Sourcing Capital In The United States And Beyond: Be Prepared For What International Investors Expect

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Asset and fund managers who have historically raised private equity funds principally from investors in the Gulf region are now seeking capital from international and, in particular, US investors in an effort to obtain desirable longer-term capital. Attracting international investors requires different offering terms and raises new disclosure and legal issues. The key contrasts between marketing funds to in-region and international investors are outlined below.

A. CHANGING TIMES… AND TERMS

Investors from outside the Gulf region frequently seek investor-friendly fund terms, and have increased leverage to obtain these terms in this difficult international fundraising environment. Notably, the traditional 2 & 20 fee structure (i.e., a 2 percent management fee and 20 percent carried interest) is under pressure. In addition, international investors typically expect: (1) appropriate alignment of interest between the asset manager and the investors; (2) termination and removal triggers; (3) investment and borrowing restrictions; (4) enhanced clawback protections; (5) comprehensive disclosure and reporting policies; and (6) the establishment of a limited partner advisory committee with formal procedures and a substantive role regarding the fund.

1. Alignment of Interest

International investors are increasingly focusing on fund terms designed to ensure appropriate alignment of interest between the asset manager and the investors. These include the following:

(a) Equity Interest of Asset Manager in Fund. The asset manager should have a substantial equity interest in the fund and should acquire a high percentage of this interest through cash capital contributions (as opposed to through deemed contributions made in exchange for a waiver of management fees).

(b) Deal Team's Share of Fees and Carried Interest. A predominant share of the fees and carried interest generated by the fund should be paid to the investment professionals of the asset manager who are specifically responsible for managing the fund.

(c) Fiduciary Duties. The fiduciary duties of the asset manager should be reinforced. International investors will resist provisions that attempt to reduce the fiduciary obligations to investors, waive broad categories of conflicts of interest or allow the manager to weigh its own self-interest against the interest of the fund.

2. Termination and Removal Triggers

In the past, many international investors found themselves contractually obligated to fund capital commitments to private equity-style funds (both in the Middle East and elsewhere) even if the fund was severely underperforming or no longer managed by its original team. As a result, international investors now insist on termination and removal rights, such as the following:

(a) No-fault termination of the fund or commitment period. Asset managers should expect international investors to seek the right to terminate the commitment period without cause with a voting threshold of as low as 50%. International investors also may press for the right to cause the dissolution of the fund or the removal of the general partner without cause with a super-majority vote of the investors (generally at least 66.6%).

(b) Key-man suspension of the commitment period. International investors are generally unwilling to rely on the reputation of the asset management house if a key manager or group of managers leaves. Key-man provisions will be particularly important in circumstances where international investors are relatively unfamiliar with the sponsoring firm, as is frequently the case with in-region asset managers seeking capital internationally for the first time. A typical key-man provision would provide that if a specified number of the senior investment professionals responsible for managing the fund leave the sponsoring firm or fail to devote substantial time to the fund, the commitment period for new investments will be automatically suspended, with an affirmative vote of the investors required to reinstate it.

(c) For-fault removal of the asset manager / general partner. Many asset managers based in the Middle East have resisted giving investors the authority to remove the asset manager or general partner of a fund, even "for fault" (or "for cause"). For-fault removal is usually limited to instances of serious misconduct, such as gross negligence, willful misconduct or fraud, although some international investors will seek a lower standard. An asset manager should be prepared to accept for-fault removal of the asset manager or general partner, at least for serious misconduct, and should offer this type of provision at the outset.

3. Investment and Borrowing Restrictions

Although limited partners (or non-voting shareholders) have no role in the management of private equity funds, they are increasingly seeking limits on the asset manager's discretionary powers. For example, international investors may insist on investment and borrowing restrictions, such as:

(a) Diversification tests. International investors will expect asset managers to limit concentration risk, which arises when a large percentage of a fund's assets are invested in a single company, geography, industry or other category. Diversification tests require the fund to spread its assets across various holdings that meet the general investment criteria of the fund. The nature of diversification tests varies for each fund, depending on its investment strategy.

(b) Investment restrictions by industry, geography, asset type. International investors may also require restrictions that prevent a fund from investing in industries considered too risky, countries outside the specified investment strategy of the fund, or asset classes viewed as inappropriate, such as raw land. Restrictions required by in-region investors, such as prohibitions on investments in the gaming and alcohol industries, can also be incorporated.

(c) Affiliated and follow-on transaction prohibition/disclosure.

International investors may insist that the fund either be prohibited from investing in the portfolio companies of an earlier fund sponsored or managed by the same asset manager or be required to disclose such investment plans. This type of limitation is designed to prevent the asset manager from using the capital from a new fund to shore up the portfolio companies of a previous fund (particularly where those investments are underperforming). At a minimum, a reasonable policy regarding affiliated or follow-on investments should be disclosed in the offering materials. Informing investors of the affiliated or follow-on nature of any investments actually made by the fund is also common practice.

(d) Borrowing intentions at the fund level. The incurrence of indebtedness by a fund has always been a concern for some investors in the Middle East because of the prohibition against interest under Islamic law. In today's investment climate, international investors are also likely to focus on fund borrowing and are unlikely to grant the fund an unrestricted ability to use leverage. If the asset manager expects the fund to incur indebtedness, the fund's offering materials should clearly disclose the intended methods of obtaining, using and managing leverage, and any limitations on its use. Even a fund that does not borrow on a routine basis should consider when borrowing may be desirable in specified circumstances (e.g., for short-term liquidity needs or in connection with assuming debt of a target company) and disclose how this borrowing will be managed.

4. Clawbacks

Private equity funds typically provide for the "clawback" of carried interest distributions that require the asset manager to return any profits that exceed its agreed-upon profit split (e.g., 20 percent) at the end of the partnership term. International investors are increasingly seeking to reinforce these protections. For example, some investors are negotiating for the escrow of a significant portion of the carried interest distributions – 30 percent or more – until the end of the partnership term. Also, international investors may request, particularly where the asset manager is a boutique firm, that the recipients of carried interest (i.e., the investment professionals) should be subject to joint and several liability for clawback obligations.

5. Disclosure and Reporting

A fund's offering materials should include comprehensive disclosure regarding the fund's asset manager and its background. International investors will also require periodic financial and other disclosure during the life of the fund. The types of disclosure fall into the following categories:

(a) Track record disclosure. Asset managers relying on prior investment performance in marketing a new fund need to provide detailed information on actual prior performance. Extrapolated, summary or selected results could be misleading and are not sufficient. In addition, asset managers should confirm that the presentation of past performance data in the offering materials complies with applicable foreign laws.

(b) Investment team disclosure. International investors expect to receive more detailed biographical information regarding senior investment professionals than is usually required by in-region investors. Educational background should include the name of the educational institution and details of each degree and designation or qualification; employment history should include the number of years of investment experience and a description of duties at all current and prior places of employment.

(c) Conflicts of Interest. The asset manager should disclose in the fund's offering materials any duties of the fund's senior investment professionals that do not relate to the fund, any economic interests of these professionals in the performance of entities other than the fund and any compensation (direct or contingent) of these professionals unrelated to the fund. International investors will also focus on how conflicts of interest arising from equity or compensation arrangements are managed and what other steps the asset manager has taken to ensure that the interests of the senior investment professionals and the investors are aligned.

(d) Reporting to investors. International investors generally expect a higher level of reporting from asset managers than their in-region counterparts. While private equity funds guard their financial performance from the outside world, international investors do expect detail about the structure of the fund's investments, strategies in managing portfolio companies, anticipated yields from dividends and dispositions, audited financial statements, and information about the financial health of the asset manager. Many regionally based asset managers may not be accustomed to providing such information to investors. Investor conferences and teleconferences are often used to communicate sensitive information.

6. Limited Partner Advisory Committee

International investors will expect a fund to have an advisory committee composed of representatives of limited partners. The traditional role of the advisory committee is to resolve conflicts of interest and to consult with the asset manager regarding other significant matters affecting the fund. Increasingly, international investors will seek to require that the advisory committee also approve the methodology for portfolio company valuations and review fund expenses and carried-interest calculations. Investors are also seeking to improve the efficacy of advisory committees by requiring that (i) the asset manager adopt formal procedures for committee meetings, (ii) the membership of the committee represents a diversified group of investors in the fund, (iii) changes in committee membership occur only with the consent of the committee and the asset manager, (iv) committee decisions are disclosed to all investors, and similar matters.

B. LEGAL AND REGULATORY CONSIDERATIONS

Raising funds internationally creates obligations under the securities laws and practical consequences in the countries where the offering is made or where the investors are located. US securities laws apply to any communication with or effort to secure capital from US investors. The same is true of any communication or effort to secure capital from EU-based investors.

Asset managers should consult legal counsel before initiating any efforts to secure capital from US, UK or other investors. Key requirements of US and UK (reflecting various EU Directives) securities laws are described below.

1. Exemptions from registration / authorization

(a) Offer or sale to US investors. All offers and sales of securities (including the sale of shares or interests in a private investment fund) within the United States must be registered with the US Securities and Exchange Commission (SEC) unless an exemption from registration is available. The most common exemptions on which private investment funds rely are provided under Section 4(2) and Regulation D of the US Securities Act. (Regulation S also provides an exemption from registration for activities that occur outside the United States). Each of these exemptions contains obligations and restrictions, such as a prohibition on general advertising or solicitation in the United States. Failure to comply with US securities laws could result in both civil and criminal liability in the United States for the asset manager.

(b) U.S. Investment Adviser Registration. As a result of the Dodd-Frank legislation recently enacted in the United States, many investment advisers (including some non-US investment advisers) that were previously exempt from registration with the SEC will be required to register by no later than July 21, 2011. As a consequence of registration, these advisers will become subject to the substantive provisions of the US Investment

Advisers Act and will be required to adopt compliance policies and undergo SEC examinations. Non-US advisers with activities in the United States or more than $25 million of assets under management attributable to clients in the United States should consult with counsel to determine whether SEC registration will be required. Even if registration is not required, non-US advisers may be subject to SEC reporting obligations under the legislation in some circumstances.

(c) Financial promotion in the UK. Communication of a 'financial promotion' (including an opportunity to invest in shares or interests in a private investment fund) without authorization by the UK Financial Services Authority is a criminal offense under the UK Financial Services and Market Act 2000 (FSMA) unless there is an applicable exemption. Of the more than 65 exemptions, several may be available to an asset manager, including exemptions for communications to high-net-worth individuals or sophisticated investors. The availability of each exemption is subject to detailed conditions such as the requirement to sign particular certificates or to include prescribed information and/or disclaimers within the communication and whether the communication was solicited or in real time. Breach of the financial promotion restriction could result in criminal liability and fines in the United Kingdom for the asset manager and render any agreements with investors unenforceable, allowing investors to claim the return of any money invested or losses incurred.

2. The EU AIFM Directive

In May 2010, the European Parliament and the Council of the European Union each approved its own version of a draft Directive on Alternative Investment Fund Managers (AIFM). The Directive remains a work in progress. Once a final version is implemented, the Directive will introduce a harmonised regulatory and supervisory framework across the European Union for alternative investment fund managers and will significantly affect the operation and marketing of alternative investment funds, including hedge funds and private equity funds.

The considerable differences between the Parliament's and the Council's drafts will not be resolved until a compromise version is negotiated and agreed, which is not expected to occur until towards the end 2010 and possibly later. Among the key unresolved issues are provisions relating to treatment of non-EU asset managers that market non-EU funds to EU investors, including provisions relating to disclosure requirements, limitations on leverage and on employee compensation and other operational matters. Although significant uncertainty remains about the application of the Directive to non-EU asset managers, asset managers outside the EU should be aware of the potential implications of the Directive for their businesses and should be preparing for operational adjustments that will be necessary to address the new regulatory landscape.

For more information on the AIFM Directive, please refer to our article entitled "The AIFM Directive - Implications for Non-European Fund Managers Raising Capital in Europe".

3. Inaccurate or incomplete disclosure

If a fund's offering materials contain any untrue statement of a material fact or omit to state a material fact necessary to make the contents of the offering materials not misleading, the asset manager may be subject to civil and criminal liability in the United States under applicable anti-fraud laws and regulations. Many other countries, including the United Kingdom, also have anti-fraud laws, making truthful and complete disclosure critically important.

C. CONCLUSIONS

Fund and asset managers in the Middle East that are poised to raise funds from international investors should consider the factors discussed above early in the process. Before circulating initial documents, such as term sheets, or even approaching investors in unfamiliar jurisdictions, asset managers should be aware of regulatory and disclosure requirements, and should have a general familiarity with market practices regarding fund terms. The selection of qualified legal advisers is an important element in structuring a fund to successfully attract international capital.

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