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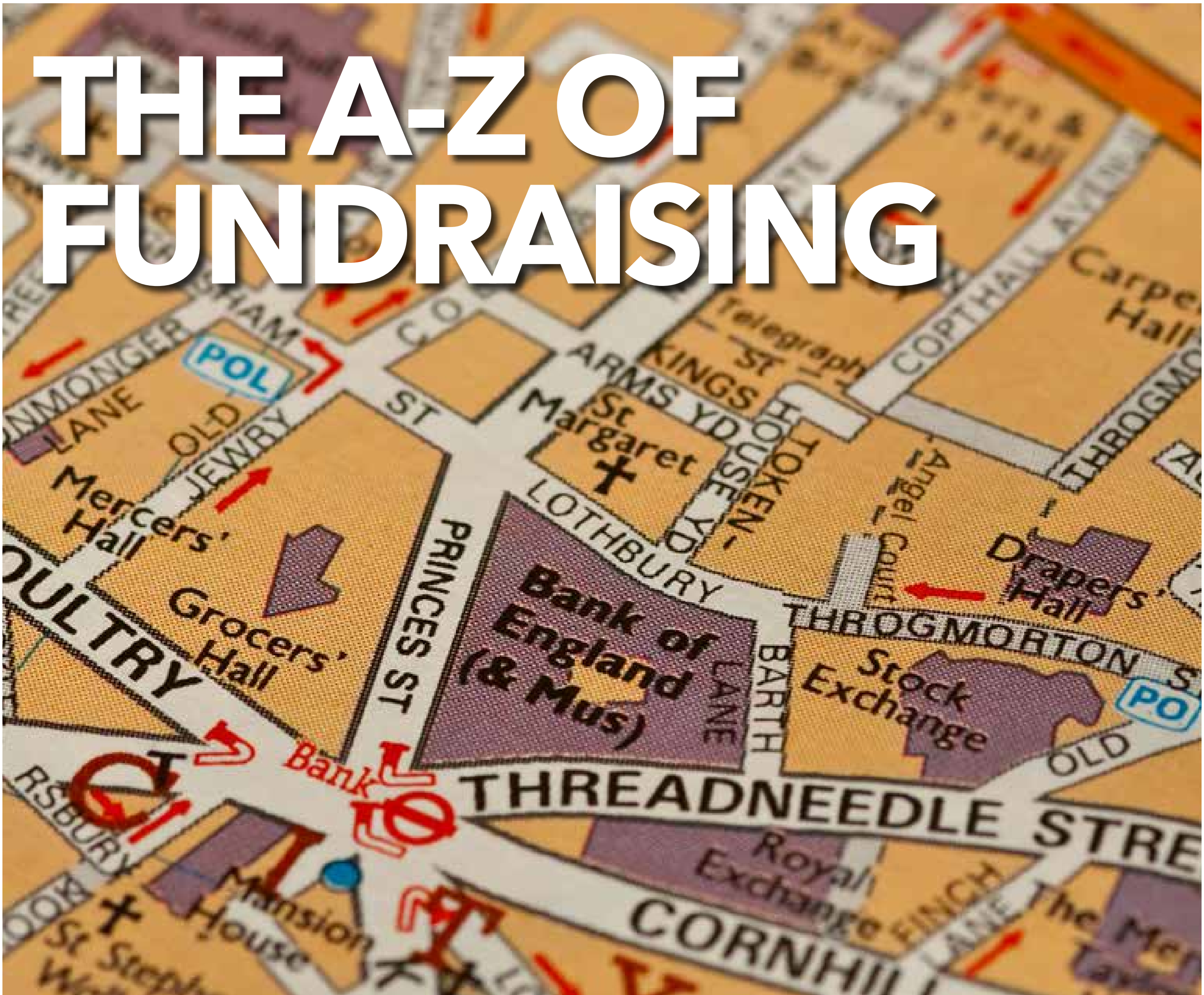
PRIVATE DEBT INVESTOR

FOR THE WORLD'S ALTERNATIVE ASSET CLASSES

THE A-Z OF FUNDRAISING



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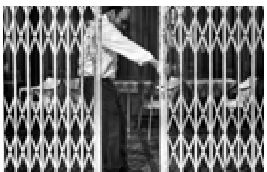
A-Z OF FUNDRAISING


G is for Gatekeepers


L is for Litigation


Z is for Zombies

INTRODUCTION

THIS WAY

Navigating your way through a private investment fund raise can be challenging – for everyone involved. Our A-Z of Fundraising is designed to help you better spot landmark issues and map the best route to the best outcome.

Fundraising is the beating heart of most general partners. Without investor capital, there's nowhere for an asset manager to go. Of course, it differs dramatically from a heart beat in almost every other respect; it is not an automatic function and the process must be managed strategically to achieve success but you get the point: raising capital is a life or death requirement for GPs.

PDI felt an up-to-date and engaging guide to fundraising would find a happy home with many of our subscribers as the number of debt funds climbs steadily higher – there are 237 debt funds-in-market, according to *PDI Research and Analytics* (for the full list, see page 34 of our accompanying March issue). So we have teamed up with global law firm Clifford Chance to produce the A-Z of Fundraising.

Whenever a significant piece of legislation or test case hits the market, *PDI* calls on contacts in the market to get their take. It's telling that the more serious the issue, the more those contacts tell us they can't comment – but they do say they have been in touch with their lawyers for advice. So we asked the private fund formation experts at Clifford Chance to unpack some of their knowledge and experience to help readers identify 26 themes they need to think about.

As the first port of call for advice in many scenarios, and having a view of the market from both sides (GP and LP), fund formation lawyers are ideally placed to guide and inform on fundraising. Clifford Chance were able to draw on partners and associates in their fund formation team based in 14 key financial centres globally. Besides helping to draft many of the entries in the A-Z itself, we also sat down with seasoned fund formation partners Nigel Hatfield and Gerard Saviola at the firm, who talked to us about some of the key trends they see shaping the market today. Hear more from them from page 5 of this report.

Pausing to take stock is important as the fundraising environment and process have been subject to significant change, particularly in the wake of the new European AIFMD regulations which are having profound effects on capital raising as well as reporting requirements. Turn to page 10 to get the full rundown on the stickiest AIFMD-flavoured questions including identifying the line between pre- and actual marketing.

By breaking the process down into 26 sections, we've endeavoured to bring you an easily digestible overview of fundraising. Though *PDI* focuses on the private debt market, this guide covers all private funds – both equity and debt strategies in private equity, real estate and infrastructure as well as our favourite asset class.

By speaking to general partners either planning their next fund raise or actively fundraising now, as well as liaising with investors and specialist advisers [lawyers and placement agents in particular], we've drawn on decades of expertise to dig into the most important issues and key points that make the difference between a successful fundraising and a painfully drawn-out damp squib.

Some of our alphabet soup will be immediately self-explanatory, such as fees. Funds charge them, investors pay them and for a long time in private equity, industry standard rates held. But that has changed: debt funds for a start have a different dynamic, as Monroe Capital's director of institutional relationships, Sean Duff explains: "The fee structure really depends on how you are structuring your portfolio, with some consensus emerging around one and 12.5 per cent [fee and carry] with a six percent preferred return. But the fee structure is definitely a sticking point, and every large pension fund takes word from their consultant, who takes a view on fees, with everyone negotiating pretty hard." For more on this long-standing topic, turn to page 13.

For something more esoteric but significant, we take a look at the potential ramifications of the OECD's Base Erosion and Profit Sharing project (BEPS for short) on page 10. Though it is not an initiative aimed directly at private funds, it is a factor that anyone engaged in raising a private investment fund needs to bear in mind. Aimed at multinationals channelling profits through low-tax jurisdictions, it threatens to capture funds that are simply aiming to remain tax-neutral.

On page 23, we look at due diligence questionnaires – home to the increasingly complex and extensive enquiries prospective investors now require of managers. The basics of who, what, where, when and how must be covered but, as MezzVest partner Rafael Calvo tells us, his firm has developed detailed reporting systems to furnish investors with the information they may want. The firm preps for fundraising by drawing up a database of due diligence questions. "We try to think about everything an investor will want to ask, and stand ready to deliver it in their own format so that they can compare the numbers however they wish to do so," says Calvo.

Understanding the applicability of key US regulations, how to agree appropriate and mutually agreeable investor protections, negotiating co-investment rights – these are all vital ingredients to a successful fundraising. Likewise, track-record (page 26) is key to convincing investors that a manager can deliver, but our guide also attempts to capture the softer, more ephemeral, aspects of a fund raise and remind managers that an over-rehearsed and over-scripted pitch will not replace market knowledge and know-how.

Investors have a lot of voices to listen to, so managers must make sure it is their voice and their story that is remembered. "The people that really raise a lot of money just go in and say, 'Let me tell you about the market right now' – they don't even open a document. That's how you get across the DNA of an organisation," as James Newsome, a partner with Arbour Partners, puts it on page 30.

These are just a few of the highlights from the guide; we hope you enjoy it and can take something specific from our fundraising rundown for yours. Given the continued popularity of private markets, the appetite amongst investors for private funds is unlikely to abate in the year ahead.

Welcome to the A to Z.

Rachel McGovern
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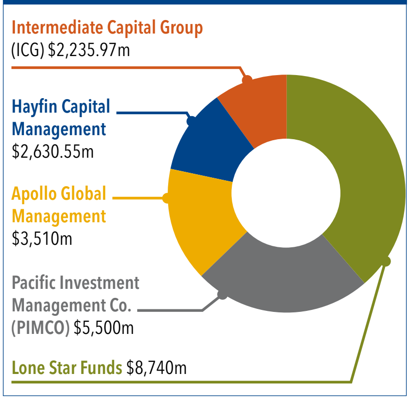
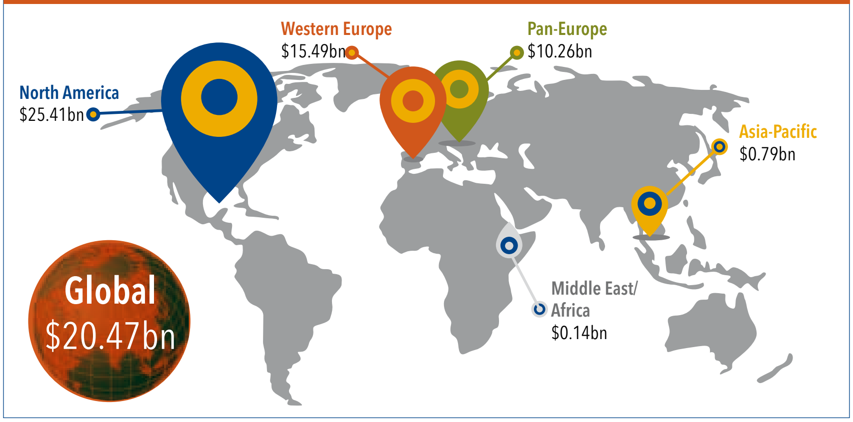
FUNDRAISING BY THE NUMBERS

Private Debt Investor's own Research & Analytics unit tracks fund raising activity for the asset class globally and recently released summaries for 2014 that revealed a drop year-on-year in total capital raised. It also monitors funds that are currently in market both by sector and geographic focus and these figures confirm the view that there are many GPs out there aiming to raise significant amounts at present. Anecdotal evidence also suggests that many sizeable funds are near to a final close in Q1 of 2015 [helping explain the dip in total capital raised last year].

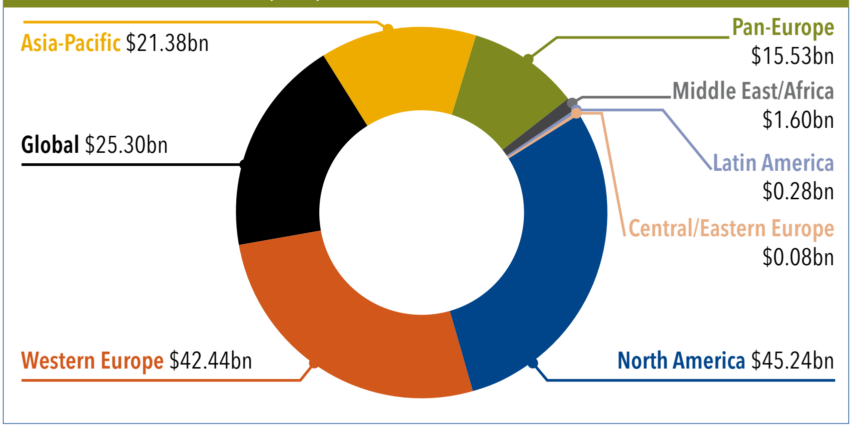
TOP 5 FUND MANAGERS IN 2014 BY CAPITAL RAISED ($M)



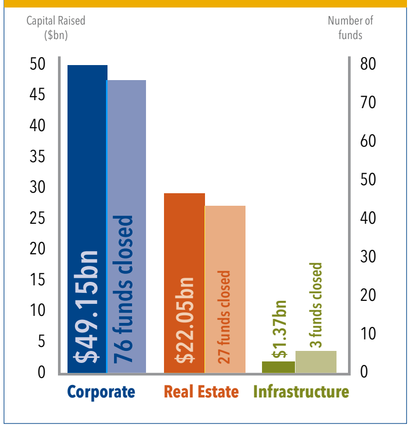
CAPITAL RAISED BY FUNDS CLOSED IN 2014 ($BN)



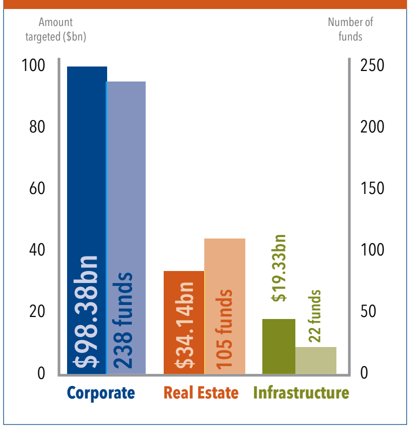
AMOUNT OF CAPITAL TARGETED BY FUNDS IN MARKET CURRENTLY FUNDRAISING AS AT 01 FEBRUARY 2015 ($BN)



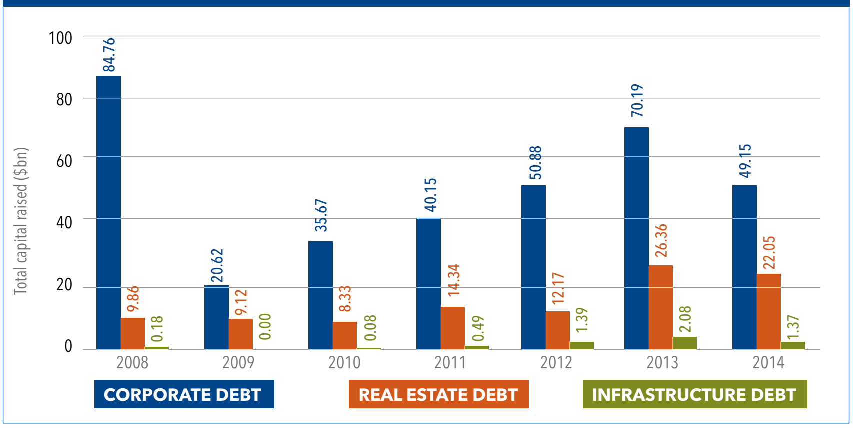
CAPITAL RAISED/ NUMBER OF FUNDS CLOSED PER SECTOR IN 2014 ($BN)



AMOUNT TARGETED PER SECTOR BY FUNDS IN MARKET AS AT 01/02/15 ($BN)



DEBT FUNDRAISING IN NUMBERS



KEYNOTE INTERVIEW

CLIFFORD CHANCE

Preparation, patience and perseverance

Except perhaps in the heady days just before the global financial crisis, raising an alternative asset fund has never been easy. According to PEI's own research, alternative asset managers in private debt, private equity, real estate and infrastructure raised $371bn globally in 2010. That total had moved to $607bn for 2014. Clearly the market has warmed since the bleak days following the crisis, but what are the characteristics of a successful fundraising today? We asked two seasoned fund formation lawyers at global law firm Clifford Chance for their views on the current fundraising environment.

"For some managers it's pretty rosy," says Nigel Hatfield, partner and head of Clifford Chance's London private funds group, before ticking off the characteristics investors continue to look for in a fund manager: a strong track record, strong GP/LP alignment, a solid team with shared history, good internal processes, strong existing investor relationships, good investor relations. The kind of traits that most established firms will want to evidence – and all will want to claim. "We are seeing some funds oversubscribed and investors being scaled-back – this is something we didn't see for quite a number of years following 2008."

KEYNOTE INTERVIEW

CLIFFORD CHANCE

PRETTY MUCH ANY GP FUND RAISING TODAY HAS TO SHOW THE ABILITY TO BE INNOVATIVE AND FLEXIBLE

Saviola

However, investors are far more particular today, and their requirements very precise – often driven by the heightened regulatory environment in which private fund managers now operate the world over.

"The market is a little uneven", adds Gerard Saviola, Hatfield's fellow London-based private funds partner. The ease with which a manager will raise its fund will depend heavily on the maturity and experience of the fund manager concerned, the target jurisdiction, investor appetite for the underlying asset class and the type of investor base the manager is targeting.

That unevenness is itself also a function of history. For many investors who have been investing in private funds over the longer term, the knowledge and experience they have accrued is at once technical (of which more later) and emotional. Some have invested in less well-performing funds and most are subject to increased levels of regulation and compliance. Investors are seeking more protections, some having been through less positive experiences in relation to certain of their fund investments over recent years. That has been an important learning process.

It is a fine balancing act: to succeed in the current market, a fund's terms need to be commercially attractive for the manager whilst at the same time addressing key investor concerns around transparency, alignment of interest and governance. Says Hatfield: "A GP needs to be offering a set of terms for their fund that LPs can readily recognise as being appropriate to them: terms that acknowledge how the market has evolved." He goes on to offer an example: "Managers are now often much less able to take key fund governance decisions – such as an extension to a fund's life – without some form of investor approval."

Saviola confirms that seasoned investors will not just scrutinise a fund's draft documents carefully but also apply discreet pressure on the manager during negotiations in order to frame what is going to be a long-term relationship with an optimal set of terms. For Saviola, the successful fundraising manager has had to show a willingness to be creative and flexible. "Look at how the two and 20 commingled fund model has had to change. Look at the rise of co-investment rights and managed or separate accounts. Look at the flexibility that is now shown in the drafting – such as letting a large LP into the management company and making sure that the control provisions permit that. Pretty much any manager fund raising today has to show this ability to be innovative."

However, successful private fund investors understand that the managers they commit to need to be motivated to succeed. "I don't think investors are persuaded to invest in a fund simply because of a 10 or 20 per cent discount on fees," says Saviola.

KNOW YOUR DFIS AND SWFS

Not only are all investors different in terms of temperament and requirement but they are also not all equal when it comes to advancing the fundraising.

For example, for managers raising capital to deploy in emerging markets, Development Finance Institutions (DFIs) can be a vital ingredient in a successful fund raise [see also D for DFIs]. Besides being committed to helping channel private capital into these economies, most DFIs are also seasoned LPs with a reputation for vigorous due diligence and a keen eye for the up and coming manager. Having one or several join your fund at an early stage can create a valuable halo effect. But they also bring with them some unique requirements.

"DFIs are a very important source of capital for emerging market managers but they can also shape how a fund is perceived by other non-DFI investors who may get very nervous about some of the rights a DFI will insist upon. For example if a DFI has veto rights across the board on a manager's investment decisions then that can be unattractive to other investors," notes Saviola.

Along with DFIs, Sovereign Wealth Funds (SWFs) are another group of key strategic investors. Over recent years, SWFs have become very active investors in alternative assets, both directly and indirectly. Their appetite to deploy very significant amounts of capital has encouraged some to gravitate towards capital intensive areas like infrastructure as well as towards funds that can accommodate very big cheques. SWFs as well as DFI investors can bring with them a wealth of experience and provide a manager with a strategic or key cornerstone investment, but managers should take care to avoid any perception amongst other potential investors in their fund that those investors are receiving special treatment or terms (unless, of course, the DFI or SWF is providing a cornerstone investment that sets them apart from other investors).

Hatfield confirms: "You have to be a little sensitive where a SWF seeks special co-investment rights or an investment committee seat that could put other investors off."

Some of the SWFs will not be shy in pushing for favourable terms if they are contemplating committing to fund in its early round[s]. There may therefore be a tactical argument to try to bring such investors into a fund close at its final stages in order to avoid early-stage pressure in negotiations. However, their participation in an early close can boost LP confidence in the fundraising. Hatfield expands: "SWFs are great investors – it is just important to manage the negotiations carefully to avoid giving significant terms too early in the process."

THE IMPORTANCE OF MOMENTUM

The task of confirming first round commitments to build momentum around your fundraising, without being over-accommodating to those investors, is one of the key challenges facing managers – especially first time funds. For some new managers it may make sense to raise capital from one key investor before coming to market with a full fund offering. Says Hatfield: "For first time funds a cornerstone investor can be key. This may be a group with whom the manager has a relationship with – it might be an affiliated company or a large strategic co-investor – and the manager might even close with this investor, do some deals, build some track record and then go out to third parties."

For all managers, building and then maintaining fundraising momentum is something that is generated early on in the process. Maintaining this momentum is critical in the current market. Hatfield observes that "adopting and adhering to a cap on fund size can help build momentum once marketing efforts have commenced." Both lawyers remark that the pre-marketing undertaken by a manager, where senior members of the manager's team have built a dialogue with prospective investors over the long term, is vital. Turning up for the first meeting with your offering document is not going to win hearts and minds. So the more the manager can cultivate a broad group of potential investors before officially launching their fund, the better.

WE ARE SEEING SOME FUNDS OVERSUBSCRIBED AND INVESTORS BEING SCALED-BACK

Hatfield

This is inevitably easier for seasoned managers raising their latest fund where they have the history, the contacts and the resources to undertake a consistent and extensive communication programme. Indicative of this requirement is how larger GP groups have invested in internal teams to service investors: "One big change amongst the manager community is the expansion of in-house IR departments," comments Saviola.

For newer, smaller managers who don't have internal IR personnel it can make sense to leverage the expertise and contacts of a placement agent to help build a network of engaged investors. The agent can also play a key role in the later stages of the fund raise, moving investors through the decision-making and due diligence process. All of the time they should be leveraging their knowledge of particular institutions – and those individuals responsible for assessing private funds within the investor. "The right placement can really help maintain momentum. They really have their finger on the pulse of micro-trends in the market," says Saviola.

THE ROLE OF THE LAWYER

The law firm representing the manager through the fund raise is another important member of the GP's team. Few law firms active in alternative assets have failed to make a play for fund raising mandates, building teams dedicated to the task. The challenge is to identify those firms who have the breadth and depth of experience to look beyond the documentation and identify how best to service the differing requirements and objectives of various investors coming from different markets.

KEYNOTE INTERVIEW
CLIFFORD CHANCE

MANAGERS OPERATE IN A DIFFERENT WORLD POST-2008. FUNDRAISING IS NEVER GOING TO BE QUICK AND EASY

Hatfield

For a global firm like Clifford Chance, with strong local relationships across all the key jurisdictions, this has meant that its private funds group is represented on the ground in 14 centres globally. The global funds practice consists not only of highly experienced fundraising specialists, but has also carefully integrated its private funds tax and regulatory specialists across the US, Europe and Asia into the group. Today, when investors and fund managers alike have to comply with a host of regulations [see A for AIFMD, B for BEPs, U for US regulation…], this range of expertise is essential. Your lawyer needs to be able to steer the early stages of tax and regulatory structuring of the fund right through to negotiating investor comments and on to final close.

Hatfield has been with Clifford Chance for 24 years with Saviola joining in 2011 from Debevoise & Plimpton – his time there involving periods based in Hong Kong and Paris. Both lawyers clearly relish the theory and practice of representing both managers and investors [the practice spends around 20 per cent of its time working for investors] and they have each worked across a variety of alternative assets, geographies and manager types – "We like to advise on a diverse range of fundraisings at any given time" declares Hatfield.

Recent sample clients confirm this, and include Permira, Equistone, M&G Investments, AXA (Real Estate and Private Equity), Deutsche Asset & Wealth Management, the International Finance Corporation and European Capital.

I DON'T THINK INVESTORS ARE PERSUADED TO INVEST IN A FUND SIMPLY BECAUSE OF A 10 OR 20 PER CENT DISCOUNT ON FEES

Saviola

This diversity of clientele has helped the firm develop a breadth and depth of institutional knowledge that assists manager clients approach a fundraising armed with a valuable range of reference points both in terms of tactics and drafting.

The team is always thinking about hot-button topics such as co-investment rights, the inclusion of "speed bumps" to regulate the pace of a fund's capital deployment, the handling of changes in personnel. "There have been a lot of key person issues since 2008, so key person clauses are now very closely scrutinised by investors and must be carefully crafted to ensure they sufficiently protect investors but do not hamper the operation of a manager's business more generally," explains Saviola.

Has the process of negotiating a new fund become more combative as more demanding investors push managers harder across a range of issues? The two lawyers pause. Saviola explains: "We are spending a lot of time with managers thinking about the medium term – will they develop managed accounts, will investors come into the management company… these days there are many strategic considerations at play."

Hatfield agrees: "The alternative asset classes remain very popular, and we've seen a marked improvement in the pace of the fundraising process over the last 12 months. However, managers operate in a different world post-2008. Fundraising is never going to be quick and easy. It requires preparation, patience and perseverance." ■

A-Z OF FUNDRAISING

A IS FOR AIFMD

The marketing requirements for raising funds in Europe are still not entirely clear and if you speak to any fund manager raising funds in Europe post-AIFMD, it's likely you'll hear some war stories. Staying the right side of the line when marketing has raised a surprising number of thorny questions, even on such fundamental issues as what constitutes marketing or reverse solicitation: where do you draw the line between 'pre-marketing' and 'marketing' under AIFMD and how exactly would you satisfy any marketing registration requirements should you need to?

Fund managers have had to seek answers to these questions – and many more – in the months since the AIFMD came into force. The picture that has emerged reveals diverging requirements from one country to the next and a number of practical issues to overcome.

Generally speaking, 'marketing' will trigger AIFMD requirements and reverse solicitation will not. Knowing where the boundary lies between 'pre-' or 'soft' marketing and other promotional activity that triggers AIFMD requirements is crucial. Unfortunately, this boundary remains blurred, as there is no uniform definition of what activities would be classed as 'marketing' and the position varies from country to country.

In a number of jurisdictions (such as the UK, The Netherlands and Luxembourg), the test is broadly whether an investor at that stage can subscribe for an interest in the fund or not. This is being understood as something like the issuance/distribution of a final PPM or subscription documents, with activities in the earlier stages of the life-cycle of promoting a fund (such as teaser documents or presentations) not amounting to marketing under AIFMD. Other jurisdictions have taken a broader approach though. In Sweden, for example, if the relevant fund structure is in existence, any promotional activity (including meetings, teasers, or draft documentation) can constitute AIFMD marketing. Likewise, in some jurisdictions the authorities have issued guidance linking the marketing question to whether a fund name, structure and investment strategy has been finalised.

Having established that marketing is taking place, the next step is to ensure that it complies with the AIFMD marketing requirements, either for marketing with a passport (available to EEA managers of EEA funds) or using national private placement regimes.

KNOWING WHERE THE BOUNDARY LIES BETWEEN 'PRE-' OR 'SOFT' MARKETING AND OTHER PROMOTIONAL ACTIVITY THAT TRIGGERS AIFMD REQUIREMENTS IS CRUCIAL.

Again, the precise requirements differ from country to country. In France, for example, fund managers have to pay a passporting fee and appoint a 'centralising agent' to handle redemptions and document provision. Fees are also charged in Austria, Denmark, Germany and Latvia, while Italy and Finland are considering charging fees. Particularly important in all cases is ensuring that a marketing passport has been applied for sufficiently ahead of moving from 'pre-marketing' to AIFMD marketing to ensure that a fund manager does not have to postpone further contact with an investor whilst waiting for a regulator to approve a marketing passport.

Non-EEA managers are similarly burdened, having to satisfy the 'marketing registration procedures' which vary across the EEA and range from 'notification' at one end of the spectrum, to 'prior approval' at the other. In some countries, the notification requirements are relatively straightforward, requiring the manager to submit a notification form to the regulator in the country where marketing is to take place. In other countries, formal approval is required prior to marketing, which can, as has been the experience in Germany, be complicated and take several months to achieve.

Given these hurdles, it is perhaps not surprising that some regulators have not received as many applications for registration from GPs as they would have anticipated. It is possible that some fund managers are relying on reverse solicitation. However, reverse solicitation is sometimes not as easy to rely on as some people think, and there are grey areas here, for example where placement agents are utilised. Any 'pre-marketing' activity may also take away the ability to rely on reverse solicitation. ■

A-Z OF FUNDRAISING

B IS FOR BEPS

The OECD's catchily titled Base Erosion and Profit Shifting (BEPS) project is principally aimed at multinational corporations that 'artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.' That's OECD-speak for the sort of tax engineering that has been hitting the front page of the popular press (think Amazon, Google). Although many of the elements of BEPS have been on the agenda for some time, it was this high profile perceived tax avoidance by household names that seems to have galvanised the OECD into action.

BEPS comprises fifteen different 'Actions' that are intended to change the way international tax rules work so as to prevent cynical and, to quote the politicians, "unfair" tax avoidance. For private funds, this may seem a remote issue but in fact the proposals carry a number of significant implications for such managers.

As the Actions change the rules that apply to all taxpayers, depending upon how they are eventually implemented, a number of them could radically alter the tax landscape, potentially with very significant effect for private funds. The Action that is causing the most concern amongst funds tax specialists deals with Abuse of Tax Treaties (Action 6). The idea is to stop "treaty shopping" – i.e. locating companies in jurisdictions with a good network of double tax treaties solely to access those double tax treaties so as to eliminate withholding and other taxes. The way BEPS proposes to block this is to deny the application of double tax treaties to companies whose shareholders couldn't benefit from treaty benefits themselves – a so-called "limitation on benefits" provision that US treaties typically already have.

The problem for funds is that they typically make investments through intermediate holding companies. There are a number of non-tax reasons for this, but they also need to ensure that returns to their investors don't suffer unnecessary tax leakage that might happen if the fund invested directly. This isn't because funds want to avoid tax – it's because they need to achieve "tax neutrality" for their investors, i.e. they need to put investors into the same position they would have been in had they invested into the fund's assets directly. As many investors in private funds are tax exempt and wouldn't pay tax if they held the fund assets directly, they won't be happy to lose a significant part of their profits in tax. Equally, tax-paying investors will be worried that they may end up suffering double tax – i.e. tax at the fund level and then again when they get their profits. Although one might think that the limitation on benefits provision shouldn't kick in where tax neutrality is the aim, it may do.

All isn't lost for funds, however. The OECD admitted that they had overlooked funds when they first put out the BEPS proposals and they are now considering how funds should be treated. However, it's not entirely clear that the OECD fully buys into the proposition that funds are benign entities that should be given favourable treatment, but the fact that they are engaging is encouraging at least. Fund managers and their tax advisers should stay tuned as the OECD deliberates and then pronounces. The law of unintended consequences makes it still possible that they will have to look very closely at the tax domiciles they choose in readiness for tax discussions with prospective LPs. ■

C IS FOR CO-INVESTMENT

Co-investment has emerged as a huge area of LP interest over the past few years. For GPs, offers of co-investment bring additional deal capital, generate momentum in fundraisings and help build relationships with investors. For LPs, with "no fee, no carry" now the norm for LP co-investment alongside a fund, the fee reductions created by co-investment are a very attractive way to increase overall net returns. Co-investing can also provide valuable experience for LPs looking to build direct investment programmes – which inevitably is a latent GP concern. The issue of co-investment prompts some key questions for consideration during the course of a fundraising.

A co-investment is not necessarily always going to be a good deal for LPs though. Co-investments are often available on large deals, which may not always be the best deals, particularly if a fund's diversification limits are being exceeded. Time pressure on LPs to complete co-investments can invite short cuts on due diligence – and a co-investment needs to be done properly, or not at all.

For a GP considering LP co-investment requests, investor motivation is vital. Is the request simply the LP box ticking to present to its investment committee, or does the LP view co-investment as essential bit part of its investment strategy?

GPs and LPs must both consider whether co-investment opportunities will actually become available. If an investment strategy doesn't lend itself to co-investment, offers become meaningless and hence negotiating co-investment rights is of limited value. Full discretion in allocating co-investment opportunities remains the preference for GPs, however LPs often want more certainty. Giving too many LPs ➤

too many co-investment rights can end up making deal execution impracticable and giving each LP too small a slice of the pie to make it worthwhile. Pro rata co-investment can be attractive for smaller investors but often results in GPs avoiding co-investment all together.

Selecting preferred co-investors can work for both GPs and LPs. Identifying those LPs who have the appetite, capital and ability to execute co-investment deals at the outset can be a powerful tool in getting commitments from these LPs. Whilst often just an allocation protocol amongst the largest investors, more formal club structures can be created, and side car funds (possibly carrying fees and carried interest) create pre-committed firepower. However, a GP that promises too much co-investment, with too much certainty, may find less money in its fund.

Strategic co-investors can add significant value to a deal. Neither GPs nor LPs stand to gain if an LP takes precedence over a strategic co-investor, but the interests of the fund can end up being overlooked.

A co-investment can be implemented at pre-signing, at completion or as part of a later syndication. Syndication limits the ability of the co-investors to negotiate terms – the investment is a done deal – but leaves the GP with the risk if the syndication doesn't complete. Implementing the co-investment pre-signing or at completion can be complex with LPs seeking more involvement in the deal process. Co-investment by some LPs may require regulatory approvals. These should be anticipated and resolved as early as possible to prevent delay or uncertainty.

A co-investment can be made directly into the asset or achieved through a vehicle controlled by the GP. Direct co-investment puts the LP closer to the investment, typically giving it more rights and more information. Indirect co-investment gives the GP more control leaving the LP as a more passive investor. The best approach will vary depending on each investment, the asset class and transaction-specific considerations. For example, in the debt context withholding tax and lender of record considerations, together with the risk of the LP having to take control of the investment on a default, all favour the indirect route.

There is no correct way to arrange co-investment rights and deals, and considering all circumstances is crucial. ■

D IS FOR DFIs

Development Finance Institutions (DFIs) come in all shapes and sizes, but share an investment mandate focused on economic development by providing private capital in growth markets where private investors focused purely on financial returns may be more reluctant to invest. With a goal of sustainable, long-term investing aimed at encouraging growth in smaller and medium-sized enterprises, the DFI investment mandate is naturally aligned with the strategy of private funds investing in emerging markets.

DFIs commonly play the role of anchor investors in emerging markets funds, with their presence paving the way for participation by more commercially-driven investors. These funds benefit from the halo-effect of having being due-diligenced by DFIs, who are typically longstanding, well-connected and sophisticated investors in riskier emerging markets. Having one or several DFIs participate in a fund also facilitates one of their key goals of attracting other types of private capital to the developing world. They often require managers to include a restriction on the percentage of capital raised from DFIs to oblige managers to seek other sources of capital.

An important beneficiary of DFI participation is the first-time, locally-based fund manager where the lack of a track record can be a significant hurdle. DFIs are supportive of emerging managers and therefore play a vital role in the development of the private fund industry and the adoption of international best practices by new managers in developing markets. According to the International Finance Corporation (IFC), a major DFI investor, more than half of the funds that it has backed over the past decade have been with first-time managers.

GPS CAN EXPECT BOTH RIGOROUS NEGOTIATION AND A SIZEABLE SET OF ONGOING REQUIREMENTS IF THEY ARE TO HAVE DFIS AMONGST THEIR LPS

DFI investment in your fund, however, comes with many requirements and limitations. DFIs have developed a justified reputation for being fierce negotiators who can be unyielding with GPs. Interestingly, a recent trend has seen DFIs negotiate together with a GP as an investor consortium, evidence that their requirements often set them apart from other types of investors. Although this increases the DFIs' bargaining power, it also provides a more streamlined approach to negotiations

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given the consolidation of requirements and perspectives.

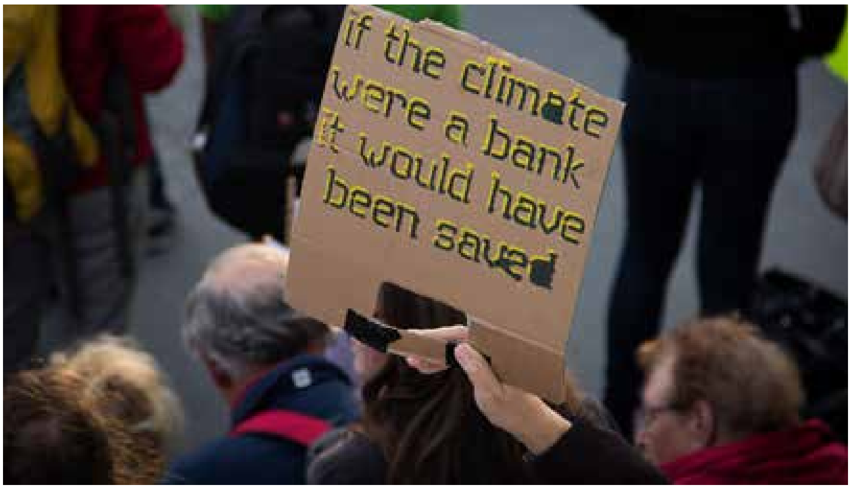
DFIs are often subject to internal policy restrictions on investments in certain sectors or geographies, which are typically accommodated by managers by way of excuse provisions in the fund documentation or inclusion in the fund's investment criteria. Additionally, DFIs generally require managers to observe international standards on various issues, for example, in relation to dealings with sanctioned countries.

Another feature of DFI investment is the emphasis on compliance with ESG standards (for more, see E for ESG), which can often be challenging for smaller and less experienced managers who may not have the knowledge or the resources to deal with such stipulations.

DFIs typically require detailed reports on a number of financial and non-financial performance indicators, in line with their overall focus on transparency and governance. This is not always easy for new fund managers to comply with, particularly where their expertise and customary practices fall short of international, and particularly, DFI standards.

It should come as no surprise therefore that DFI participation makes the fundraising process more involved given the wide range of issues that they raise (have a look at N for Negotiation to help put this in context). DFIs are great investors to have participate in a fund but GPs can expect both rigorous negotiation and a sizeable set of ongoing requirements if they are to have DFIs amongst their LPs – and that may involve building an internal infrastructure more extensive and at an earlier stage than originally anticipated. ■

E IS FOR ESG



Environmental, social and corporate governance are the three key factors measuring the sustainability and ethical impact of an investment. Many investors and private fund managers are amongst corporate groups that have signed up to the UN Principles for Responsible Investment (UNPRI), or may be signatories themselves, and will be required to undertake formal reporting on ESG matters as a result. For an increasing number of investors, compliance with ESG standards will be a prerequisite of committing to a fund. ESG is no longer a general concept – it is now possible to see hard evidence that a manager's approach to ESG can have a real impact on the value of the underlying investments held by a fund, and investors will scrutinise this during the due diligence process.

The application of ESG principles can depend on the asset class. Primary infrastructure, real estate and renewable energy funds may have a particular focus on the potential environmental impact of the investments they make, and emerging markets funds may need to consider certain social and corporate governance implications specific to the jurisdictions in which they operate. However, each of the three areas raise certain themes which are applicable to all asset classes and include the following:

- **Environmental:** emissions; pollution; renewable energy possibilities; water protection; waste processing; construction impact and biodiversity (greenfield investments).
- **Social:** labour relations; workplace safety; impact on local communities (greenfield and brownfield sites); human rights.
- **Corporate Governance:** improving governance on portfolio company boards; employee training; appropriate policies and processes embedded in portfolio company businesses.

For fundraising GPs, prospective investors will want to know that the manager not only has appropriate ESG policies in place but also that an understanding and respect for ESG permeates the culture of the business. Some investors (particularly development finance institutions – see D for DFIs – and institutional investors with their own detailed reporting requirements such

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ESG IS NO LONGER A GENERAL CONCEPT – IT IS NOW POSSIBLE TO SEE HARD EVIDENCE THAT A MANAGER'S APPROACH TO ESG CAN HAVE A REAL IMPACT ON THE VALUE OF THE UNDERLYING INVESTMENTS HELD BY A FUND, AND INVESTORS WILL SCRUTINISE THIS DURING THE DUE DILIGENCE PROCESS

as public pension funds) have very specific ESG reporting requirements they will insist the fund manager adheres to. Typically these are agreed to by way of investor side letters rather than wholesale incorporation into the fund's constitutional documents. A GP may want to consider developing terms for the incorporation of ESG obligations alongside a robust standalone policy, including reporting standards and format, rather than reacting to various ESG requests from different investors. In this way a GP can ensure ESG provisions are not overly prescriptive and that they have broad discretion in dealing with ESG issues.

The implementation of effective ESG processes by the GP will involve incurring operational costs, both at the fund management level and portfolio company level. But it's worth noting that effective ESG processes can enhance value. Potential purchasers of a portfolio company will diligence ESG matters and price their absence or non-conformity into the deal and companies that don't have them may find themselves losing competitive edge in their marketplace. Failure to adopt and embed ESG into the culture of an investment manager can depress returns to investors, leading to a longer-term impact on the manager's track record. But more telling still is the risk that ESG failings can lead to civil and criminal liabilities for portfolio companies and even for the managers of the funds that own them. ■

F IS FOR FEES

Fees can readily take centre stage during a fund raise and all parties can usefully remind themselves that the difference between a good and bad fund is never determined by the fees.

While private equity fund fee structures have settled over time – broadly a management fee based on between one and a half and two per cent. per annum, on commitments (and depending on the size of the fund) and a 20 per cent carried interest, private debt funds have yet to see anything like such market norms being established. When it comes to fees, private debt fundraisers can expect a vigorous debate with prospective investors, even though they are well advised not to let the fee structure become the centrepiece of the discussion.

THE DIFFERENCE BETWEEN A GOOD AND BAD FUND IS NEVER DETERMINED BY THE FEES

Needless to say, no two private debt funds are the same, and with strategies that range from the first-lien leveraged loan space absent deal underwriting, through to the senior growth debt funds that require a distressed skill-set more akin to private equity, fee structures remain divergent. Senior loan funds that typically return less than a 10 percent gross IRR can often see management fees of less than one per cent calculated only on invested capital, with carry running at below 10 per cent of total asset value. At the other extreme, debt funds seeking 20 per cent-plus gross returns for investors can still command the classic 2-and-20 structure.

The hottest areas of debate when it comes to a fee discussion go beyond the management fee and carried interest rates and instead focus on whether investors will pay fees on committed capital or invested capital, the level of preferred returns and incentives.

One fund manager comments: "We took the view quite early on that we should only get paid on deployed capital and that our carry should be back-ended, so we have always been wired in to an investor-friendly fee construct. There were others that tried to hold on to committed capital and the pay-as-you-go private equity model, but that's exceptionally hard today."

The LP view appears to be that it is easier to deploy private debt than it is private equity, and as such fees should only become payable on investments once the money has been put to work. The level of preferred return, or the hurdle rate of return that a GP needs to hit before claiming its share of profits, is increasingly being contested too. Typically set at eight per cent for private equity funds, managers across private funds have been calling for lower hurdles in the current tough markets. In debt funds, hurdles of between five and seven per cent have become commonplace.

Sean Duff is director of institutional relationships at Monroe Capital. He says: "The fee structure really depends on how you are structuring your portfolio, with some consensus emerging around one and 12.5 per cent [fee and carry] with a six per cent preferred return. But the fee structure is definitely a sticking point, and every large pension fund takes word from their consultant, who takes a view on fees, with everyone negotiating pretty hard."

When it comes to fee-oriented incentives offered by fundraising GPs, Clifford Chance partner Roger Singer says: "We see more than half of our funds today having fee concessions for either larger investors or early participants in the fund. As such, managers need to make sure that the fee disclosures are properly drafted, such that if they are not going to offer something to everyone, it is properly not offered to everyone." ■

G IS FOR GATEKEEPERS

Finalising a fundraising today almost inevitably involves lengthy interactions with third parties, and the consultants that sit beside the major pension funds and insurers, acting as gatekeepers for their investments, are becoming ever more powerful. Nowadays, large-scale commitments from pension funds or insurers rarely come unless first signed off by the gatekeepers who shape and monitor their allocations and represent them in negotiations with fund managers.

The fact that gatekeepers are often tasked to advise a large number of clients on allocations and manager selection across a wide range of asset classes, manager types and geographies means that they develop significant breadth and depth of knowledge and experience. Comments Nigel Hatfield, a partner with Clifford Chance in London: "It is sometimes more important to get the gatekeepers onside now than it is the underlying investors themselves, because they are quite influential in the market."

GATEKEEPERS WILL FOCUS ON ALL THE SAME ISSUES THAT INDIVIDUAL INVESTORS TEND TO PRIORITISE, BUT MAY DRIVE A HARDER BARGAIN

Not all gatekeepers will have the discretion to make decisions on behalf of their LP clients, but many consultants act as an invaluable sounding board for a number of key investors.

One head of investor relations at a large private debt fund says: "For us, establishing and maintaining good relationships with consultants is really important, because it gives us real leverage and they control a lot of capital. We spend a lot of time with them, and a number have got to know us very well. They can be really valuable partners to us and we treat them as such."

The way in which consultants react to a manager seeking investment can make or break a fundraising process, because of their ability to greenlight a process and carry several large LPs along with them.

Sean Duff, director of institutional relationships at Monroe Capital, says: "Consultants have become more important since 2008 occurred. The pension funds lost a tremendous amount of money, and the boards of pension funds didn't necessarily want to take responsibility for making those decisions going forward."

Duff continues: "Now you don't always know who is making the decisions behind the scenes, so it is very important to get all your information in front of all the consultants. If you get approved by a big group of consultants then you are going to do better, though you also need to maintain good one-to-one relationships with all your potential investors too."

The gatekeepers will focus on all the same issues that individual investors tend to prioritise, but may drive a harder bargain during negotiations. And of course not all investors come with consultants on side; sovereign wealth funds and development finance institutions, for example, tend not to employ the services of third parties.

Hatfield declares: "The key thing for GPs dealing with consultants is the need to differentiate themselves from the competition in the minds of those consultants. That could be by having a better track record, or having some differentiating factor based on geographic concentration or experience in a particular sector." ■

H IS FOR HARD CAP

A hard cap is more than just a number, reflecting instead some careful calculations on the likely appetite of investors for a fund and a maximum size that can be sensibly invested during the fund's investment period. Setting a hard cap at the outset of the fund raise can have a positive impact on investor sentiment, indicating a sense of discipline and focus on the part of the GP and can really help to build momentum. But it can also create challenges if disclosed early, with market sentiment tending to cool if the pace of fundraising slows.

Most managers go out to investors with a hard cap early on and aim to stick with it. Philip Robson is president of the private debt group at Integrated Asset Management, Canada's largest independent provider of investment grade senior private debt. He says a lot of thought goes into the fixed hard cap: "We have always gone out with a fund minimum of $300m and a maximum of $700m. Our maximum loan investment amount is 7.5 percent of the total fund value, and a bigger fund size sends us into a larger loan market and loan size, which in turn makes it difficult for us to achieve our target yield. We prefer to fundraise little and often, staying in the borrower segment that has delivered our 10-year track record."

Others play their cards closer to their chests at day one: "We always form a view going into the process about what we would like to raise, based on market capacity and our capacity," says one manager who preferred not to be named. "We won't formally go out with a cap in the beginning, but we are always prepared to address the question. Typically a large early investor will work with us to formalise where the cap should be set through an iterative process."

One key element of fundraising discussions will be explaining the thinking behind the hard cap, and justifying its level, to potential investors. Large early backers will want reassurance that GPs will resist the temptation to raise the cap if the fundraising goes well, and to see evidence of how the limitation on the size of the fund plays into the strategy of deal targeting and execution.

But it is not always a bad thing to review and reduce the hard cap during the course of the process. Rafael Calvo is a partner at London-based MezzVest and recalls going out fundraising for their Fund III with a hard cap that was subsequently adjusted downwards. He says: "We started fundraising in late 2011, which was not the best time to fundraise, and our initial hard cap in the documents was €1bn. In the middle of the fundraising we realised that was going to be difficult to get to – some investors were raising eyebrows at the size of the headroom."

The first close was extended to 18 months, which early investors agreed to on the proviso that the hard cap be cut to €750m. "We did that," says Calvo, "and then we got to our target. A hard cap becomes an issue when you have multiple closes, because your first close and your second close investors are a bit more affected by having huge headroom on the hard cap." ■

I IS FOR INVESTOR PROTECTIONS

Investor protection mechanisms are, of course, nothing new. Though GPs may look back with nostalgia on the fundraising frenzy of 2007, in truth the majority of funds that held a final closing in that period already featured carry clawback provisions, key person clauses and GP removal language.

What is new, however, is the level of investor scrutiny that such investor protections attract. The key person provision, for example, is a case in point. The core attributes of key executive clauses remains the same: the ability to vote to suspend or terminate the fund's investment period if a certain number of investment professionals (the "key executives") leave. Historically, investors focussed on the essentials: the percentage vote required, the number of key executives leaving which triggers a "key person event".

Having realised post-crisis that many key person clauses were not as watertight as they thought, investors are focussing on the detail. What level of time commitment to the fund is required from the key person? Will LPs only hear about a key person event ex post-facto, or do they have notice rights every time a key person leaves? Precisely who gets to vote: are sponsors, GP affiliates and executive co-investors carved out? On what basis is the percentage vote calculated: a percentage of all LPs, or only the eligible LPs, or voting LPs? Is suspension of the investment period automatic upon a key person event, or is an LP vote required? If the latter, how long do LPs have to act? In this way, investors have changed the terms of the debate and – through a process of ➤

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incremental negotiation – made real inroads into GP powers.

This has been reflected and amplified by the success of the Institutional Limited Partner Association [ILPA], whose 2009 'Private Equity Principles' and 2012 update provided a manifesto for fund investors. Yet the value of a "consensus view" should not obscure the need to tailor its one-size-fits-all, PE-focussed approach to the specifics of a particular manager and to the characteristics of a particular asset class. To continue with the example of the key man provision: the relevance of the provision greatly depends on the institutional manager. Many larger debt sponsors, for example, (and in particular, banks and insurance companies) see their funds as an institutional offering, and so not tied to the participation of a particular star manager. Similarly, as senior debt funds are often viewed as more commoditised, low-risk products more akin to CLOs, the "nuclear option" of key man suspension may not be appropriate.

This nuanced approach to investor protections is also reflected in the carried interest and other incentive arrangements for the sponsor and executives. The debt space features a wider range of manager incentive arrangements than perhaps any other fund asset class. Although some debt managers, generally at the mezzanine/distressed end of the spectrum, have retained the classic PE model (with fees on committed capital and carried interest after a preferred return with 100% catch up), many have not. Fees on invested – rather than committed – capital are now common, as are fees charged on a hybrid basis. Yet investors should take care to weigh the benefits of such arrangements. For example, fees calculated on invested capital result in lower aggregate fees in the investment period and ensure that the manager is only paid for concrete investments. But they can also create a perverse incentive to get money out of the door as quickly as possible – which may require further protections (e.g. "speed bump" restrictions) to mitigate.

There is also a danger that investor protections can create operational risk for GPs: the nightmare scenario being a hostile GP removal by investors. In the new fundraising environment, careful drafting is needed to ensure that each hard-won investor protection does not turn into a manager liability. Debt is – workout situations aside – a far more passive investment than private equity. Consequently, investors may be tempted to invoke their new no-fault-removal rights to take the manager out of the picture as soon as a fund is fully-invested, and thereby cut out the management fee and carry. ■

J IS FOR JURISDICTION

Which jurisdiction? This is historically one of the first, if not the first, question asked when structuring a private fund. A manager recently commented about the ongoing competition between fund domiciles that the "battle has been fought, asset managers have made their minds up by now". Some seem to believe that the jurisdictional dilemma was settled once and for all some time ago. Others recognise that stereotypes such as "Cayman for Asian investors" or "Ireland for hedge funds" must be revisited in these times of regulatory change. Several recent pieces of regulation have revived the jurisdictional debate, causing managers to pause and ask whether they really want to locate in a particular market and to consider again the consequences (including the cost) of doing so.

In today's globalised private fund management industry, fund structuring has become an intrinsically international and multi-disciplinary exercise, for reasons linked with the sponsor or asset manager, a fund's target investors, the investments targeted, and the expertise required.

The sponsoring manager may have a natural preference for "domestic" structures just for reasons of familiarity: i.e. US managers know Delaware or Cayman limited partnerships, while UK managers tend to default to English or Channel Islands limited partnerships. That said, those natural tendencies do not necessarily match with investor preferences or requirements today.

The AIFMD has materially impacted fund structuring amongst alternative asset managers and many non-EU managers have been looking to avoid the challenges it presents by choosing simply not to market into Europe. That approach is not necessarily sustainable for all US and Asian managers, just as it is not for European fund managers to avoid worries triggered by US regulations such as Regulation S, ERISA, Dodd Frank and Volker by not soliciting US investors or not investing into the US.

SEVERAL RECENT PIECES OF REGULATION HAVE REVIVED THE JURISDICTIONAL DEBATE, CAUSING MANAGERS TO PAUSE AND ASK WHETHER THEY REALLY WANT TO TAP INTO A PARTICULAR MARKET

The fund investment process may also steer jurisdictional debates regarding the main fund vehicle and the underlying investment structure. Many European debt funds, for example, take the form of a Luxembourg specialised investment fund ("SIF" or "FIS") but create local origination or holding vehicles in the target investment markets to cater for applicable legal, regulatory or tax requirements.

In the current regulatory environment, going offshore is not necessarily the right answer. Offshore structures are not attractive to investors in certain jurisdictions – even if they can be marketed from a strict legal and regulatory point of view – because some jurisdictions now see the "offshore" model as tainted. The current environment tends to favour the regulated structure, whether on account of the availability of management or marketing passports within the EEA, investor appetite, regulatory constraints or simply adding positive branding. Regulatory compliance requires expertise, both in structuring and running the fund, so Luxembourg and Ireland are on the most-wanted lists of many fund managers given the local presence of experienced service providers. And if those structures don't provide everything that investors want, parallel funds combining an onshore regulated vehicle (e.g. a Luxembourg special limited partnership) with an offshore unregulated vehicle (e.g. a Cayman partnership) are an increasingly popular option. ■

K IS FOR KEY EXECUTIVES

The success or failure of a fundraising will often rest on the quality and reputation of the fund management team and as a result, high quality, experienced key executives are one of the main reasons why investors will choose to invest with a particular manager. Key executive provisions are now fairly standard across private funds, but continue to be among the most heavily negotiated terms in a fund's constitutional documents. The detail of the triggers and implications of a key executive event taking place tend to depend on the nature of the fund management business and the asset class in which it operates. There is both an art and science to getting the balance right when dealing with all this.

IT IS NOT IN ANY PARTY'S INTERESTS FOR THE PROPER FUNCTIONING OF THE MANAGEMENT TEAM TO BE HAMPERED BY DRACONIAN OR IMPRACTICAL KEY EXECUTIVE PROVISIONS

As mentioned in I for Investor Protections, key executive clauses give a level of investor protection by providing for certain contractual consequences in the event that a specified number of "key executives" cease to devote a specified amount of time to the fund. However, in negotiating key executive provisions, the need for investor protection has to be balanced with the practical reality that individuals do sometimes leave their employer, for various reasons. It is not in any party's interests for the proper functioning of the management team to be hampered by draconian or impractical key executive provisions when such situations arise.

There are a number of points to consider here. For a start, key executive provisions that list large numbers of individuals can be unhelpful in that they can hinder the normal management of the team. Managers should therefore consider the wider future strategy of the business when agreeing key executive clauses. On the other hand, provisions that focus on only one or two individuals can place considerable power in their hands, and as ➤

a result are now rarely seen or welcomed. Managers should be mindful that individuals can have conflicts of interest here! A related point is that investors may form strong relationships with particular individual members of a management team they encounter, so it makes sense to involve the full team in the fund marketing process.

A fund's documents should provide for a smooth replacement process, whereby the manager can appoint appropriately qualified key executives with advisory board consent rather than needing to go back to all investors. In addition, such consents should be asked for on a case-by-case basis by reference to the experience of the proposed replacement to avoid storing up a problem.

The underlying asset class and geography is also relevant. Key executive provisions appropriate to a European buyout fund may be inappropriate for an Africa-based private real estate fund manager, because the talent pool available is not comparable. Recruitment of a replacement may be a very lengthy process in a specialist niche in a growth market.

It is common when dealing with key person provisions for different thresholds to apply to different people. This varies between "active involvement", "a majority of business time", "a substantial majority of business time" and "substantially all business time". The drafting of this aspect of the key executive provision is also heavily negotiated, as investors want to ensure that the team they have backed is sufficiently focussed on managing the fund during the investment period. However, it is often appropriate to have a different test for a deal executive than for the managing partner of the team who will inevitably have other responsibilities.

As a general guide, a key executive clause is often triggered by the departure of around one quarter to one half of the named key executives. The most common contractual consequence after the triggering event is the automatic suspension of the manager's ability to make new investments of the fund (though limited investment powers are normally retained – such as the power to make follow-on investments). In some cases, the suspension is not automatic, but rather a positive investor approval is required before a suspension kicks-in, and although this is far less common, there are circumstances in which it is more appropriate, as any suspension is automatically going to constrain the GP.

Suspension periods customarily last for six, nine or twelve months in order to provide adequate time for the manager to source, negotiate with and hire a replacement and it is then either lifted following appointment of the replacement, or it expires. If this happens and a replacement has not been found, the investment period will usually terminate. Sometimes suspension of the investment period may be also accompanied by management fee freezes. However, a fee freeze is a double-edged sword, because a lack of fee income can hamper the manager's ability to hire an appropriate replacement.

All in all the key person provisions are exceptionally important and demand early attention from fund managers to ensure the right result. ■

L IS FOR LITIGATION

The possibility of litigation between a private fund and its investors has become much more of a reality since the financial crisis, with investors now far more attuned to issues they are prepared to litigate over. Two recent cases in particular have highlighted this reality, and each case gives rise to some practical lessons for GPs.

Whilst fundraising for an infrastructure fund ("Fund II"), Henderson, the fund manager, identified John Laing plc as a potential asset for Fund II. As John Laing was a listed company at the time, Henderson was prohibited from disclosing this to prospective Fund II investors.

John Laing was acquired by Fund II shortly after final closing, but the investment subsequently lost two thirds of its value. A number of the fund's investors sued Henderson. As is fairly usual in an English limited partnership fund structure, the fund manager had been appointed by the general partner of the partnership pursuant to a management agreement, and the manager was not a party to the LPA. As such, the claimants could not bring a direct claim against the manager. The claims were therefore made directly against the GP as well as derivatively against the manager under the management agreement and were also for misrepresentation on the basis that the fund's PPM failed adequately to disclose Fund II's investment strategy.

A preliminary hearing focussed on the derivative action, and found that although such a claim could be brought, it would constitute involvement in the management of the limited partnership by the claimants, resulting in loss of their limited liability status. The case also highlights two other points. The first related to the manager's fiduciary duties: the claimants did not attempt to argue that the manager owed a fiduciary duty direct to the Limited Partners because any such duty was expressly excluded by the Management Agreement. The second related to the content of the PPM, and the Judge held that the PPM was non-contractual and should not be used as a basis on which to construe the LPA.

THE POSSIBILITY OF LITIGATION BETWEEN A PRIVATE FUND AND ITS INVESTORS HAS BECOME MUCH MORE OF A REALITY SINCE THE FINANCIAL CRISIS

This case highlights the need for care in defining the duties of a manager, and in particular, to whom its duties are owed. Also, it is important to review indemnity provisions to ensure that potential exposure to investor derivative claims is dealt with appropriately.

The second case involved Inversiones Frieira SL and Inversiones Valea SL who were limited partner investors in Colyzeo Investors II LP, which was managed by Colyzeo Investment Management Limited ("CIML"). The value of the investors' interests had fallen by around 50 per cent and they sought to obtain detailed information from CIML. The investors sought "all books and records of the Partnership that concern the investments made by CIML", and the Court was asked, twice, to consider the scope of information to which the investors were entitled.

In his first decision, the judge addressed points of principle, and ruled that every partner has the right (regardless of motive) to disclosure by the other partners of all matters relating to the partnership's dealings and transactions to enable it to examine the state and prospects of the partnership business and consult with the other limited partners. Critically, however, he also made clear that what was required by this will vary from case to case depending on the nature of the partnership business and its mode of conduct and the terms of the governing documents read in the light of current business practice. A second ruling from the judge was required because the investors were not happy with the documents offered by CIML. On this occasion, the judge found in favour of CIML, stating that the onus was on the Investors to indicate in what respects the available documents were not sufficient, and the Investors were unable to do so.

A practical lesson to be drawn from this case is that paperwork generated in the course of a fund's operations may be the focus of attention where investors are unhappy with the fund's management. Care should be taken therefore to ensure that appropriate records are kept, but that the prospect that those records may later be scrutinised by investors is also kept in mind. ■

M IS FOR MANAGED ACCOUNTS

In the aftermath of the credit crisis, separate or managed account arrangements were seen by a number of investors as a way of continuing to invest capital indirectly with fund managers without committing to a long-term classic "blind pool" arrangement. As a result, bespoke, individual account structures have become more common in Europe, Asia and North America and across multiple asset classes. As the fundraising market for private funds recovers, managed accounts remain a popular choice for a number of investors. They are particularly suitable for sovereign wealth funds or pension fund investors with large amounts of capital to deploy.

Managed accounts remain fundamentally bespoke products, and it is difficult to identify "market standard" provisions. Terms will depend in part upon whether the arrangement is a true management relationship, or advisory only. However, a number of high-level trends do exist.

For investors, managed accounts generally offer better economic terms than classic blind pool structures. For example, management fees are often payable on invested capital rather than a notional committed capital amount. Carried interest is typically payable at a significantly lower rate than the classic 20 per cent private equity blind pool figure, often on a deal-by-deal basis, and indeed a number of arrangements (particularly in the credit asset class) do not include any performance uplift.

For non-economic terms, a key advantage of managed accounts for investors relates to information and manager access. At a time when some LPs have been seeking to reduce the number of manager relationships they have, separate accounts offer an opportunity ➤

A-Z OF FUNDRAISING

for enhanced relationship building. The trade-off for investors who may enjoy a greater level of control and visibility in a separate account structure than in a blind pool fund though is that they may have fewer (or no) assurances as to dealflow allocation compared to what they might expect in a classic comingled arrangement. This is linked to the fact that GPs will often seek to carve out separate management or advisory mandates from the typical restrictions on raising successor funds that are imposed upon them in the blind pool context: the rationale being that managed accounts should not be seen as competing products.

For GPs, managed accounts are a way of developing close relationships with significant investors. This has been particularly prominent in the United States, where a number of large, high-profile public pension plans have entered into relationships covering a full range of asset classes, from private equity to real estate to credit (the "one stop shop" model, which only a few asset management houses can offer). Managed accounts also offer access to large pools of capital which, over recent years, might not have been available otherwise. This has enabled GPs to bridge gaps between mainstream fundraises, thereby avoiding track record lulls and generating sufficient revenue to keep teams incentivised (though the portability of track record may depend in part upon whether the relationship is managerial or advisory). In some circumstances managed accounts are implemented as a precursor to a fund, often as a cornerstone arrangement on the basis of which further capital is then sourced.

A feature of the bespoke nature of separate accounts is that their terms tend to be heavily interdependent. For example, a fee based on invested capital is common across all asset classes in the managed account context. However, a manager's willingness to accept a fee based solely on invested capital may be influenced by the level of investment discretion that the investor has, which of course will depend on whether the relationship is managerial or advisory. If an absolute veto right is crucial for an investor, this can impact termination provisions; managers may seek to retain flexibility to end the arrangements on short notice to cater for a scenario in which the time and cost of the deal-sourcing process is not justified by the resulting fee revenue. ■

N IS FOR NEGOTIATIONS

It is no secret that the negotiations between GPs and LPs during the formation of a private fund are generally more drawn out and intense than they were pre-financial crisis. The turbulence of the crisis led many investors to adopt stricter investment criteria and to push for increased transparency and alignment, as was reflected, for example, in the ILPA principles. Today there are a number of tactical and technical points to consider.

Firstly, deal with structural matters upfront: the domicile of the fund vehicle and management structure is arguably more important than ever, and investors have increasingly bespoke requirements and preferences on structural matters. It is tempting to frontload core commercial discussions around economics and investment scope, but leaving investors' more technical requests to the end of the negotiation process can cause delay. Even if both parties are willing to compromise, complicated structural requirements or tax-related matters have the potential to be deal-breakers on both sides if they are not flushed out early and planned for accordingly.

Get these into the conversation early.

Secondly, delineate decision-making authority within all counterparties: knowing who has the authority to take a view on a particular matter, and which teams within the GP (or LP) need to be involved in discussions on any given topic, can facilitate a smoother process to closing. For example, decisions on key economic provisions will typically be reserved for upper level decision-makers, but it may be appropriate (and efficient) for certain other matters to be handled by an internal legal team alone. Identifying each team member's remit in advance of the negotiation process increases efficiency.

Thirdly, it's entirely possible to anticipate a number of likely investor issues: most managers will have a clear idea of the profile and nature of their target investor base. The manager's fund formation lawyers will have negotiated with many investors before so should have a sense of any structuring issues or particular regulatory concerns applicable to a particular type of LP. And this is where the placement agent can really help too, using their in-depth understanding of the key players in private fund investing and the types of issues that concern them.

Next, for any GP, it pays to be prepared. Although an obvious point, it is important to be both thorough and prompt when responding to investors' requests. Preparation is key: GPs should put together stock answers to typical due diligence questionnaire questions in order to turn around responses quickly and keep up momentum.

It also pays to have a critical eye. GPs can sensibly anticipate what investors will look at and what they will seek to negotiate. GPs with clear views as to the fund's strategy, scope and features fare better in such negotiations at a different time to other investors. Each party needs to be able to justify and explain the reason for its position on a particular commercial or legal term if it is to defend it.

Managers should also avoid bilateral negotiations with their investor group. It is a challenge, particularly on larger funds, but when negotiating with a number of investors GPs should generally avoid entering into one-to-one negotiations at a different time to other investors. Good lawyers advising the GP will have this down to a fine art: the process of receiving, analysing, turning and negotiating multiple sets of investor comments, many of which may address similar issues in slightly different ways. It's imperative to ensure that all responses are consistent and on-message.

Finally and perhaps most importantly: communicate. GPs and their counsel should keep in close contact with all investors during the negotiation process to ensure the process runs smoothly and deliverables are met fully and promptly. Placement agents can have a key role here in keeping all investors informed and helping both manager and lawyers to maintain momentum to a timely closing. It always pays to take the conversation to your counterparties, not least as negotiations will remain constructive and be far less likely to become adversarial. ■

O IS FOR OPEN-ENDED

Open-ended funds are typically funds that can be offered for subscription and can be redeemed by investors voluntarily at prescribed times and at prices reflecting the funds' net asset value. As a result the life span of these funds can seen as continuous, unlike closed-ended funds. Open-ended funds have also traditionally been set up for investments in relatively liquid or readily realisable assets (in contrast to investments in unlisted companies or real assets found in closed-ended funds).

There are various ways for open-ended funds to deal with the redemption needs of investors. For instance, open-ended funds may impose redemption gates whereby the aggregate redemption requests to be dealt with on a redemption day will not exceed a particular limit typically between 10 and 30 per cent of the aggregate net asset value of the fund. A fund's investors may also be subject to lock-ups (generally one to 12 months depending on the nature of the underlying investments of the funds) meaning that redemptions can't happen during that period and there may also be a stipulation that redemption proceeds be paid in tranches.

Prior to the global financial crisis, it was customary for open-ended funds to have "side pockets" constituting typically one-third but sometimes up to as much as half of the net asset value of the fund. Side pockets enable managers to set aside relatively illiquid assets from the rest of the fund's assets, with investors only being entitled to redeem out of the non-side pocket assets. Many fund managers had difficulties realising the assets of their funds to meet the requests from redeeming investors during the financial crisis and had to make extensive use of the side pocket mechanism and redemption gates to restrict and delay investors from redeeming. In some cases the inability to sell assets to fund redemptions laid bare the shortcomings of an open-ended structure for funds investing in illiquid ➤

assets – essentially "open-ended" funds were precisely not that, at the very time investors most needed them to be. The use of side pockets by open-ended funds has since come under much closer scrutiny both by investors and regulators.

Increasingly, hedge fund managers are opting to set up hybrid funds primarily for their credit strategies. These funds are set up as closed-funds with limited duration where no investors can voluntarily redeem or withdraw prior to the termination of the fund. The fund will undertake multiple closings within a window of time (generally 12 or 18 months) and drawdown from its investors. However, the strategies and risks of these funds are similar to open-ended hedge funds, for instance making extensive use of leverage and derivatives to achieve their investment objectives. Managers are not entitled to performance fees for unrealised gains and will only be entitled to carry if the return upon realisation of the investments exceeds the designated hurdle. However, managers will effectively be guaranteed a steady pool of funds which they can deploy (or even redeploy if permitted under the fund's constitution) at such time and pace as they wish.

In the private fund context, open-ended funds are traditionally less common, because of the illiquid nature of the underlying asset classes, although the model is sometimes used in relation to core real estate strategies. The hybrid model, where a closed end fund has redemption features at specified intervals is also seen, for example in the secondary infrastructure space. One model involves the use of a long-term fund (perhaps 25 to 30 years) but with redemption gates at say year ten or so, to allow investors a measure of liquidity. Such mechanisms can be popular with investors, whether their liquidity requirements represent real commercial needs or are simply a response to regulatory rules or "tick box" requirements. ■

P IS FOR PLACEMENT AGENT

Ask a placement agent which funds they prefer to advise on and most will jokingly declare it's the ones that don't need them: a fund manager with a compelling track record, a stable team and with consistent, disciplined focus makes an investor pay attention. Yet an agent's ability to deliver these messages in a compelling way and in many cases badge the manager as high quality through their association with it means their role continues to be important.

The fact that an agent spends all of its time talking to investors about what they are looking for, liking and disliking, means they can not only help connect the GP with a relevant set of investors but also help refine the manager's messaging for that group of prospects. And once underway, the agent can bring valuable momentum to the fundraising process, helping run due diligence, promptly responding to investor queries and ensuring that all parties remain focused on decision making

Likewise, although many large fund management groups have built their own internal fundraising infrastructure, placement agents are still an important resource for funds wanting to cover a diverse and/or sizeable universe of investor prospects efficiently. Even the large GPs may use an agent with a particular geographic expertise or proven network of hard-to-access relationships.

It's notable though that agents are having to work much harder today for their fee [typically a retainer plus a percentage of the new capital they help raise, although first time funds may instead offer a cut of the carry to help defray up front costs].

The challenges for agents are several: many managers are opting to test the market unassisted first, preferring to bring in an agent at a later stage and, by implication, if required. GPs are also putting very specific constraints around any subsequent agent mandate. Defining the geography and institution type that will be targeted by the agent is vital, as is clarity around the handling of particular institutions where both the GP and the agent have a connection. This becomes especially pertinent when addressing follow-on investments by that same investor. As one GP who used an agent on past fund raises puts it: "Success can have many fathers . . . and an agent will want to retain at least some of their economics when commitments are made over a succession of funds."

There is also today far greater sensitivity around compliance in the fund raising process. Several high profile prosecutions in the US (the Pay-to-Play Rule) have obliged all parties to maintain far greater levels of hygiene. In the US, all agents who are involved in soliciting capital from government institutions have to be registered as a broker-dealer with the SEC and be a member of FINRA. Likewise the AIFMD (see A for AIFMD) is an important factor when fund raising in Europe with the interpretation of what reverse solicitation does and does not allow being key. This enables non-EU based GPs to bypass the directive's marketing requirements so long as an LP makes the first approach about a fund opportunity. What's not clear though is how an agent (or GP) can encourage that first approach from an investor and care must be taken to ensure that the reverse solicitation is exactly that. Anecdotal evidence suggests that some EU regulators are looking more closely at reverse solicitation in their jurisdiction having received less passport applications than expected. ■

Q IS FOR QUESTIONNAIRE

There's an old joke on Wall Street that the word *prospectus* is actually Latin for "that which is not read". So whatever work you may put into producing a comprehensive private placement memorandum (PPM), you need to stand ready with a host of additional answers when investors and consultants send back their own questionnaires in response.

The due diligence questionnaires that accompany fundraisings have grown in number and scale over the past few years, even though the vast majority of the questions contained within might already have been covered elsewhere in a GP's marketing materials. Often these supplementary questions are heavily focused on the internal workings of a manager, covering processes – such as how investment decisions are made – that may not be outlined in detail in the PPM.

Other issues often coming in for greater examination today include the team's track record, the ownership structure of the management company, the accuracy of the track record using different forms of analysis, the stability of the team, longevity of working relationships and so on.

Nigel Hatfield, a private funds partner at Clifford Chance in London, says: "The key thing from a GP's point of view is to have thought about all the issues in advance and have prepared answers ready and waiting. The answers are often very similar for all the questionnaires, but they need to be put in to different types of questions using different formats for different investors. The process can be quite time consuming, and it can delay things if a GP hasn't prepared sufficiently in advance."

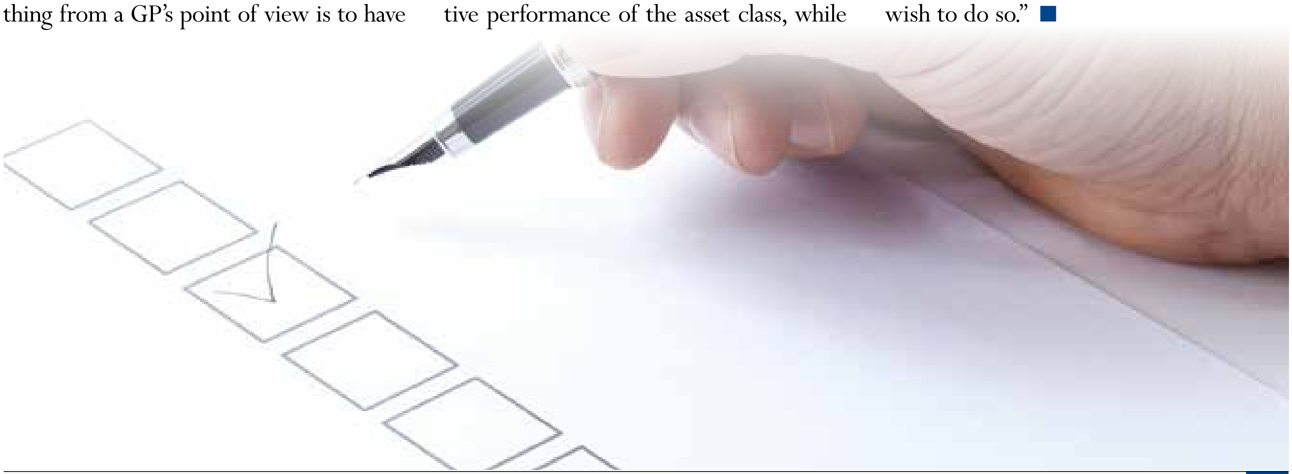
Attention to detail is vitally important because although the questionnaire may be technically carved out of the managers' warranties on accuracy, if the statements given within it are wrong or misleading, that is still potentially problematic. As such, even though the questionnaires are less formal and are susceptible to vague responses, they still require due care and attention. Quite apart from anything else, detailed and professional responses reflect well on a manager at a crucial time.

James Newsome, managing partner at corporate finance house Arbour Partners, says managers will come across four types of questionnaires, from consultants representing big pension funds and insurers, and from sovereign wealth funds, family offices and pension funds investing directly. Those coming from wealth funds and family offices may focus more heavily on the relative performance of the asset class, while consultants may more quickly drill down in to origination strategies.

Newsome says: "The questions will vary depending on whether they come from those who invest extremely widely or those who know the asset class very well. A manager has to be prepared for both extremes, and ready to cater for people who are lacking any focus on the asset class."

As a ready reckoner he recommends that questionnaires should answer: What (about the asset class); Why (the market); Who (the manager and the team); How (how you invest and choose assets); and When (how long it will all take).

At a more practical level, many GPs now use online platforms to post a set of readymade responses. Rafael Calvo is a partner at MezzVest, and developed the reporting systems that the firm uses to provide periodic information to limited partners. He says: "The way we normally prepare for fundraisings is by preparing a fully comprehensive database of due diligence questions, and hopefully we won't get asked a lot of questions beyond that. We try to think about everything an investor will want to ask, and stand ready to deliver it in their own format so that they can compare the numbers however they wish to do so." ■



R IS FOR RECYCLING

Recycling and reinvestment provisions in fund documentation tend to divide investor opinion: certain LPs support wide reinvestment authority for the fund manager, while others prefer the GP to have more limited reinvestment rights.

As commonly understood in the market, re-investment covers two similar but distinct scenarios related to the use of proceeds from existing investment. The first scenario occurs when capital contributed by investors to fund the acquisition of a portfolio investment is returned to the investors and subsequently drawn down again by the fund to make a new investment (reinvestment). The second scenario occurs when capital contributed by investors to fund the payment of fees and expenses – including management fees, operating expenses and organisational expense – is returned to the investors and subsequently drawn down again by the fund to make a new investment (recycling).

From the perspective of the GP and many LPs, reinvestment and recycling benefit all investors by allowing the fund to put a higher percentage of capital commitments to work in investments within the fund's investment strategy. Without these provisions, a significant portion of the fund's commitments would never be invested, because of the need to cover the costs, fees and expenses associated with raising and operating a private investment fund. In addition, many managers (particularly debt fund managers) believe that reinvestment provides a way to leverage the fund's investment returns without increasing the investors' liabilities or exposing the fund to third-party creditors.

Some investors, however, insist that a fund's ability to reinvest proceeds should be limited, due to a preference to receive distributions as soon as capital is available, and a perception that reinvesting proceeds is somehow more risky. LPs may request that proceeds from an investment are only available for reinvestment if the proceeds are realised within a short period of time, calculated from the date of the initial investment (12 to 24 months is typical, with a slightly longer period for senior debt funds). In addition, investors may request that the manager is entitled to use proceeds for reinvestment only during the investment period, or in certain circumstances a specifically defined "reinvestment period" (often expiring on an anniversary of the last day of the investment period). Some investors in debt funds also distinguish between the reinvestment of interest proceeds and capital proceeds, with specific investor or advisory committee consent prior to reinvestment. Finally, some investors believe that proceeds in respect of an investment should only be used for reinvestment once 100 per cent of the capital contributed in respect of the initial investment has been returned – in other words, once it is clear that the initial investment was in fact profitable. This can, of course, be very difficult for a debt fund manager to agree to, as the GP may prefer to reinvest current income distributed from the existing loans held by the fund as soon as possible.

INCREASINGLY ACTIVE PORTFOLIO MANAGEMENT BY LPS LEADS SOME TO SEEK TO EXIT FUNDS EARLIER THAN ANTICIPATED

In the current market, debt funds with well-defined investment strategies and a clearly articulated approach to reinvestment are generally successful in convincing their investors to permit the strategic use of recycling in order to take advantage of opportunities and potentially increase investor returns. ■

S IS FOR SECONDARIES

The global secondary market for private fund interests has increased significantly in volume over the last five years. According to PEI data, secondary funds closed on a total of $28.6bn in 2014. LPs are buying and selling fund interests for a variety of reasons, no longer limited to distressed situations. What are the reasons for this increase – and what are some of the key issues that arise in the course of a secondary transaction?

Various drivers have emerged, relating both to supply and demand. In terms of supply, a greater number of LPs are seeking liquidity from their alternative asset holdings, particularly in the aftermath of the financial crisis. Shorter holding periods have also become attractive to some investors: a general desire for more flexibility and increasingly active portfolio management by LPs leads some to seek to exit funds earlier than anticipated. This can be for a variety of reasons, including a desire to alter levels of exposure to particular geographies, asset classes or sponsors. For some LPs, the advent of increased regulation (such as the Volcker Rule, Solvency II and Basel III) continues to require them to reduce their exposure to private fund investments due to high-risk weightings and onerous regulatory capital requirements or, in the case of Volcker, straightforward prohibitions.

In terms of demand, purchasing investors have visibility over a fund's performance which is not available to LPs who commit upfront. Additionally, some of the larger secondary fund managers may often be familiar with the GP management team so may feel more comfortable acquiring a "known quantity". And again, flexibility plays a part here: certain LPs may wish to acquire a stake in a particular fund or asset class to which they are not exposed, or increase an existing stake. Likewise, buyers with a degree of appetite for risk may be attracted to opportunities to acquire an interest in an underperforming fund for less than NAV.

A sale of one or more secondary fund interests is not of itself a complicated transaction. The buyer and the seller will agree (i) a price; (ii) the apportionment of ongoing liabilities; (iii) apportionment of costs (and transfer taxes); and (iv) appropriate representations and warranties to sufficiently protect both parties. The issues arising during the course of a secondary transaction tend to be practical and logistical.

Transferability can be an issue too. Private fund constitutive documents will typically prohibit a transfer unless the GP provides consent. Some documents also contain right of first offer or refusal provisions in favour of other investors in the fund or the GP itself. Managing the practical aspects of those hurdles can be challenging – particularly where a large portfolio of interests is being sold.

INCREASINGLY ACTIVE PORTFOLIO MANAGEMENT BY LPS LEADS SOME TO SEEK TO EXIT FUNDS EARLIER THAN ANTICIPATED

There are also often concerns about confidentiality. In the first instance the seller must identify any confidentiality provisions in the documentation that could prevent the seller from organising an auction process or providing sufficient information for buyers to carry out due diligence. The level of co-operation which the GP concerned feels able to provide can be critical to a successful transaction.

Finally, LPs participate in private funds through increasingly complex structures, dependent on their particular tax and regulatory requirements. If a seller has participated through such a structure, it may not be appropriate for the buyer – so further restructuring may be required. Certain investor-specific issues can also give rise to complications. For example, a fund may be operating within an exemption from certain US ERISA requirements, whose applicability may need to be carefully assessed in the context of the proposed purchaser and, where relevant, its underlying investors.

As a result of these kind of issues, a specialist secondary adviser can be important to the success of a secondary transaction – particularly those involving the sale of a large portfolio of interests. The lawyers on both sides will be heavily involved in due-diligencing the underlying fund interests and negotiating the terms of the legal documents, but as mentioned above, there are also a number of practical hurdles to overcome during the transaction. See also Z for Zombie Funds for a further discussion of secondaries in the context of a fund restructuring. ■

T IS FOR TRACK RECORD

A good track record is of huge importance – the length and strength of a team's track record can clearly make or break a fundraising. But while a sponsor going to market with a stellar track record is starting with a handsome advantage, there are nevertheless opportunities for others. What happens if the team has a long track record with some patchiness in the performance, for example, or if there is no track record at all to speak of because team members gained experience at previous employers?

"Limited partners are just looking for honesty, more than anything else," says Oliver Wriedt, co-president at CIFC Asset Management. "There has been a pervasive issue around showing truncated track records, or not showing composite track records, and trying to cherry pick. Investors continue to react extremely negatively to that."

Regulators too have implemented rules regarding the presentation of historic performance information by managers. For example, the UK FCA's rules applicable to AIFMs require managers to disclose (where available) the historic performance of the alternative investment fund in the prior disclosure information given to investors that are considering an investment in such a fund. The FCA rules also include detailed requirements regarding fund past performance, simulated past performance and future performance which, whilst not always strictly applicable to managers dealing with professional investors, serve as useful guidance to the regulator's "clear, fair and not misleading" standard.

Even if a track record is patchy, investors might welcome information from managers showing how they have learned from any problems that arose in past funds, or explaining any external factors that had an impact. What looks like a patchy performance may also be justifiable with evidence of the fund outperforming the market or other similar managers, even if its own results were not spectacular.

Likewise, if a team has no track record to speak of, illustrating the strength of the current pipeline and sharing the CVs of the group can provide reassurance to investors that the necessary relationships, market knowledge and ability to source deals are in place.

In the US, track record presentation is regulated by the SEC and as such there are strict rules to prevent fraudulent, deceptive or manipulative activities, including presenting misleading information. Performance information can be deemed misleading for a wide array of reasons: if it fails to reflect the deduction of advisory fees, for example, or if it fails to disclose the effect of material market or economic conditions on the results portrayed (if the accounts appreciated by 25% at a time when the market appreciated 40%, say).

Managers risk falling foul of the SEC if they fail to disclose a host of details, like the fact that the results published only relate to a select group of the adviser's clients; or that the results include the reinvestment of dividends; or the omission of any material conditions or investment strategies used to obtain the performance advertised.

These standards are particularly important if the GP needs to market a fund based on the past performance of its key personnel when they were employed elsewhere. Such "portable performance" can be used in marketing, but only if conditions are met: the individual was primarily responsible for achieving the prior performance results, for example, and the accounts managed previously were so similar to the accounts under management now that the performance data is relevant and useful to prospective clients.

The SEC, for one, has become increasingly sensitive to presentations of performance information because it can so easily and significantly impact an adviser's success. Wriedt says: "Investors continue to expect a no-nonsense approach, showing the full body of work and letting the investors digest that. The number of investors prepared to accept shorter track records has come down in recent years, and there is now a smaller community of investors willing to back start-ups." ■

U IS FOR U.S. INVESTMENT ADVISERS ACT OF 1940

Generally all investment advisers [and this includes private fund managers] must register as such with the US SEC to comply with the U.S. Investment Advisers Act of 1940, unless they qualify for an exemption. An investment adviser is defined relatively broadly and includes any person who engages in the business of providing advice to others or issuing reports or analyses regarding securities and is compensated for this in return.

Depending on the size and reach of its advisory business in the United States, an investment adviser may have no obligations to the SEC, or may have to report to the SEC as a so-called "exempt reporting adviser" (an "ERA") or register in full pursuant to the Advisers Act. It's worth noting that even if the adviser has no obligations to the SEC, that adviser will nevertheless be subject to standard fiduciary duties to its clients and other anti-fraud principles applicable to any person involved in a securities-related business in the United States.

ERAs, which are generally advisers without a place of business in the United States and with a de minimis number of clients and assets under management in the United States, must file an abbreviated "Form ADV" with the SEC and are otherwise subject to the jurisdiction of the SEC (and inspections by its staff). As a reminder, that de minimis definition is the adviser having fewer than 15 U.S. clients and/or U.S. private fund investors or less than US$25 million in assets under management attributable to such U.S. clients or investors.

Registered advisers, which are typically larger and/or based in the United States than those which fall in to the ERA category, must unsurprisingly comply with more requirements. These include, among other things, having to complete and file a lengthier Form ADV; adopt written policies and procedures and codes of ethics to govern their activities; comply with detailed disclosure and advertising restrictions and develop internal controls and procedures for purposes of internal auditing.

The requirements imposed on registered advisers may, at least initially, appear more daunting, but they are predominantly administrative in nature. Once an adviser has registered, its ongoing duties with respect to the SEC under the Advisers Act do not, generally speaking, vary significantly from those imposed on an ERA. Many advisers are eager to avoid registration because they assume the spectre of the SEC will loom larger over their operations if they do. In reality, the SEC and its staff's interest in an ERA and a registered adviser is, in this regulatory climate, largely the same and differs mainly with respect to the paperwork a registered adviser must maintain. For example, registered advisers are currently subject to formal recordkeeping requirements under Advisers Act Rule 204-2, but ERAs are not.

Advisers should carefully consider whether they would like to operate in the United States, but they should not be deterred simply on account of the perceived burden of compliance obligations required by the SEC. ■

V IS FOR VALUATION

What is the value of a 1964 Aston Martin DB5 (the one of James Bond Goldfinger fame)? This seems a relatively simple question, yet is one that elicits differing and not-so-straightforward responses from interested (seller, auctioneer, bidder, etc.) and uninterested parties alike, due to varying objectives and valuation methodologies. While different private fund managers will propose different funds as their equivalent to the DB5, most will agree that, like other asset classes, including classic cars, valuations in the private fund space can vary among parties, and at times significantly.

Different models for determining valuations have always existed in the private fund industry; however, securities regulators, most notably the SEC in the US, have recently begun to look at valuation methods with increased scrutiny. Specifically, the Office of Compliance Inspections and Examinations (OCIE) at the SEC is currently conducting an extensive review of private fund managers with one of the main areas of focus being fund valuation.

With this increased focus on the valuation activities of the private fund industry, investment managers are increasingly turning to independent pricing and valuation services to help value assets that do not have readily available market prices. This is a trend that falls most squarely on the shoulders of private fund managers, as their assets, unlike their hedge fund counterparts (excluding potential side pocket investments that may be more illiquid), generally are not publicly traded.

It is the role of the independent pricing service to try and determine what a specific asset is worth at any given time. Their valuations are based on reported trades ➤

(if available), surveys of trading desks (if available), internet chatter, and/or proprietary pricing models that may reference other areas of the market to estimate the value of the specific asset in question. While these valuation service providers are very good at what they do, their ability to accurately price an off-market asset that may have very distinct – even unique – characteristics, is ultimately going to be constrained by this context.

The silver lining to this is that it does not appear that regulators are, at this point, requiring precise and immutable prices or a specific valuation methodology to be adopted, but rather that disclosure in the fund offering documents needs to properly reflect the valuation methods employed by the fund manager. In a recent interview given by Andrew Bowden, the director of OCIE, to Private Equity International, he stated that the aim of OCIE was not to second-guess a fund manager's assessment of the value of the private fund assets (except in instances where the manager's valuation is clearly erroneous), but rather to "scrutinize whether the actual valuation process aligns with the process that an adviser has promised to investors."

INVESTMENT MANAGERS SHOULD CAREFULLY CONSIDER THE EXTENT OF THE VALUATION DISCLOSURE PROVIDED IN THE OFFERING DOCUMENTS OF THEIR FUNDS

Therefore Investment managers should carefully consider the extent of the valuation disclosure provided in the offering documents of their funds. The prospect of a more extensive breakdown of the valuation methods used by fund managers should be music to the ears of fund investors and debt providers whose due diligence processes continue to require greater degrees of information to sanction both fund investments and lending. ■

W IS FOR WATERFALL

The distribution model typically adopted in private fund structures to distribute income and capital proceeds is the classic "whole-of-fund" waterfall model (sometimes called the "European model") in which investors receive all their money and a preferred return before any carried interest is paid. There are a number of variations on this model though.

A whole-of-fund waterfall requires all capital drawn from investors to be returned (rather than just amounts drawn in respect of the investment to which the distribution relates), before any preferred return or carried interest is paid. After all drawn-down

A HYBRID DEAL-BY-DEAL WATERFALL IS NOWADAYS RELATIVELY RARE IN FUND STRUCTURES

capital has been returned, investors receive a preferred return, which might be set at, say, eight per cent per annum (compounded annually). Then the GP receives a "catch-up" payment until the carried interest percentage has been paid in respect of all the profits of the fund, and not just those in excess of the preferred return. The percentage catch-up split will vary depending on the commercial terms agreed with investors, and is sometimes as low as 50:50. Some funds have no catch-up at all. Thereafter, all profits are split between investors and the carried interest partner, typically with 80 per cent going to investors and 20 per cent to the GP – but the percentages will depend on what has been agreed between the GP and investors, as well as the type of fund. For example, the position in debt funds is often very different to private equity funds, and will depend on the type of debt being taken. More secure senior debt funds typically have lower performance fees than the riskier mezzanine or junior debt funds.

An alternative to the whole-of-fund model is the cross-aggregated deal-by-deal structure. Here, carry is payable from the returns of a realised investment after investors have received amounts equal to their drawn down commitments for that investment plus amounts drawn down for any previous investments which have been realised or written off plus a preferred return on all such amounts. The principal advantage of this waterfall over a whole-of-fund waterfall is that carried interest is likely to be paid out sooner. However, investor demands for (i) escrows and similar carry protection mechanisms, (ii) conservative valuation mechanisms, and (iii) adjustments to account for expenses, write-downs and impairments can result in the profile of a cross-aggregated deal-by-deal waterfall not being so different from a whole-of-fund waterfall in practice.

Finally, there is the pure deal-by-deal model, where carry is payable from the returns of a realised investment after investors have received amounts equal to their drawn down commitments for that particular investment plus a preferred return on such amounts. If an investment is realised at a loss this will not impact on the carried interest payable in respect of any other investments. A pure deal-by-deal waterfall is nowadays relatively rare in fund structures, tending to be limited to US venture funds, but is obviously present in deal-by-deal co-investment structures (although the carried interest rates on co-investments are closer to 10-12 per cent rather than 20 per cent). The pure deal-by-deal model offers less investor protection because investors are exposed to deals going bad later in the life of the fund, after carried interest has been paid on earlier, successful investments.

Some funds have been established using a hybrid waterfall structure, or parallel partnerships offering investors different waterfall structures, and different rates of carried interest depending on the type of waterfall selected.

Where managers have marketed European funds with cross-aggregated deal-by-deal waterfalls they have faced investor resistance, so these are now far less common than they were in the past. Certain European managers that have historically used these waterfalls are often now marketing new funds on the basis of whole of fund waterfalls. GPs that are regulated under AIFMD will also need to give consideration to the relevant remuneration rules (in the UK, the FCA's Remuneration Code) when considering their waterfall mechanics. The whole compensation package of code staff needs to be considered – not just the carried interest element. ■

X IS FOR EXTRAS

It has become increasingly common for private fund managers to offer certain benefits or favourable terms to investors as an incentive to make a commitment to their fund at first closing or to make a commitment in excess of a certain size. Following the financial crisis, first closing (or "early bird") incentives were introduced to help build momentum for a fundraising and to counter the extended fundraising periods that were become prevalent. Today, investors increasingly expect to be incentivised to support a fundraising and to commit at a first close.

One popular incentive for first closers is a fee-based incentive, structured as a discount or a rebate. There are various ways of structuring this package but a common method is to offer a discount of between 10 and 20 basis points on the headline rate of management fee during and/or after the investment period (see also F for Fees). Although arguably still predominantly a tool for larger fund sponsors, small first closing fee discounts are now being offered by some managers of sub-€1 billion funds. Given that the level of management fees charged by a fund is intended to reflect reasonable operating expenses, sponsors need to be able to justify why they believe that they can offer a fee discount to certain investors.

Another economic incentive in a similar vein is a discount on the rate of carried interest paid to the sponsor by first closers. However, this is far less frequently offered by sponsors than fee discounts.

Another common incentive for investors that are active co-investors is their being designated as a priority co-investor and granted a right to receive a priority allocation of co-investment opportunities with respect to investors coming into the fund at a later close. ➤

How such a right is structured raises some important questions for investors and managers alike. For a start, what proportion of available co-investment opportunities should be set aside for priority co-investors? And should an allocation also be kept aside for strategic third-party co-investors or large subsequent closers? Also, does it make sense for all first closing investors who elect to be priority co-investors to receive a pro rata share (based on respective commitment sizes) of each and every co-investment opportunity? If there are a number of priority co-investors, this could result in very small ticket sizes being offered to each of them which would be unattractive.

There is then the question, if a pro rata allocation of co-investment opportunities based on commitment size has been offered, of how any top-ups to the investor's commitment at subsequent closings be taken into account – or should it be based on the first closing commitment only? The GP will also need to consider at what point a priority investor has been offered enough co-investment. Managers often cap this at the point each priority co-investor has been offered a share of co-investment opportunities equal to such investor's commitment. For more discussion on co-investment see C for Co-investment.

Another incentive a GP may consider relates to the allocation of advisory board seats, although this tends to depend on other factors such as the size of an investor's commitment and whether it had a seat on any of the sponsor's previous funds. With investors increasingly insisting on a cap on the size of the advisory board, even if a sponsor does not have a set policy with respect to allocation of seats, investors who commit in subsequent closings run the risk of all the available seats having been allocated by the time of their commitment to the fund. Again, this is a case where care should be taken to ensure that incentives to some investors will not act as disincentives to other later investors. ■

Y IS FOR YOU ARE IT

While a fundraising can feel like it's all about a stack of spreadsheets and some beautifully crafted PowerPoint presentations, the truth is it's personal. Putting the right people in front of the right investors, while simultaneously building a rapport with intermediaries, can often prove to be the key to success.

Many of the larger GPs now devote resources to internal training and programmes from placement agents that look at how best to approach fundraisings. These may involve mock Q&As with management, or a focus on ensuring all the representatives from a firm are saying the same things and ironing out inconsistencies. "Schooling people to make sure that everybody thoroughly understands the strategy of the fund and the criteria the manager uses for judging a good deal," says Nigel Hatfield, a partner at Clifford Chance in London.

James Newsome, managing partner at the corporate finance firm Arbour Partners, has been on the road during fundraisings with as many as 100 asset managers. He says that one of the most important messages that a GP needs to communicate is the integrity of the team.

"What's important is that the person doing the speaking should not be a figurehead or the chair necessarily," says Newsome. "Whoever it is has to be the best person to answer the investors' questions; that is the person that should be on the road."

When it comes to the presentation, he advises GPs against simply talking through 50 slides on a screen, which the investors will likely have already looked at, and says a cast of two or three is usually efficient for that first introductory meeting. "The people that really raise a lot of money just go in and say, 'Let me tell you about the market right now' – they don't even open a document. That's how you get across the DNA of an organisation," says Newsome.

And it is that DNA that investors are really trying to get to grips with before they decide whether or not to part with their money. But the length of time it may take to convince them that your fund is the one to back is on the increase.

> THE PEOPLE THAT REALLY RAISE A LOT OF MONEY JUST GO IN AND SAY, 'LET ME TELL YOU ABOUT THE MARKET RIGHT NOW'

Oliver Wriedt, co-president at CIFC Asset Management, says: "In my experience, making contact is easy. Investors are generally still pretty accessible and have possibly become more so in the last few years. But closing investors and maintaining traction has become more difficult. As investors have expanded their willingness to talk to multiple groups, so it has become increasingly difficult to keep their interest, maintain relevance, and keep them focused on your firm."

One of the challenges is maintaining, and indeed building, momentum into the fundraising process as it unfolds. Hatfield concludes: "Building momentum is a bit of an art form. You can do it partly by offering financial or other incentives to come in early, and building pressure around the timetable. Being very organised about things, setting the investors' goals, driving them forward as a pack and having some deals or some realisations in the pipeline can all help to give the fundraising process further impetus." ■

Z IS FOR ZOMBIE FUNDS

For private funds, the term "zombie fund" refers to a pool of capital – typically an older, closed-ended fund – with no real value creation prospects remaining but whose lifespan has yet to expire. In July 2013, data-provider Preqin estimated that $116 billion of capital was tied up in zombie funds, with around 1,200 such funds in existence at that time. Zombie funds give rise to a number of issues in the context of private funds.

For LPs it is of course unattractive for capital to remain locked up for a prolonged (or indefinite) period of time with little or no prospect of any meaningful return. This is particularly problematic for major institutional investors such as insurers, life companies and pension funds who are reliant on their investments to meet underlying liabilities.

For GPs, any perception of misalignment of interest between the fund manager and its investors is deeply unattractive and damaging to a GP's brand. Managers struggling with a moribund fund may find it difficult to retain the resources needed to oversee it and may also see a broader decline in morale within the firm. It is in the GP's interest to manage out a struggling portfolio with a view to mitigating losses – this is relevant not only with respect to any amounts co-invested by the GP and its personnel, but also from a reputational perspective.

In order to optimise the remaining portfolio, a restructuring of existing LPs' fund interests may be pursued. A secondary transaction of this kind depends (see also S for Secondaries), of course, on there being at least a degree of residual value or prospects with respect to the portfolio. If adequate potential can be identified, under a secondary arrangement a group of new investors would acquire some or all of the existing LPs' interests, thereby offering liquidity to those wanting to exit. The fund would typically be restructured or extended with a view to providing sufficient time to recover (or improve upon) the value of the assets, and its purpose and scope may be broadened so as to permit new acquisitions in addition to the maintenance and disposal of the original assets. This restructuring may be accompanied by the redevelopment of the management team, or indeed a change of the GP/sponsor itself. Depending upon the circumstances, the parties may also look to vary the economic terms of the new arrangements.

GPS MUST BALANCE THEIR DESIRE TO ACHIEVE A POSITIVE RESTRUCTURING WITH THEIR DUTIES TO EXISTING INVESTORS.

The key challenge in this context relates to the potential for conflicts of interest: GPs must balance their desire to achieve a positive restructuring with their duties to existing investors. Existing investors need to feel that they are achieving the best result in the circumstances when weighed against the alternative. Involving a third party financial adviser to coordinate the process and provide independent evaluations on strategy, pricing and terms can assist GPs in demonstrating that they have discharged their duties in this regard, as an external adviser offers a degree of neutrality. Third party intermediaries of this kind may also enable the parties to access a wider range of potential new investors.

As an alternative to a fund-level secondary, a GP might look to sell its portfolio to a secondary player focused on distressed assets. If the price is good enough, a secondary sale offers a solution to a stalemate, though these transactions can be complex and are of course highly dependent on the specific assets. Sales of this kind can be as bespoke as the circumstances require, and concepts such as joint venture structures may sometimes be appropriate. ■

FURTHER READING

FURTHER READING VIA THE FUNDS AND INVESTMENT MANAGEMENT SECTION OF THE CLIFFORD CHANCE FINANCIAL MARKETS TOOLKIT:

The Clifford Chance Financial Markets Toolkit contains our growing collection of publications, guides, videos and transaction tools from across our global network. It provides links to all our recent client briefings relevant to the funds and investment management sector. The resources are available for you on demand, whenever you need them.

The Financial Markets Toolkit has been designed to be compatible with devices such as Blackberrys, smart phones and tablets.

Access the Financial Markets Toolkit here:
http://financialmarketstoolkit.cliffordchance.com/en/home.html

FURTHER READING FROM PEI:

PEI provides deep coverage of the flow of capital into the alternative asset classes of private equity, real estate and infrastructure as well as private debt. The homepages of each of our publications carry daily news tracking fund closes, investor commitments and LP strategies:

www.PrivateDebtInvestor.com
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