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## THE PEI FUND ADMINISTRATION & TECHNOLOGY COMPENDIUM

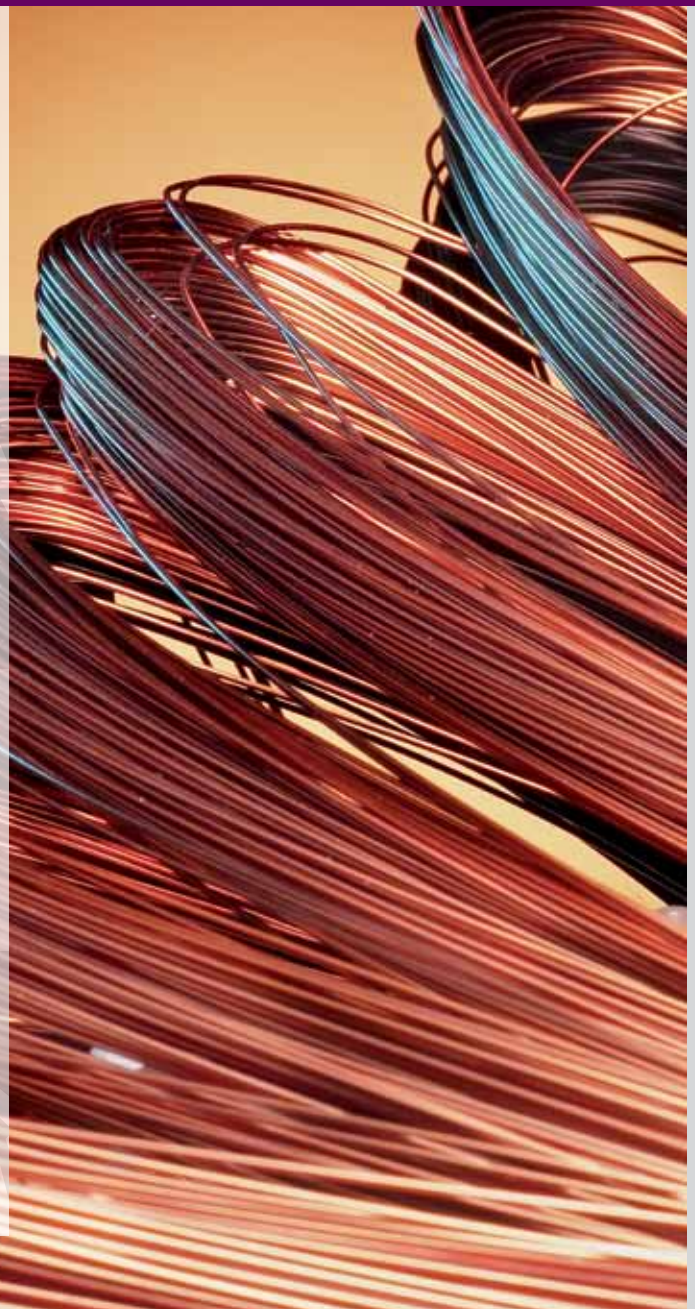
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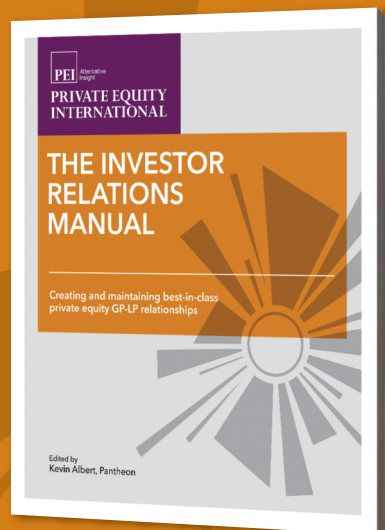
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## EDITOR'S LETTER



### PRIVATE EQUITY INTERNATIONAL

#### LONDON

Second floor, Sycamore House,  
Sycamore Street  
London EC1Y 0SG

#### NEW YORK

3 East 28th Street, 7th Floor  
New York, NY 10016

#### SINGAPORE

105 Cecil Street  
Unit 10-01 The Octagon  
Singapore 069534

#### HONG KONG

Level 19, Silver Fortune Plaza  
1 Wellington Street  
Central  
Hong Kong

#### Supplement Editor

**Jenna Gottlieb**  
Tel: +1 212 937 0385  
jenna.g@peimedia.com

#### Contributors

**Nicholas Donato**  
**Hsiang-Ching Tseng**

#### Senior Editor, Private Equity

**Amanda Janis**  
Tel: +44 20 7566 4270  
amanda.j@peimedia.com

#### Editorial Director

**Philip Borel**  
Tel: +44 20 7566 5434  
philip.b@peimedia.com

#### Head of Marketing

**Paul McLean**  
Tel: +44 20 7566 5456  
Paul.m@peimedia.com

#### Head of Production

**Tian Mullarkey**  
Tel: +44 20 7566 4276  
tian.m@peimedia.com

#### Group Managing Director

**Tim McLoughlin**  
Tel: +44 20 7566 4276  
tim.m@peimedia.com

#### Co-founder

**David Hawkins**  
Tel: +44 20 7566 5440  
david.h@peimedia.com

#### Co-founder

**Richard O'Donohoe**  
Tel: +44 20 7566 5430  
richard.o@peimedia.com

#### Head of Advertising

**Alistair Robinson**  
Tel: +44 20 7566 5454  
alistair.r@peimedia.com

#### Head of Business Development

**Jeff Gendel**  
Tel: +1 212 633 1452  
jeff.g@peimedia.com



THE QUEEN'S AWARDS  
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# Celebrating transparency



Welcome to *Private Equity International's* Private Equity Fund Administration and Technology Compendium 2011.

The landscape for fund administration has changed since our last compendium.

Private equity fund managers are being pressured towards greater transparency and accountability, and major financial regulatory overhauls are also threatening to require a much higher level of disclosure from GPs.

Pressure on fees and LP interest in due diligence activities, along with new regulations in the US and Europe that will impose compliance requirements on GPs will shine the

spotlight on fund administration more than ever, Jenna Gottlieb writes on p.4.

Meanwhile, some of the proposals in the Dodd-Frank legislation in the US are leading private equity firms to rethink the hidden costs of in-house fund administration. As Cesar Estrada and Georges Archibald of JP Morgan write on p. 13, fund administrators can help GPs understand and comply with a host of new regulatory requirements.

Herve Schunke of Caceis notes that the transparency requirement under the Alternative Investment Fund Managers directive may have a strong impact on the moral hazard faced by financial authorities. He writes on pg. 21 that the national regulators thus insulated from the inherent risks, may suggest to investors that the investment is "transparent", leaving the investors to bear the consequences of the risks taken.

As Ernst & Young writes on p. 29, fund administrators are impacted by current changes regarding increased reporting, transparency and disclosure requirements. New developments will ultimately create both opportunities and threats for the fund administrator community.

In a separate feature, Nicholas Donato explores the evolution of fund administration technology, as GPs are looking for more sophisticated tools to handle regulatory compliance portfolio reporting demands on p. 8.

Meanwhile, regulatory developments in China are laying the foundation for fund disclosure policies in the region, writes Hsiang-Ching Tseng on p. 18. The National Development and Reform Commission took a first step towards regulation of its private equity industry with the implementation of a pilot measure, providing some much needed guidance on many issues, including fund administration.

While there are changes and challenges ahead, all of these pieces create a picture that is decidedly positive for the fund administration industry. Increased reporting, transparency and disclosure requirements will require fund administrators to expand their offering to meet the new needs of their private equity clients, ultimately creating new opportunities and stronger partnerships.

Enjoy the supplement,

Jenna Gottlieb  
Editor, PE Manager

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#### Subscriptions

London: +44 20 7566 5444  
New York: +1 212 645 1919  
Singapore: +65 6838 4563  
subscriptions@peimedia.com

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Fran Hobson  
+44 20 7566 5444  
fran.h@peimedia.com

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**New York:**

Mark O'Connor  
+1 917 326 5227

Virginia Volpe  
+1 212 816 7352

**San Francisco:**  
Michelle White Hopfner  
+1 415 627 6377

**Asia:**

Glenn Kennedy  
+852 2868 8986

**Europe:**

Kamran Anwar  
+44 207 986 2989

**Latin America:**  
Alejandro Berney  
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## FUND ADMINISTRATION

# Changing landscape

*Over the past few months several factors have changed the way in which private equity executives approach fund administration. Managers are facing new regulatory requirements, pressure on fees and increased LP scrutiny of due diligence procedures, writes Jenna Gottlieb*

As the private equity industry enters a new era of regulation and reporting requirements, fund managers are being forced to disclose more information, engage in tougher negotiations with LPs and account for the investments GPs make. Here are five trends that have forced GPs to operate in a “new normal”.

## US regulation

Registering with the US Securities and Exchange Commission will require private equity managers to document many aspects of their business and maintain that documentation in an easily accessible place so that it can be provided if regulators come knocking.

Managers will need to have a strong understanding of the books and records required by the Advisors Act as well as other items that the SEC expects an advisor maintain.

Private equity managers will specifically need to consider the presentation and preservation of: corporate records, compliance records, portfolio management documents, client records and proxy voting materials.

An area of frequent lapses for private equity advisors is the failure to create written policies and procedures to document ongoing business practices and operations, according to a New York-based fund formation lawyer.

“The challenge is one of consistency. All the information is there, it just has to be organised in a more rigid process,” said the lawyer.

Perhaps the most important of the required records is the Form ADV, which consists of two parts. Part 1 is filed with the SEC and contains information about the advisor, including business, affiliations and assets under management.

Part 2 discloses more detailed information

*“The challenge is one of consistency. All the information is there, it just has to be organised in a more rigid process”*

about the advisor, its potential conflicts, its business practices and the background of its key executive officers.

“This adds yet another layer to the operational process,” said a New York-based compliance officer.

In the past, the manager provided ADV Part 2 to investors to comply with the SEC’s Brochure Rule, but Part 2 was not filed with the SEC.

SEC examiners closely scrutinise information managers have to report and the attention to detail will continue, with some new information made public. New rules require ADV Part 2 to be available on the SEC’s website.

## European regulation

The long-anticipated EU’s Alternative Investment Fund Managers directive, which passed the EU Parliament in the autumn, will impose rules on general partners’ pay, fund transparency, and restrictions on asset stripping.

As of May 2011, fund managers have been awaiting details on the first phase of the directive for months. How to calculate assets under management, for instance, will

determine which funds are netted by the directive and which fall under minimum thresholds for regulation. The current benchmark for most funds will be €500 million. The AIFM has yet to begin the technical second phase of the directive.

Other questions yet to be fleshed out by the European Securities and Markets Authority relate to how leverage influences the assets under management; how to treat GPs whose total assets under management sometimes exceed or fall below the relevant thresholds; and what the registration requirements for GPs falling below the threshold should be.

“Of course, these are not the only questions which are crucial to the industry – others include the role of the depositary, detailed capital requirements, and the reporting framework, for example,” noted an SJ Berwin client memo addressing the matter.

Costs associated with implementing new policies concerns GPs and impacts administration functions.

Ongoing compliance costs will rise for funds directly or through their service providers. “Compliance costs could rise by €110 million to €2.2 billion for private equity funds that operate in the EU,” said one fund formation lawyer based in London. “At the time of the [EU Parliament’s] decision we were pleased. It could have been negative, but now the additional costs are beginning to sink in,” he said.

EU fund managers will also have to hire independent valuers and depositories to hold assets in segregated accounts. The new transparency measures will mean hiring an outsourced fund administrator will start to look very appealing to some managers.

GPs will soon have their answers as the ESMA has stated it intends to formally

propose follow-up rules to the directive this summer. The formal proposal will then undergo its own public consultation, which will be later used to finalise the watchdog's advice to EU legislators.

### Pressure on fees

In challenging economic times, more private equity firms are considering outsourcing their fund operations as a way to reduce costs. LPs, however, are increasingly unwilling to foot the outsourcing bill. GPs are engaging in tough negotiations with LPs with regard to outsourcing expenses.

As with companies in most other industries, private equity firms need to keep a closer eye on costs.

"We are constantly reassessing our costs," said one chief operating officer. "We are going to save where we can, but we are going to spend when we need to spend."

Some private equity shops are keen to add staff instead of outsourcing administrative functions keeping a close eye on costs.

Stephen Hoey, partner, administration and chief financial officer at New York-based KPS Capital Partners told *PEI*: "We made the decision to keep the administration and accounting function in house".

### Broadening reach

While consolidation among fund administrators is a concern, some positive news for GPs came when several firms decided to expand over the past year, setting their sights on new regions.

In April, The Carlyle Group sold Offshore Incorporations Group (OIL) to IK Investment Partners, which will merge the OIL's corporate services businesses with its portfolio company Vistra Group, which provides fund administration, trust and corporate services in Europe.

"The merger will also offer an opportunity to expand Vistra's footprint in mainland China and that of OIL into new selected geographies such as the Americas, Indonesia and India," the European private equity firm said in the statement.

In November, Citigroup increased its private equity and real estate service capabilities for managers based in Europe, the Middle East and Africa. In expanding its Global Transaction Services unit into EMEA, Citi began offering GPs in the region greater

*Compliance costs could rise by €110 million to €2.2 billion for private equity funds that operate in the EU*

fund administration services including financial reporting, cash management and asset safekeeping solutions.

As part of the expansion, Citi has also established a new client service team in Dublin. The team joins existing funds businesses in Luxembourg and Jersey as part of Citi's overall private equity capabilities in the EMEA space.

Luxembourg-based fund administration provider Alter Domus launched two new European offices in Belgium and Malta in September. Alter Domus provides fund administration services to the private equity industry, including assistance in a fund's launch, compliance support and managing capital calls.

In July Alter Domus opened an additional office in Singapore as a way of offering further support to clients in Asia.

New offices are often opened at the request of clients, said a New York-based fund formation lawyer. "The overhead is low and it keeps clients happy."

Apex Fund Services opened a Luxembourg office in August, in response to high demand for favourably taxed fund vehicles.

"Our clients are increasingly demanding Luxembourg vehicles as a launch point for

the European market," said Christophe Lentschat, an Apex managing director. "The country offers a safe, tax-neutral and stable regulatory environment for foreign investors."

In addition to servicing public and private funds domiciled in Luxembourg, the new office provides fund administrator services for three types of fund platform. The Luxembourg office administers one platform for the re-domiciliation of offshore funds, alternative investment fund manager activities and the creation of non-UCITS vehicles; a second platform to service Luxembourg-based Shariah compliant funds; and a third UCITS-compliant platform for the re-domiciliation of offshore non-UCITS, passported alternative investment fund manager activities and non-UCITS vehicles

### LP focus on fund administration due diligence

Limited partners are closely watching their GPs' due diligence procedures, including fund administration functions, investment decisions and incentive fees.

According to a recent report by EisnerAmper, LPs put the most significance (91 percent) on due diligence relating to fund administration, followed by investments (83 percent) as well as management and incentive fees and other expenses (79 percent).

The report, dubbed *The Pulse of Private Equity*, surveyed 107 US-based general partners, managing directors, CFOs and COOs on private equity trends.

"The concerns that private equity executives have with respect to limited partners are significant," according to the report. "The private equity executives rate their perception of the LPs interest in due diligence very high."

Other fund terms, such as lockups rated at 67 percent and fair value investment valuations rated 62 percent.

However, GPs should not discount the importance of fair value.

"The lower ratings by LPs for the importance of the fair value investment valuation does not suggest this is no longer an issue," said Michael Laveman, a partner at EisnerAmper. "Instead its relative rating highlights the critical nature of the other areas explored on manager and investment due diligence along with fund terms, fees and expenses." ■

## NEWS BRIEFS

# Fund administration briefs

*LPs negotiating for fee breaks and formalising transparency procedures were among recent fund administration and technology stories that have appeared on PrivateEquityManager.com*

## LPs focus on due diligence

Limited partners are closely watching their GPs' due diligence procedures, and it's a trend that is unlikely to change, according to a recent survey by EisnerAmper.

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**Moret:** examining fees and megafunds

## CalPERS debates fee stance

The California Public Employees' Retirement System in the past few years has been on the receiving end of some of the industry's biggest fee breaks.

The pension board and staff discussed at a recent board meeting a number of goals going

forward, including negotiating with managers for lower fees and other fund structures that could cut away at the cost of private equity.

One problem with an aggressive stance on terms, though, was the pension would have to be prepared to miss out on potentially quality funds, CalPERS' chief investment officer Joseph Dear said at the meeting.

"If we want to insist on the terms that are best for the limited partner and are willing to forego that investment, are we prepared to reduce our exposure to private equity ... in order to accomplish that?" Dear asked. "We believe we're going to get 3 percent over the public markets in that asset class, so this is a pretty important strategy for [us to] achieve our investment objective."

The pension system also was recently rethinking its stance on mega funds.

CalPERS investment staff reviewed with the board the alternative investment programme at the last meeting – a review staff undertakes each year. The pensions' alternative investment portfolio had a total market value, including \$16 billion of unfunded commitments, of about \$48 billion. About 38 percent of the portfolio was invested in "large/mega-buyouts", according to the pension's annual programme review.

"I've never understood why we, as the biggest pension fund in America, continue to do business with the mega-funds," said Louis Moret, a member of CalPERS' board of administration. "There's no movement to say 'bye, Apollo, bye Carlyle, bye TPG'."

## SEC proposes rule on performance fees

The US regulator plans on raising the net worth required of an investor in order for advisors to charge performance fees.

The Securities and Exchange Commission proposed a rule recently under the Dodd-Frank Act that would adjust the threshold amounts for inflation that a "qualified client" must meet before an investment advisor can charge performance fees.

Under the Investment Advisers Act of 1940, an advisor can charge for performance fees if the firm manages at least \$750,000 of a client's assets and if the client's net worth exceeds \$1.5 million. The SEC proposed raising the thresholds to \$1 million under management and \$2 million for total net worth.

The adjustment would take effect 21 July, with future changes made every five years.

The SEC also proposed a rule that would require the agency to show the method for calculating inflation adjustments to exclude the client's primary residence in calculating net worth.



**Dear:** contact us with the tools we have

## CalPERS unveils online PPM idea

The private equity industry has reacted with skepticism over a plan by the California Public Employees' Retirement System to create an online service for managers to electronically submit investment proposals.

The pension system plans on launching the system in July in an effort to halt the use of placement agents.

"We're working hard to make sure that money managers have all the access they need to do business with us. There's no need for them to pay someone to call us or to set up a meeting. They can contact us themselves with the tools and technology we have. Our door



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is open,” said CalPERS chief investment officer Joseph Dear, in a statement.

The proposals, once submitted, will be reviewed by CalPERS investment staff. It would cover private placement memoranda from managers of private equity, real estate, and infrastructure funds. The new policy will also be required for forestland, commodities, global fixed income and global equity investments.

In submitting an investment proposal, managers will be asked to select the asset class that fits their proposal. The manager also would have to provide information about its history, track record, strategy, deal sourcing and geographic and industry focus.

After the investment office reviews the proposal, it may be declined, accepted for additional due diligence or referred to one of the pension's external partners for further review.

## New York unveils pension transparency plan

New York City's \$113 billion pension system will provide greater public access to information, including webcasts of pension board meetings and online access to pension fund information, New



*Liu: greater transparency leads to greater performance*

York City Comptroller John Liu announced earlier this year.

“Taxpayers and pensioners deserve to know how the money is being invested and spent,” Liu said in a statement. “We have always aspired to run the best performing funds - it's time we broaden our aspirations to also run the most transparent funds. In fact, greater transparency ultimately will lead to stronger performance.”

Starting 1 July, the new initiative, Pension NYC, will give the public access to information about the New York City pension system.

Pension board meetings will be webcast live and then archived on the comptroller's website.

## Taylor Wessing digitises due diligence work

Taylor Wessing recently launched a new service providing electronic data mining, contract management and due diligence services for its private equity clients and others.

The international law firm joined forces with information management company Swiss Post Solutions in creating its new division “New Street Solutions”.

The software acts as an alternative to legal process outsourcing—which is when firms delegate support services to third party providers.

“Unlike other initiatives that have sought efficiencies by sending volume legal work to lower-cost jurisdictions, New Street Solutions aims to enhance the value-added aspect of legal services,” said Tim Stocks, a corporate partner at Taylor Wessing.

The new technology will initially be reserved for Taylor Wessing clients, but rival law firms will not be ruled out from accessing the service sometime down the line, said Stocks in an interview. ■

## TECHNOLOGY



# The fund of tomorrow...today

*As technology shapes GPs' reporting methods, regulatory compliance checks and portfolio monitoring, staying ahead of the curve could make these tasks significantly simpler. Nicholas Donato reports*

It's unlikely a coincidence that investors and regulators are demanding firms deliver information in a quicker, more efficient and customised manner at a time when managers have at their disposal a supermarket of new software designed to help expedite (and often enhance) routine fund administration tasks.

Yet for many fund sponsors, quarterly reports and updates are still delivered to investors on PDFs and Excel spreadsheets via password-protected investor portals. The process can seem outdated at a time when limited partners are requesting tailor-made fund reports.

The portals are certainly a major improvement on the technology of just a few years ago, allowing LPs to access reports, and receive drawdown notices and asset updates instantly. But in a world where the ability to interact is the mark of technological evolution, LPs are beginning to push for greater control over the presentation of data.

Rather than manually uploading individual fund reports into proprietary systems – all with their own templates and reporting standards – LPs are looking for the ability to

*“In a world where the ability to interact is the mark of technological evolution, LPs are beginning to push for greater control over the presentation of data”*

electronically import GP's data, aggregate and view that information in different ways to assess various risks and, ultimately, compare GPs with similar investment strategies. The technology for this type of communication certainly exists, but until the industry can agree on a common language used in reporting it will remain too cumbersome for software systems to automate and share.

Most software vendors have side-stepped the issue by offering multiple reporting templates. A GP can log on, and depending on their LP's preference, generate a number of different reporting standards, including those drafted by the International Private Equity and Venture Capital Valuation board (IPEV) or the more US-focused Private Equity Industry Guidelines Group (PEIGG).

### Data feeds

Electronic information sharing should become easier as the industry heads towards greater standardisation in GP reporting, says William Hupp, the chief financial officer of Adams Street Partners and an IPEV board member.

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IPEV, which was launched in 2005 by the major European trade bodies to harmonise valuation guidelines, recently stocked its board with more US-based practitioners in the greater goal of having Europe and the US stand shoulder to shoulder on valuation methods and then reporting standards. On the reporting front, the board is expected to publish new guidelines this year.

One outcome of this convergence will be software equipped to not only allow GPs to generate reports with the push of a button, but communicated with LP data systems, says Tony Piper, a software consultant for private equity firms. "Further to that, investors want to seamlessly explore data right down to the fund's underlying assets for their own valuation purposes", says Piper. A data feed between GPs and LPs could mean an end to picking up the phone to request detailed figures on a portfolio company's revenues or EBITDA, instead pulling the information straight from their own portal, he adds.

Until that time comes however, LPs will have to continue managing the different reporting standards or delegate the task to an intermediary which acts similar to a clearinghouse. "LPs may subscribe to services like The Burgiss Group and Cambridge Associates, which achieve economies of scale by using their own technology and analysts to interpret thousands of quarterly reports," says Piper.

But while data feeds from GPs to investors is still some time off, an information pipeline from portfolio companies to the GP can be built much more effortlessly. And similar to what's being demanded by LPs, the software allows managers to tweak submitted data – a useful function when for instance there are variances between a company's projections and the GP's own estimates.

"Let's say you have a forecast for three million widgets to be sold by a portfolio company, and the fund manager might disagree saying the number is closer to 3.2 million – the fund can track a company's forecast and its own amendments as a way of doing a comparative analysis," explains Sanjay Tolani, head of North American operations at 3i Infotech, a software provider.

*“Investors want to seamlessly explore data right down to the fund's underlying assets for their own valuation purpose”*

### Into the cloud

For all the benefits of a sophisticated onsite IT infrastructure, such as security control and flexibility, some firms may be unable to absorb the costs that come with it. Smaller funds in particular are more likely to see the appeal in cloud computing technology – which allows firms to bypass the expenses of managing an in-house IT division.

The cloud essentially denotes a migration to internet-based software programs that are shared by several users under a concept known as "multitenancy" – think Gmail instead of an internal Microsoft exchange program. Multitenancy describes firms sharing the same software application which is run by a third party's external server. With only an internet connection and web-browser, GPs then access the cloud using their BlackBerry, iPhone or computer.

Importantly, the cloud works on a pay-as-you-go plan, meaning firms with five to 10 employees would pay around a hundred dollars or so for each user per month. And "tenants" can configure the software application to suit their firm's needs or strategy all while receiving seamless updates to the software's core code the next time they sign in.

However security concerns have prevented GPs from fully embracing the concept which is still in its infancy. GPs thinking of purchasing cloud solutions should ask providers how data privacy is handled, and how access to the shared central data repository is managed.

Other questions surround what happens if a cloud service provider goes out of business or if there is a temporary power outage. Servers being down for even a few hours could disrupt a firm's operations or leave LPs grumbling. Moreover how is sensitive data handled as it shoots across different jurisdictions within the cloud? Different countries have their own take on how data should be stored and protected. The European Union is currently trying to harmonise its data laws across all member states.

Despite these concerns the cloud offers an attractive alternative to spending hundreds of thousands of dollars upfront on an in-house IT system, says Alok Misra, the co-founder of Navatar Group, a cloud service provider

which customised salesforce.com for private equity clients.

“The concern about security is valid, however, it’s also highly unlikely that a firm with less than 100 people can maintain better infrastructure or security than, say, Microsoft or salesforce.com,” he argues.

Similar to other software vendors Navatar is also rolling out a free cloud service to connect GPs with M&A bankers and other industry contacts to form an online community where deals can be collaborated. Navatar’s social networking site for private equity professionals works by having buyout shops create an online profile describing the types of deals they target alongside their contact information. Bankers, business owners and other sources of deal flow can then access profiles that match their capital-seeking enterprises.

At the moment GPs don’t rely on portals for originating transactions, sources say. Private equity is after all a people business, points out Philippe Bucher, chief financial officer of Adveq. But similar to the evolution of social networking sites, who’s to say one portal won’t feed off its own success to morph into a dominant internet presence, a feat Facebook accomplished after eclipsing rival sites such as hi5 and MySpace. “One can imagine a GP in the future sourcing deals from the comfort of an armchair,” jokes Bucher when asked whether portals have the potential to be a significant source of deal flow down the line.

### Up to code

As technology continues its march towards ever greater levels of sophistication, regulators have kept pace ensuring their ability to police the markets has not been made obsolete. Regulations around where data is stored and handled for instance leave no excuses for fund managers when investigators demand to check a firm’s books and records.

Registering with the US Securities and Exchange Commission will bring the issue to the forefront for those firms with assets under management north of \$150 million in the US. As registered investment advisors, firms are required to keep a searchable archive of all business books and records including communications for five years. This certainly includes work emails, but

*“As technology continues its march towards ever greater levels of sophistication, regulators have kept pace ensuring their ability to police the markets has not been made obsolete”*

the full scope of the rule isn’t entirely clear. In the age of social networking websites, chat and news sites that allow readers to comment on stories, the question of how much digital communication needs to be archived becomes complicated.

Fund of funds firm SL Capital has tackled the uncertainty by removing access to sites like Facebook and further requires employees to sign a code of conduct outlining their responsibilities in meeting compliance rules. As an additional precaution he firms IT team can monitor and police employee’s online access to the web. Most firms have specifically required that employees direct all business correspondence through the firm’s email system, which is archived in accordance with SEC rules.

Indeed most firms limit employees online social networking to sites like LinkedIn, and require that employees only provide an individual’s brief biography and work history, says Charles Lerner, a compliance consultant at Fiduciary Compliance Associates.

Firms should realistically be saving their records for six years, which is standard in the advisor world, though advisors unregistered with the SEC may not have adequate storage requirements or even been only storing them for 90 days, says Lerner. Should the SEC surprise your firm with an examination they’ll demand emails on a specific topic, say a particular portfolio company covering a certain time period, or all correspondence by an individual employee, he explains.

“Saying your employee accidentally cleaned his deleted items folder won’t cut it, all emails should be stored on a second external server as a safeguard,” says Lerner.

European-based firms are facing similar changes in their reporting duties under the pending Alternative Investment Fund Managers Directive. The EU-wide fund regulation is currently being fleshed out, but already includes core provisions mandating private equity houses regularly report to authorities regarding their market activities.

Software vendors have kept in dialogue with policy makers and trade groups to keep up to speed on all the changes. The goal is to automate regulatory reporting as much as possible, allowing GPs to concentrate their attention on investor returns. ■

# PRIVATE EQUITY VALUATION

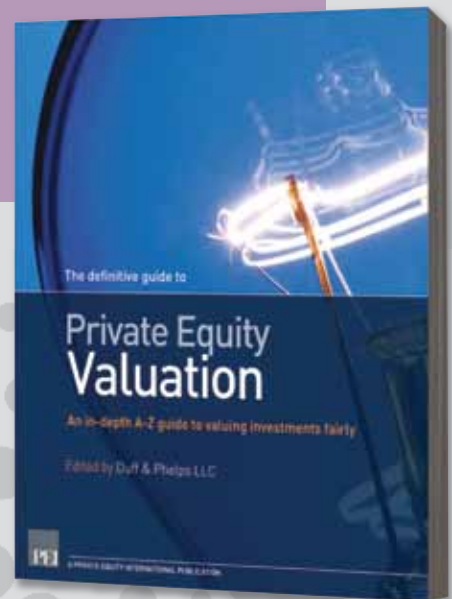
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EXPERT COMMENTARY **J.P. MORGAN**

# Why outsource now?

*Dodd-Frank is causing some blue chip private equity firms to re-think the hidden costs of in-house fund administration. By **Cesar Estrada** and **Georges Archibald***

**I**ncreased scrutiny and a host of new issues raised by regulation under Dodd-Frank are causing major private equity firms to seriously consider working with third party fund administrators. For some firms heretofore committed to administering their funds in-house, this is a historic first.

Vast changes in the regulatory landscape are prompting widespread re-thinking about the real costs of in-house fund administration. Under Dodd-Frank, private equity firms managing \$150 million or more have been scrambling to meet the SEC registration deadline of 21 July 2011.

And, irrespective of where regulations ultimately land, institutional limited partnerships are getting increasingly organised to demand more transparency, better reporting and tighter controls.

All of this means new concerns about the operating model for fund administration currently in use by major players. CFOs face higher risk in many key areas. Funds must understand and comply with a host of regulations regarding trading and document retention, and cope with how these will affect their employees. Additionally, private equity firms will have to contend with the custody rule and its application to their respective businesses.

As leading private equity firms re-think these concerns regarding their in-house fund administration, many are coming to the conclusion that now is the right time to outsource.

This represents a paradigm shift for major funds' CFOs, who acknowledge that it requires a significant leap of faith to partner with an outside fund administrator. When thinking about outsourcing, CFOs naturally consider execution risk and control concerns. In addition, deep discussions with many CFOs reveal that they are mindful of the fact that not all fund administrators are created equal. Most are keenly aware that a fund administrator with a blue chip name and a high level of experience sends the right signals to both regulators and clients.

## Outsourcing: The value proposition

For private equity firms, the value proposition for outsourcing involves avoiding both present and future costs related to back office functions, while enabling fund managers to focus on their core capabilities -- executing fund strategy and increasing investor returns.

For many major funds, Dodd-Frank presents them with a decision point. Bearing in mind the new compliance and reporting burden, should they keep fund administration under their roof? Doing so means hiring new in-house people and investing in new technological infrastructure today – as well as committing the firm to the necessary future expenditures involved with keeping current in this rapidly developing field.

Fund administration is a business of specialists. J.P. Morgan, for example, is in the business of attracting, training and retaining the best people in the field. Retention is key – and it is often a matter of career opportunities. Accordingly, fund administrators are in the best position to offer career growth opportunities for the best people.

In the face of all of these developments, it's important to understand the magnitude of the stakes involved. History shows us that the pitfalls of many hedge funds who kept fund administration in-house may be instructional for private equity firms.

Fully 50 percent of all hedge fund failures to date have been due to operational risk. With this in mind, the time spent on a careful cost/benefit analysis is well worth the time in terms of quantifying the true cost for your private equity firm.

Outsourcing fund administration gets private equity firms out of the expensive, time-consuming business of back office management, including the worries involved with technology investment. In effect, they pay a fund administrator to keep up with the evolving technology of the marketplace.

Here are the key questions and criteria to consider about people, technology and processes when re-thinking outsourcing. →

### KEY CFO QUESTIONS:

- What tasks or burdens are preventing you from focusing on value-added functions?
- How agile is your firm in terms of launching new funds, closing deals and assessing market opportunities?
- Are you equipped to respond to market conditions in navigating the complex regulatory landscape?
- What challenges has your firm faced regarding staffing, hiring or replacing key fund administration employees?

EXPERT COMMENTARY **J.P. MORGAN**

“Some managers only feel the sting of these people-related costs when they’re hiring – and then only consider pay and benefits”

### → The cost of people

When a key employee departs, CFOs often find themselves in a time-consuming rush to recruit, train and retain a skilled fund administrator. And the pain isn’t limited to the CFO. Filling a senior position often involves the commitment of significant executive time from a number of busy people on the CFO’s staff.

Some managers only feel the sting of these people-related costs when they’re hiring – and then only consider pay and benefits. However, both cost accountants and human resources professionals point out that CFOs with this mindset are ignoring significant hidden costs.

Some people-related tasks and costs are straightforward and transparent, such as hiring a recruiter or providing the necessary technology and connectivity and/or physical workspace. Others, by their very nature, are voracious consumers of managerial time, and difficult to extract from a cost/benefit analysis.

### The costs of internal processing and reporting

Private equity funds’ monthly and quarterly processes are designed to ensure efficient operations, meaning a whole host of protracted, cyclical administrative tasks for the CFO, including:

- Capital call and distribution processing: Massive Excel workbooks with no defined workflow or controls, linked together by custom formulas engineered on a one-off basis, are a particular concern in the area of distribution waterfalls and carried interest calculations.
- Managing cash receipt and distribution requires efficient cash management, and CFOs can effectively leverage bank services that support these processes.
- Costly quarterly and annual audits: Non-audit trail tools such as Excel spreadsheets used as a main calculation engine can raise audit concerns.
- Investment valuation and fund returns requires maintaining a clean record of periodic valuation integrated with core →

**Table 1: Hidden costs of internal staff**

*When hiring new employees, general partners need to consider more than just pay and benefits – not just the time spent in sourcing and hiring talent but also in training and managing staff*

Task	Hidden Costs	Important Considerations
Sourcing/Hiring	<b>Interviewing time:</b> Four to eight hours for each candidate means between 32 hours to 64 hours per hire <b>Administrative time:</b> debrief, reference and background checks, drafting the offer letter	<b>Rule of thumb:</b> On average, managers interview eight people in order to hire one
Training	<b>Managerial time:</b> Five hours a week per employee for coaching	<b>Training time:</b> Employees need to get up to speed and become independent, taking a minimum of six to nine months, with a larger organization, and years before determining if hiring cycle must begin again
Pay	Time spent evaluating competitive pay	Existing employee pay in a normal market with two percent cost of living adjustment annually – employers can expect a five to ten percent annual increase in total compensation for performing employees
Benefits	Managerial time spent negotiating benefits with provider and enrolling new employees	Cost of benefits in the future
Managing	Managerial time averages 15 percent of total working hours per week	Personal coaching, directing and maintaining priorities

## Complex Issues. Clear Solutions. Leadership in Private Equity Administration

As investments in private equity increase, so do the challenges. New staffing, reporting, and administration requirements are just some of the demands facing today's private equity firms.

At J.P. Morgan, we are uniquely positioned to help investors meet these new complexities. We deliver innovative outsourced fund administration and infrastructure solutions to support private equity funds around the globe. Our services enable our clients to focus on the core activities of investment management – maximizing returns for investors, while keeping business process streamlined and efficient.

To learn more about Private Equity & Real Estate Services, visit us today at [www.jpmorgan.com/visit/pefs](http://www.jpmorgan.com/visit/pefs)

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For more information, please contact your relationship manager or:

Americas **John Weeda** at [john.weeda@jpmorgan.com](mailto:john.weeda@jpmorgan.com) or +212 552 4553

Asia **Sam Lam** at [sam.lam@jpmorgan.com](mailto:sam.lam@jpmorgan.com) or +852 2800 0780

Australia **Nick Paparo** at [nick.x.paparo@jpmorgan.com](mailto:nick.x.paparo@jpmorgan.com) or +612 9250 4712

Europe **Patrick McCullagh** at [patrick.h.mccullagh@jpmorgan.com](mailto:patrick.h.mccullagh@jpmorgan.com) or +44 0 207 3259566

## EXPERT COMMENTARY J.P. MORGAN

- accounting processes, and a detailed awareness of assumptions which vary between regions and asset types.
- Quarterly financial reporting involves accumulating all the data necessary to create financial statements, including investment books and records for fund consolidation and delivery to investors.
  - Sustaining investor confidence can be an ongoing challenge for CFOs who are not supported by state-of-the-art processing and reporting and can raise concerns during annual audits, prolonging the costly, time-consuming audit process.

Designing, managing and re-engineering these critical processes requires substantial commitments of management time and attention – thereby incurring real, if hidden, opportunity costs.

### The cost of technology

Technology heightens your efficiency, but comes with some significant costs of its own. Establishing repeated processes and acquiring, managing and upgrading the technology to support them may well be the biggest challenge that private equity funds face today.

Funds' typical technology investment is likely to be in the six-to-seven figure range. This includes an all-encompassing fund

accounting, administration and reporting platform, and an investor communication portal. Maintaining, keeping current, upgrading and training people on new technology is an ongoing cost that must be considered, as well.

To properly assess the costs for each of these investments every single time they occur, you should identify the hidden expenses in addition to the outright costs of purchasing the hardware and software and maintaining the system. A similar approach should be used for those separate costs of maintaining adequate disaster recovery for all of your books and records.

### A new level of thinking

Today, the benefits of outsourcing are clear:

- **Increased focus on core capabilities:** In an increasingly competitive market, outsourcing enhances managerial focus, allowing C-level executives and their staffs to focus on what they do best -- investing money.
- **Flexibility and speed:** The ability to quickly alter investment and portfolio strategy based on rapidly changing market conditions.
- **Enhanced control:** Provides a level of continuity in operations to the firm while reducing the risk in an ever-changing business environment.

**Table 2: Hidden costs of fund administration technology**

*In identifying the costs of introducing an all-encompassing fund administration programme, CFOs should also consider the hidden costs of buying technology, including time spent on evaluating systems, implementation, maintenance and upgrades*

Task	Hidden Costs	Important Considerations
Evaluation	<i>Time:</i> Requirements, RFP review, demonstrations, vendor visits, scorecards.	Do you know requirements?
Implementation	<i>Time:</i> Scoping, project management, parallel processing of old and new system/process, process re-engineering, un-met expectations  <i>Economics:</i> Customisation, scope creep, sub-par implementation	What if the implementation is unsuccessful?  Can you assure continuity of resources on implementation, both internally and for your vendors?
Software	<i>Time:</i> Negotiating contract  <i>Economic:</i> Legal fees, unforeseen maintenance fees, further customisation	Do you have external counsel with technology background?
Hardware*	<i>Economic:</i> Additional network/IT resource time, periodic server replacement and maintenance	Do you have in-depth knowledge of complex hardware requirements?
Business Continuity*	<i>Time:</i> Designing plan, testing, failure to execute	What if your plan doesn't work? What happens to your data?

\*Assumes hosting technology in-house

## EXPERT COMMENTARY J.P. MORGAN

For CFOs of major private equity funds, a cost/benefit exercise such as we have described here should also be the start of a tantalising new line of thinking:

- “What would happen if I took steps to alleviate some operational burdens?”
- “What if I focused more time on developing an exceptional executive team, attracting investor capital or identifying investments that we can use to maximize return?”
- “What would my IRR look like in such a brave new world?”

In order to get to this new level, however, private equity firms must partner with outside fund administrators who tailor their offerings to their firm’s very specific needs – no small task, indeed, for some providers. Such a high level of expertise and careful attention requires an experienced partner.

At J.P. Morgan, we are uniquely positioned to help investors meet the new challenges they face. We deliver innovative outsourced fund administration and infrastructure solutions to support private equity funds around the globe, helping them enhance their control environment and increase transparency for their investors.

We can help your private equity fund by providing the tailored, scalable solutions you need as your fund grows. Contact us to learn how your firm can thrive in today’s challenging markets. ■

### Checklist: Can your fund administrator do this?

Not all providers are created equal. Be sure to ask any potential providers whether they offer these important capabilities:

- Provide a one stop shop for all your back office needs as you continue to expand your business and develop new strategies
- Service closed end fund structures which have investment styles that rival hedge fund complexes
- Deliver aggregated reporting across all your fund products
- Provide full disaster recovery for all books and records, supported in an offsite, secure environment, stored and backed up against any eventuality
- Constantly look to the future, evaluating the best options for sourcing and implementing the next new technology
- Focus on innovation and offer products to meet your growing fund, portfolio, organisational and market needs

### Automating waterfalls

*J.P. Morgan’s approach is deliberate and methodical*

Our experienced, centralised waterfall team has developed these industry-leading best practices:

- **Gathering requirements:** We seek a detailed understanding of waterfall requirements through discussions with our clients, in order to understand the interpretations of the limited partnership agreements and other documents. Waterfall requirements for each fund are documented before a waterfall is developed. Process and expectations are clearly documented before moving forward.
- **Development:** During development, we consider all potential scenarios that could possibly impact the portfolio with the aim of limiting any need for manual interaction with the model.
- **Automation:** We automate the waterfall calculation at an investor level, which includes pulling data directly from the general ledger system. The result is a more controlled process with full insight into the source data and calculations.

**Cesar Estrada** is head of product management for private equity and real estate services and **Georges Archibald** is head of strategy for alternative investment services for J.P. Morgan Worldwide Securities Services. J.P. Morgan supports the world’s leading private investors, complex portfolios and global fund structures through innovative outsourced private equity, real estate and infrastructure solutions which leverage our extensive expertise, powerful technology platform and proven processes. With more than \$300 billion assets under administration and a staff of over 350 professionals operating from offices in Chicago, Dallas, New York, San Francisco, Bermuda, London, Guernsey and Jersey (Channel Islands), Luxembourg and Sydney, J.P. Morgan is one of the largest and fastest growing service providers, earning top ranking in the 2007-2010 Global Custodian Private Equity Fund Administration Surveys. Our decades of experience, reputation for superior quality of service, and breadth of capabilities — waterfall and carry administration, financial calculations oversight, and complete banking services — have earned the trust of the world’s leading private equity CFOs, COOs and institutional investors. For more information, please visit us at [www.jpmorgan.com/visit/pefs](http://www.jpmorgan.com/visit/pefs)

## ASIA REGULATION

# China lays down some rules

*The National Development and Reform Commission has laid the foundations for private equity regulation, especially around fund disclosure policies, writes Hsiang-Ching Tseng*

In February, the world's second largest economy took a first step towards regulation of its private equity industry with the implementation of a pilot measure in six key regions.

Under the "Circular on Further Regulating the Development, and the Administration on Filings, of Equity Investment Enterprises in Pilot Areas", private equity firms with assets under management of over RMB500 million will have to register with China's National Development and Reform Commission (NDRC).

The measure applies to both domestic and foreign GPs with onshore private equity funds registered in Beijing, Shanghai, Tianjin, Jiangsu Province, Zhejiang Province and Hubei Province. While onshore private equity real estate funds are also believed to fall under its remit, the Circular's reach does not extend to global or pan-Asian funds with China strategies.

While the measures have been broadly welcomed, there has been some concern over what exactly firms will be required to disclose and how intrusive a regulator the NDRC will turn out to be.

"I think people are very concerned about disclosure because they don't want to disclose any sensitive details about their fund terms and deals," says Larry Sussman, managing partner at law firm O'Melveny & Myers in Beijing.

In order to register, firms are asked to fill in an NDRC-issued form and submit their business license, PPMs and Limited Partnership Agreements for review.

However, Sussman asserts, since many GPs use so-called "short forms" to preserve the confidentiality of their arrangements and operations, they should not be too concerned. In this case the main fund partnership agreement and management contracts – which would be the articles disclosed to the NDRC – tend to be fairly standardised,

*"I think people are very concerned about disclosure because they don't want to disclose any sensitive details about their fund terms and deals"*

but are supplemented with side agreements "which [fund managers] would not disclose to any authority", says Sussman.

In this way, "some fund managers may be able to continue to keep sensitive issues a secret despite the new recordal requirement", Sussman states.

The NDRC is also asking GPs to file audited annual financial statements and annual business reports within a four-month period after the end of every fiscal year. In addition, the Circular entitles NDRC to conduct annual reviews of the private equity firms contained within its records, to check on their operations.

What the NDRC plans to do with the information it collects is unknown and the NDRC declined to comment when approached. However, failure to comply with disclosure requirements may lead a firm to be "publicly named", the NDRC has stated, without going into further detail.

"The Circular does not provide for an explicit penalty [for non-disclosure] – perhaps other than disclosing the names of those who do not comply to the public," says Maurice Hoo, partner at law firm Orrick, Herrington & Sutcliffe in Hong Kong.

However, Hoo asserts that reputational damage is threat enough for many firms with serious private equity intentions: "If you get the stigma of being a violating fund, I expect that status will affect your portfolio companies. Therefore ultimately people won't want you to invest in them, and investors may not invest in you, and that affects your business."

Any GP hoping to slip under the radar of the NDRC can think again. Under Chinese company law, any new business must register with the State Administration for Industry & Commerce (SAIC), which could then alert the NDRC to any firm formed with equity investment in mind.

### Focus on fundraising

As well as asking firms to submit information for review, the NDRC has issued a set of ‘best practice’ guidelines for private equity managers to follow. As with industry-wide regulations seen recently in the US from the Securities and Exchange Commission (SEC) and in Europe with the passing of EU’s Directive on Alternative Investment Fund Managers, a key focus is fundraising.

According to the new rules, private equity firms can no longer use websites, publications, messages, or conferences to market themselves to the general public, nor can they use commercial banks or securities companies to transmit information for them. They are not allowed to make specific promises about returns to investors and should only raise money from LPs who “recognise and have the ability to shoulder the risk” – although the NDRC has yet to clarify who those LPs are.

In a question and answer session with Chinese reporters published on its website, the NDRC explained the reasoning behind its thrust:

“One of [the problems the private equity industry has] is that there are no regulations around fundraising. Because private equity investment is relatively high risk, the capital is usually raised from specific targets in a private way so that only the institutional investors and high-net-worth individuals ... can participate. But currently, some of the private equity firms in our nation hold seminars and forums to advertise their funds, and therefore let in public investors who don’t have the basic ability to recognise the risk they’re taking.”

Even if it remains unclear exactly who firms are able to target for capital, the guidelines have been welcomed as a long-awaited one-stop “national standard for private equity fundraising”.

“Prior to this, fundraising PPMs were drafted based on a draft of this notice as

*“It is an initial step toward regulating an industry that the West initially did not regulate much and then may have gone towards over-regulation”*

well as other unpublished guidelines. Now we have guidelines published for the content of a PPM that you’re giving the prospective investors,” says Sussman.

### Comparisons with the west

If the NDRC’s focus on fundraising, disclosure and risk management encourages comparison between its Circular and the moves towards more stringent regulation seen from Europe and the US, Orrick’s Hoo asserts that the similarities end there.

“I would say the Western regulations are products of the financial crisis, and as such many provisions have found their way into the earlier drafts and the final regulations as a reaction to political pressures, and aim at purging the financial systems of certain perceived ‘evils’,” he says.

In China, however, where financial crisis was not the primary motivation for reform, Hoo believes that the Circular is more “contemplative”. He points out that at this stage it lays down only broad-brush principles, rather than detailed rules, and has only been applied to six pilot regions.

“It is an initial step toward regulating an industry that the West initially did not regulate much and then may have gone towards over-regulation,” Hoo adds.

As such, reaction from the industry has been moderate.

“It lays out [some] best practices principles, and that is actually valuable to the industry because right now I think the practices are a little bit all over the place,” says Hoo.

“People are OK with it because it’s not overly intrusive – at least for now it doesn’t look to be. These are the rational things fund manager would already do,” says O’Melveny’s Sussman.

He points out that though “people want to avoid national regulation as much as possible”, “everyone knew it would eventually happen at some point, and it’s almost unavoidable in some respects.”

## A MOVEABLE FEAST

As one LP put it to *PEI* recently, 'Chinese private equity is a constantly evolving entity.' That is illustrated by the following snapshot of major policy changes that have taken place in the last year alone.

### MARCH 2010

*Shanghai announces it is bringing down the currency conversion barrier*

The Shanghai government announces it is to introduce a pilot programme enabling up to 50 percent of the total capital of RMB-denominated funds domiciled within its jurisdiction to be converted from foreign currency. This would remove one of the biggest hurdles facing foreign investors, as foreign currency conversion for the purposes of investment is restricted in China under a 2008 law from the State Administration of Foreign Exchange (SAFE) called Circular 142. The announcement proves to be premature, however, as Shanghai has failed to gather the support of central government – it comes back later in the year with a second, centrally approved, attempt.

### AUGUST 2010

*China allows insurance firms to invest in private equity*

The China Insurance Regulatory Commission (CIRC) releases a measure that allows China-registered insurance companies to invest no higher than 5 percent of their latest quarter's total assets either directly or indirectly into domestic private equity. While they can invest their full 5 percent allocation into China-registered unlisted companies, if they choose to go down the fund investment route, they can commit no higher than 4 percent of total assets to China-registered private equity funds.

### OCTOBER 2010

*Hong Kong Stock Exchange puts brakes on pre-IPO plays*

The Exchange's Listing Committee releases interim guidelines to prevent pre-IPO investors from enjoying unfair advantages over other shareholders. Under the guidelines, pre-IPO investments must be completed and fully funded either 28 days before the company submits its first application for an IPO, or 180 days before the company's shares begin to trade except in "very exceptional circumstances". The move is aimed squarely at the private equity community, according to one source close to the Listing Committee, and aims to stem what are seen as unfair and exploitative short-termist practices from certain sectors of the Chinese GP community.

*Shanghai reintroduces a pilot currency conversion scheme*

Following its premature announcement in March, Shanghai receives in-principle approval from China's central government to launch the pilot program allowing the conversion of certain amounts of foreign capital into RMB for the purposes of private equity and venture capital investments. At the time of this second announcement, it is believed the scheme will allow offshore LPs to contribute up to 50 percent of an onshore fund's capital and it is widely described as a Qualified Foreign LP programme. Shanghai promises detailed rules on the programme by early November.

### NOVEMBER 2010

*The plot thickens around Shanghai's QFLP*

Although no detailed rules on the so-called QFLP scheme emerge, the Shanghai government is granted a \$3 billion quota by SAFE to be converted into RMB for investment into private equity funds. Shanghai plans

to give three institutions, said to be The Carlyle Group, The Blackstone Group and Hong Kong-based First Eastern Investment Group, a \$300 million conversion quota each initially. However, whether this money will be fully treated as local capital remains unclear.

### JANUARY 2011

*Beijing secures approval for QFLP scheme*

The Chinese capital joins Shanghai in securing the necessary backing from the country's central government to launch the currency conversion programme for offshore LPs. It is anticipated that more detail on Beijing's scheme will emerge early in the year.

*Shanghai publishes guidelines to its currency conversion scheme*

Shanghai finally releases a detailed guide to the so-called QFLP programme that will allow foreign investors to commit to onshore RMB-denominated private equity funds. However, the fine print still leaves many grey areas for offshore LPs in terms of what they can and can't do. The major breakthrough, on the other hand, is that foreign-managed RMB funds, into which foreign GPs are allowed to invest up to 5 percent of their own money, are now classed as "pure" RMB funds. These funds are exempt from the restrictions imposed on foreign investment when it comes to certain industries and can invest without approvals.

### FEBRUARY 2011

*Chinese brokerages get the green light to enter PE*

The China Securities Regulatory Commission (CSRC) is reported to be in the process of drafting rules that will allow select securities firms' asset management units to launch private equity funds as early as this year. Currently, select brokerages are only able to invest directly in unlisted companies.

*China moves towards regulation of its PE industry*

China's National Development and Reform Commission (NDRC) releases a measure that requires onshore private equity funds in Beijing, Shanghai, Tianjin, Jiangsu Province, Zhejiang Province and Hubei Province with an AuM of over RMB500 million to register with it. The circular sets a national standard for private equity fundraising and expands the investable universe of China's Social Security Fund.

### MAY 2011

*Five firms approved for Shanghai's Pilot Measure*

The Blackstone Group, The Carlyle Group, DT Capital Partners, First Eastern Investment Group and a joint venture between CLSA and Shanghai Guosheng have been cleared for Shanghai's QFLP programme. The Carlyle Group and Shanghai-headquartered DT Capital Partners are among five firms to have obtained approval for Shanghai's pilot programme, QFLP, which allows foreign investors to commit to onshore RMB-denominated private equity funds.

In addition, multiple industry sources told *PE Asia* that The Blackstone Group and Hong Kong-based First Eastern Investment Group were also among the five, while there was some dispute among the sources who spoke to *PE Asia* over whether a joint venture between CLSA and state-owned Shanghai Guosheng Company had made the cut in the selection process.

EXPERT COMMENTARY **CACEIS**

# Talking transparency

*The transparency requirement under the AIFM aimed at protecting the investor may have a strong impact on the moral hazard faced by the financial authorities.*  
 By *Hervé Schunke* of *Caceis*

The global financial crisis has raised a number of different issues: problems relating to transparency, market integrity, regulation and supervision have induced serious more than worrying situations for investors and a true brain teaser for regulators. In the aftermath of the financial crisis, the G20 leaders pointed out that alternative investment fund managers had become significant actors in the European financial system, managing a large quantity of assets on behalf of investors and now having a more than noticeable impact on the economy: therefore they should be subject to appropriate regulation and supervision.

The corollary was unsurprising: the European Parliament has come under rising pressure from the public to adopt in November 2010 the draft directive on alternative investment fund managers (AIFM) issued by the European Commission, aiming to increase investors protection and the alternative investment market transparency. Under the new rules hedge funds and private equity fund managers will now be allowed to market themselves to EU investors if they accept to give up, inter alia, one of the factors that made this industry successful: the opacity, seen as a way to produce liquidity and the efficiency of that specific market and asset class.

This raises two concerns.

The first relates to costs: regulators have to improve their own performance, to hire qualified staff that will have to put in place a regular and rigorous contact with alternative fund managers and deeply understand their



*Schunke: transparency impacts 'moral hazard'*

strategies and related risks. On the other hand, past experience has shown that nobody, not even the regulators, seem to be willing to act during the growth of a bubble, when everybody takes advantage of it. One could also point out that, despite the existence of high risk, until now the regulators have considered that the disclosure of private information could destroy the positive impact of the alternative fund industry on the economy. What will now be the cost for making the regulators stop the bubble before it bursts and does the AIFM help in reaching that goal?

The second concern relates to the so called moral hazard: the transparency requirement aimed at protecting the investor may have a strong impact on the moral hazard faced by the financial authorities, as by imposing those strict rules on transparency and communication, the national regulators thus insulated from the inherent risks, may suggest to investors that the investment is "transparent" and, therefore, leaving the investors to bear entirely the consequences of the risks taken. One could also qualify this as misleading.

A way out from a financial crisis was made through a new regulation. In parallel we often bear the risk of over-regulation in such post-crisis phase. But a rethink of the European Union regulatory gap should start from a definition of what is desirable and, most importantly, from an understanding of what is really feasible.

European investors have historically not been keen on choosing private equity or hedge funds. Many of them have entered this market too late, when the returns were no longer at →

## EXPERT COMMENTARY CACEIS

→ their peak. Some of them have also faced up to big losses after the internet bubble burst in 2000. Many remaining players like endowments, foundations and pension funds, which invested in venture capital before the crisis, withdrew (as much as the fund rules and secondary market allowed) after their private equity holdings were hit.

The financial statistics have shown that past venture capital fundraising levels are far from having recovered and that European investors have lost their enthusiasm for investing in hedge funds and private equity, probably much more so than US investors.

European mistrust is increasing and it is difficult to believe that transparency and supervision will necessarily boost the appetite of professional investors for alternative investments. One aim of this new European Directive is certainly to boost the alternative fund industry by fighting excesses. But, as mentioned above, through the moral hazard, the policymakers may encourage investors to enter blindly the hedge fund and private equity market, offering what can be understood as a regulatory "guarantee" that managers will act properly.

Some could argue that, in finance, the moral hazard, with respect to policy responses to financial stress, is not always bad. A relevant instance is the moral hazard which central banks are faced with while trying to keep the financial system working smoothly and ensuring that the banking system has enough liquidity: if the system gets stuck, credit will become scarce and market interest rates will rise and the economy may suffer too. On the other hand, pumping in liquidity too eagerly in order to avoid the economy jamming, could lead the banks to think that central banks will bail them out come what may. They would therefore be more inclined to lend recklessly, making handsome profits if the investment turns out well, but putting the burden of losses on taxpayers, depositors or other

*European investors have historically not been keen on choosing private equity or hedge funds. Many of them have entered this market too late, when the returns were no longer at their peak*

creditors if the investment turns out badly. The rescue of Northern Rock by the Bank of England in order to avoid a bank run which could have infected the whole banking system is a prime example.

However, the moral hazard concern should remain one way out of a financial dilemma and should not be transformed into rules, in particular when we talk about the moral hazard that may be faced by the policymakers who want to introduce measures of collective interest which can be misused by fund managers acting in their own interests, thus rendering them counterproductive.

Until now, alternative fund managers have built their successful business on the basis of some lack of transparency regarding their activities and above all strategy, by inducing that this "cloudiness" permits innovation.

Taking into consideration the fact that only sophisticated clients invest in alternative funds, financial authorities have never considered that enforced supervision should be taken into consideration in order to protect those investors. It was generally accepted that those experienced wealthy clients (high-net-worth individuals, pension schemes, insurance companies, banks, endowments and more recently funds of hedge funds) are aware of the risk assumed and so they are accepting with full understanding the consequences in terms of losses. Therefore, the issue of lack of information disclosure in the alternative fund industry has been accepted by supervisors as a trade-off for the promised advantages for the investors and implicitly for all other stakeholders (prime brokers, other service providers, regulatory authorities and all other people through the growth in GDP). Nowadays, the regulators highlight the need for more transparency.

Should national regulators now encourage the investors to become players in the new regulated and transparent world of the alternative fund industry or should the investors lose sleep

*“If the new transparency requirement of the Alternative Fund Managers directive will prove its net benefit for the managers, a strong voluntary registering of alternative fund managers with regulatory bodies should be expected”*

over the fact that by investing into alternative investments, they are bound to loose? Or should they even rest easy and safely?

The answer, as we should know after the failure of existing legislations in their main aim of assuring stability to the financial system, is that we need a drastic rethink of the code of conduct for fund managers.

The key provision of the AIFM directive regarding the transparency should not be seen as a long list of reports for regulators and a guarantee of a "transparent" investment, thus, a way of increasing investors confidence, but as a "moral obligation" between the manager of the fund, as a guardian of the financial stability at the micro-economy level and the financial regulator, as the guardian of financial stability at the macro-economic level.

From a regulatory authority perspective, the proposed IOSCO template for hedge fund regulation could be a fair enough solution for a principles-based regime that could be extended to the entire alternative fund industry. The eleven categories of information should ensure the regulatory transparency requirements. In order to ensure that the moral hazard cannot impact the investor protection and that fund managers consider this reporting as a proper code of conduct, this informational disclosure should be put into practice as a light national regulation, as guidelines or best practices, that respect the level of disclosure feasible for this business – a level that could permit alternative fund managers to create market efficiency and be of benefit to the stakeholders. The collected information should not be communicated further, but could be disclosed, at request, to other national regulatory authorities.

Could the transparency requirements under the new AIFM directive bring new confidence into the alternative fund industry and attract more investors, allowing the fund managers to achieve higher performance, receive higher fees while facilitating the process of raising capital?

It is fashionable to say no. However, if the new transparency requirement of the Alternative Fund Managers directive will prove its net benefit for the managers, a strong voluntary registering of alternative fund managers with regulatory bodies should be expected. ■



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## RISK MANAGEMENT

# Risk management modelling

*Thomas Meyer of the European Private Equity & Venture Capital Association explores the regulatory treatment of private equity funds in an excerpt from The Definitive Guide to Risk Management in Private equity, a recent book published by PEI*

Investments into private equity have been booming over the last few decades. Against the background of the financial crisis, the large amount of capital invested in this asset class is attracting ever-increasing attention from industry regulators across a range of jurisdictions. The Walker Report in the UK, which called for more stakeholder transparency with respect to large buyouts, and the European Union's Alternative Investment Fund Manager Directive, which addresses potential systemic risks arising from the alternative investment space, are both examples of increased regulatory scrutiny. The Basel Committee on Banking Supervision is issuing recommendations for banking regulation and is currently working on an updated version of the Basel II Capital Accord. The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) is addressing regulation of the insurance industry within the framework of its Solvency II project.

The private equity boom of recent years has been matched by huge advances in financial risk management. Nevertheless, Bongaerts & Charlier found "the academic literature on the intersection of the two is very close to an empty set." While there is an abundance of papers on banking regulation, there was "curiously enough", hardly any on the treatment of private equity under the Basel II Capital Accord for the banking industry. At the time of writing this chapter, the situation has not significantly changed, however new regulation is likely to have an adverse impact on this asset class.

One example of such incoming regulation is Solvency II, the updated set of regulatory requirements for insurance firms that operate in the European Union.



*Meyer: private equity is attracting ever-increasing attention from regulators*

*“The private equity boom of recent years has been matched by huge advances in financial risk management”*

Solvency II foresees significantly higher risk weights for alternative assets such as private equity compared to public equity. While pension schemes still fall outside Solvency II it appears to be just a question of time before a comparable regulatory regime is put in place. The Netherlands has already introduced a more risk-based supervision for pension funds in the shape of Financieel Toetsingskader.

All of these regulatory regimes place greater emphasis on risk measurement and promote the use of internal models. It is now widely feared that regulated financial institutions will reduce their private equity exposures in order to minimise overall capital requirements for investment risk. Under-allocation of regulatory capital gives the appearance that an investment is attractive and can lead to overly risky investments that could destroy capital, whereas over-allocation might lead to foregoing investment opportunities that appear unexciting but in fact could increase economic value.

As private equity only represents a small part of a typical financial institution's capital, it has not been high on the regulators' agenda. As these new financial regulations are still being implemented, or discussed, and are at different stages of maturity, this chapter cannot be the final word on this subject. Its objective is to highlight areas for increased analysis and discussion, develop solutions and provide an opportunity for the industry to engage with various regulatory bodies.

This chapter takes Basel II as a representative example of how risk weights under financial regulation for banking, insurance or pension schemes will affect the amount of capital required to be allocated when investing into the private equity asset class.

## Regulation and its impact on private equity

The Basel II Capital Accord describes the risk weights to be applied to private equity investments using the standardised Internal Ratings-Based (IRB) approach for credit risk and the Internal Models (IM) approach for market risk. Under the standardised approach the risk weight for 'other assets' like private equity is 150 percent, resulting in a capital requirement of 12 percent compared to 8 percent for public equity. This does not look conservative, but banks that have decided to implement an IRB approach for their loans cannot follow the standard approach for their other assets anymore.

In August 2001, the Basel Committee published its Working Paper on Risk Sensitive Approaches for Equity Exposures in the Banking Book for IRB Banks, envisaging a significant increase in the minimum risk weighting for private equity investments. Banks can follow three approaches to calculate the capital requirements for such exposures:

1. Banks that do not have a qualifying internal model for equity exposures or choose not to use such a model must use the Simple Risk Weight (SRW) approach. Under the SRW approach, capital requirements for private equity are 32 percent compared to 24 percent for public equity.
2. Under the IM approach, a 99 percent three-month Value-at-Risk (VaR) quantile should be established for the returns on the private equity investments in excess of an appropriate long-term risk-free rate. The IM approach allows banks to use their own models, subject to approval by the regulators, for estimating the risk of loss on equity exposures.

However, there are minimum risk weights, i.e. 'floors' set under Basel II: the floor of 300 percent translates into a minimum capital requirement of 24 percent for private equity exposures. For public equity the floor is 200 percent.

3. In cases where the bank has a debt exposure to the same firm, private equity investments can also be treated within the Probability of Default/Loss Given Default (PD/LGD) approach. For example, in the case of corporate bonds using a 90 percent LGD and a maturity of five years, banks must determine the PD. Applying the PD/LGD approach is subject to certain qualifying criteria, and Bongaerts & Charlier see it as less advantageous compared to an internal model. The IM approach is based on a shorter horizon of three months instead of one year, and the lower confidence level of 99 percent versus 99.9 percent.

*“The treatment of private equity funds as equity is the convention, but is this the right way of looking at it?”*

Under both the IM and IRB approaches, banks have to apply a capital charge of at least 24 percent for their private equity exposures under Basel II.

## How to model risks of private equity funds?

This questions whether research results such as those put forward by Sanyal are based on the correct model for portfolios of private equity funds, and underscores how unsustainable his approach is. Using public equity proxies or attempts to calculate the volatility of NAVs is like trying to transpose the fund manager/portfolio company

perspective onto the limited partner/fund manager level. This is arguably the wrong model for a number of reasons, because limited partners do not have the option to force the sale of a private equity fund's underlying portfolio. The treatment of private equity funds as equity is the convention, but is this the right way of looking at it?

Market risk is the risk of losses arising from adverse movements in market prices or market rates (e.g. interest or exchange rate fluctuations), while credit risk is the risk of losses stemming from the failure of a counterparty to make a promised payment. When dealing with market risk, a relatively short time horizon is considered. Equity investments are mainly exposed to market risk, and it might be assumed private equity investments should be treated within this framework. However, is such a perspective in line with the role of private equity investments in the portfolio of an institutional investor? To view their risks in the context of regulatory capital as a buffer against unexpected losses on a relatively short-term horizon is at odds with private equity's long-term horizon.

The problems to overcome in assessing private equity funds are conceptually different. They are blind pool investments and their undrawn commitments need to be reflected in a risk model. It is insufficient for limited partners to start evaluating the risk of a fund only after it has commenced investment activities. Regulators require risk measurement be part of the due diligence process and work ex-ante, i.e. before investing in a fund. Hence, the quality of the fund managers, the expected returns and the future timing and use of outstanding commitments must be included in the analysis. Together with the long time horizon, these factors strengthen the case for a credit risk approach.

To conclude, the divide between market and credit risk is not entirely clear for private equity funds. Therefore, dogmatically pigeonholing this asset class into one framework or the other can alter and distort the perception of risk. Therefore, an internal

model that properly reflects the economics of private equity funds will require a not only quantitative, but to a large degree qualitative inputs. How could such a model be verified?

### Back-testing

For internal models, regulators require verification, typically in the form of back-testing.

Back-testing mainly appears to address trading activities. The BIS specified “the essence of all back-testing efforts is the comparison of actual trading results with model-generated risk measures” and described a back-testing framework involving the use of risk measures calibrated to a one-day holding period. Such a framework, however, cannot be used in the context of a long-term buy-and-hold asset like a portfolio of private equity funds.

Essentially, back-testing as described above presupposes the modelled environment is behaving orderly, predictably, and rationally. Unless portfolios are highly diversified, this will not work for large infrequent events characterising situations that are chaotic, non-linear and subject to the force of personalities that are typical to private equity.

The major challenge to modelling private equity risks is data is too limited for a meaningful level of statistical certainty. Whereas for publicly traded assets VaR models are based on tens, maybe hundreds, of thousands of different assets with data on prices and price changes available in real-time, very few institutional investors hold portfolios of more than 300 private equity funds with changes in valuation reported only once per quarter. Within the regulatory framework, private equity is not alone with its data scarcity and modelling problems. Take the example of the treatment of operational risk under Basel II. Here, regulators eventually acknowledged there are significant sources of uncertainty in terms of data, assumptions and modelling choices, and recognised highly judgemental scenario analysis has to play a significant role. There is a comparable approach for modelling risks for private equity portfolios as feasible. This can assure an appropriate degree of conservatism in the calculation of capital requirements and be integrated in a sound governance process.

Regulation and the associated capital requirement are increasingly likely to become

*“The industry, together with its institutional investors, needs to provide regulators with a clearer framework of how to view risks in this asset class – a framework based on prudence and judgement”*

issues for the private equity industry. Historically, it was possible to build on the support of policymakers wanted to promote innovation and entrepreneurship through venture capital. Successful lobbying by EVCA led to carve-outs from CAD III. Such carve-outs were criticised as counteracting the goal set by BIS, since they fail to create incentives for banks to invest in a more sophisticated risk management system.

There is, of course, a danger that in trying to exempt itself from an increasingly comprehensive and global system of regulatory risk weightings, private equity becomes seen as a troublesome exception, always unable or unwilling to fall into line with the rest of the financial sector. There is also the risk that any further exemption pleas will increasingly meet deaf ears, given an economic environment that hardly lends itself to looser oversight for any asset perceived to involve risk. It is unrealistic to believe regulated institutions will continue investing in this asset class without the private equity industry providing solutions for quantifying risks.

Without a fresh view of how risks are modelled and integrated into the regulatory frameworks, the private equity industry will give the impression of not offering an attractive relationship between risks and returns. Alternatively, factoring the limited partnership structure into the modelling shows diversified portfolios of private equity funds are less risky in terms of volatility.

Data is scarce, and back-testing for more sophisticated models in private equity has clear limits, particularly for venture capital investments in innovation. Consequently, regulators need to be convinced that applying judgement based on experience can play a significant role in assessing risks, and prudence and process reviews will have to be elements of private equity risk management.

The industry, together with its institutional investors, needs to provide regulators with a clearer framework of how to view risks in this asset class – a framework based on prudence and judgement. ■

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*This is an excerpt from the recent PEI book: The Definitive Guide to Risk Management in Private equity. Information on the book can be found at [www.peimedia.com/risk](http://www.peimedia.com/risk).*

## FUND OF FUNDS

# Same rules, different concerns

*Private equity firms of all shapes and sizes are bracing themselves for an onslaught of new regulations on both sides of the Atlantic, but funds of funds face a unique set of resulting challenges, writes Nicholas Donato*

Cheerleaders for new regulations governing the private equity industry often argue stricter rules and reporting requirements will throw light on an asset class perceived by too many as esoteric and risky. Seldom mentioned by this group, however, is the uncertainty caused by legislators' snail's pace approach to crafting how exactly these rules should read and be interpreted.

The EU's Alternative Investment Fund Manager directive, which was passed in November last year, is a prime example of such regulation that is poised to affect funds of funds managers. Among other things, the long-anticipated directive will impose new reporting requirements on funds, set restrictions on "asset stripping" and introduce stricter depositary guidelines. It will also impact the way in which Europe-domiciled as well as third-country funds market their vehicles across the 27-member bloc.

EU legislators volleyed back and forth 17 different compromise proposals before finally agreeing the directive's language late last year. But fund managers will be unsure of what to fully expect until the directive's core principles are fleshed out under so-called "Level 2" measures which are due to be completed by early 2013.

During this compromise process, several market sources expressed dismay over how little the government seemed to understand about the alternative assets it was determined to supervise. More than a handful of fund of fund managers *PEI* spoke with pointed to depositary rules as a primary example of where the directive gets private equity wrong. Article 21 of the directive mandates GPs to appoint a depositary whose task is to safeguard a fund's financial instruments – a measure designed to ensure tradable securities don't fall into the wrong hands. But the

*“The only true safe way for the fund of funds and direct fund to ensure FACTA compliance is for both to demand the other party guarantees maintaining its tax sharing information agreement with US authorities”*

instruments in the private equity toolbox have less need for this protection, argues David Currie, chief executive officer of fund of funds SL Capital Partners. "Banks are going to charge silly money just to keep a copy of your partnership agreement in a safe box," he notes.

### Unintended consequences

Lawmakers' lack of understanding when it comes to private equity has led to some sore spots for funds of funds managers in particular.

For example, in a bid to prevent private equity firms from "asset stripping" a portfolio company, AIFM rules governing the buyout of large non-listed companies will limit GPs as to how much capital they may extract from the company in the first two years of ownership. This could also affect funds of funds' receiving distributions in some instances, as taking a stake in a private equity investment vehicle structured as an EU-based non-listed company would be captured under the provision. "Buyout funds are typically setup as limited partnerships but some debt, energy or infrastructure-focused funds and holding vehicles use non-listed company structures," notes Michael Newell, a private equity specialist at international law firm Norton Rose.

Legislators have already carved out an exemption for special purpose vehicles holding real estate investments, although it's not yet clear exactly what this covers or whether further exceptions will be made for the non-listed corporate funds and joint ventures holding into which a fund of fund might invest.

Another worry are the provisions in the AIFM designed to increase fund transparency by having GPs submit detailed reports to investors and regulators on an annual basis. For direct investment funds,

the requirement means that portfolio companies must follow a more rigid reporting process. For funds of funds the task may not be so simple, warns Gregg Beechey of international law firm SJ Berwin, who notes a fund of funds lacks the same level of control over an investee fund. “Emerging market funds in particular may be subject to light-touch reporting regimes and unfamiliar with such extensive reporting requirements,” he adds.

Above all else is the lingering question of whether a fund of funds would be responsible for an underlying fund’s financial records. “It would be a heavy cost if we were subject to independent monitoring and verification of reporting we get from our investee funds, compared to taking the information at face value – subject to meeting certain standards and an audit”, says Dan Kjerulf, chief legal counsel at bank-owned fund of funds operation Danske Private Equity.

### A new advantage

On the bright side third country restrictions under the AIFM may provide a market niche for funds of funds. While a fund of funds is treated as a fund manager with respect to raising capital, its role shifts to that of an investor when choosing which funds it commits capital to. In essence wearing two hats gives a fund of funds the unique advantage of being able to act as a middleman between EU institutional investors and non-EU private equity funds unwilling to meet the directive’s demands.

Smaller funds unwilling to absorb the compliance costs of the directive, or funds domiciled in jurisdictions deemed unfit for the privileges of a marketing passport are barred from knocking on the doors of EU investors, or what’s known as “active marketing”. However passive marketing, in which EU investors are the ones initiating contact, would still be allowable.

While it’s feasible a large EU pension or dedicated wealthy individual could jet set around the globe in search for an attractive non-compliant fund, “it’s funds of funds with a network of relationships and knowledge of the most promising funds in market best suited to handle the task”, says Andrew Lebus, a partner at Pantheon, one of the world’s largest primary and secondary funds of funds managers.

*“It would be a heavy cost if we were subject to independent monitoring and verification of reporting we get from our investee funds, compared to taking the information at face value – subject to meeting certain standards and an audit”*

But the advantage doesn’t come without its own regulatory issues, cautions Christopher Gardner of international law firm Dechert. A fund of funds placing 85 percent or more of its capital in one fund, or funds with identical investment strategies, falls into the definition of a “feeder fund”, notes Gardner.

EU lawmakers were careful to include feeder fund setups in the directive’s scope to prevent crafty managers from using an offshore master fund, fed into by a compliant fund, from circumventing the law’s intent. An EU fund of funds captured under the feeder definition would consequently lose its ability to freely market its fund across the EU under the passport regime if the “master fund” it invests into is non-compliant, explains Tamasin Little a partner at SJ Berwin.

### Double taxation

If the AIFM gives funds of funds managers a headache, even more ibuprofen may be needed over a new US law aiming to clamp down on tax dodgers. The Foreign Account Tax Compliance Act (FATCA), which takes effect in 2013, will among other things impose a 30 percent levy on certain types of distributions made by a US-based fund to a foreign fund of funds. That is unless the taxman is satisfied he knows enough about all the US limited partners involved in the relationship.

Non-US firms will have to provide US tax authorities a look into the financial details of all its US-based limited partners. But for funds of funds the law means not only ensuring its own investors are FACTA compliant, but confirming that any non-US funds within the portfolio are also compliant. Likewise GPs taking on a fund of funds as an investor risk swallowing a 30 percent tax penalty when exiting certain US assets should a fund of funds skirt the new tax-avoidance rules.

Thus for funds of funds, compliance costs hit from both ends, both as an investor and fund manager, explains Adam Levin, a private equity lawyer at Dechert. “Worst still the only true safe way for the fund of funds and direct fund to ensure FACTA compliance is for both to demand the other party guarantees maintaining its tax sharing information agreement with US authorities,” exhorts Levin, adding, “I would expect many GPs to balk at this commitment, especially if it means exposing itself to liabilities for the actions of its LPs”.

While much will depend on the Treasury department’s issuance of specific regulations for the applications of FACTA, a report from PricewaterhouseCoopers warned that some fund managers may find compliance costs prohibitive and choose to stop making US investments or taking commitments from US-based investors.

Just how the global funds of funds industry confronts all of these challenges will be interesting to observe in coming months and years. The various regulations on the horizon will mean a great deal of time, energy and money on the part of managers, and perhaps even some changes to certain funds’ investment strategies. Watch this space. ■

EXPERT COMMENTARY **ERNST & YOUNG**

# Shifting the back-office to the centre stage

*Providing insights and exploring emerging trends in private equity fund administration across Europe, by **Alain Kinsch, Olivier Coekelbergs and Martin Derfesser***

In a reshaping environment marked by a new regulatory era in Europe, the second Ernst & Young report on the European private equity fund administration industry provides insights into the main issues faced by leading fund administrators based in Luxembourg, Jersey, London and Guernsey, and identifies the emerging trends. Key questions for administrators are “Which organisational model fits best for my clients’ needs?” and “What type of services will I need to offer to my clients in order to stay competitive?”. The feedback from the survey participants provides guidance to answer these matters.

### A new context for European fund administrators

Two years after the first survey was completed in 2009, Ernst & Young is pleased to note that our belief according to which the private equity model is robust has proven to be a true statement. Indeed, the private equity business model went through the crisis with limited damages as compared to other asset



*Kinsch: the private equity model is robust*

classes and we believe that, in spite of the challenges facing the industry, private equity will continue to play an important role in the post-crisis environment, as will the industry’s fund administrators.

Going forward, and according to the recent Ernst & Young 2011 Global Private Equity watch, tomorrow’s winners will be those who, apart from emphasising value creation in the portfolio and executing on a defined and clearly set investment strategy, also manage to create a professionalised back-office function. The increasing demand from limited partners for open communication and increased transparency, as well as strengthened due diligence procedures have resulted in moving the back-office to the centre stage.

As key service providers to the private equity fund industry, the fund administrators are impacted by these current changes, and the latter one in particular. Increased reporting, transparency and disclosure requirements will require fund administrators to expand their offering to meet the new needs of their →

## Main pricing drivers for administrators

Central administration	Accounting	Transfer agency	Reporting	Company secretarial
Number of investors	Frequency of NAV calculation	Number of investors	Number of reports to be produced	Volume of board meetings
Volume of investment transactions	Choice of GAAP used	Volume of capital calls / distributions	Type of reports to be produced	Volume of investment transactions
Volume of capital calls / distributions	Volume of investment transactions	Number of reports to be produced	Frequency of NAV calculation	Number of investors

## EXPERT COMMENTARY ERNST & YOUNG

private equity clients. This will ultimately create both opportunities and threats for the fund administrator community.

In this new context, Ernst & Young has conducted its second European private equity fund administration survey, using the same geographical reach as for the first survey, and interviewing a total of 34 fund administrators.

### What service offer to serve which clients?

Back in 2009, 53 percent of the survey participants announced that they wanted to expand geographically. Indeed two years later, 35 percent of survey participants have implemented new offices, which is considerably less than expected. This can be seen as a direct effect of the European-wide recession but should also be analysed as a desire to control costs, focus on core activities and concentrate on providing quality services to their existing client base. However, fund administrators have not fully abandoned their expansion plans as shown by 45 percent of participants anticipating obtaining additional regulatory approvals for undertaking fund administration activities in new jurisdictions, with Asia and the Far East as the most popular locations.

However, expansion can also be achieved through an expansion of current service offering. In this respect, and as was already the case in 2009, the vast majority of fund administrators provides central administration, accounting and reporting, transfer agent and company secretarial services, while those offering services in taxation remain an exception. The same applies to valuation and legal services, thus creating a differentiating factor with competitors.

Interestingly enough, the survey also reveals that participants developed new ways of sourcing business, through the use of thought leadership, for instance, to raise their profile and demonstrate their technical expertise, or by participating in private equity associations which increased from around 50 percent of respondents in 2009 to 76 percent in 2011.

### Converting business to revenues: from desire to reality

Converting business to revenues remains a key topic for contributors to the survey.

While many survey respondents expressed a desire to reduce their exposure to a decrease



*Coekelbergs: pricing pressure remains high*

in Net Asset Values (NAVs) of underlying funds in 2009, none of the 2011 respondents reported having decreased the use of NAV linkage in their pricing strategies, while two had even expanded this approach.

If most administrators apply multiple pricing structures, the vast majority (80 percent) has revenues linked to assets under administration. In order to have some downside protection on the fees, 79 percent of participants apply minimum fees in their administration agreements.

When looking deeper into the details of the main pricing drivers per department of a fund administrator (Table 1), the biggest surprise, consistent with the 2009 survey, is the low weight given by respondents in any category to the number of portfolio lines and the nature of the investments, which indicates that the

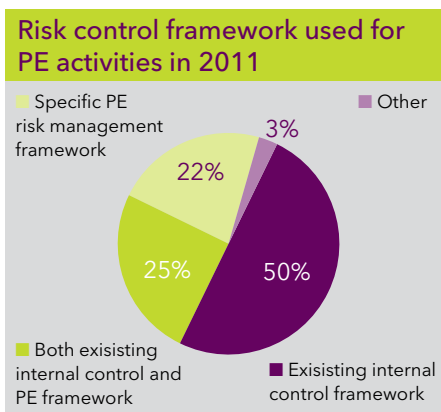
industry may not be overly concerned by valuation complexities.

Overall, pricing pressure remains high as noted by the survey respondents: only 6 percent reported a decrease in pricing pressure over the last months. This is fully in line with the increasing level of competition in the market. However, the competitive landscape may evolve in the near future, with 32 percent of respondents planning to acquire another administrator during the next 18 months.

This consolidation trend expected within the industry is also a clear answer to the expectations of private equity houses who want to deal with globally present service providers.

### The role of risk management in the organisational model

The currently changing business environment and practices lead to one of the main issues for service providers at this time: "What should the organisational model of my company look like?" - meaning global vs. local approach and insourcing vs. outsourcing / offshoring. For a number of evident reasons, such as the demand from private equity houses to have more global service providers and cost control, fund administrators and other service providers will have no other choice but to become global or integrate with an existing global network. From the survey, it looks like this trend to globalisation will go beyond the geographic aspect to affect the internal organisation of



## Private Equity is a Ernst & Young priority

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the fund administrator, switching to a business model organised around the client globally and not around the type of service actually contemplated by a number of fund administrators.

With the upcoming Alternative Investment Fund Manager Directive (AIFM), the private equity industry will have to cope with increased risk management requirements. As discussed above, the question is whether service providers employ a model where their internal risk teams are enforced or where support from outside is requested. Throughout the survey, we analysed the responses relating to the future plan in this context of risk management requirements and outsourcing of risk functions. The most noticeable trend is that nearly half (45 percent) of the survey sample was undecided regarding whether they will offer risk management services themselves, with a similar number keeping the option to collaborate with third parties open (47 percent).

But how does the current situation with regards to risk management look like? Half of the survey respondents confirmed the use of an existing internal control framework, 22 percent have a specific private equity risk management framework in place and 25 percent use both a general and a private equity specific model (Chart 1). In comparison to 2009 survey figures, the amount of administrators using a specific risk management framework almost doubled (2009: 26 percent).



*Derfesser: administrators coping with increased regulation*

Reasons for the increased application of such frameworks could lie in higher risk levels and upcoming new regulations for the private equity industry.

### What's next for service providers?

The survey has overall demonstrated that the fund administrator community will have no choice but to accompany the private equity houses in their current and upcoming challenges. By positioning themselves more in the center of private equity business, fund administrators have now – in times of increased regulatory constraints - the chance to get closer to private equity houses' activities. Stricter reporting requirements and increased global operations are examples of such activities administrators have to cope with and turn into opportunities. Being able to grasp these in a

consolidating market will be critical for the fund administrators willing to play a major and effective role in this post-crisis environment. ■

*Alain Kinsch, EMEA\* Private Equity Fund Leader, Ernst & Young, Luxembourg*

*Olivier Coekelbergs, Partner, Private Equity, Ernst & Young, Luxembourg*

*Martin Derfesser, Senior Consultant, Private Equity, Ernst & Young, Luxembourg*

\*EMEA: Europe, Middle-East, India and Africa



# PRIVATE EQUITY INTERNATIONAL

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245 Fifth Avenue  
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T: +1 212 447 0909

Contacts:

**Joe Patellaro**

T: +1 917 472 5971

E: [joseph.patellaro@citi.com](mailto:joseph.patellaro@citi.com)

**Mark O'Connor**

T: +1 917 326 5227

E: [mark.oconnor@citi.com](mailto:mark.oconnor@citi.com)

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7, rue Gabriel Lippmann  
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Munsbach  
L5365 Luxembourg

T: +352 42 124 1

F: +352 42 124 5555

Contacts:

**Alain Kinsch**

Country Managing Partner and EMEA

Private Equity Fund Leader

Ernst & Young, Luxembourg

E: [alain.kinsch@lu.ey.com](mailto:alain.kinsch@lu.ey.com)

**Olivier Coekelbergs**

Partner, Private Equity

Ernst & Young, Luxembourg

E: [Olivier.coekelbergs@lu.ey.com](mailto:Olivier.coekelbergs@lu.ey.com)

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[www.caceis.com](http://www.caceis.com)

1,3 place Valhubert  
75206 Paris Cedex 13  
France

T: +33 1 57 78 00 00

Contact:

**Hervé Schunke**

Head of Private Equity & Real Estate Servicing

T: +352 4767 6367

E: [herve.schunke@caceis.com](mailto:herve.schunke@caceis.com)

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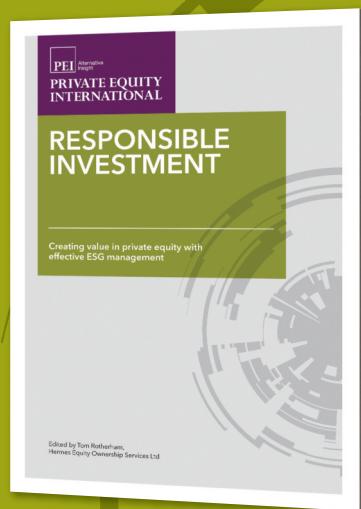
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