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private funds management

# THE MODERN FUNDRAISER

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private alternative asset fund managers and their investors**

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Editor, *pfm*

**Nicholas Donato**

Tel: +1 212 937 0385  
nicholas.d@peimedia.com

Reporter, *pfm*

**Katherine Buccaccio**

Tel: +1 646 545 4430  
katherine.b@peimedia.com

Contributor

**Claire Coe Smith**

Design and Production Manager

**Ethan Byun**

Tel: +1 212 633 2906  
ethan.b@peimedia.com

Head of Advertising  
**Alistair Robinson**

Advertising Manager

**Anthony Hackett**

Tel: +44 207 566 4273  
anthony.h@peimedia.com

Subscription Sales  
EMEA

**Alexis Savvides**

Tel: +44 207 566 5458  
alexis.s@peimedia.com

Asia Pacific

**Brix Sumagaysay**

Tel: +852 2153 3848  
brix.s@peimedia.com

Americas

**Andre Anderson**

Tel: +1 646 545 6296  
andre.a@peimedia.com

Customer Services

**Fran Hobson**

Tel: +44 207 566 5444  
fran.h@peimedia.com

**An Nguyen**

Tel: +1 212 645 1919  
an.n@peimedia.com

For subscription information please visit  
[www.privatefundsmanagement.net](http://www.privatefundsmanagement.net).

Group Managing Editor

**Amanda Janis**

amanda.j@peimedia.com

Editorial Director

**Philip Borel**

philip.b@peimedia.com

Head of Research & Analytics

**Dan Gunner**

dan.g@peimedia.com

Publishing Director

**Paul McLean**

paul.m@peimedia.com

Group Managing Director

**Tim McLoughlin**

tim.m@peimedia.com

Managing Director – Americas

**Colm Gilmore**

colm.g@peimedia.com

Managing Director – Asia

**Chris Petersen**

chris.p@peimedia.com

## editor's letter



# All hands on deck

Today's fund managers are expected to be able to accommodate a range of requirements from investors wanting exposure to alternative investments, but may be reluctant to sign up to many of the orthodoxies of the limited partnership fund structure.

In order to map out the choices, vehicles and structures being adopted in today's buoyant fundraising climate, *pfm* partnered with global law firm Proskauer to produce this special report on what it takes to successfully raise a fund today.

Regulations including Dodd-Frank in the US, and the Alternative Investment Fund Managers Directive in Europe, have drastically changed the rules of the road. Hazy concepts like "reverse solicitation" and what it means to be a SEC-registered advisor deserves managers' careful consideration before distributing marketing materials and ultimately securing commitments. CCOs have always been a part of the fundraising process, but are increasingly expected to navigate GPs through these new, choppy regulatory waters.

Heightened investor due diligence is another trend. LPs are requesting CFOs' time to discuss budget numbers, IT security and the firm's reporting capacities. As stewards of the back-office, CFOs are expected to speak confidently about accounting software, wire transfers and other operational matters to visiting LPs.

I could go on, but the point is this: fundraising is increasingly an "all hands on deck" exercise given the various factors investors consider before making a commitment. Investor relations

personnel, placement agents and senior managers will continue to manage the process through careful coordination, but everyone at the firm now has a role to play, including those responsible for tasks related to compliance, finance, tax and administration.

Throughout these pages, we provide readers an overview of the fundraising environment, and subsequently drill down into key fundraising issues that warrant deeper analysis and discussion, including the challenges of managing an oversubscribed fund – a nice problem to have, but one fraught with investor relations risks (p.23); distributing co-investment opportunities to keen LPs (p.26); and knowing where crucial partnership terms have moved now that the so-called pendulum of power is swinging back in GPs' favor (p. 13).

While the demands and complexity of fundraising today is a challenge, increased regulatory attention and investor understanding of the asset class will be beneficial for the industry long-term. And with special reports like these, we aim to be another so-called hand on deck.

Happy reading,

Nicholas Donato

Editor, *pfm*

nicholas.d@peimedia.com



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The modern fundraiser: prepared to meet new challenges head-on

“The days of having only to think about a fundraising once every three or four years are long gone”

ing relationships with investors and potential investors have to juggle many competing demands and requirements. The days of having only to think about a fundraising once every three or four years are long gone.

In the current fundraising environment investor relations professionals are constantly “fundraising”, developing and enhancing relationships with their investor base and seeking to build connections with new investors, coupled with anticipating where new sources of capital are likely to come from and which sources are likely to dry up. The importance of having an investor base that is diverse not only geographically, but in terms of investor type was highlighted following the global financial crisis, when many of the banks that had been both significant and loyal investors for many GPs disappeared.

The modern fundraiser has to give careful thought to fund terms, those that will remain the same, and those that will change, as well as where “the market” is on certain key terms; how investors might respond to changes to terms that are favorable for the GP, and whether the GPs believe that they have sufficient momentum and support from their investors to push through with such changes. Reading the market and investor sentiment, and getting the terms right at the outset is critical to a successful fundraising. Careful thought

## Meet the modern fundraiser

Successful fund managers are identifying, reacting and ultimately overcoming a plethora of new challenges presented in today’s fundraising environment, writes **Proskauer** partner **Nigel van Zyl**

A successful fundraising is the lifeblood of any private fund management business. It allows the investment team to execute on their investment strategy, while providing revenue to the firm and performance incentives for the executives tasked with sourcing the deals, investing and managing the capital with the goal of delivering strong returns to investors.

As the asset class has matured investors’ expectations of how general

partners manage the relationships with their investors has radically evolved; capital raisings have become truly global as general partners travel far and wide to raise money from potential LPs and compete with more funds looking to raise more capital than ever before. Regulations and securities laws have become more complex and burdensome and impact on how capital is raised. Those individuals tasked with the job of raising capital and manag-



van Zyl: successful GPs must juggle competing demands

“Reading the market and investor sentiment, and getting the terms right at the outset is critical to a successful fundraising”

needs to be given to fund terms such as hard-caps and “waterfalls”. GPs need to consider the impact that pushing out the boundaries on terms could have on the speed at which they manage to raise capital – a fine line to navigate.

In addition, today’s fundraiser is often tasked with managing investors’ expectations and demands for co-investment opportunities. Managing competing demands from a diverse investor base is no easy task – deciding what undertakings and commitments are made to investors at fund closings and how co-investment opportunities are managed in a fair and equitable manner, while keeping all investors and the regulator happy is a minefield. Moreover, ensuring that the investors who are allocated the opportunity are there when the deal needs to close so the fund is not over-allocated to an investment is a key consideration.

Investor relations and fundraising professionals also have to bear in mind the tightening regulatory and securities law environment across the globe, and how this impacts where capital is raised, where investors are based and “marketed” to, and the timing of the fundraising process. Whether it is requirements for registering as “lobbyists” in California, complying with the AIFMD in the European Union and similar legislation in Switzerland, or the strict requirements in the Middle East – these issues need to be carefully considered and a clear marketing strategy taking these issues into account must be formulated.

Recent findings, speeches and fines levied on GPs by the US Securities and Exchange Commission in relation to transaction and monitoring fees, expense allocations and the allocation of co-investment opportunities has resulted in LPs shining a spotlight on these issues during their due diligence

and requiring far more detailed information on these arrangements, as well as additional comfort that there are no “hidden fees” being paid by portfolio companies to fund managers that investors are not aware of. In turn GPs are focusing on the language in their LPAs to ensure it encompasses all necessary provisions, and that there can be no question of LPs not being aware of and informed as to what a GP’s approach is on these matters.

In demand GPs who have the ability to raise capital quickly have the “enviable” challenge of managing excess demand from LPs. Whilst a nice position to be in, it is nevertheless a challenge, and one that needs to be carefully and well managed. Disappointing LPs who do not get an allocation to a fund that they want to invest in, or being given a significantly lower allocation than they expected can strain relationships for many years – LPs can often be unforgiving in this regard. The key to managing this issue is smart, clear and early communication to properly manage expectations while GPs harness the demand in the market to achieve a speedy closing while obtaining the commercial terms they want.

In an increasingly sophisticated fundraising landscape, we have needed to adapt. Today’s investor relations and fundraising professionals are the true renaissance men and women of the asset class. Versatility and flexibility are proving vital to handling the challenges, demands and pressures that come with managing a global investor base and ensuring the stream of capital, fundamental to any private fund management business continues to flow.

Welcome to *The Modern Fundraiser*. ■

*Nigel van Zyl is a London based partner and head of the European private investment funds practice of law firm Proskauer.*

# The power of commitment

In this first of our three-part series interviewing GPs with recent successful fundraises, we ask Ridgemont Equity Partners partner **Travis Hain** how the firm managed to corral \$995m for its Fund II in only seven months

**Pfm:** *What was the timeline like for raising Fund II?*

**Hain:** We started contemplating things in the fourth quarter of 2014 and we started talking to our placement agent Brooklands Capital Strategies around that timeframe. We began to pull materials together and work on a private placement memorandum (PPM), which all culminated in a March 2015 launch. We had our first close in June at \$750 million, which was nice for us, because that was bigger than our first fund and allowed us the luxury of taking our time to make sure we were getting to the right group of additional LPs that we wanted to bring in. By our final close in October, we were oversubscribed.

**How was the fundraising for REP II different from the raise for REP I?**

The first fund took about 18 months to raise, so it was a longer period of time and a lot more work. The biggest reason is that this time around we already had a base of investors, while REP I was a cold start and we had to educate the market on who we were. We built up a reputation and an investor base through REP I, which made things significantly easier for us in raising REP II. A vast majority of LPs from Fund I invested with us again in Fund II, along with a handful of new investors.

**In what ways did your fund terms shift from REP I to REP II?**

The terms of Fund I and the terms of Fund II are very similar. The GP made a substantial commitment to Fund I and an even larger commitment to Fund II. Actually, the GP is among the top four investors in REP II. That certainly resonates with investors from an alignment standpoint. It shows we're really focused on the risk and return and driving attractive outcomes; that's always important to folks and makes a big statement. We all have opportunities outside the firm from an investment standpoint, but if you see a GP leaning in, that means they have a lot of confidence in what they're doing. This is a crowded market and there are a record number of funds being raised, so everything that you can do to stand out from the crowd in a differentiated or special way helps.

**How did you communicate your message for REP II?**

The things we were emphasizing this time I'm sure were a little bit different than what we emphasized last time, because some things are probably more important today than three or four years ago. One piece that's a little bit different today is that we are more focused on the "hands on" aspect of driving value. We're spending more time with our portfolio companies than ever before. For example, many of our strategic plans for our portfolio companies include M&A as a key driver of growth in today's slow paced economy.




Hain: evolution, not revolution

“ We’re spending more time with our portfolio companies than ever before ”

Fundamentally our business and strategies haven't changed so our key messages haven't changed. We have been together for more than two decades – our investment committee is comprised of eight people who have been working together an average of 19 years – and that level of continuity across a very strong team is unique in the middle market. We invest in four sectors and have a track record that corroborates that the people and the strategies actually work. ■

# Better, faster, stronger





Navigating today's fundraising market has become increasingly complex for both fund managers and investors – but those getting it right are reaping substantial rewards. What does it take to fall in that category? Late last year, *pfm* assembled an expert panel of industry insiders to find out

by NICHOLAS DONATO

photography by JAMES CLARKE

**Around the table**



**Sergey Sheshuryak**

is a partner at fund of funds investor **Adams Street Partners**. He is responsible for managing the group's investor

relationships across Europe, and is additionally an LP advisory board member of 17 private equity firms within the Adams Street portfolio.



**Helen Steers** is a partner and head of European primary investments at **Pantheon**, a fund of funds investor where she is also active in the group's

co-investment program. Steers is a board member of Invest Europe (formerly the EVCA) with 25 years of industry experience.



**Nigel van Zyl** is a London based partner in the private investment funds practice of law firm **Proskauer**. van Zyl has over 14 years of experience

advising private fund managers and institutional investors on a broad range of issues, including fund formations, fundraisings, secondary transactions and co-investment arrangements.



**David Tegeler** is a US-based partner and global co-head of the private investment funds practice at **Proskauer**, a law firm. Tegeler

has expertise in a broad range of matters, including fund formations, buy and sell side secondary transactions, direct secondary transactions, co-investments, restructurings and upper tier management governance issues.

**R**ight from the start, it was obvious that things were going to be interesting – and not just because of the dazzling view of the financial district from Proskauer's London office.

After introductions were made, and pleasantries exchanged, our panel of fundraising experts – a mix of fund managers, investors and legal advisors – were asked a question bound to elicit strong, contrasting opinions: Has the so-called 'power pendulum' swung back towards GPs post-global financial crisis?

It's a question that required our roundtable participants to consider a host of factors, including the estimated 2,000-plus fund managers on the fundraising trail today; the lightning-quick speeds at which top-tier GPs have managed to close multi-billion funds, while others struggle or experiment with different funding models; and the resoluteness of LPs while negotiating investor protection rights and certain other terms.

"At the moment it's swinging back in the favor of GPs," says Helen Steers, a

partner at fund of funds group Pantheon, who was the first to offer such a verdict. The pendulum's swing back, however, has been limited, Steers believes.

Delaney Brown, a senior principal at the Canada Pension Plan Investment Board (CPPIB), disagrees, saying that the pendulum is better described as having swung *significantly* back in GPs' direction.

"Managers with a good track record are generally less receptive to what investors want," says Brown. "A more balanced conversation between LP and GP occurs when you go beyond the top quartile GPs – and more and more managers feel that they are in that category."

Brown says that LPs did "a fair job" of influencing terms in the years immediately after the crisis, when the pendulum is said to have gone the other way, but "not as great of a job as could have been done."

Soon after, the roundtable agreed that the question was hard to answer generally, and it varied based on managers' size, strategy, track record and terms.





That's because the market is "hot but still selective" at the moment, says Adams Street Partners' Sergey Sheshuryak. "Many smaller funds, that don't usually need as many LPs to reach a close, are having great fundraising success. Certain mega-funds with good performance and differentiated approach, are accomplishing the same thing with larger pools of LPs to consider. But some managers misread the environment entirely by going out with aggressive size targets and unusual terms, and receiving less demand than expected, despite a good brand name and decent historic performance."

### Managers: Proceed with caution

Despite the general market shift in their favor, managers are exercising restraint when negotiating fund terms. The roundtable cited three specific reasons why.

For starters, GPs understand that unfavorable terms can prolong the fund-

raising process, which isn't typically worth the tradeoff. Equistone is a recent case study in this type of restraint. The pan-European mid-market firm corralled €2 billion in commitments after just six months in market, sealing a first and final close on its fifth buyout fund earlier this April.

"It does mean you stand in front of your colleagues and say 'Yes, our success here indicates we could have asked for better off-market terms; but do we really want to put additional risk in our business by prolonging the fundraising for an additional six months?'" says Equistone IR partner Christiian Marriott.

Secondly, regulators have entered the mix with greater visibility since post-crisis regulations placed an unprecedented level of scrutiny over the private funds industry. After reviewing managers' marketing materials, regulatory filings, partnership agreements and other records, inspectors are flagging certain practices and expense al-

### Around the table



**Delaney Brown** is a senior principal at the **Canada Pension Plan Investment Board (CPPIB)**, a Toronto based pension plan where he evaluates

fund investments, secondaries transactions and co-investment opportunities. Prior to joining CPPIB in 2013, he spent eight years at Hermes GPE performing a similar role.



**Jeremy Lytle** is an investor relations partner at UK mid-market firm **ECI**. He is chair of the British Venture Capital Association's Responsible

Investment Advisory Board and is additionally a member of the trade body's committee on investor relations.



**Christiian Marriott** is a partner responsible for fundraising and investor relations at **Equistone Partners Europe**, the mid-market

firm that spun out from Barclays. Before that he was IR director for Mezzanine Management (now MML Capital).



**Vince O'Brien** is a director at **Montagu Private Equity**, a European private equity firm. He sits on the firm's investment committee and

is responsible for fundraising and investor relations. A former chairman of the British Venture Capital Association, O'Brien has worked in the private equity industry for nearly 30 years.



locations as potentially violating GPs' fiduciary duty to investors.

"Transaction fees, accelerated monitoring fees and certain other terms cited specifically in recent SEC enforcement cases are either staying put with additional disclosure to the LPs, or becoming more conservative," says David Tegeler, a US-based partner at Proskauer, who co-heads the group's private investment funds practice.

Thirdly, terms that stray too far in GP's favor can come across as opportunistic to investors. Jeremy Lytle, an investor relations partner at ECI, says that LPs like to see a certain level of consistency from one fund to the next. The UK mid-market firm closed its tenth fund on a £500 million hard-cap in September 2014 following a five month fundraising sprint.

"If we attempted to adjust our terms in our favor, given the current environment, it would have been very difficult to justify why," says Lytle. What's more is that GPs "behaving badly during one



fundraise" or ending up "pushing too hard on any one term" risk upsetting their investor base – who are bound to share their experiences with other, possibly prospective investors, Lytle continues.

However, not all terms appear static. For instance, London-based Proskauer fund formation Nigel van Zyl is noticing funds switching back to the US-style deal-by-deal waterfall approach after having conceded a European-style "fund-as-a-whole" approach immediately after the crisis. "It's a trend particularly strong in the large-cap end of the market," van Zyl says. But even here further qualifications are in order: While some European GPs are abandoning their typical per-fund waterfall to dabble in deal-by-deal carry, US managers are moving in the opposite direction, incorporating more elements of the European waterfall into their carry provisions in order to satisfy LPs. "There's a strong contrast to be made here between Europe and the US," van Zyl cautions.

But with the fundraising spigot cranked left, one term in particular is proving hard for managers to resist moving, thus becoming a flashpoint during negotiations.

### Bigger isn't always better

Hard-caps, which several roundtable participants pointed to as one of the most important terms during negotiations, are another area where GPs can inadvertently come across as self-serving.

"The key question is: can you commit to a hard cap up front. Because if not, it looks like you're out there to see what the market will give you and then take it all," says Marriott, adding that GPs "who do their homework" and "understand their business and market well" should be able to include a hard cap in their PPM.

Indeed, overall fund size is something GPs don't spend enough time thinking about or trying to justify, despite fund size affecting almost every aspect of a firm's business model (including head-count decisions, internal organization, co-investment and borrowing policies and overall economics). LPs want to know exactly why the target is what it is, and exactly what consequences that has for a firm's strategy and resource base.

For Sheshuryak, there are many cases when rising fund sizes are justifiable, but he questions GPs who contradict themselves by saying that their pipelines are "jammed full of potential" but at the same time ask for longer investment periods (increasingly as long as six years). "It doesn't make sense. If you're justifying a bigger fund by pointing to all these deals in the works, then why do you need so much more time to execute?"

The desire to raise the fund size, though, can come as much from LPs jockeying to enter a popular fund as it does from fund managers, says Steers.

That said, other LPs want to limit fund sizes in order to increase their chances of being offered co-investment opportunities, says Tegeler. “They will want to limit the manager’s dry powder, resulting in the need to seek additional capital from co-investors.” To that same end, investors are negotiating stricter investment limitations set forth in the fund’s governing documents. “So any one deal can’t be 15 percent instead of 20 percent of the fund size, which creates that same need to bring on other investors to close deals.”

### Co-investment challenges

With the roundtable’s attention turned towards co-investments, Lytle says that “it’s really a trend taking hold in the larger end of the market. The market is seeing bigger LPs quickly lose interest in a fund if the co-investment opportunity just isn’t there.”

Brown agrees, saying that co-investments, at all levels of the market, can

“make or break a manager’s chances on the margin.”

But there are significant challenges when it comes to managing co-investments. Tegeler says that one major challenge is finding LPs capable enough of analyzing deals and reaching an investment decision within tight timeframes. “If it’s a straightforward buyout deal, it’s relatively simple to get it done. But if your fund is investing in, for example a complicated infrastructure transaction, or one that includes complex financial engineering, it becomes much more challenging for the GPs to manage the co-investment process.”

A temptation for GPs, Lytle continues, is to give the impression that co-investment opportunities will be plentiful, but managers “must be realistic and transparent” about how many they expect to do. “You don’t want to give your investors the wrong impression and then that they might expect too much.”

And once the fund closes, many GPs now send LPs questionnaires to better understand their level of interest in co-investments, whether they have any deal type preferences and/or their limits when it comes to reviewing transactions, adds Steers. “One indicator that an LP is interested in co-investments is if they bother to answer the questionnaire at all,” Steers says.

For van Zyl, the other major challenge surrounding co-investments relates to compliance.

“What we say to GP clients is: “It doesn’t matter what your co-investment allocation policy is – you can decide what’s in the best interests of your fund – but be sure to clearly articulate how it will be done. So if it’s on a size of capital basis, say that. Or if it’s based completely on your discretion, then carefully explain that.”

Under any policy, however, GPs are going to have to tread delicately when talking to their LPs about the rationale behind co-investments and other preferential agreements, the panelists agreed. That’s because co-investment opportunities tend to go to LPs with large sums to put to work, which can create different tiers of investors in the same fund.

### The AIFMD effect

As all fundraising conversations go, people’s attention inevitably turned towards the impact of regulation, with the Alternative Investment Fund Managers Directive (AIFMD) a strong area of focus.

In 2009, during the initial drafting stages of the directive, there were legitimate concerns that the AIFMD would erect a regulatory ring-fence around outside managers wanting in. Meanwhile, confusing provisions around reporting, near-impossible rules requiring firms to isolate dealmakers from the



valuation process and costly depositary arrangements were all cause for concern for EU-based managers. Six years on, where GPs right to be worried?

“From a practical standpoint, it wasn’t a great deal of grief,” says Montagu Private Equity director Vince O’Brien, whose firm went through the directive’s authorization process. That’s not to say the extra regulation isn’t having any impact at all. For all the hassle of authorization, the AIFMD rewards fund managers with a pan-EU marketing passport allowing for a more seamless fundraising process. But O’Brien says that GP’s need to plan carefully. “Registering for AIFMD purposes across Europe can result in significant registration fees being incurred in some countries, so if a GP does not expect to market in certain countries it is worth considering whether there is any necessity to register at all.”

Outside of the EU, “smaller GPs less able, or less willing, to meet the directive’s challenges are steering clear of Europe,” says Steers. Sheshuryak agrees, noting that European LPs are

losing access to US mid-market funds no longer comfortable with Europe’s new private funds regime.

For managers already authorized, AIFMD simply means “managing their reporting, checking their compliance timetables and up fronting the legals a lot more during dealmaking,” says van Zyl. For managers outside the EU, van Zyl recommends senior management alongside compliance and legal personnel to “sit down and work out exactly where they wish to market, if they are going to the national private placement route and/or relying on reverse solicitation to seal commitments.”

Across the Atlantic, the directive is having a more peculiar effect, adds Tegeler.

“Many US regulations make a distinction between prospective investors and existing investors. It’s how US managers are trained to think. Unfortunately, the AIFMD doesn’t make that distinction, so it’s creating compliance issues when a GP prepares for its next fundraise.”

The compliance questions brought forth by AIFMD and other recent regulation is resulting in LP advisory boards adding new sections geared specifically to compliance and regulatory matters, says Brown. “Five years ago you didn’t have that.”

### Parting advice

The roundtable closed with each panelist answering a simpler, less unsettled question compared to the one asked at the start. What’s the one piece of advice you would give a manager about to hit the fundraising trail?

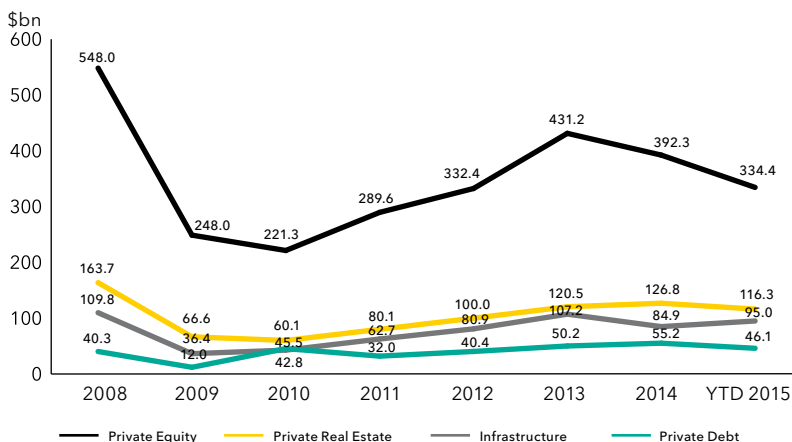
Some answered the question by describing the fundraising process as an ongoing exercise that shouldn’t only be considered six months before fund launch. “Meet with LPs year in and year out, regardless when you’re fundraising. And be clear about your timetables. If you say you’re launching the fund in the next six months, you need to honor that or risk losing their trust,” says Lytle.

Others mentioned ESG reporting as a new priority, and doing more than just paying lip service to responsible investment. “If you look across GPs’ websites these days, they all say how much they are embracing ESG. But having specific policies, and demonstrating that your deal executives have bought into the concept as well, is becoming a must-have item,” says O’Brien.

Smart and consistent communication, however, was the one common denominator in all the advice given. GPs hoping to stand out from the crowd by promoting key differentiators, such as the promise of co-investments or the expertise of their deal partners, will always capture investors’ attention. But the roundtable stressed that a ten-year commitment, like all long-term relationships, should be based on regular and open communication. ■

## Gaining lost ground

Fundraising levels have rebounded after crashing in 2010, but the peak reached in 2008 is still some ways off



Source: PEI Research & Analytics

# At the negotiating table: Ts & Cs that require attention

What are the focal points during private fund negotiations today? Proskauer lawyers **Michael Suppappola**, **Edward Lee**, **Lewis Phillips** and **Andrew Shore** dissect key private equity terms receiving careful scrutiny



**The fine print:** fees and fund extensions are key talking points

Throughout the years, private equity fund limited partners have sought to align interests with general partners through the good faith negotiation of private equity fund limited partnership agreements and other governing documents. The relationship between LPs and GPs has continually shifted as market conditions and the private equity industry have evolved.

During the global financial crisis of 2007-2009 and subsequent recession, severe economic headwinds resulted in a very difficult fundraising environment for many GPs. During this time and for a number of years thereafter,

the “pendulum” of negotiating leverage shifted sharply in the direction of LPs, culminating in the publication of the first version of the “ILPA Private Equity Principles” in September of 2009. Although a number of oversubscribed GPs with distinguished track records were able to push through this period relatively unscathed, many other GPs were no longer in a position to dictate terms.

However, in the more robust post-recessionary fundraising environment, the fundraising pendulum has begun shifting back to a wider group of general partners that have exhibited a consistent ability to procure strong returns.

Regardless of the state of the market, there are several economic and governance terms that remain a continual focal point for LPs when reviewing and negotiating fund agreements. Here are our top nine:

## Management fees

A private equity fund’s management fee is generally utilized to support the fund manager’s overhead and operating costs, such as salaries, employee compensation, benefits, rent and office equipment. Most private equity funds calculate management fees during the fund’s “commitment period” based on a percentage of the fund’s committed capital, with post-commitment period fees calculated by reference to the acquisition cost of unrealized investments. The fee percentages are driven largely by fund size, the breadth of a GP’s back-office operations and, to a certain extent, strategy. Top-performing GPs have generally been able to resist recent LP pressure to reduce management fee levels.

However, in light of the growing number of funds that remain in existence long past their stated terms, LPs have increasingly focused their attention on management fee payments following a fund’s initial term (typically 10 years) in an effort to ensure that GP/LP interests remain aligned in the later years of a fund’s life. Accordingly, LPs have increasingly requested that GPs place limitations on how long the GP can extend the term of a fund (typically by requesting that LPs or LP advisory board representatives approve term extensions beyond a certain time horizon) and the amount of management fee that is subsequently payable during a fund’s liquidation period.

Although many GPs have successfully resisted LP pressure to reduce management fee levels, a continued focus on the amount of transaction fees and

other portfolio company remuneration received by the GP and its affiliates that will offset the management fee has recently seen a shift in favor of the LPs, with many funds moving to a 100 percent offset. Additionally, recent regulatory scrutiny regarding the collection and retention of such fees by the certain consultants, advisors and operating partners has resulted in increased disclosure and transparency around such arrangements.

Finally, many GPs desiring to expedite fundraising efforts in recent years have successfully implemented “early closer” management fee discounts, which provide investors with an incentive to commit capital at or near the fund’s initial closing. Volume discounts, whereby an investor pays a reduced percentage of management fee when committing above a certain tier of capital, have also become increasingly popular for GPs wishing to incentivize LPs to make additional commitments.

### The waterfall

While “2 and 20” remains the general guidepost for private equity management fee and carried interest, there has been an increasing amount of bifurcation in the industry with respect to the structure of distribution waterfalls. Some GPs have been required to give up their historic “deal-by-deal” carried interest structure (whereby carried interest is generally collected based on the performance of individual realized investments) for a more LP-favorable “whole fund” model (whereby carried interest is generally collected only after a return of all capital contributions plus a preferred return). With respect to GPs who have retained deal-by-deal waterfalls, LPs have increasingly demanded additional interim clawback calculations and/or escrow mechanisms to address investor concerns regarding over-distribution of



carried interest to the GP prior to the fund’s liquidation period.

At the other end of the market, top-tier GPs have not only retained their deal-by-deal carried interest but have also introduced “premium carry” waterfalls, whereby the GP receives a higher carried interest percentage (e.g., 25 percent to 30 percent) if the fund meets certain IRR, NAV or other performance objectives. The increasingly wide disparity in waterfall structures is largely the result of a maturing marketplace.

The balance of power in negotiating these key economics is largely determined by the supply and demand for allocations to a particular fund. As a result, GPs who have outperformed their peers and have not sought to substantially increase their fund size in recent

years often have stronger negotiating positions than others.

### Fund size & GP commitment

An increase in a private equity fund’s size also tends to lead to an increase in the size of the GP’s team, and LPs continue to focus on ensuring a strong GP/LP alignment with respect to the GP’s capital commitment to a fund. In recent years, the market has witnessed a general increase of the percentage that the GP’s commitment represents of third party commitments to the fund. When assessing fund size and the GP’s commitment, LPs may also focus on additional key factors such as whether the fund has a “hard cap” on the amount it may raise, use of leverage, the size of the team, team succession matters, and increased internal regulatory costs.



### Key person clauses

Key person clauses are one of the most highly negotiated provisions in a fund agreement. The actual key person event trigger (i.e., the number and nature of the key persons who must abide by the requisite time devotion standard) will depend on the structure of the particular GP's team and business. The time devotion required of the key persons should accurately and fairly reflect those persons' responsibilities to the GP's general business and other investment products. It is increasingly common for individual key persons to be subject to different time and attention requirements.

When triggered, key person provisions typically result in the suspension of the investment period. LPs will often look for the suspension to be automatic

rather than requiring an advisory committee or investor vote, but this may depend on the circumstances of the trigger. There may also be some discussion regarding the GP's permitted activities during a suspension. Although a suspension period will typically result in a prohibition on investments in new portfolio companies, some investors will push for additional limitations (such as limitations relating to follow-on investment activity) and/or advisory board oversight functions.

When reviewing general investor protection provisions on a holistic basis, an LP's comfort level with the key person standard will typically impact negotiations around other protections, from seeking potential "no fault" suspension of the investment period with an investor vote to potential "no fault"

**Fund negotiations:** Successor funds a point of interest

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and "for cause" removal and/or dissolution votes.

### GP removal rights

Provisions giving investors the power to remove the GP are increasingly common. Negotiations surrounding potential removal rights will often focus on (i) whether the GP may be removed "for cause" and/or on a "no fault" basis; (ii) the types of bad acts and other events that may trigger a "for cause" removal; (iii) the voting threshold to trigger the removal; and (iv) the result of removal on the GP's capital commitment and carried interest. In some situations, the fund agreement may require the newly appointed replacement GP to purchase the removed GP's interest at a certain appraised value, and often at a discount in the event the GP is removed "for cause."

Focal points for negotiations between the GP and LPs over what amounts to "cause" will include the relevant persons whose conduct will be considered (e.g. the manager, GP, key persons, etc.), certain materiality standards, and the type of court decision required to trigger removal.

As an alternative or supplement to GP removal rights, LPs may also consider requesting the right to commence an early dissolution of the fund, either on a "no fault" or "for cause" basis.

### Term and extensions

The traditional model for a private equity fund provides for a fixed term of approximately 10 years, plus up to 2-3 extensions of one year each. There are often variations to this model depending on the fund's strategy and the types of assets that the fund is acquiring. For

example, debt funds may feature shorter terms and infrastructure funds typically have longer lifespans.

Following the financial crisis, many private equity funds found it increasingly difficult to sell certain assets that were purchased during the early part of the decade. These difficulties have resulted in a large number of funds that are out of term extensions but still retain a handful of remaining assets that cannot be sold at a desirable value. In light of these issues, some LPs are taking a pragmatic view on negotiating the basis on which a fund's term may be extended, preferring sales at an appropriate time over a premature forced liquidation. As noted above, LPs are increasingly focused on the level of management fees paid during any extension and during liquidation.

Some GPs are now contemplating longer terms for newer funds in an effort to mitigate these issues on a go-forward basis. Moreover, the inability of GPs to efficiently liquidate existing funds combined with increased LP pressure regarding liquidity has recently led to the increased prevalence of complex secondary restructurings of end-of-life funds.

### Successor funds

LPs will want to ensure that each GP they invest with spends an appropriate period of time investing their capital and not end the search for new investments prematurely. The key persons are typically permitted to dedicate time to a successor fund within their time commitment obligations, and therefore a restriction on when a successor fund can be raised is important. GPs will typically want to ensure that any restriction on raising a successor fund is only tied to products with a substantially similar strategy, particularly larger GPs that may manage

multiple funds with a large disparity in investment strategies and/or investment teams.

Successor fund restrictions are often based on when a certain percentage of total commitments have been made by the fund (i.e., a successor fund is typically permitted when a substantial amount of the fund's capital is invested and/or reserved for follow-on investments or expenses). LPs will also typically request that a fund's management fee "ramp down" to the post-investment period formulation when a successor fund is raised.

### Conflicts & allocations

A GP may manage multiple funds making new investments at the same time, such as successor funds and managed accounts. To the extent that multiple funds or accounts have an overlapping

“ The fundraising pendulum has begun shifting back to a wider group of GPs that have exhibited a consistent ability to procure strong returns ”

investment strategy, the GP may be faced with allocation conflicts. For example, should a new investment be allocated to the prior fund, the successor fund, or proportionally to both funds? Should follow-on investment opportunities be solely allocated to the fund(s) that previously invested in the related portfolio company? Even if a prior fund is no longer making new investments and/or no longer has capital to make a

follow-on investment, fund agreements may permit a successor fund sharing the same investment strategy to make "cross-over" investments in a portfolio company of the prior fund.

The typical forum for resolving such conflicts is the fund's LP advisory board. LPs have sought increasing transparency regarding conflicts in recent years, and many LPs will request that the GP have a stated allocation policy when investing on behalf of multiple accounts with similar strategies.

### Side letters and most-favored nation

Side letters have become a burdensome but necessary aspect of the fundraising process for GPs in recent years. LPs with considerable capital commitments may seek protection against the general partner agreeing to preferential terms with other investors through receipt of a "most-favored nation" provision, which would require the GP to provide (and, in some cases, offer) to the LP certain side letter provisions the GP has agreed to with other investors. The MFN may be included in the LPA, although is more typically negotiated with individual investors. MFN rights will also typically be subject to certain carve-outs, so that terms relating to, for example, advisory board seats or an investor's specific regulatory or tax status are not available to all investors. In addition, GPs will often seek to limit the MFN so that investors may only obtain the benefit of provisions given to investors with the same or smaller commitments. Oversubscribed GPs may seek to eliminate side letters altogether. ■

*Michael Suppappola is a Boston-based partner in Proskauer's Private Investment Funds Group, while Proskauer associates Edward Lee, Lewis Phillips and Andrew Shore are based in the same practice in London.*

## Reading the fee leaves

Despite fee transparency having become a top priority in the LP community, a buoyant fundraising market is keeping many terms around fees and expenses firmly put. How long that lasts, however, appears to be an open question

by CLAIRE COE SMITH



“The money will talk, and in the end the market will move in the direction that the LPs want it to go”

On the face of it, it would seem that managers are under immense pressure to concede more favorable fund terms for LPs in the partnership agreement.

As regular readers of *pfm* are aware, fees have become a hot issue in the press, which has caught the eye of the public sector. In July, a letter signed by 13 state treasurers and elected city officials was sent to the US Securities and Exchange Commission (SEC) urging the regulator to require standardized private equity fee disclosures from GPs.

Meanwhile, the California Public Employees' Retirement System (CalPERS) and other LPs have been under intense media pressure to justify performance fees. Amid the controversy, the Institutional Limited Partners Association (ILPA), which CalPERS is a member of, launched a fee transparency initiative last year that included a standardized fee reporting template for managers to use.

If the court of public opinion determines private equity to be too opaque, or too expensive, LPs will have a more difficult time justifying their private equity portfolios to outside stakeholders, even when their alternative assets deliver superior returns – which investors could use as leverage during fund negotiations.

But by far the biggest trend explaining this perception is the SEC and other regulators taking a more aggressive approach to enforcement when it comes to fees. Last year, Kohlberg Kravis Roberts and The Blackstone Group became the

two most recent high-profile examples of this trend, with both GPs agreeing to eight-figure settlements for SEC charges related to broken deal expenses and accelerating monitoring fees respectively.

But here's the thing: despite these trends, today's bullish fundraising market is limiting investors' ability to move terms on fees, expenses and carry models.

Sean Hill, a Boston-based partner with Proskauer, who is also co-head of the law firm's private investment funds group, says that when it comes to GP compensation, investors are not focusing on any one issue, which may decrease their leverage to significantly move any one term in their favor.

"Smarter and more experienced institutional investors are looking at it more holistically, focusing more broadly on alignment of interests. Investors certainly want to pay less, but for managers with a strong track record and a good reputation, to the extent that they have in place the so-called US waterfall, they have been able to retain that."

The US waterfall, or deal-by-deal waterfall, is more favorable to GPs than the alternative "fund as a whole" European approach. Hill says he has not seen a US



Hill: watching waterfalls

manager having to switch to a European waterfall in quite some time, and indeed some larger high-performing European managers have been able to agree deal-by-deal waterfall arrangements that are cross-collateralized.

Others agree that, despite all the recent attention on fees, LPs are not necessarily pushing back harder on the issue during fund negotiations.

"The bigger funds are all getting whatever they want when it comes to GP compensation at the moment, and that is the standard 2 percent annual management fee and 20 percent carry over an 8 percent preferred return," says David Waxman, managing director at Azla Advisers, a fundraising and secondaries advisory firm.

"Even for the smaller or newer funds in the US, who most likely have to go with the European waterfall, they are still also pushing for 2-and-20," Waxman continues.

At that smaller end of the market, or for first-time funds, he says he has seen GPs more willing to negotiate on fees and carry in order to attract LPs, and a tiered carry structure is not uncommon, where carry increases once certain performance criteria are met.

"We have seen models with 17.5 percent, 20 percent and then 22.5 percent carry, depending on performance. GPs are interested in doing that kind of thing to align interests and introduce LPs to their funds."

### More disclosures

Although greater regulatory scrutiny hasn't necessarily moved fund terms, the SEC and other agencies are certainly prompting GPs to include more disclosures in their marketing materials and fund documents.

Hill says it is in the expenses provisions that GPs are seeing the real impact of the conversation going on between

regulators and investors, and the enormous drive for transparency and clarity.

"The 'partnership expenses' section used to be a small paragraph; now it's a full page in the fund agreement, listing out every single thing that will be borne by the partnership in fine detail, so that there is no doubt about it."

But will greater regulatory oversight start to move certain terms in the time ahead?

"I expect to see GP compensation certainly becoming more efficient—and a desperate need for more alignment coming from investors. The money will talk, and in the end the market will move in the direction that the LPs want it to go," predicts Mounir Guen, founder and chief executive of MVision, a placement agency.

That's a view shared by Waxman, who argues that longer term, investors will be able to get much more bespoke arrangements on GP compensation by focusing their attention on separately managed accounts, which are rapidly growing in popularity.

He says: "Managed accounts are a huge trend and are something the large managers are doing a lot of with their biggest investors, and there everything is negotiated—fees, carry, everything. Those are fully negotiated on all terms, regardless of who the manager is. That's where everything is headed, because the very large LPs would rather do that than be in a pooled vehicle where they are subject to standard terms."

He adds that the bulk of large buyout firms' assets under management used to be in pooled vehicles, but things are beginning to move to the opposite end of the spectrum. "By 2020 we will see a major shift to a much larger percentage of assets being in managed accounts, and that's a function of negotiation, because LPs will then be able to get the terms they want."



SEC: pushing disclosures, not terms

### Skin in the game

While compensation-related terms may not experience significant movement for some time, if at all, investors are experiencing success in certain other areas.

For instance, investors see the amount of management team commitments as a key element in aligning GPs interests with their own, and so while 1 percent used to be standard, there are signs of this moving higher, and closer to 2 percent. In a recent speech, Terra Firma boss Guy Hands picked up on this sentiment.

“If an investment team has a substantial portion of their liquid net worth invested in a fund, you know that they are not motivated just by fees – their

main objective will be to protect and grow their own capital alongside that of investors.”

Remarkably, he went on to say that, at Terra Firma, that meant “not sponsoring any fund, or any deal, unless we can put at least 10 percent of our own money into it. We are not going to make our money on fees – we are going to make it through carry, and we are only going to get paid if our investors make money.”

### Tailored approach

It is a sentiment that many LPs find especially welcoming as they look for ways to tailor their views on GP compensation to the specifics of the team involved.

“The first thing that LPs are looking at is being fair,” says Guen. According to him, this involves looking at a firm’s finances, with leeway given to smaller groups who may need limited transaction fees, or higher management fees, in return for better alignment in the profit share. The idea is that smaller groups, who are raising a couple of hundred million dollars or less, tend to tighter on their internal budgets.

“The first thing investors do is try to understand the budget of the fund, and then they try to assess how much money those at the senior level of the partnership have made for themselves, which drives GP commitments. From that, they come back with recommendations, suggestions and ideas,” says Guen.

Waxman says he has also seen examples of smaller managers able to secure an agreement that they can charge due diligence fees to the fund, where the management fee would not be sizeable enough to cover such expenses.

Meanwhile, at the larger end of the market, LPs committing hundreds of millions to a fund expect this tailored approach to result in savings.

“That recognition can be made by a GP giving them some form of co-investment confirmation relative to their contribution, which allows them to blend their fees. That may not be a straight-up discount, but it is a reduction because of the blend – we see models where investors commit €500 million to a fund and may then have the same amount of co-invest, which means they can deploy €1 billion at 0.75-and-10 rather than 1.5-and-20,” observes Guen.

All told, the fee transparency debate and other recent trends may not be significantly changing GP compensation models at the moment, but as investors’ increasingly tailored approach to fund negotiations indicates, things rarely stand still for long. ■

## CalSTRS speaks out on fees

The ‘real’ story behind portfolio monitoring fees and today’s market challenges were among topics we discussed in Sacramento recently with **Margot Wirth**, head of private equity for the \$188bn California State Teachers’ Retirement System

**Pfm:** *Are you loving the asset class these days or ...?*

**Wirth:** I always love the asset class.

**What’s challenging in today’s market?**

The challenge is high entry prices – it’s a cyclical issue – certain opportunities exist in non-cyclical sectors and situations and of course the opportunity to sell ... [is] a chance for us to perform well relative to the public asset classes. The investment spectrum is compressed and it’s really hard for any asset class to excel, but hopefully private equity will perform well; I think it has been performing well in terms of investments made since the global financial crisis.



**Wirth:** performance trumps all

**Are you worried about upcoming NAVs because of public market volatility?**

Not in the long-term.

**A number of large LPs are moving towards separate accounts or product offerings that blur the lines between asset classes. Is that of interest to CalSTRS?**

Those are of interest. Some fund managers are also coming out with yet another product that I call the Warren Buffet strategy, the long-hold approach. We’ll be looking at it.

**In terms of fund commitments, is it business as usual? Or are you reducing relationships?**

We never really over-indulged in terms of number of relationships. Plus, we’re always pruning; I think we’ve shown fairly good discipline.

**Have portfolio monitoring fees become more important given recent media attention?**

Portfolio monitoring fees and transaction fees combined have historically been (probably) the third most important fee stream for the GPs, after carried interest and management fees. Some members of the general press discovered them three or four years ago and presented it as news that these fees exist and the ‘dumb LPs’ have been oblivious to them, when in fact LPs have waged a long-term battle for at least 15 or 20 years and driven these fees down to

“You’re a fool if you ignore fees but you’re also a fool if you focus on fees to the detriment of focusing on performance”

such a point that for the next generation of buyout funds, the majority, have 100 percent offsets.

When I look at my chart of fee-offsets circa 2000, they were in the 50 percent range; that was the most typical. Circa 2005, most of those were going to 65-75 percent, and now, post global financial crisis, we’re at 80-100 percent. So the ‘real’ story has been that these fees have been largely neutralized in most cases going forward. That’s important both because they’re so significant and also because they’re hard to track and less objectively specified.

**The SEC has taken an interest in accelerated and evergreen portfolio monitoring fees; what’s your view?**

The accelerated monitoring fees and the evergreens were a black eye on the industry. I think those were wholly inappropriate when the GP benefitted disproportionately. Sometimes however, overall portfolio monitoring fee issue and this issue [of accelerated or evergreen fees] get conflated. The evergreen agreements were insidious because we didn’t

expect them, we didn't factor them into our models when we were trying to estimate overall fee loads. Once LPs realized what was happening, we started pushing back. The first thing that happened was that those evergreen agreements stopped being written onto new deals (or at least not being written when sharing ratios are not favorable or at least neutral for LPs). Then GPs started to either voluntarily forgo or greatly reduce the amount they would realize on legacy evergreens ... and with this latest SEC action, now we're recovering some of the past fees charged.

***Have fees become more of a talking point generally?***

Yes, but first of all, let me state that this program has delivered a lot of value over the long-run to our beneficiaries. I would also like to state that our accounting and reporting systems meet or exceed industry standards and that all of our performance figures are net of all fees and carry.

Fees are always very important – fees and carry take a large portion of the gain so they're terribly important. However, performance varies quite a bit in this industry and so it is ultimately net performance that determines the success or not of a private equity program. In other words, performance in this industry typically varies a lot more than fee loads. You're a fool if you ignore fees but you're also a fool if you focus on fees to the detriment of focusing on performance.

Performance and fee levels are often negatively correlated: the funds with the higher fees often have the higher performance (on a net, after fee and carry basis). This isn't shocking to people who are in the industry, that it's a market-based system that sets these fees, and better groups drive better eco-



CalSTRS HQ: high-performing managers welcomed

COOLCAESAR

nomics (just like better baseball players get more lucrative contracts). Fees are important, but just as important can be fund size and other factors – waterfalls, GP commits, GP guarantees, clawbacks, and so on.

Just so I don't get taken out of context, let me state for the record that obviously, all other things being equal, lower fee loads are always better. We seek lower fee loads, not higher fee loads. Ultimately though, we seek the best risk adjusted net returns.

***We've heard of some GPs doing away with hurdle rates and clauses includ-***

***ing key-man; is that something to be concerned about?***

I think those are the exceptions. Some groups do have more of an institutional strength, rather than being tied to an individual, and some of these funds may not have a key-man clause. Often though, those same funds might have a relatively low threshold for their no-fault divorce clause activation. Overall I'd rather take a low threshold on a no-fault, which gives you universal flexibility. But again, you can't look at terms in isolation, you've got to look at the whole package. ■

## Cutting through the red tape

In this second of our three-part series interviewing GPs with recent successful fundraises, we ask Silverfleet Capital managing partner **Neil MacDougall** how his group tackled AIFMD and other new rules while busting past its \$850m hard-cap for Fund II

**Pfm:** *How did Silverfleet adjust to the regulatory changes that occurred between the close of Fund I and the launch of Fund II?*

**MacDougall:** Here in Europe, we had to deal with the Alternative Investment Fund Managers Directive (AIFMD). It was new, and how people were dealing with it was emerging rather than established.

One tedious part was the premarketing. The new rules regarding what you needed to do in order to market a fund in each European country were far from clear. And what we defined as reverse solicitation wasn't necessarily what the LP or their legal advisors would regard as reverse solicitation. That had to be ironed out.

Our legal advisors sent letters to the LPs to set up the reverse solicitation,



**MacDougall:** meeting regulators' challenges

but in some cases an LP responded, "You're the only fund that we've encountered so far that's actually asked us to send one of these letters." It was interesting because we were doing it by the book, and we wondered, "Does that mean everyone else is winging it?" In Europe, we have LPs from Finland, Sweden, Norway, Denmark, the Netherlands, Germany, Switzerland and the UK, and there was quite a lot of variation from investor to investor and from country to country.

As time has gone by, it has become more established what customer practice needs to be in each country. Once we were fully AIFMD approved and signed off by the Financial Conduct Authority, we had a passport and we were able to market.

**What kind of challenges did you face bringing non-European investors onboard?**

We were in contact with investors from Saudi Arabia and had to go through the right way to market to them, as well as some from Israel, and the way they're regulated is unique as well. That produced some interesting negotiations in the LPA.

But I think the most surreal moment was when a US investor's Employee Retirement Income Security Act of 1974 (ERISA) counsel was disagreeing with a European investor's counsel on the interpretation of how ERISA should be documented in the LPA. So it's not just Europe, there were some other places we had to think through carefully as well.

**How do you navigate these in-depth LP negotiations, especially when your fund is nearly oversubscribed?**

You try to minimize the set-up costs for your investors and you're permanently torn, wondering "Is this issue really essential and how much are we going to spend on it?" We had one investor who did a deep dive on everything, and it probably cost seven times as much as the average investor to settle their LPA comments. But it was a reasonable check in terms of size, so it was worth it.

We were lucky that from Fund I to Fund II, all the investors who were able to invest again did. Unfortunately, some who we worked with closely in Fund I didn't have the money or couldn't justify coming into a fund of our size, so it was a smaller re-up rate than you would expect, but those who did re-up were the bigger investors so the number of euros raised was quite significant. You can manage the situation so that the people who want to be in the fund can be in the fund and you don't end up with LPs doing lots of work for no benefit.

**What was one of the more heavily negotiated terms?**

There's much more sensitivity as to what the role of the LP advisory committee is. Nobody on the advisory committee wants to be sued, but they also want to have a fair amount of say in how the GP deals with certain situations, so there's an inherent conflict. ■



Smashing the target size: GPs challenged to handle with more care

## Careful what you wish for

It's a nice problem to have, but managing a fundraising that is the subject of far more interest than it can handle is fraught with investor relations challenges for GPs

by CLAIRE COE SMITH

The number of private equity funds finding themselves oversubscribed at fundraising has been following an upward trajectory year-on-year since 2009, with 260 managers facing the problem of demand outstripping supply in 2014, as against 83 in 2009. In the first nine months of 2015, 183 funds have been oversubscribed, according to figures from PEI Research & Analytics, meaning this year could top even last year's total.

But while oversubscription may seem like a fundraiser's dream at the start of a process, working out the criteria that should be applied when it comes to choosing which investors make it in, and managing the communications challenges associated with those decisions, can be far from easy.

Audrey Klein is senior managing director and head of fundraising at Aerium Finance, the European real estate fund manager. She says: "One of the things that GPs must be aware of is that investors talk to each other; so besides the fact that it's wrong just to shut some-

body out without any warning, it's not great PR for the GP to just decide not to deal with an investor's questions... because they never know what's going to happen next time around."

She points out that, by handling the process badly on any particular fundraising, the GP damages relations with investors and its reputation within the broader investor community for future funds.

"Communication is really important," says Klein. GPs should be upfront with investors about their timetables, and if a LP is taking too long on due diligence, especially relative to others, they should be informed sooner rather than later that they risk getting left behind. GPs can "get really cocky" and ignore questions from certain LPs that they don't need, but that can result in reputational damage down the road, she warns.

### Plan ahead

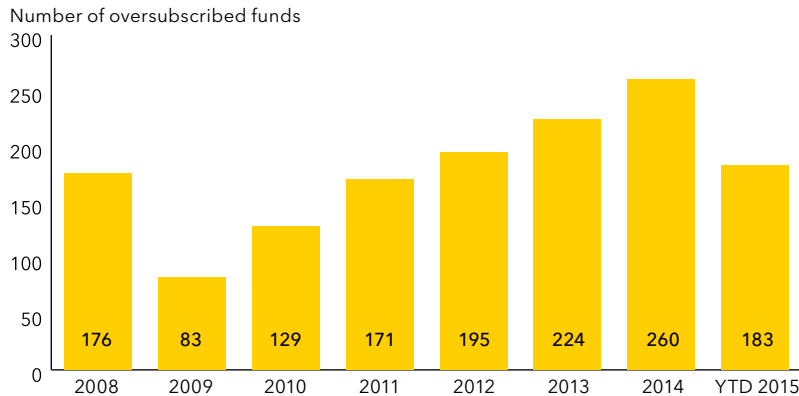
One of the first challenges can be to identify the potential for oversubscription early enough in the process to be able to manage expectations. Often the managers of over-subscribed funds find themselves facing accusations of over-marketing when they realize, further down the line, that many of the new leads they have been chasing down might have to be turned away.

Equistone Partners Europe closed its fifth fund at a €2 billion hard cap in April 2015, exceeding its initial target of €1.75 billion and completing the process in just six months. Approximately 80 percent of the capital committed came from existing investors, but the oversubscribed fund followed a previous fundraising that closed in January 2013 at €1.5 billion after nearly two and a half years on the road.

Would the firm have been wise to conduct less marketing? Equistone

## Capital magnets

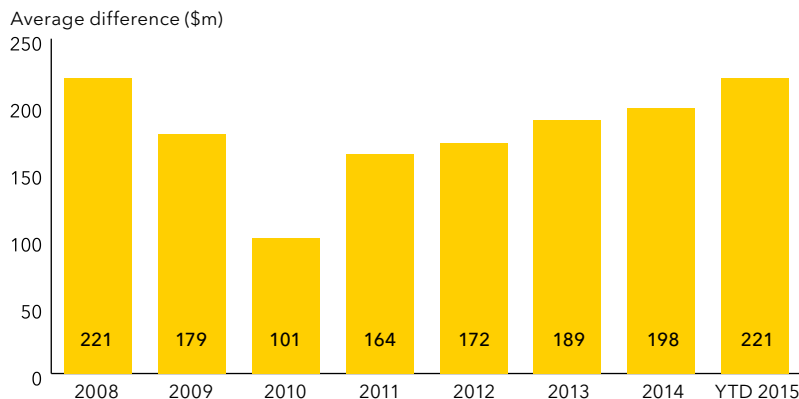
The number of oversubscribed vehicles in market is returning to pre-crisis levels



Source: PEI Research & Analytics

## Shooting for the stars

The average difference between capital raised and targeted across oversubscribe vehicles from 2008 to Q3 2015



Source: PEI Research & Analytics

fundraising and investor relations partner Christiian Marriott says that, in the end, the firm only had to turn two investors off completely.

“Our last fundraising took a long time, because we were just coming out of Barclays and it was at the height of the Eurozone crisis. It was quite hard to

come from that experience and then not market to too many people, because our job is to de-risk the process and secure the capital base of our business for the next ten years. I don’t think there was any other way to do it.”

What he does advise against is letting slower-moving investors drift, instead

of very proactively keeping in touch with them and constantly making them aware of the timeframes others are working to. Otherwise he says there is a risk that when those investors do get their ducks in a row, they will be disappointed to find out they have been left behind.

### How to say no

There are a few important criteria that should be applied by GPs faced with the problem of deciding which LPs to turn away.

“Managers should ideally have clear and fair guidelines, so that you are not only being fair, but also being seen to be fair,” says Andrew Bentley, a partner at Campbell Lutyens, a placement agent.

“For example, investors will understand if you treat existing investors in a slightly preferential way to newer investors, and you may also decide to distinguish between those that commit to the fund earlier and on time and those that don’t. That is also a good way to manage the timetable.”

Some managers seek to diversify their investor base and so give preference to LPs coming in from parts of the world not currently in the fund.

“In setting allocations it is understandable to give preference to X or Y geography, but really only if you have been clear on your strategic aims from the start. Ultimately the GP has to right to accept whoever they want into the fund, but the aim should be to leave no LP feeling upset, because LPs, if treated badly, can remember that for a decade or more,” says Bentley.

Klein says the LPs that are going to be real partners, and may be able to invest across multiple products longer term, are the ones to take forward. She adds: “The other criteria should be diversity, because it’s really important to have diversification of types of investors, and

investors from different areas and different parts of the world.”

Howard Beber, a partner with the law firm Proskauer, and co-head of its investment funds practice, echoes the sentiment that some level of LP diversity is good in a fund: “You want to look at your LP base, and in most cases it’s important to have a good mix of endowments, sovereign wealth funds, funds of funds and so on, because often those groups invest in cycles, and you don’t want to be over-concentrated in one type or another.”

Still, managers should always provide special attention to their current LP base, says Jeremy Lytle, an investor relations partner at ECI Partners, which closed its tenth buyout fund, ECI 10, at the hard cap of £500 million in five months last year, having been significantly oversubscribed.

“Really, most people end up giving priority to existing investors. Some people may use the fundraising to change out certain LPs, or target new geographies, but one of the aims of the fundraising is really to hit the hard cap as quickly as possible and then get back to the day job. The easiest way to get there is to look after your existing investors.”

He adds: “We spent a lot of time with existing investors first, finding out how they were positioned, and then you can start to get a feel for the level of demand. If you’re getting a re-up rate of 80 percent, which is what we were getting last summer, then you quickly know where the holes are.”

For new investors, the ECI approach was to encourage them to move quickly. Lytle says: “For the bigger prospective investors, we said if you can drive hard and get into the first close, and give us a strong indication of your demand and level of appetite, then we can accommodate you. That inevitably ends up moving along some of your

existing investors too, some of whom may be waiting to see what the level of demand is.”

At Equistone, investors coming in to the first close and proposing to commit an amount of money that was less than €100 million were given their allocation at that stage, whether they were new or existing LPs. Marriott says: “We didn’t tell anyone we were going to do that, and in fact we said we couldn’t

“Managers should ideally have clear and fair guidelines, so that you are not only being fair, but also being seen to be fair”

guarantee allocations even at first close, because even by that time we had started to believe that we were going to be oversubscribed. So for some people that was a positive surprise, because they were expecting to be scaled back, but it meant that the first close took us to roughly 75 percent of our hard cap.”

At final close, new investors were scaled back less than existing investors who might reasonably have been expected to have made it into the first close, but did not meet the timetable.

One thing Equistone was committed to was a hard cap that was immovable, and which was set out in the fundraising documents at the outset. “We made a conscious decision to set up a hard cap up front, and we did something that I think is becoming more common, which is that we put that hard cap in the private placement memoranda,

which means that in the offering document you are committing to an amount of money that you will not go above. The concept of movable hard caps can be pretty frustrating for a lot of LPs,” says Marriott.

Bentley says bumping up the fund size is tempting but not always a good option: “Managers should be cautious about it when the fund size sits at the heart of the proposition that you have sold to LPs, because if someone has taken this to investment committee on the basis of a particular strategy, and then you take it outside of that segment or blur the lines, then the whole proposition becomes a bit compromised and LPs will justifiably feel irritated.”

For him, the biggest no-no in an oversubscribed fundraising is setting LPs up for a fall in front of their own investment committees. He cautions: “Managers should be reading the book well enough to judge when to slow down the marketing so that they minimize the oversubscription problem at the end. Some oversubscription is often unavoidable but the key point is to avoid letting LPs going through final investment approvals thinking they have got a specific allocation, and then end up not being able to provide that. Communication of the pressures in advance so they are forewarned is important.”

Beber concludes: “Where I have seen trouble is when GPs were perhaps not as forthright, and then at the last minute they had to disappoint people, which is a quick way to upset people and damage relationships with investors who might otherwise have been prospects for successor funds.”

Foresight and forewarnings, alongside clear, consistent and fair communications, appear to be the key things to bear in mind if you are to avoid upsetting the investor base and burning bridges for future raisings. ■

## Finding what works for you

As investor demand for co-investment opportunities escalates, GPs are considering new ways to manage the process, including the creation of a ‘chief co-investment officer’, making less promises during fundraising and whether to raise separate top-up funds

by CLAIRE COE SMITH

There is no doubt that demand for co-investment opportunities has sky-rocketed among the limited partner community in recent years. But sponsors are struggling to keep up with investor demand to team up on deals, and with regulators baring down on them, many are re-thinking how to satisfy demand in a way that works for everyone.

In 2014, \$5.8 billion was raised for co-investment funds, while \$10 billion has already been raised in the first nine months of 2015 alone, according to data from PE Research & Analytics. LPs are queueing up for more opportunities to put additional capital to work alongside their favorite managers, leaving GPs in a quandary and in need of more sophisticated answers.

Crucially, dealing with sourcing extra capital to top up the fund’s commitment on larger transactional opportunities has moved from being a deal-team issue, to being a critical

“When you offer co-investment opportunities to LPs, it can be quite a cumbersome process, and it is not always harmonious”

point of investor relations risk management.

### The IR factor

Stephen Cavell is head of investor relations at Graphite Capital, a private equity investor focused on the UK mid-market. He says: “In our experience almost all LPs want co-investment, and they increasingly ring up about it. But when you offer co-investment opportunities to LPs, it can be quite a cumbersome process, and it is not always harmonious. If you have a limited amount you can offer, do you offer that to X, Y or Z? Or do you offer it to everyone, and everyone ends up with tiny amounts? That can be very difficult to manage.”

David Smith, a managing director and co-head of co-investment at Capital Dynamics, a major investor in private equity funds around the world, echoes the sentiment. He predicts more GPs to allocate additional resources to systems and controls in co-investments, because it is an area that can no longer be primarily managed by the investor relations function.

In fact, the complexity of fundraising today, which requires careful management of various LP relationships and new regulatory burdens, is already a full-time job for IR staff. Adding co-investments to their list of responsibilities can start to “stretch their capacity,” says Smith.

He offers a solution to the problem: “I think we will see the advent of a



‘chief co-investment officer’ role, in the larger funds in particular, because interest in co-investment and its prominence is becoming such a significant aspect of business for most GPs.”

### No promises made

Co-investments offer several potential attractions to LPs, not least a chance to reduce fees. Private equity firms that ordinarily charge a management fee of 2 percent and take 20 percent of profits in carried interest will bring in partners on co-investments with much reduced fees, and sometimes none at all. Given that private equity remains a relative-



ly expensive asset class for investors to access, and returns are under pressure, that has a big appeal – as does the chance to get a bigger slice of the action alongside a popular manager, and deal-by-deal investment selection.

But as one investor relations partner at a private equity firm points out, investor demand for co-investments is becoming a challenge for GPs: “Our observation is that, firstly, LPs are quite often motivated by their own economics to do it: they either have carried interest deals or some other arrangements internally that are pushing them to do it. Secondly, they make out

to their investors that they are great at doing it and it will enhance returns, but really a lot of LPs talk the talk but then when you want them to get their act together and commit, they are busy doing something else or they are not set up to respond.”

Smith says there was a time when sizeable LPs such as Capital Dynamics could have bilateral discussions with general partners at fundraising stage and secure a co-investment rights agreement, guaranteeing them a true legal right to make co-investments. Now, he says: “As co-investment has become more popular – the demand for it and its profile within

**Co-investments:** GPs piecing together new ways to manage the process

the private equity industry has increased more than I would ever have imagined – now, no promises are made. It will come up in a fundraising conversation, and the GP will ask the LP whether they would be interested, but there is no legal right. Most serious LPs with a co-investment appetite and demonstrable execution credentials will make sure that that appetite is noted and described in a side letter.”

### Strategies pursued

But are GPs wise to keep things open-ended? Kate Simpson, a partner in the private investment funds practice at law firm Proskauer, says yes.

“The general approach is for GPs to keep a softer, more discretionary co-investment approach, so they say that they acknowledge the LP’s interest, but they will approach any opportunity on a case-by-case basis. There are people that do harder things in the limited partnership agreement, or offer co-investment rights as a first-close incentive, but most GPs want to try to exercise discretion.”

GPs have in the past sometimes promised co-investment rights pro rata to each LP’s commitment to a fund – some have delivered LPs as much as three times their fund commitment in co-investments.

Graphite’s solution is to set up and raise a separate top-up fund, at the same time as the main fund, that invests in the larger deals where syndication would be necessary. That blind co-investment pool is open to all LPs interested in such opportunities.

Cavell says: “The positives for the investors are that they get a bigger exposure to Graphite funds, which is attractive especially to larger global investors

who want to put larger checks to work. It also reduces their overall costs of being in our fund, because the top-up fund comes at a lower cost, with a fee that is only charged on invested money with deal-by-deal carry. The negative is that it's a blind pool, so they can't pick which deals they get in to."

He says Graphite decided some time ago that the classic co-investment model is ineffective in the mid-market for two reasons. One, the firm refuses to underwrite larger transactions and then sell them down in case circumstances change suddenly. And two, the alternative route of taking LPs along to deal meetings so that they can make decisions on whether to come aboard is too complicated to execute.

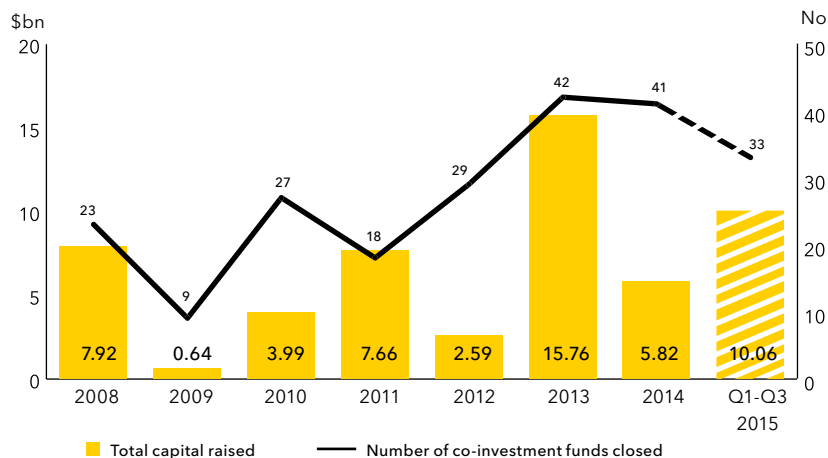
He adds, "We arrived at this decision because we looked at the structure of our 2007 fund and at the market, and we decided we didn't want to raise an enormous amount of capital, and we wanted to stay in the mid-market without the pressure of a huge amount of capital to deploy. We did see a lot of large opportunities, though, which we didn't want to put into the main fund for fear of risking that fund, but we saw no reason why we couldn't manage them."

The Graphite model deals with both the fundraising challenge and the allocation problems associated with LPs desperate to secure co-investment rights, and Cavell expects it to become more commonplace.

It also helps with the messaging, which can be a real challenge, as Guy Hands, founder and chairman of Terra Firma Capital Partners, recently set out in a speech at *pfm's Investor Relations and Communications Forum Europe*. He said: "You can't go to one group of LPs and say this is all about co-investment, we'll give you great co-investment, and go to another group of LPs

## Rebound enthusiasm

After experiencing a dip in 2013, co-investment funds experienced a resurgence in popularity during the first nine months of 2015



Source: PEI Research & Analytics

and say we are here to do deals that are the right size for the fund."

### Regulatory concerns

That challenge is compounded by regulatory scrutiny. In 2012, the US Securities and Exchange Commission (SEC) began taking an interest in conflicts of interest arising in co-investments, and it has since increasingly focused on the offering process, making sure all opportunities are represented clearly and fairly to all LPs.

In light of this, Simpson says the best way forward now is for GPs to have a very clear and well-documented policy on co-investment strategy, and to communicate that widely. She says: "All GPs should have a co-investment policy saying how they look at opportunities as they arise, and how they allocate them in the best interests of the partnership."

The first decision will always be whether it is in the best interests of the fund to do a deal that is of such a size

that it requires co-investors, and that has to be decided based on clear criteria before any consideration is given to which LPs might be offered the opportunity. Then allocations may be offered based on any number of criteria, ranging from the size of the LP and the size of its commitment, to the geography, industry sector or strategy of the target business.

"The SEC is very close to this at the moment," says Simpson, "and the expectation is that GPs will have a policy. Most people may not have it fully documented, but they have always had a policy, so the point is that they need to memorialize it now. Investor relations are important for all GPs, so there has long been the driver to be seen to be doing things fairly and reasonably, so as not to be risking relationships, not just so that they are doing things by the book."

As with all investor relations issues, transparency, clarity and good communication appears to be the order of the day. ■

## Proving your partnership

In the final installment of our three-part series interviewing GPs with recent successful fundraises, we ask The Carlyle Group's head of global investor relations **Mike Arpey** how firms raising multiple, simultaneous funds approach investor relations

**Pfm:** *With the recent trend among LPs to consolidate their GP relationships, how do you ensure that LPs continue working with Carlyle?*

**Arpey:** You have to do more listening than talking. LPs are looking to get more out of the GP/LP relationship than just commitments, and they're thinking holistically. It's not just that they'd like more co-investment, it's beyond that – they're looking for information, they're looking at thought leadership, and they're looking to have a partner. One of the best ways to ensure that we're relevant is that we're in touch with our limited partners and we understand what their needs are. What we do is germane to what LPs tell us they need and want. The best way to measure that is to look at what you offered and ask, did people consume it? Did they commit to these funds? If you're not listening well, you may be offering opportunities they don't want to buy.

The other aspect is that you have to execute. Carlyle has done a very good job generating realizations through a variety of cycles. LPs see that across our platform and view Carlyle as a core holding for them. LPs working with fewer managers plays out for us, because they take comfort in the quality of Carlyle and also can be tactical in how it is that they deploy capital with us. We give them choices; we don't have a one-size-fits-all approach. If they want to allocate specifically to Europe, or specifically to small cap in Asia, we have



**Arpey:** embracing new ways to communicate with LPs

that. That winds up being very helpful to clients thinking holistically about their portfolios.

***What is your approach to investor communications, and how are you handling investors' increased reporting demands?***

We're in very regular communication with our LPs, whether that's in person during site visits or conferences; over the phone, one-on-one, or in calls with multiple investors; and through web-based portals that LPs use to access and slice and dice information. We're also using our external affairs folks to do podcasts and research reports and increase communications with regards to events in the market. It's multifaceted

in terms of how we communicate but the expectation is to be high-touch, and we're responding that way.

And it's not just our IR people who are reaching out. The people managing the money are in touch as well. After wrapping up our large cap European fund, Carlyle Europe Partners IV, this summer, two of the fund's managing directors went out to Asia to sit down with some of their investors just to catch them up on what's going on in the European market. Moments like that are important. We can't forget whose money it is.


***Looking back on Carlyle's recent fundraisings, what's the biggest shift you've seen in the GP/LP relationship?***


More emphasis is being placed on the word "partnership." When people talk about General Partners sometimes the word "partner" gets lost in the process. Overarching everything, LP and GP interests are converging and there's a real partnership mentality taking hold, whether that means greater alignment of interest or more mutuality around information and thought sharing. The years of the "presidential cycle" in investor relations – only seeing people every four years when you're trying to raise money – is over. If people take that approach, they do so at their own peril. If you're not in communication with your LPs, someone else will be. The emphasis has to be around the partnership, and that's where we live. ■


# Proskauer

## Private Investment Funds Group

Our Private Investment Funds Group is a dynamic, interdisciplinary team of lawyers offering a complete package of services to private investment funds and institutional investors globally. We are consistently ranked as a top-tier practice in leading industry publications, including as one of the top five “most active law firms” for sponsor-side fund formations and most recently as “Fund Formation Team of the Year” in Chambers.

 In 2015, we advised sponsors in closing more than **100 funds** with well over **\$26 billion** in committed capital.

 Institutional investors on more than **180 investments**, representing over **\$7 billion**.

 And on more than **60 secondary transactions**.

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With over 300 GP and 100 LP clients globally, our experience representing both sponsors and institutional investors across the alternative asset class on a daily basis gives our clients access to our unparalleled insight into trends, developments, and terms and conditions. We have extensive familiarity with the terms and conditions found in typical partnership agreements, segregated accounts, funds of one and specialized investment mandates, having written, reviewed and negotiated such documents both for general partners and limited partners. Our ability to advise on fund structuring, capital raising and investment activities on a daily basis gives us unmatched insight into market terms and trends.

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## Key contacts

### London



**Bruno Bertrand-Delfau**

Partner  
dd +44.20.7280.2126  
bbertrand-delfau@proskauer.com



**Robert Gaut**

Partner  
dd +44.20.7280.2064  
rgaut@proskauer.com



**Peter McGowan**

Partner  
dd +44.20.7280.2066  
pmcgowan@proskauer.com



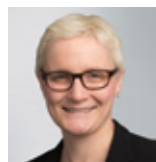
**Oliver Rochman**

Partner  
dd +44.20.7280.2069  
orochman@proskauer.com



**Catherine Sear**

Partner  
dd +44.20.7280.2061  
csear@proskauer.com



**Kate Simpson**

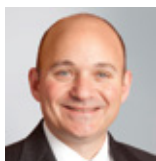
Partner  
dd +44.20.7280.2068  
ksimpson@proskauer.com



**Nigel van Zyl**

Partner  
dd +44.20.7280.2070  
nvanzyl@proskauer.com

### Boston



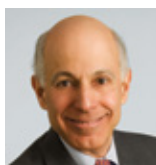
**Howard J. Beber**

Partner  
dd +1.617.526.9754  
hbeber@proskauer.com



**Sarah K. Cherry**

Partner  
dd +1.617.526.9769  
scherry@proskauer.com



**Daniel P. Finkelman**

Partner  
dd +1.617.526.9755  
dfinkelman@proskauer.com



**Sean J. Hill**

Partner  
dd +1.617.526.9805  
shill@proskauer.com



**David T. Jones**

Partner  
dd +1.617.526.9751  
djones@proskauer.com



**Scott S. Jones**

Partner  
dd +1.617.526.9772  
sjones@proskauer.com

**Boston**



**Mary B Kuusisto**  
Tax Partner  
dd +1.617.526.9760  
mkuusisto@proskauer.com



**Arnold P. May**  
Partner  
dd +1.617.526.9757  
amay@proskauer.com



**Stephen T. Mears**  
Partner  
dd +1.617.526.9775  
smears@proskauer.com



**Malcolm B. Nicholls III**  
Partner  
dd +1.617.526.9787  
mnicholls@proskauer.com



**Robin A. Painter**  
Partner  
dd +1.617.526.9790  
rpainter@proskauer.com



**Jamiel E. Poindexter**  
Partner  
dd +1.617.526.9773  
jpoindexter@proskauer.com



**Michael R. Suppappola**  
Partner  
dd +1.617.526.9821  
msuppappola@proskauer.com



**David W. Tegeler**  
Partner  
dd +1.617.526.9795  
dtegeler@proskauer.com

**New York**



**Ira G. Bogner**  
Partner  
dd +1.212.969.3947  
ibogner@proskauer.com



**Niamh A. Curry**  
Partner  
dd +1.212.969.3474  
ncurry@prosakuer.com



**Bruce L. Lieb**  
Partner  
dd +1.212.969.3320  
blieb@proskauer.com



**Amanda H. Nussbaum**  
Partner  
dd +1.212.969.3642  
anussbaum@proskauer.com



**Chip Parsons**  
Partner  
dd +1.212.969.3254  
cparsons@proskauer.com



**Marc A. Persily**  
Partner  
dd +1.212.969.3403  
mpersily@proskauer.com

**Beijing**



**Ying Li**  
Partner  
dd +852.3410.8088  
yli@proskauer.com



**Yong Ren**  
Partner  
dd +86.10.8572.1899  
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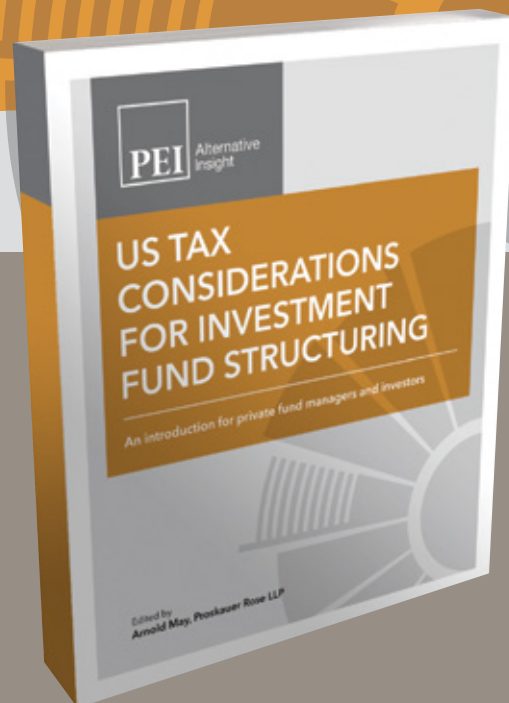
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