers will be required to take reasonable steps to verify whether investors are accredited. Firms are expected to define what these steps are

D. Will private equity funds want to take advantage of the JOBS Act?

1. On the positive side, public solicitation will allow discussions with the press and cold calls, thereby avoiding exceptions to legal opinions or "cooling off" periods. The JOBS Act could offer "branding" opportunities for managers by allowing more public dissemination about their funds

2. On the other side, there is no expectation that private equity funds will share performance data or other detailed information publicly. Also, advertising rules are not changing, and managers will have to comply with all of the rules above whether or not information is publicly provided. The SEC may scrutinize managers more closely if they publicly solicit investors

E. The JOBS Act may present integration issues. For example, the use of public solicitation in U.S. markets may taint private placement exemptions under non-U.S. jurisdictions. Further, the sale of interests by funds to a permitted number of non-accredited investors may not be permitted if such sale is integrated with the sale of interests in funds to only accredited investors during which public solicitation was utilized

## VI. Use of Placement Agents

A. The payment of compensation to placement agents is subject to disclosure. Most investors require information about the terms of the agreement

B. Placement agent agreements should include carve outs for the payment of fees that would otherwise violate laws

C. Placement agent representations should be expanded to cover possible payments to persons outside the placement agent firm, including employees of investors

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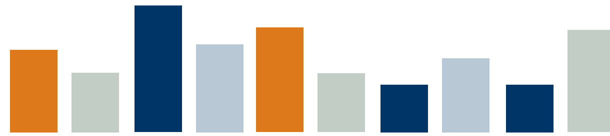

**Investment Management Hot Topics**

# 4. Compliance Outline

# Compliance

## I. Conflicts of Interest

The SEC is very focused on conflicts of interest. In the private equity world, the intended resolution of conflicts is often contractually negotiated by investors. Key areas of conflict include:

A. Successor funds

1. Limited partnership agreements for private equity funds often contain provisions that restrict the sponsors of such funds from raising successor funds (i.e., funds following the same or a substantially similar investment strategy) until a certain minimum percentage of committed capital has been drawn down or reserved for investment by the fund. Typically this percentage is at least 70 percent. The goal of these types of provisions is to ensure that the fund sponsor is focused on investing the particular fund and not on marketing or fundraising for another fund

2. This provision also serves to mitigate (but not eliminate) the conflicts that arise when a manager has two or more funds that have essentially the same investment strategy. The primary conflicts that arise include:

   (a) How investments should be allocated among funds following similar strategies (i.e., is the allocation done pro rata based on available capital, does one fund have priority over another with respect to all investments or a particular sub-category of investments, is there some other pre-set allocation methodology between private equity funds, hedge funds or separately managed accounts managed by the same manager, or is some other allocation mechanism utilized)

   (b) Are investments and exits from such investments made at the same time, and

   (c) Are each fund's investments to be made on the same economic terms

3. Investors often negotiate provisions in funds' limited partnership agreements that require investments (and dispositions thereof) made by affiliated funds to be made at the same time on the same terms. Investors will also sometimes negotiate with sponsors to specify in the fund documentation exactly how investments will be allocated between a particular fund and a successor fund (e.g., the fund may have priority over the successor fund with respect to all investments or particular sub-categories of investments or the fund sponsor may be required to disclose the investment pipeline to the LP advisory board and/or obtain approval from the LP advisory board for any deviation from the terms agreed to with investors

4. It is critical from a compliance perspective for managers to document their allocation policies and compliance with those policies. Non-standard allocations should be documented with the reasons for those non-standard allocations. In particular, managers should be sensitive to allocations between funds or accounts with proprietary capital money and those without as well as to allocations among funds with different fee structures

B. Co-investments

1. Fund sponsors typically arrange for third parties to co-invest alongside the fund when they have an investment opportunity that is too large for the fund (i.e., having the fund make the investment in its entirety would result in the fund breaching size, industry or geographical diversification limits or other investment parameters). Co-investors can be fund LPs, industry players or other third parties. One of the principal concerns investors have with co-investments is that fund sponsors will grant co-investment rights to third parties that effectively permit those investors to "cherry pick" the more attractive investments. Another concern is that sponsors will steer co-investment opportunities that may otherwise have gone to the fund to favored LPs (or prospective investors). Sponsors may also be incentivized to arrange co-

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investments if they can receive higher carry or other fees from such co-investment than they would from the fund

2. Conflicts arising from co-investments are usually addressed by having provisions in fund documentation that specify the circumstances under which co-investments are permitted (e.g., investment is too large for the fund or the particular co-investment opportunity has been sourced in whole or in part by the co-investor). In addition, investors will also expect to receive the benefit of standard fund terms requiring investments (and dispositions thereof) to be at the same time and on the same terms

C. Capital structure

1. Some fund sponsors manage funds which can invest in different parts of the capital structure of a particular portfolio company. For example, a buyout fund manager may also manage a mezzanine debt fund or a distressed debt manager may manage a fund that invests in debt securities of a particular portfolio company that are senior in the capital structure to other securities issued by the same portfolio company and held by another fund managed by the same manager. In the event of a default by a company on its financial covenants, the various funds holding different investments in the capital structure of such company could have diametrically opposed interests (e.g., a reorganization or refinancing plan that is good for shareholders or junior debt holders may not be good for senior debt holders). Other potential conflicts include a fund making an equity investment in a portfolio company in which an affiliated fund owns debt securities thereby raising the prospect that the fund making the equity investment is “bailing out” the other fund. Investors typically try to address these conflicts by requesting that fund documentation contain restrictions on a fund investing in any portfolio company in which an affiliated fund already has an investment

D. Running hedge funds

1. Many managers manage both hedge funds and private equity funds. In the distressed investment space it is fairly common for managers to manage both a hedge fund that focuses on more liquid names and a private equity style fund that focuses on less liquid names. Because hedge funds need to provide their investors with regular withdrawal/redemption rights, the typical investor request to have investment exits occur at the same time for both the hedge fund and the private equity fund may be impractical though investors will still often request that fund documentation require investments to be made on the same terms

E. Proprietary capital

1. Fund sponsors sometimes make investments in portfolio companies in which their funds have invested or make investments alongside funds that they manage. Investors’ concerns with these proprietary investments primarily relate to the manager

   (a) “Cherry picking” the more attractive investment opportunities

   (b) Using investors’ capital to get access to investment opportunities that they would otherwise have had insufficient capital to participate in. Investors will often insist on a requirement that a manager, its principals and their respective affiliates make all their investments in a particular strategy through investments in the applicable fund (or a permitted parallel fund) as well as on restrictions on the fund investing in any portfolio company in which the manager, its principals and their respective affiliates has made a prior investment

F. Fund professionals taking roles at portfolio companies

1. This is another area that has been specifically highlighted by the SEC. The SEC has noted that there is nothing “inherently wrong” with this activity and acknowledged that it is “part of the private equity business model”

2. However, the SEC will look at this in many respects, including compensation paid for serving on boards of portfolio companies (which should be less of an issue as directors’ fees are typically

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included in the transaction fees that are offset against management fees), potential receipt of material non-public information and "tipping" to investors, and any potential conflicts between the individual's duty to the investment manager (and the manager's fiduciary duty to its clients), and the individual's responsibility as a director or officer of the portfolio company

## II. Fees and Expenses

The SEC is focused on the allocation and reasonableness of expenses. Potential areas of concern include:

A. Travel

1. Fund limited partnership agreements almost always contain an expense provision that requires the fund to pay for or reimburse investment-related expenses which often specifically include travel expenses. Sometimes the provision includes a qualifier that such travel related expenses need to be "reasonable," and the SEC will likely impose this requirement even absent a contractual provision

2. Funds typically pay for travel expenses relating to making or exiting investments. In addition, some funds also pay for travel expenses related to monitoring investments (though whether this is permitted depends on the specific language included in the expense provision). Investors will often take the position that a fund's management fee should cover any expenses (including travel expenses) relating to monitoring investments, and therefore, to have the fund separately pay for such expenses means that the investors are getting charged twice

B. Transaction fee offsets

1. Transaction fees offsets require managers to offset transaction fees such as broken deal fees, origination fees, investment banking fees, financing fees, brokerage fees, directors fees and other similar fees against the fund's management fee

2. In today's market investors often expect that 100 percent of such transactions fee will be applied to reduce future installments of a fund's management fee though some funds have 80 percent offsets. The rationale for the fee offset is that investors want to receive the economic benefit of any such fees as a manager would not have had the opportunity to receive such fees without the benefit of the fund's capital

3. In addition, because of the tax sensitivities of tax-exempt and non-U.S. investors, a transaction fee offset is usually preferable to just having such fees paid directly to the fund. When agreeing to transaction fee offsets, managers need to make sure that where a manager receives a transaction fee on account of an investment or prospective investment made or to be made by multiple accounts/funds, the transaction fee offset applicable to a particular fund is limited to that fund's allocable share of such transaction fee (i.e., the fee offset needs to be pro rated based on the size of the investment or commitment to invest attributable to the particular fund)

C. Allocation of expenses across vehicles

1. Investment-related expenses should be allocated across all accounts/funds (and co-investors) participating in a particular investment pro rata based on the capital invested or committed to be invested in each such account/fund

2. In circumstances where the regulatory, legal or tax requirements of a particular account/fund result in additional costs being incurred, a well crafted expense allocation provision should provide the manager with discretion to allocate such additional expenses to the particular account/fund that was the cause of such additional expenses

3. The SEC is looking very closely at allocation of expenses between the manager and the funds, different funds, separately managed accounts and co-investors, and funds with principal investments

D. Monitoring expenses

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1. Investors typically expect that fund management fees received by the manager should cover the manager's expenses relating to monitoring or managing investments (as opposed to having the manager receive a separate fee or reimbursement for monitoring investments)

2. However, in circumstances where a manager would pay a third party to monitor or manage investments (e.g., a real estate fund paying a property management fee or servicing fee to a third party) it may often be more efficient (and less expensive) for the fund to instead pay the manager to provide the same service

3. Typically this is accomplished by disclosing to investors in the fund's limited partnership agreement and PPM the types of services to be provided to the fund by the manager and its affiliates (and the fees to be charged for such services)

4. If the manager has not yet determined the level of fees to be charged for such services, the fund's limited partnership agreement will typically limit such fees to rates no more favorable than those charged by unaffiliated third parties in arms' length transactions. In addition, managers are often required to disclose all such fees to the LP advisory board

E. Form PF expenses

1. Whether Form PF expenses are permitted to be borne by the fund or should instead be borne by the manager depends on the exact language in the expense provisions of a fund's limited partnership agreement

2. Some expense provisions are drafted broadly to encompass all regulatory filings "relating to" the fund and therefore certain Form PF expenses. Because private equity fund expense provisions are often the subject of negotiations with investors, fund managers may find it difficult to get investors to agree to such broader language or to language that expressly includes Form PF expenses as a fund expense

F. Registration expenses

1. Expenses relating to a manager's registration as an investment adviser under the U.S. Investment Advisers Act of 1940 are generally considered to be an expense of the manager and not of the fund. Some investors will ask for side letter provisions expressly providing that registration expenses of the manager in the U.S (and in any non-U.S. jurisdiction) are not fund expenses

G. Compensation at portfolio companies

1. Investors are sometimes concerned that employees of the manager may be employed by portfolio companies and receive above market rate compensation from such portfolio companies (essentially reducing the profits from such portfolio company that should otherwise accrue to the fund's benefit)

2. This particular concern is often not addressed in fund documentation (though questions relating to the amount and source of the principals' and employees' compensation may be included in an investors' due diligence checklist — and could trigger certain Form ADV disclosures in Part 2A or Part 2B of Form ADV)

3. The concern is also really only applicable to buyout funds and other funds that hold controlling interests in their portfolio companies and can be addressed by requiring LP advisory board approval for any transaction between a fund and its portfolio companies, on the one hand, and the manager and its affiliates and employees, on the other hand

## III. Valuation

A. When and why does it matter

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1. Because most private equity funds charge management fees based on committed capital during the investment period, and on invested capital after the investment period, investment valuations matter much less to private equity fund investors than they do to hedge fund investors (as hedge funds typically charge management fees based on the fund's net asset value)

2. In private equity funds that have deal-by-deal carried interest arrangements there is often a requirement that, prior to a GP receiving carry, in addition to investors recouping the cost of realized investments and a preferred return, the fund should also return to investors a dollar amount equivalent to net unrealized losses (or net writedowns) of the fund's investments

3. Thus, a GP that overvalues a fund's investments could receive carry sooner than such manager is actually entitled to receive such carry

4. Funds sometimes also have interim clawbacks or carry escrow arrangements where the clawback obligation or requirement to add or release amounts from escrow is based in part on the performance (i.e., valuation) of unrealized investments. In such cases, an overvaluation of a fund's investments could result in a smaller than required clawback obligation or in a premature release of carry to the GP

B. Distributions in-kind

1. Private equity funds often permit in-kind distributions, either of marketable securities or nonmarketable assets. In-kind distributions are made using the same distribution waterfall that applies to cash distributions (but assuming for purposes of applying such waterfall that the assets being distributed are valued at their fair value)

2. Marketable securities are less of an issue than non-marketable assets since these investments are often marked to market. Investors will however often require that the valuation used for distributions of marketable securities be the average trading price over some time period that includes a number of days before, and a number of days after, the actual deemed date of distribution

3. The reason for using the average trading price over a specified time period is to:

(a) Reduce the impact (both positive and negative) of some of the volatility inherent in the trading price of a publicly traded security

(b) Minimize the manager's incentive (particularly in the case of a portfolio company that the manager controls or that the manager receives restricted information from) to time the date of distribution of the marketable securities such that information which could adversely affect the price of the particular security is not reflected in the security's trading price

(c) Enable investors, who are generally more concerned with the valuation of non-marketable assets than the valuation of marketable securities and will often negotiate with managers, to have:

(i) Such assets appraised by a third party valuation agent, or

(ii) The LP advisory board approve any such valuation (typically with some type of resolution mechanism in the event that the manager and LP advisory board disagree of the appropriate valuation)

**IV. Side Letters**

A. SEC concerns

1. The SEC has generally had a concern that side letters, by allowing individual investors to cut specific (and more favorable) deals with a manager, could cause the manager may breach its fiduciary duties to other investors

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2. With respect to hedge funds, the SEC has been particularly concerned that provisions relating to transparency, notice of regulatory events and withdrawal rights can benefit some investors at the expense of others. These concerns are generally not as relevant to private equity funds where investors typically have very limited withdrawal rights (almost always relating to the regulatory status of the applicable investors, e.g., ERISA or BHCA related withdrawal rights).

3. However, there may be disclosure issues under the U.S. Securities Act of 1933 that arise from failing to disclose to investors that a sub-set of a fund's investors have entered into side letters with the manager that provide them with certain rights (e.g., not disclosing that a side letter provides for a seed investor to receive a share of carried interest/management fees or grants the applicable investor certain governance rights with respect to the manager or the fund)

B. Transparency

1. The typical side letter provision on transparency will provide an investor with a breakdown of a fund's portfolio on a monthly or quarterly basis. The actual report may include a categorization of the type of investment, description/activities/plans relating to the particular investment, the amount of invested capital and the fair value of the fund's investment

2. Unlike transparency provisions in hedge fund side letters, transparency provisions in private equity fund side letters do not generally raise concerns that an investor may utilize its access to information to make a withdrawal request

3. A transparency provision could however still facilitate front running or insider trading by an investor though these are less serious issues for private equity funds with illiquid portfolios since investors likely have a significantly reduced ability to engage in front running and insider trading based on the information typically provided about such illiquid investments. However, private equity fund managers, who themselves may have material non-public information on portfolio companies (in particular public portfolio companies), have to be very careful about not "tipping" potential MNPI to investors

C. Jurisdiction/governing law

1. Side letters often include a governing law provision that matches the governing law used in the fund's limited partnership agreement (e.g., Cayman Islands law for a Cayman Islands fund and Delaware law for a Delaware fund)

2. Certain state plans, either as a matter or policy or as a matter of law, require that their side letters to be governed by the law of their home state. Similarly, some of these state plans also require any legal claims or suits against the investor to be filed by the GP or the fund in the investor's home state

3. In situations where there is a legal dispute between a GP/manager on the one hand and multiple fund investors, on the other hand, a choice of jurisdiction provision could result in such dispute being litigated in multiple jurisdictions

D. Pay to play

1. Many state and other governmental plans:

   (a) Require managers to disclose any use of placement agents

   (b) Prohibit campaign contributions to employees and other related persons of the investor, and

   (c) Require managers to certify that the manager has not utilized the services of any non-disclosed person or non-registered placement agent to solicit investments from the particular investor. A few state plan investors also completely prohibit the use of placement agents in soliciting investments from such investors.

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2. Pay to play side letter provisions often provide that, in the event of a breach by a manager of its pay to play representations, the investor will

    (a) Receive a rebate of fees and carry paid to the manager and/or any impermissible placement fees

    (b) Be excused from making subsequent capital contributions; and/or be permitted to withdraw from the fund. The withdrawal right is particularly problematic as the illiquid nature of private equity fund portfolios makes it impractical to liquidate investments to pay out the capital account of a withdrawing investor. One option is to provide that (similar to ERISA and other regulatory withdrawal rights that will typically be included in the fund's limited partnership agreement) a withdrawing investor could be paid out in some combination of cash, promissory notes and/or in-kind assets (and that payments under any such promissory note will be made only when the fund is otherwise making a distribution)

3. Fund sponsors also need to be aware of:

    (a) The federal pay to play rule

    (b) State pay to play rules, and

    (c) State and local lobbyist registration requirements

E. LP confidentiality

1. Investors frequently ask for side letter provisions providing that the manager will not disclose the investor's name (except to other investors in the fund) and that the fund will otherwise keep confidential the information it receives from the investors

2. Common carve outs from this provision include "as required by law or legal or regulatory process" carve outs, carve outs for disclosure to lenders and counterparties and carve outs for FATCA compliance. These provisions are unlikely to be of concern to the SEC

**V. Investor Complaints**

A. Registered investment advisors are required to keep a record of investor complaints

B. Managers therefore need to keep track of investor inquiries and determine which inquiries rise to the level of investor complaints. This will often involve a judgment call as to materiality

**VI. Custody Rule Compliance**

A. Many funds are relying on the "Pooled Investment Vehicle Exception" from the Surprise Examination Requirement under the Custody Rule. To rely on this exception, the fund must satisfy the following requirements:

1. The pooled vehicle is audited annually by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board (PCAOB)

2. Financial statements are delivered to investors in the pooled investment vehicle within 120 days (180 days for funds of funds) of its fiscal year-end

3. In the event of a liquidation, advisers to pooled investment vehicles obtain a final liquidation audit of the pool's financial statements in accordance with generally accepted accounting principles and distribute it to investors promptly after completion of the audit

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B. The SEC has been focusing on custody rule compliance in examinations, including whether managers have delivered annual audited financial statements to their clients with the 120-day deadline

C. SEC-registered advisers must have a qualified custodian maintain client funds and securities in a separate account for each client under the client's name or in accounts that contain only client funds and securities under the adviser's name as agent or trustee for the client

D. There is a very limited exception for "privately offered securities" that does not require such securities to be maintained by a qualified custodian if such securities are

   1. Acquired from the issuer in a transaction or chain of transactions not involving any public offering

   2. Are uncertificated, and ownership thereof is recorded only on the books of the issuer or its transfer agent in the name of the client

   3. Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer

E. For practical purposes, this exception is often not available. Managers have to make sure to not hold "securities" and, if they inadvertently come to the managers, to get them out to a qualified custodian immediately

**VII. Record Keeping and Retention**

A. Rule 204-2 under the Investment Advisers Act requires registered investment advisers to make and keep specified books and records. The general rule is that books and records must be maintained by registered investment advisers in an easily accessible place for at least five years from the end of the fiscal year during which the record was created (thus effectively six years), the first two years in an appropriate office of the registered investment adviser

B. Private equity fund managers need to think carefully about their record keeping policies and other important issues such as email archiving and use of social media. Private equity fund managers need to be prepared to demonstrate to the SEC in examination that they are complying with their compliance manual and code of ethics. It is not sufficient to do it — managers have to be able to show that they are implementing their compliance manuals. Keeping records and developing a practical plan for doing so is very important for private equity fund managers

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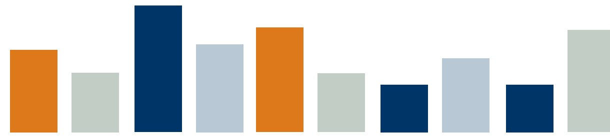
Schulte Roth & Zabel 

**Investment Management Hot Topics**

# 5. Additional Materials

Schulte Roth&Zabel

# Alert

## SEC Announces “Presence Exams” for Newly-Registered Investment Advisers

### October 9, 2012

The staff of the U.S. Securities and Exchange Commission (the “SEC”) has announced its new National Exam Program (“NEP”) initiative to conduct “Presence Exams” of newly-registered investment advisers. In a letter sent today from various regional offices of the SEC to newly-registered advisers, the staff described the new exams as “focused” and “risk-based” and highlighted the following five “higher-risk” areas that may be covered during an exam:

- Marketing
- Portfolio Management
- Conflicts of Interest
- Safety of Client Assets
- Valuation

The letter makes it clear that the NEP staff will contact advisers separately if and when their firm is selected for an examination. The letter also explains that the Presence Exams are part of a two-year initiative that will include (1) an Engagement Phase — involving outreach to newly registered advisers, (2) an Examination Phase — during which the exams will occur and (3) a Reporting Phase — during which the NEP will report to the SEC and the public its observations from the examinations (including common practices identified in the higher-risk areas, industry trends and significant issues).

The higher-risk areas identified in the letter are consistent with many of the issues we are seeing in recent SEC examinations. Fund managers should be prepared to address these issues in detail with the SEC staff, for example, by explaining their procedures, disclosures and testing with respect to allocation of investment opportunities and allocation of expenses among funds and other accounts. Supporting materials for all factual statements made in marketing materials (including pitch books, DDQs and other communications) should be identified and their accuracy confirmed. Advisers should be prepared to explain their valuation methodologies, particularly for fair valuing illiquid or difficult-to-value instruments. In preparation for examination, fund managers should review the accuracy of their management- and performance-fee calculations, as well as the means by which they satisfy the custody rule taking into consideration all categories of instruments and other investments.

Identifying and addressing the types of issues raised in today’s letter should be a priority for all registered advisers.

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*Attorneys in Schulte Roth & Zabel’s Regulatory & Compliance Group regularly advise private fund managers with respect to preparing for and undergoing an SEC examination.*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

# THE LONG VIEW

MARC E. ELOVITZ (PICTURED) AND BRAD L. CASWELL
describe how hedge fund advertising has been impacted by the JOBS Act

"NEWS MEDIA OUTREACH AND PR CAMPAIGNS ARE STAPLES OF CORPORATE MARKETING. WILL THE JOBS ACT OPEN THE DOOR FOR HEDGE FUNDS IN THESE AREAS?"

Marketing hedge funds to US investors has long been shaped by the ban on "general solicitation" and "general advertising" contained in the private placement regulation commonly relied on by private funds. The Jumpstart Our Business Startups Act, or JOBS Act, enacted 5 April 2012, requires the SEC to modify its regulations to lift the ban.

As the SEC goes ahead with its new regulations, the focus is on the "reasonable steps" hedge fund managers must take to ensure only accredited investors come into their funds. But once these mechanics are worked out, what will the impact be?

One change is that private fund managers will now be able to correct misinformation. The ban on general solicitation has never been clearly defined, so many fund managers have been hesitant to correct inaccurate news stories about their funds.

Another impact will be on industry meetings and conferences. The current ban makes it difficult for managers to speak freely and answer questions even in private settings. The opportunity for a more open dialogue will be welcomed by many.

The bigger question is what will the impact be on hedge funds' affirmative marketing efforts? Publicly available websites and social media are primary means by which businesses brand themselves. News media outreach and PR campaigns are staples of corporate marketing. Will the JOBS Act open the door for hedge funds in these areas? The answer will be dictated in part by the market, in particular how institutional investors will view hedge fund marketing. But there is a regulatory component as well. Despite all the attention being paid to private placement regulation, there is a whole other set of rules governing hedge fund marketing.

The SEC imposes restrictions on the content and format of marketing materials used by investment advisers. All hedge fund managers – whether registered with the SEC, filing as an "exempt reporting adviser" with the SEC or just marketing to US investors – are subject to a hedge fund anti-fraud rule. Under this rule, a manager may be liable for any misleading statements to prospective investors, even where the manager was simply negligent.

SEC registered hedge fund managers are subject to additional layers of scrutiny with their marketing materials. Under the SEC's "Advertising Rule", managers are prohibited from "cherry picking" profitable investments for inclusion in their pitchbooks, websites and other marketing materials.

Track record is a key component of hedge fund marketing. Both the Advertising Rule and SEC guidance impose stringent requirements on any performance reporting. A portfolio manager who moves from one firm to another may only use his or her track record if the portfolio manager had "primary responsibility" for the investments at issue, the prior firm's strategy was similar to the new firm and if the new firm has the underlying data to support the performance being presented.

Marketing materials distributed by US registered broker dealers are subject to substantive advertising rules imposed by FINRA, which are, in many respects, more restrictive than those imposed by the SEC. The US Commodity Futures Trading Commission (CFTC) also has rules governing marketing materials.

Broader use of performance reporting may focus attention on various standards, such as the Global Investment Performance Standards (GIPS) promulgated by the CFA Institute, which have not yet been adopted by a majority of the industry. Increased standardisation of hedge fund reporting could also impact more reporting initiatives such as the OPERA (Open Protocol Enabling Risk Aggregation) standard launched last year.

Lifting the ban on general solicitation will create marketing opportunities for hedge fund managers. It will also focus attention on the SEC's Advertising Rule and other restrictions on the content of marketing materials. ■

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# THE LONG VIEW

MARC ELOVITZ
explains US regulation of private fund managers, beyond Dodd-Frank

"ONE OF THE MOST CUMBERSOME ASPECTS OF CPO REGISTRATION IS THAT CERTAIN HEDGE FUND MANAGER PRINCIPALS MUST OBTAIN A SERIES 3 LICENCE AND PROVIDE FINGERPRINTS"

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 has dominated the discussion of US regulatory requirements. During Q1 2012, thousands of private fund managers that were previously exempt had to register with the SEC or file as Exempt Reporting Advisers. But there are significant developments beyond Dodd-Frank. One major change involves new registration and oversight by the US Commodity Futures Trading Commission (CFTC).

Since 2003, many hedge fund managers have relied on an exemption from registration as a commodity pool operator (CPO) available where only "qualified eligible persons" invested in the fund, a category that includes "qualified purchaser" investors in funds offered pursuant to Section 3(c)(7) of the Investment Company Act. This exemption, under Rule 4.13(a)(4), was rescinded by the CFTC in final rules adopted in February. With the exemption gone, fund managers that trade any "commodity interests" will need to find another exemption, or register with the CFTC.

Many managers are looking to the "de minimus" exemption under Rule 4.13(a)(3). This exemption, available where only "accredited investors" invest in the fund, restricts trading in commodity interests to 5% of the fund's liquidation value, measured by including the fund's initial margin and premiums to establish the commodity interest position. Alternatively, the exemption may be met if the net notional value of the fund's commodity interests does not exceed 100% of the fund's liquidation value. To evaluate these thresholds, managers need to know which investments constitute "commodity interests" and are included, and which are excluded. The CFTC has yet to settle on "swap product definition" rules, but in the meantime managers who trade commodity interests are well served by inventorying their portfolios to sort out the instruments they trade.

Managers outside the US may be exempt from CFTC registration in certain circumstances, including with respect to funds organised and operated outside the US with no US investors. Guidance on the CFTC view of its extraterritorial jurisdiction is expected in the next few months.

If no exemption is available, registration is required. One of the most cumbersome aspects of CPO registration is that certain of the hedge fund manager's principals and marketing personnel must obtain a Series 3 licence and provide fingerprints. CPOs of funds whose investors are all qualified eligible persons may avail themselves of "registration lite" under Rule 4.7, which minimises some of these burdens.

In addition to the reporting requirements imposed on CPOs, the CFTC added a new set of disclosures similar to the Form PF systemic risk reports mandated by the SEC. Form CPO-PQR will, like Form PF, provide the regulators with data related to systemic risk. The good news: dual SEC/CFTC registered firms will generally only have to complete Form PF.

Private fund managers also have to consider whether they need to register with the CFTC as a commodity trading adviser (CTA). There is still a "fewer than 15 client" exemption from CTA registration, which many managers may be able to rely on, as well as another exemption if the manager is SEC-registered and not "primarily engaged" in trading commodity interests. The "registration lite" relief under Rule 4.7 also may be available.

The implication of these changes is that many private fund managers now not only need to register with the US SEC – they may also need to register with the CFTC.

What's next? A potential sea-change in hedge fund marketing rules – the JOBS Act, signed into law on 5 April, eliminates the ban on general solicitation and advertising under Reg. D of the Securities Act, provided that all investors are accredited investors. Eagerly anticipated SEC rules implementing the changes are due by 4 July.

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