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PEI Alternative Insight

PRIVATE EQUITY INTERNATIONAL

ISSN 1474-8800
MAY 2019

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Private equity's platonic relationships

GRAEME KERR
EDITOR'S LETTER

"Things are not always what they seem, the first appearance deceives many. The intelligence of a few perceives what has been carefully hidden."

It's not often *Private Equity International* can turn to Plato for words of wisdom, but the Greek philosopher came to mind editing this year's *Legal Special* as it became apparent just how much private equity firms rely on lawyers for insight into a world that is rarely as straightforward as it appears.

Take Brexit, for example. More than 1,000 days since the answer to a simple yes or no question plunged Britain into a political crisis, UK private funds are realising that the choice of domicile is much more complex than simply being inside or outside the EU.

There's a whole set of other considerations – tax, status, marketing, reputation, cost – that make deciding whether UK managers should shift from London to Luxembourg or elsewhere a good deal more difficult than it would first seem. While Luxembourg is winning favour as the post-Brexit jurisdiction of choice, the UK still holds plenty of attractions for investors, as Sam Kay and Emily Clark of Travers Smith argue on p. 12.

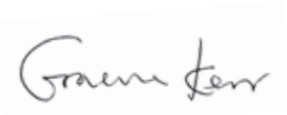
Or take the deregulatory zeal of the Trump Administration and the talk of dismantling Dodd-Frank. Anyone who thought this would mean a softly, softly approach by the Securities and Exchange Commission towards the private equity industry clearly has not been reading Plato. Yes, the SEC's Office of Compliance Inspections and Examinations, its inspection arm, has cut the time it spends on-site at fund managers but that doesn't mean the buyout industry can breathe easy. Far from it. "Don't believe what you read in the papers," Norm Champ of Kirkland & Ellis tells us on p. 16. "This may be a deregulatory Administration, but that doesn't mean the SEC exam programme is doing less."

In fact, the number of exams has increased every year since they began.

And so it goes on. Practically every article in this issue has that moment where you realise that what on the face of it seemed relatively straightforward is actually a good deal more complex once you scratch the surface.

Whether it is the conflicts caused by funds reaching the end of their lives (p. 10), the myriad tax issues posed by family offices that have private foundations as investors (p. 6) or the surprisingly tough exit conditions in the German market (p. 18), this issue is full of the kind of insights that can only come from legal minds.

Enjoy the supplement



Graeme Kerr

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Private Equity International is published 10 times a year by PEI.

To find out more about PEI please visit: **www.thisisPEI.com**

PRINTED BY: Stephens & George Ltd.
www.stephensandgeorge.co.uk

TOP ISSUES

The five hot topics on lawyers' minds

From the implications of Brexit to the growing number of GP-led restructurings, fund managers are wrestling with some weighty legal issues, writes Claire Coe Smith

With so much macroeconomic uncertainty, one could be forgiven for thinking that legal issues are taking a backseat to economic concerns in the private equity industry. In fact, the lawyers advising sponsors see another busy year ahead. Here are the five legal issues at the top of the private equity agenda.

1 BREXIT'S LEGAL IMPLICATIONS

It is impossible to deny that Brexit is front and centre of UK-related investment decisions as we move into the second quarter of 2019, and there are plenty of associated legal issues that are already keeping funds and their advisors busy. For a start, a slowdown in deal activity means a window in which to focus on compliance across the portfolio.

Stephen Drewitt, head of private equity at Macfarlanes, says: "Given the current macroeconomic and political situation, legal issues are not getting much airtime and there is an obvious slowdown in the rate of investment. For the time being, a number of PE houses are very much focused on their portfolios and driving good behaviours within those businesses, rather than embarking on new investments or exits."

> ***"All UK managers are having to grapple with fund structures for their next funds"***
>
> **Nigel van Zyl**

Where deals are proceeding, there is an extra layer of due diligence to be completed, according to Kem Ihenacho, global co-chair of the private equity practice at Latham & Watkins.

He says: "Overall we have not seen a drop in activity, though investors are approaching businesses with predominantly UK revenues in certain sectors with caution. What we do see is another line of diligence in deals, to look at what the impact of Brexit might be on the business, and what that business is doing to plan for different types of Brexit. That may lead to some investments being delayed, but overall activity is still pretty strong."

On fundraising, the Brexit impact is already significant: "All UK managers are having to grapple with fund structures for their next funds," says Nigel van Zyl, a partner in the funds practice at Proskauer. "They are thinking about where they are going to be located, whether they will have access to EU markets with or without passporting and whether a particular jurisdiction will impact on their investor base and make fundraising easier or harder," he says.

Such decisions come down to where managers believe their future investment will come from and, for larger GPs, whether to commit resources to establishing their own Luxembourg entities. "For small GPs, that's not really an option, so they have to assess the structure in light of that," he says. »

2 MORE OPPORTUNITIES IN THE PUBLIC MARKETS

Many private equity firms are increasingly focused on the opportunity to invest in companies listed on stock markets around the world, as evidenced by this year's consortium acquisition of Inmarsat, the UK satellite group that was once a FTSE 100 business. Inmarsat accepted a $3.4 billion cash bid from a consortium comprising Apax Partners, Warburg Pincus, Canada Pension Plan Investment Board and Ontario Teachers' Pension Plan Board, just weeks after Hellman & Friedman and Blackstone had made a $6.4 billion offer for online classified group Scout24, which will be the biggest takeover of a listed German company by private equity.

Ihenacho says: "One thing our clients continue to focus on is the opportunities to acquire public companies, where valuations are seen as attractive. Being able to navigate the rules around public company transactions and being ready to be flexible and innovative around those approaches, focused on a path to control, is something we are working with clients on."

A related trend sees buyout firms circling divisions of major corporates for carve-out deals, with German industrial gases group Linde agreeing in March to sell its South Korean assets to private equity firm IMM for $1.15 billion. Michael Francies, managing partner of Weil's London office, says: "We are currently seeing a lot of carve-out sales, with corporates selling off non-core assets, and those deals are proving attractive to private equity. Carve-outs are not necessarily easy transactions to do, but buyout firms have a good track record of finding value in those transactions and it looks like we will see more of them this year than maybe we have in the recent past."

3 GP-LED RESTRUCTURINGS MOVE UP THE AGENDA

With a glut of funds raised between 2006 and 2008 now reaching the end of their 10-year life span, many of those GPs find themselves holding assets that their limited partners would like to liquidate and they would prefer to keep working. With the global financial crisis having impacted many of those funds, managers are increasingly exploring ways to move on without having to exit assets that may yet have plenty of value left to be extracted.

One of largest such deals took place last year, when Coller Capital and a unit of Goldman Sachs backed a €2.5 billion restructuring of Nordic Capital's 2008 seventh fund. That deal, which involved nine companies worth €4.4 billion, allowed the firm to hold the assets for another five years, with about 60 percent of the original LPs selling their stakes to secondaries investors, and the remainder rolling over into the new structure.

Drewitt says: "What we see now is that, instead of GPs being almost passengers in secondary transactions, they are now actively pursuing and participating in those arrangements as a means of assisting their investors with liquidity solutions; previously for investments leftover at the end of the life of a fund but also now creatively as a means of actively managing the portfolio."

4 THE RETURN OF THE CLUB DEAL

With the prospect of large public-to-private transactions coming back onto the table, we are seeing a renewed trend towards consortia of private equity investors clubbing together on larger transactions, as well as a growing number of LPs seeking more active co-investment opportunities.

David Walker, global vice-chair of the corporate department at Latham & Watkins, says: "Private equity lawyers are thinking carefully about the terms of the equity arrangements between consortium members on these deals, which is probably something we have been less focused on in recent years. That gives rise to a whole host of issues around board rights, governance and exit and also links into another hot topic around anti-trust, where there is an increasing regulatory focus on non-controlling stakes."

Ihenacho adds: "The pool of capital available for these deals continues to expand – we are increasingly seeing family offices buying into large companies and sovereign wealth funds and pension funds doing direct investments."

5 DIRECTORS' LIABILITIES CONTINUE TO INCREASE

A raft of new legislation in Europe and around the world in recent years has often made directors criminally liable for the activities of employees and agents, most notably in areas such as bribery and corruption, terrorist financing, tax evasion, money laundering and sanctions. Regulators and authorities are showing a greater willingness to flex their muscles, and new legislation has often changed the criminal standard to put directors on the hook. Such advances have driven a renewed focus on compliance policies and procedures within private equity firms, with culture and ethics becoming buzzwords.

Drewitt says: "There's a fair amount of concern around criminalisation of the board and where that is going, covering issues such as the Bribery Act, modern slavery and the new tax evasion rules. People are looking very closely at all of these new items of legislation that the government has introduced as a means of holding directors responsible on a criminal basis for acts where they might previously have used the corporate veil to protect themselves." ■

EXIT PLANNING

Family offices need solid foundations

Private foundations can be attractive investment partners, but deals need to be structured with the exit in mind to avoid some tricky tax issues, say Stephanie Pindyck-Costantino, P. Thao Le and Christopher Bird of Pepper Hamilton

Family office investment vehicles typically have a diverse pool of investors, both entities and individuals, each with their own unique attributes. Pooling these investors into a common investment vehicle takes advance planning for the exit, especially if private foundations are among the investors.

Private foundations are generally exempt from US tax. But that statement is deceptively simple. Private foundations are subject to US tax on income they derive from the conduct of a trade or business that is unrelated to their tax-exempt purpose. (And, for this purpose, any unrelated trade or business activities of a partnership, like a family office vehicle, are attributed to its tax-exempt partners.)

In addition, private foundations – and, in some cases, their managers – are subject to a litany of penalty taxes on investment income, self-dealing, the failure to distribute income, excess business holdings, jeopardising investments and taxable expenditures. In this article, we introduce topics such as self-dealing and excess business holdings in the context of making an investment in a family office vehicle so that practitioners are able to issue spot and obtain the right advice.

INVESTMENT ALLOCATIONS

When an investment opportunity presents itself, a family office typically will make two allocation determinations: the right size of the opportunity for the family office as a whole and the correct allocation among the family members and entities of the family office. Factors include the size of the investment opportunity, the amount of the family office's investable capital, the appropriateness of the investment for the family office and its affiliates, the potential hold period for the investment and the potential sources of revenue from the investment opportunity. Additional factors that may be considered when allocating to particular family investors include the domicile of the investor, type of investing entity and the investment mandate or restrictions of the investor.

INVESTING THROUGH SPVs

An investment opportunity may be pursued by family office vehicles and family office organisations on a co-investment basis. In that case, a single investment vehicle – often referred to as a "special purpose vehicle" – will be formed to aggregate the funds of the family offices for the specific investment. The SPV is often structured as a flow-through entity for tax purposes, such as a limited partnership or a limited liability company. However, SPVs are structured more frequently as limited partnerships because limited partnerships are more commonly recognised as a legal entity in most jurisdictions (US and non-US). Using co-investment structures (without an aggregator) facilitates use of corporate blockers.

The SPV allows a family office to aggregate investors' funds, and the SPV, in turn, will make an aggregate investment in the form of debt, equity or any combination thereof. The SPV's limited purpose is to hold the investment and do any ancillary things until the investment is liquidated.

The beneficial owners of the SPV only need to be disclosed in limited circumstances. For example, to a lender, or if there are "know your customer" requirements.

Some family offices may have an opportunity to invest in investment advisers and broker-dealers. Investment advisors (whether they are registered or exempt reporting advisors) and registered broker-dealers must disclose in a public filing all of their 5 percent owners and each 25 percent owner of any 5 percent owner. As a result, when structuring investments, some family offices may allocate an investment opportunity so that no investing entity or individual owns more than 25 percent of the SPV.

***Le**: the SPV is not an evergreen investment vehicle*

TERMS OF THE SPV

SPVs are generally formed for a specific investment, but can also handle multiple investments. Here, we are focusing on an SPV formed to make a specific investment by investors from a single family office. When an SPV is formed for a specific investment, its terms are relatively simple:

Length of term: The SPV will have an indefinite term but will often have a provision that the SPV will be dissolved once all of its assets are sold and the underlying investment has been liquidated.

Economics: The SPV will often have some type of economic arrangement where the investing entities and individuals will pay for all of the expenses of the SPV (including any expenses relating to the SPV's investment in the underlying investment and its sale or liquidation). If the SPV has any private foundations as investors, the ability to charge the foundation any management fees or performance fees will be subject to certain IRS self-dealing rules.

Withdrawal rights: Given the limited purpose of the SPV, it rarely provides withdrawal rights to investors without the approval of the SPV's general partner.

Transfer rights: Even though the SPV is formed to invest the funds of family office vehicles (many, if not all, are related entities), the ability of the investors to transfer their interest in SPVs will be limited and subject to the consent of the general partner.

Since the SPV is formed to make an investment in the securities of an underlying issuer, each beneficial owner will need to be an "accredited investor" as defined in Regulation D of the Securities Act of 1933, as amended.

***Pindyck-Costantino**: foundations are subject to myriad penalty taxes*

> ***A transaction between a private foundation and a disqualified person is subject to self-dealing rules which, if violated, could have significant consequences***

PRIVATE FOUNDATIONS

Private foundations are subject to myriad penalty taxes on investment income, self-dealing, the failure to distribute income, excess business holdings, jeopardising investments and taxable expenditures. Here we focus only on self-dealing and excess business holdings rules which may impact a private foundation's ability to participate in an investment.

DISQUALIFIED PERSONS

The discussions below on self-dealing and excess business holdings refer to a private foundation's "disqualified persons". This is a broad term and generally encompasses those who control and fund the foundation, and includes these individuals:

- A "substantial contributor" to the foundation, ie, a person who has contributed or bequeathed more than $5,000 if that represents more than 2 percent of the total contributions and bequests received by the foundation since its creation. Once a person is considered a substantial contributor, that individual generally remains a substantial contributor even if the 2 percent threshold is subsequently no longer met. The person ceases to be a substantial contributor if that individual (and all related people) has not made any contributions to the foundation for 10 years, if that or any related individual was not a foundation manager at any time during that 10-year period, or if the total contributions made are determined by the IRS to be insignificant compared with the total contributions to the foundation by someone else.
- A "manager" of the foundation, ie, an officer, director or trustee (or an individual having similar powers or responsibilities). In some cases, an employee can be considered a manager with respect to a particular act or failure to act if that employee has final authority or responsibility with respect to the act or failure to act.
- An owner of more than 20 percent of the combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust, any of which is a substantial contributor to the foundation. »

- A family member of a substantial contributor, manager or 20 percent owner as described above.
- A corporation of which more than 35 percent of the total combined voting power is owned by substantial contributors, managers, 20 percent owners or family members.
- A partnership of which more than 35 percent of the profits interest is owned by substantial contributors, managers, 20 percent owners or family members.
- A trust, estate or unincorporated enterprise of which more than 35 percent of the beneficial interest is owned by substantial contributors, managers, 20 percent owners or family members.
- For purposes of excess business holding rules, another private foundation that either (a) is effectively controlled by the same person or persons who control the private foundation in question or (b) received substantially all of its contributions from the same substantial contributors, managers, 20 percent owners or family members who made substantially all the contributions to the private foundation in question. For this purpose, "substantially all" means at least 85 percent.
- For purposes of the self-dealing rules, certain individuals who at the time of the self-dealing hold certain elected or appointed offices at the federal or state level and acted knowingly.

Given the broad definition of disqualified persons, family offices must be very careful in determining whether a prospective investment and the SPV for such an investment is appropriate for the private foundation and whether it would constitute a prohibited transaction. A transaction between a private foundation and a disqualified person is subject to self-dealing rules which, if violated, could have significant consequences.

***Bird**: self-dealing rules can impact family offices*

SELF-DEALING

Generally, all direct and indirect financial transactions between a private foundation and its disqualified persons are subject to an excise tax. There are six categories of self-dealing: (1) sale, exchange or leasing of property; (2) lending money or other extension of credit; (3) furnishing goods, services or facilities; (4) payment of compensation (or payment or reimbursement of expenses); (5) transfer to, or use by or for the benefit of, a disqualified person of any income or assets of the foundation; and (6) agreement to pay a government official. Each of these categories is subject to exceptions.

If a private foundation and a disqualified person engage in an act of self-dealing, then the disqualified individual (other than a foundation manager acting only in this capacity) will be subject to an excise tax equal to 10 percent of the amount involved for each year (or part of a year) in the "taxable period", ie, the period beginning with the date on which the act of self-dealing occurred and ending on the earliest of either the date of mailing of a notice of deficiency with respect to the initial tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A foundation manager who knowingly participates in the self-dealing will also be subject to an excise tax equal to 5 percent of the amount involved for each year (or part of a year) in the same taxable period, unless the manager's participation is not wilful and is due to reasonable cause.

If the initial taxes are imposed and the act of self-dealing is not corrected, then the disqualified person will be subject to an additional excise tax of 200 percent of the amount involved, and a manager who refuses to agree to the correction will be subject to an excise tax of 50 percent of the amount involved. A foundation that repeatedly and wilfully engages in self-dealing could lose its tax-exempt status and be required to repay all the tax benefits that the foundation and its contributors have received, which could represent all its remaining assets.

The restrictions on self-dealing can impact family offices with private foundation investors in several ways. For example, a private foundation generally cannot compensate (or pay or reimburse the expenses of) a disqualified person. But a private foundation can compensate a disqualified person for "personal services" that are reasonable and necessary to carry out the foundation's exempt purposes, provided the compensation is reasonable. Thus, a private foundation can pay reasonable investment

management fees and carried interest to a foundation manager or other disqualified person.

As another example, a disqualified person cannot benefit more than incidentally from the use of private foundation assets. Thus, if a private foundation and a disqualified person invested in the same fund, it would be an act of self-dealing for the disqualified person to "piggyback" on the foundation's contribution to meet a minimum investment requirement. However, the converse is allowed – a private foundation may benefit from using a disqualified person's investment.

As a final example, a private foundation cannot pay rent for office space owned by a disqualified person – even below-market rent. However, if a private foundation leases office space from a disqualified person and pays no rent, the foundation can pay its fair share of utilities and other related expenses, provided that the payment for these expenses is not made directly or indirectly to the disqualified person. And a private foundation and a disqualified person can share office space owned by an unrelated person, but the foundation and disqualified person should have separate leases and pay rent directly to the landlord.

EXCESS BUSINESS HOLDINGS

Private foundations generally are prohibited from controlling a "business enterprise", either alone or together with their disqualified persons. Thus, if a private foundation and all its disqualified persons collectively own more than 20 percent of the interests of a for-profit business (or 35 percent if the business is effectively controlled by persons other than the private foundation and its disqualified persons), then the foundation will be subject to an excise tax equal to 10 percent of the value of the foundation's interest above the 20 percent (or 35 percent) threshold for each year (or part of a year) in the "taxable period".

For this purpose, "taxable period" means the period beginning with the date on which there are excess holdings and ending on the earliest of (1) the date of mailing of a notice of deficiency with respect to the initial tax, (2) the date on which the initial tax is assessed, or (3) the date on which the excess holding is eliminated. In addition, if the initial tax is imposed and the excess holding is not eliminated within a timely period, then the private foundation will be subject to an additional excise tax equal to 200 percent of the value of the foundation's interest above the 20 percent threshold.

The above rules on excess business holdings are subject to several important caveats. For example, if a private foundation and its disqualified persons do not collectively own more than 20 percent of the voting interests in the business (or 35 percent if the business is effectively controlled by third persons), then the foundation may own any amount of the non-voting interests in the business. (In the case of a business organised as a partnership, a "profits interest" is considered a voting interest, and a "capital interest" is considered a non-voting interest, which is not always easy to differentiate.) In addition, the above rules do not apply if a foundation and its related foundations do not own more than two percent of a business. Moreover, the IRS has the discretionary authority to abate the initial tax when the private foundation establishes that the violation was due to reasonable cause (and not to wilful neglect) and timely corrects the violation.

While family offices and their private foundation investors need to be cognisant of the excess business holding rules with respect to underlying investments, a business enterprise that earns at least 95 percent of its gross income from passive sources is not subject to the excess business holdings rules. Thus, a typical investment partnership (or a typical "blocker" corporation) should not be a business enterprise. In fact, the IRS has held that an investment partnership is not subject to the excess business holdings rule even if less than 95 percent of the investment partnership's income constitutes passive income. ■

PRE-DEAL PRECAUTION

If a family office is planning to allocate an investment opportunity, and one of the investors is a private foundation, it is important to look at the structure from the bottom to the top before the investment is made. Practitioners must:

- Look at both the pre-investment and post-investment ownership of the various layers (assuming the ultimate investment has multiple investment layers) and ascertain both the economic and governance control.
- Consider the relationship of the parties receiving and paying any fees.
- Be prepared to give the allocation to a different investing entity within the family office if the transaction runs afoul of the rules governing the private foundation.

FUND RESTRUCTURINGS

GP-leds: How to navigate conflicts

LPs can find the options are limited when a fund manager restructures the leftover assets in a fund nearing the end of its life, writes Claire Coe Smith

With a growing population of funds raised between 2006 and 2008 now reaching the end of their lives, the number of GP-led restructurings to deal with leftover assets is on the rise. But as managers seek out ways to keep working the assets, LPs can find themselves with limited options and the number of parties involved in restructuring negotiations often makes them fraught with conflicts.

"The big issue is that inherent conflict where the GP is really looking out for his or her own interests, potentially setting up another fund and transferring the assets in, while some LPs want to stay put and others want new investors to put capital in to take them out," says Tom Angell, leader of accounting and advisory firm Withum's Financial Services Group out of New York.

For investors presented with a secondaries deal already negotiated by the manager, there can seem like there are few options on the table, and the LPs' interests may diverge. Some LPs looking for liquidity will be focused on the price on offer, while others will want to stay in the portfolio with no change to the economics, and still more might see the potential for greater returns in a pay-to-play arrangement that splits up the assets in question.

John Rife, a London-based partner with law firm Debevoise & Plimpton, says: "While these are conflict-laden transactions, they actually start with a more fundamental conflict between the LPs, where there is one camp that believes in the fundamentals of the underlying portfolio and another that wants to take cash off the table and move on. If you don't have that conflict between your LPs, these aren't the right transactions to be looking at in the first place."

It is becoming increasingly common for the GPs to stay in on secondary restructurings, bringing in new money and selling the assets to a new fund, but continuing in the manager role with that new vehicle. If there is no feeling that the manager is to blame for the assets not yet being ready to exit, they can be the best people to take the assets through to peak valuation, adding a further layer of conflicts.

"The primary conflict is between the sponsor and its own investors," says Morri Weinberg, partner in Ropes & Gray's asset management practice, and a veteran of funds restructurings. "But then there are other constituencies at the portfolio level, including management teams, co-investors and lenders, potentially. In terms of navigating the minefield, a number of these constituencies may have to buy in to at least some aspect of the deal, and that takes a lot of thought in terms of putting together a potential transaction that is going to get the buy in required."

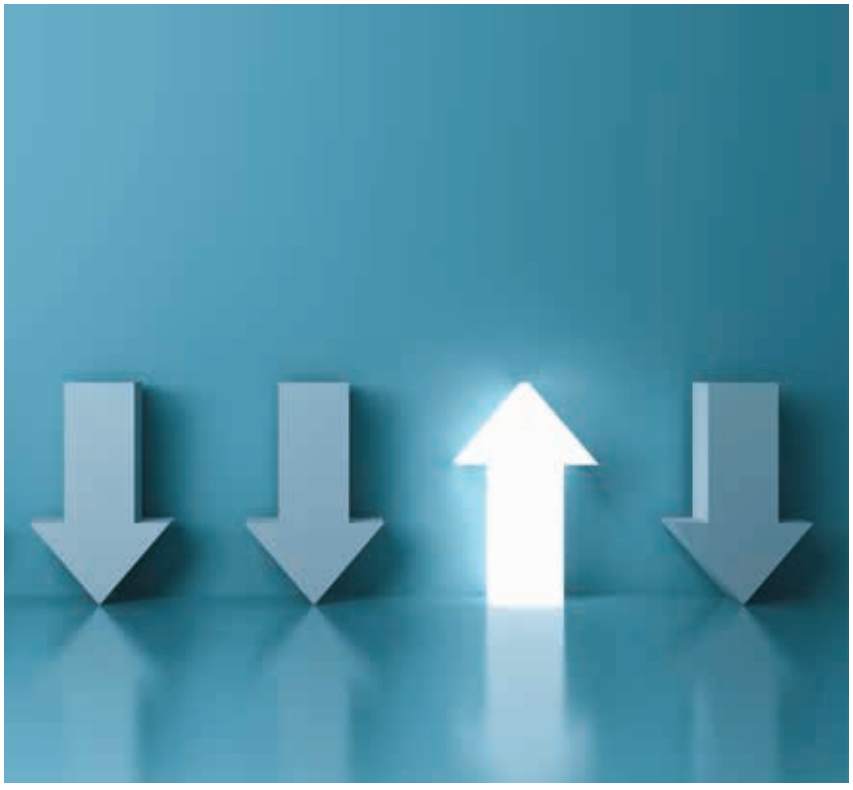
> ***The big issue is that inherent conflict where the GP is really looking out for his or her own interests***
>
> **Tom Angell**

Weinberg worked on one of the first GP-led restructurings back in 2012, when Behrman Capital formed a new fund to buy out five remaining companies from its vintage 2001 fund. Since then, activity has taken off on both sides of the Atlantic, with Nordic Capital recently completing the biggest-ever deal of its kind when Coller Capital and a unit of Goldman Sachs backed a €2.5 billion restructuring of its 2008 seventh fund. That deal, which involved nine companies worth €4.4 billion, allowed the firm to hold the assets for another five years, with about 60 percent of the original LPs selling their stakes to the secondaries investors, and the remainder rolling over into the new structure.

"These days, there is a recognition that these are transactions that GPs are viewing as potentially part of their liquidity toolkit, because the situations with respect to certain portfolio companies may just mean that the potential upside in a few more years will be much more significant," says Weinberg. "Frankly, all of these deals are bespoke and success comes down to the GP really understanding the transaction from the different points of view of the investors."

Advisers point to three must-haves for managers seeking to navigate conflicts: transparency of communication, third-party input and ample time.

Angell says: "You have to make sure that everything is done as transparently as possible. You need to make sure you take care of the interests of the current LPs, and that they are properly included in the conversation, because otherwise you run the risk of running into an issue down the road and ending up in litigation."



THE US AND EUROPE DIVIDE

There is a divergence between the approach being taken in US deals and those being done in Europe. The Securities and Exchange Commission has been vocal about scrutinising GP-led restructurings, and particularly so-called stapled secondaries, which combine the purchase of an existing pool of assets with the commitment of new capital to the GP's next fund.

Rife says: "In the US, the market seems to be coalescing around a fairly standard approach to these deals in terms of the standard of disclosure, what information is shared and how long you are giving LPs to consider the information, with the US tender offer rules applied as an overlay, requiring 20 business days from when the offer is provided until the recipient has to make a decision. In Europe, the approach is more fragmented, and we see processes being run where LPs are given a week or two to digest a thousand pages of information and come back with a decision."

Julie Corelli, a partner at Pepper Hamilton and co-chair of its funds services group, says: "Most GPs pave the road ahead rather than springing it on LPs, talking early about the options for outstanding assets in quarterly letters, and setting out plans for assets that might not be at peak valuation when the fund is due to end."

She advises GPs to shop around for several potential deals before presenting a secondaries transaction to LPs, and says getting a third-party valuation is also critical to showing all parties are getting fair treatment.

Angell says: "The valuation is basically the whole key to the deal, because the secondary wants to make a good deal and the LPs want to make a good deal, but if the discount is too large you won't get the LPs to sell and it becomes difficult. There is often a very fine line between a good deal for the secondary and a good enough deal for the LPs."

He adds: "The secondary buyer is going to do their own due diligence on the assets and make their own judgement, but if the GP gets somebody independent to look, then at least there's a little more confidence for the LPs that the GP is working in their best interests."

FAIRNESS OPINION

A third party may also provide a fairness opinion as an additional layer of comfort that potential conflicts have been addressed.

Finally, once a deal with a potential buyer is agreed, LPs will want plenty of time to digest it.

"You are going to have to give LPs plenty of time and plenty of information," says Corelli. "That time might actually include the time to go out and structure their own alternatives. If you're asking for approval in five days, that is just not enough."

Weinberg adds: "Very often LPs feel somewhat hard-pressed by the timing that might be involved after receiving the full disclosure package. These are extremely complicated transactions and it takes time for people to digest them."

While the road may not be easy, we can expect many more deals. Geoffrey Kittredge, chair of Debevoise & Plimpton's European private equity funds group, says: "Investors are becoming more accustomed to these transactions and able to consider them more quickly. In the past, they may have been viewed as a sign of weakness on the part of the GP, with some using them to create a continuation vehicle in lieu of raising a successor fund. That is certainly no longer the case. We see GPs with very strong track records considering these as one of a number of different ways to address an LP desire for liquidity."

Angell adds: "There is just so much secondary capital out there, and a willingness on the part of a number of parties to make these things work. It is just a question of striking a deal that suits everyone." ■

GERMANY

The funding gap facing German PE

Worried that its venture capital market is lagging its European neighbours, the German government is doing all it can to provide more start-up support, says Andreas Rodin of P+P Pöllath + Partners

***Rodin**: Germany's exit environment is regarded as 'difficult' by investors*

After a record year in 2017, it is perhaps no surprise that the private equity market took a breather in Germany in 2018. But the main talking point was not the dip in fundraising, but on where that capital is being invested – in particular the lack of venture capital for start-ups. There was also a heated debate in Germany about exit-related issues, especially what happens when a tech company falls into foreign hands.

That coupled with some pressing tax issues, notably proposals for tax relief for R&D expenses and an ongoing discussion over whether VAT should be levied on the management of private equity funds, made it a busy 12 months in the German private equity market.

After a record 2017, fundraising fell back in Germany last year, according to the 2018 report from the German Private Equity and Venture Capital Association (BVK) released in February. Fundraising dropped by 11 percent from €3.08 billion in 2017 to €2.74 billion in 2018. Venture capital fundraising was down 24 percent to €1.227 billion; buyout fundraising fell 20 percent to €826 million; and growth capital/mezzanine funds raised €395 million, down 11 percent.

The BVK figures are the most comprehensive data on the German private equity market, as they are derived from the European Data Cooperative – a non-commercial joint pan-European platform that covers leading European private equity associations including Invest Europe. EDC is the single data entry point for the members of the participating private equity associations and applies a standardised methodology thereby generating consistent, robust and comparable market data for the different regions in Europe.

The BVK's breakdown of investor groups via their commitments in 2018 shows that public sector bodies contributed 45 percent of the capital, pension funds (mostly non-German) 12 percent, family offices (mostly German) 9 percent, foundations and academic endowments (mostly non-German) 7 percent and insurance companies 3 percent. German investors represented 46 percent of the total, investors from elsewhere in Europe 31 percent and non-European investors 23 percent.

The total amount invested in 2018 in German portfolio companies fell by 18 percent from €11.68 billion in 2017 to €9.57 billion in 2018, according to the BVK figures. There was, however, a slight increase in the total number of German portfolio companies backed by private equity and venture capital from 1,197 in 2017 to 1,222 in 2018.

Buyout investments represented 70 percent of the total amount invested, growth capital 16 percent and venture capital 14 percent. But 55 percent of all portfolio companies received venture capital, against 33 percent for growth capital. Only 12 percent were the subject of a buyout transaction. This discrepancy between the amount invested and the number of portfolio companies that receive the different types of capital continues to be a characteristic of the German private equity market.

The data is categorised into corporate sectors, where there are also notable differences between value invested and the number of investments. For example, the business-to-business sector received 24 percent of total investment but only accounted for 18 percent in terms of the number of portfolio companies invested in. Companies engaged in information, computer and electronic technologies also received

24 percent of all investment, but accounted for 32 percent of the portfolio companies; biotech companies accounted for 16 percent of investment and 13 percent of the portfolio companies; companies focusing on energy and environmental technologies had 16 percent of the investment value but just 3 percent of the total number of portfolio companies.

There is a similar picture when the data is split by sales volume. Seven percent was invested in companies with total sales of up to €1 million, but these firms represented 53 percent of all the portfolio companies; 6 percent of capital went to companies with sales of €1 million-€10 million, but this represented 26 percent of portfolio companies; 29 percent was invested in companies with total sales of €10 million-€50 million, representing 13 percent of portfolio companies; 24 percent was invested in companies with sales of €50 million-€100 million but this went to only 3 percent of portfolio companies. So it goes on: 18 percent was invested in companies with total sales of €100 million-€250 million, but this was just 3 percent of the portfolio companies; 16 percent was invested in companies with sales of €250 million-€500 million, representing only 2 percent of the total number of portfolio companies.

The same is true when company size is broken down by workforce size: 4 percent of the total was invested in companies with up to 19 employees, but this represented 42 percent of the total number of portfolio companies; 15 percent was invested in companies with up to 99 employees representing 35 percent of the total number of portfolio companies; 36 percent was invested in companies with up to 499 employees representing 18 percent of all portfolio companies; 10 percent was invested in companies with up to 999 employees, representing 3 percent of the total number of portfolio companies; 35 percent was invested in companies with more than 1,000 employees, representing just 2 percent of the total number of portfolio companies.

In terms of divestments, the total amount of exit proceeds in 2018 dropped by 44 percent from €5.71 billion in 2017 to €3.21 billion in 2018. Trade sales represented 34 percent of the total in 2018 against 46 percent in 2017. Secondary buyouts represented 38 percent in 2018 against 36 percent in 2017. Sales via IPOs represented 12 percent in 2018 against 4 percent in 2017.

START-UP FINANCING

One of the big discussion points in Germany is the relative lack of venture capital. This is one of the issues dealt with by the Expert Commission for Research and Innovation in its 2019 annual report.

There is little doubt that Germany has become more attractive for international venture capital investors over the last 25 years. Around 20 percent of German start-ups received funding from at least one US venture capital fund between 1992 and 2018. However, the total amount of venture capital investment still lags the rest of Europe when expressed as a percentage of the gross national product. According to an analysis by Invest Europe, venture capital investment was equivalent to just 0.035 percent of German GDP in 2017, against figures of 0.075 percent or more in Finland, France, the Netherlands, Sweden, Switzerland and the UK.

The Expert Commission suggested three reasons why Germany is lagging its European neighbours. »

One of the big discussion points in Germany is the relative lack of venture capital

SLIPPING BACK

Fundraising fell in Germany last year

Venture capital fundraising
↓24%
to €1.23 billion

Buyout fundraising
↓20%
to €826 million

Growth capital/mezzanine funds
↓11%
to €395 million

Source: German Private Equity and Venture Capital Association (BVK)

NO ANCHOR INVESTORS, SMALL FUND SIZE

There are no German institutional investors that assume the role and function as anchor investors in the venture capital market and give signals to international investors. Moreover, pension funds and private pension schemes do not represent an important group of institutional investors because of the way pension commitments are funded in Germany. As a consequence, German venture capital funds are too small for larger institutional investors. For this reason, German insurance companies are more focused on the much larger venture capital markets in the US and Asia. That has damaged the track record of German managers compared with their international competitors.

This has resulted in a funding gap for German start-ups. In order to close the gap, the German federal government and the German federal states have established several programmes co-funded by the European Union to attract private investment into venture capital funds and start-ups. The most important of these are:

- High-Tech Gründerfonds focusing on early-stage investments. Its third fund started operations in 2017 with capital of €316.5 million.
- INVEST-Grant for Venture Capital, which is funded by the German Ministry for Economic Affairs. It provides tax-exempt grants to private investors, especially business angels, as well as partial relief from income tax on capital gains realised upon exit.
- The €85 million Mikromezzaninfonds-Deutschland fund co-funded by the German ERP Special Fund and the European Social Fund. The capital is for small enterprises and comes via silent partnerships.
- The ERP-EIF Facility co-funded by the German ERP Special Fund and the European Investment Fund. It has more than €3 billion for investment in venture capital funds focusing on German technology oriented SMEs.
- The €570 million European Angels Fund-Germany co-funded by the German ERP Special Fund, the Bavarian LfA and the European Investment Fund. It offers co-funding to business angels.
- The €400 million ERP-Venture Capital Fund Financing programme funded by the German ERP Special Fund and managed by KfW; its focus overlaps with the ERP-EIF Facility.

In addition, the German federal government is negotiating with the German insurance industry on funding models to encourage the insurers to offer larger commitments to German funds investing in venture capital. In its report, the Expert Commission cites the Danish model Dansk Vækstkapital as an example of how a public-private partnership can succeed in allocating large amounts of capital to start-ups and SMEs.

TAX-RELATED OBSTACLES

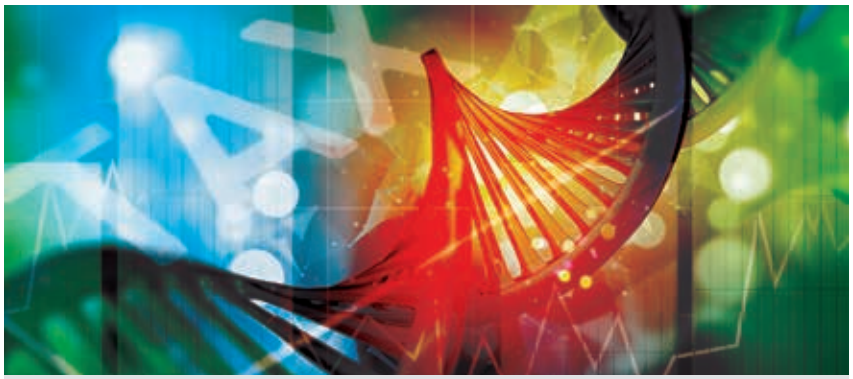
Some of these have eased in recent years. For example, in 2016 the rules were eased on the use of a tax loss carry forward in the event of admission of more than 50 percent of new shareholders during a consecutive five-year period. But the German decision to levy value-added tax (at the current rate of 19 percent) on the management of private equity and venture capital funds remains a major obstacle to establishing funds that are managed in Germany.

EXIT-RELATED ISSUES

Trade sales and IPOs are the most important exit channels for venture capital investors but the German exit environment is regarded by investors as difficult. In order to reactivate the stock exchange as a financing source for young growing enterprises and as an exit channel for investors, Deutsche Börse established the Venture Networks in 2015. This has helped: $2.4 billion has been invested in Venture Networks companies, resulting in seven IPOs, and in March 2017 Deutsche Börse set up a dedicated SME segment called Scale. Another positive sign was the first IPO of a High-Tech Gründerfonds investment: NFON in May 2018, coupled with the listing of another German high-tech company Home24 in June 2018. While this represents progress, German start-ups still struggle with specific challenges due to their small size and because their business models can restrict IPO possibilities and the structuring of subsequent financing rounds in the stock exchange.

The BVK data show a sharp fall in exit proceeds in 2018: trade sales down by 58 percent in value terms and secondary buyouts falling by 41 percent on 2017 figures. Exit-related issues have become a sensitive subject in Germany. The federal government is concerned about trends in the market because of the negative impact on the German economy as a whole. One trend currently under review relates to the large number of business models based on technology originating from Germany that are sold to purchasers from countries that offer foreign companies only limited access to their domestic market, or to foreign purchasers that take control over the technology by moving the business out of Germany or use the technology to promote their own businesses in ways that don't enhance the German economy.

The first response to the German federal government's concerns was the ninth amendment to the German anti-trust act subjecting acquisitions of German companies with sales of less than €5 million to anti-trust clearance if the total purchase price for the business exceeds €400 million.



PROPOSED TAX RELIEF FOR R&D

Germany is one of the few OECD countries that does not provide tax relief for R&D expenses. After long discussions with the industry, the German Ministry of Finance has published a draft discussion on tax-related support for R&D. In order to accommodate both taxable R&D-related losses at start-ups and taxable income for companies providing support, the relief will be structured as a tax-exempt grant, rather than as a tax credit or tax allowance. These grants are available to individuals and corporate taxpayers and to tax transparent partnerships. An appendix lists the full criteria, but, broadly speaking, the entity must be conducting basic or industrial research or experimental development in a permanent German establishment.

The tax grant for each eligible project is granted annually and is equivalent to 25 percent of the aggregate of the taxable compensation payable by the applicant to its employees involved in the project, subject to a maximum of €2 million per annum and per entity. If projects are carried out by multiple entities belonging to the same group then the €2 million threshold applies across the entire group of related entities, which means that the maximum tax grant (25 percent of €2 million) is €500,000 per annum to be divided between the related entities. To comply with the European state aid rules, the total tax grants per eligible entity and project shall not exceed a total of €15 million.

The new legislation still needs to be approved by parliament in 2019 but is set to apply to projects commenced after 31 December 2019 until 31 December 2023.

While the Expert Commission recognises the concerns that unequal market access and market distortion by public foreign companies may have an adverse impact on the market position of German companies, it emphasises the importance of unrestricted capital and technology transfer to spur innovation and economic growth.

The concerns addressed by the German federal government are shared by certain members of the European Union, in particular France, and discussions are currently pending on how to ensure that domestic funds supported with public money can structure exits through sales to domestic buyers.

> ***“There are no German institutional investors that assume the role and function as anchor investors in the venture capital market***

Given the specific weaknesses of the German venture capital markets – the lack of German institutional investors acting as anchor investors, the small size of German venture capital funds and the paucity of the track records of German managers – publicly-funded programmes are concentrating their efforts on providing more support to German and European venture capital funds to increase their attractivity compared with the large non-European financial investors.

Losing control over business models and technologies originating from Germany does not only occur once the company is exited, but also in the high-volume growth financing rounds where the small German venture capital funds are significantly diluted. Moreover, the cooperation between start-ups and other companies – particularly the more mature medium-sized and large companies – regarding the technology and business models needs to be improved if the start-ups are to be attractive for the new segments established by Deutsche Börse and Euronext or for a trade sale.

R&D SUPPORT PROGRAMMES

Various public institutions provide R&D support for start-ups but the Expert Commission pinpoints difficulties in accessing this funding. To comply with the administrative requirements is a challenge for young start-ups, a challenge made more difficult by the different requirements of each programme. Moreover, each applicant has to produce financial statements to access the funding. Start-ups can't always provide the required evidence and there are significant differences in what each programme requires. ■

REGULATION

Testing times as the OCIE gets savvy

The increasing sophistication of the Office of Compliance Inspections and Examinations may prove a mixed blessing, as exams take less time, but prove more rigorous, says Rob Kotecki

Call them teething problems if you like, but the first wave of registrations by the Securities and Exchange Commission had many detractors. The private funds industry fretted that the exam staff didn't understand their business enough to discern what was actual bad behaviour. And the Office of Compliance Inspections and Examinations didn't necessarily make a great first impression with questions that at times seemed irrelevant to how private equity firms operate.

The situation is very different today. The OCIE has learned plenty over the last few years and is quick to zero in on conflicts of interest in the asset class. Exams are conducted more quickly, thanks to technology, and while headlines might proclaim the deregulatory attitude of the current administration, that tone isn't showing up during exams.

Exam staff remain as sensitive as ever to the perennial issues of fees and expenses, allocations, insider trading, cybersecurity and valuations. GPs have done plenty to improve the rigour of their own disclosures, but now the OCIE is making sure their behaviour matches what their documents promise.

So managers would do well to prepare for that exam well before they're notified, with mock exams and day one presentations that set the right tone for the exam. The staff remain willing to recommend matters to the Division of Enforcement, which is a process that can take years, well after the current "friendlier" administration is out of office.

"The staff have been through a rapid-fire learning process over the last seven years and are a lot more sophisticated about private equity than they were immediately after the passage of Dodd-Frank," says Rob Kaplan of Debevoise & Plimpton.

That knowledge has led to a more efficient process. "The SEC is rarely on-site for more than five days, and three days isn't all that uncommon," says Joel Wattenbarger of Ropes & Gray. But that brevity shouldn't be mistaken for a lack of rigour.

"We are seeing extensive information requests, including full mailbox transfers of emails, resulting in more information being provided to examiners," says Leor Landa of Davis Polk & Wardwell.

This might come as a surprise to anyone expecting a lighter touch given the tone set by the current administration. "Don't believe what you read in the papers," says Norm Champ of Kirkland & Ellis. "This may be a deregulatory administration, but that doesn't mean the SEC exam programme is doing less." In fact, the number of exams has increased every year since they began.

That newly sophisticated OCIE remains sensitive to any behaviour that seems to favour the manager over the investor, and now they can recognise an outlier term or condition. "Some top-performing managers may be able to negotiate the right to put terms in the LPA that are particularly manager-friendly," says Kaplan. "But if, at their core, the SEC staff doesn't like the practices permitted by those terms, they will carefully scrutinise the implementation of those provisions to see if they can argue that the relevant disclosures are insufficient."

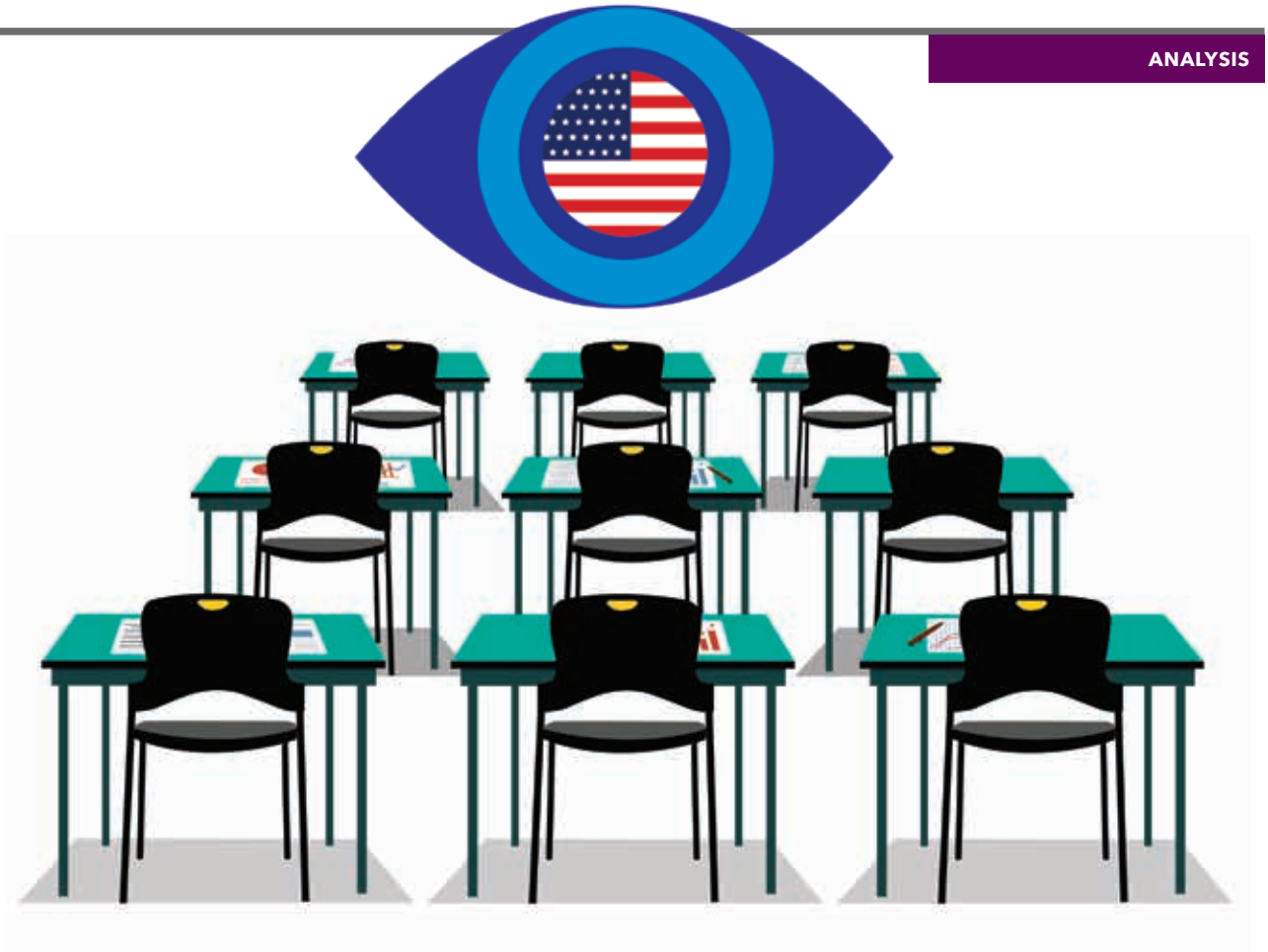
Several lawyers noted the pace of enforcement actions may be slower, and there may be less of a backlog of cases, but no one we spoke with expects regulators to hesitate to refer a case to the Division of Enforcement.

PERENNIAL THEMES

And the issues that might prompt such a referral are the perennial themes for the industry: fees and expenses. "Expenses are a natural area for conflicts to take place," says Champ. "And that covers a million topics, from private flights to operating partners." And lawyers stress the SEC remains focused on whether that fee was disclosed, and properly calculated and allocated.

By and large GPs have improved their disclosure around fees and expenses in response to the SEC's long and public focus on the topic, but staff still find GPs miscalculating fees and carry, lawyers say.

While this is not necessarily with ill-intent, firms do need to ensure their practices on this front are beyond reproach. "We're seeing the SEC frequently test that level of disclosure now," says Jason Brown of Ropes & Gray. Brown explains they are



spending a lot of time to ensure the actual practices match what's contained in bulked up limited partnership agreements.

And if the GP has a question about a particular fee, they should check to see where the LPA allows for that variance. "In terms of charging fees and expenses that are not expressly disclosed in the LPA, the question is whether the manager must seek an amendment of the LPA to charge the fee or expense in question," notes Tim Mungovan of the law firm Proskauer. "If so, the question is what's the level of approval required by the limited partners to amend the LPA? An amendment might require a high level of LP approval, sometimes as high as 90 percent."

Mungovan cautions GPs who might want to redefine a fee as a conflict of interest that could be approved by the LPAC, without an amendment. "I'd expect the SEC to cast a gimlet eye towards a fee approved by the LPAC that wasn't expressly provided in the LPA." Lawyers stress a conservative approach towards fees and expenses is still wise.

Allocations also remain a topic of interest. "It used to be that a firm would raise one fund, invest that, and raise another, but the market's evolved so that lots of firms are managing multiple funds all at once, which raised a question of how to allocate those investment opportunities," says Champ. As is the case with fees and expenses, allocation policies need to be clearly defined and disclosed, and ideally in such a way that doesn't favour the manager too much at the expense of the investor.

Valuations are still of interest, but not for the rationale that many private equity managers thought they were. "A lot of GPs might ask, 'Why do valuations matter so much when I don't get paid until I sell something?'" says Champ. "But now, when everyone is fundraising all the time and using performance based on those valuations to market funds, there is a SEC issue here."

So how do today's managers best prepare for the increasingly savvy examinations? First, the best time to begin is yesterday. Champ suggests a modest exercise that speaks to the heart of a more sophisticated review: "Select a few fee and expense records and vet them to see if they're allocated as they are documented. If GPs wait until the SEC's document request and find inconsistencies for the first time then it can prompt a deeper inquiry into expenses."

Whether it's a formal mock exam or not, lawyers suggest the prep work should include delegating who will gather information, and who will answer what kind of questions. This avoids the mistake of contradictory answers or having two people retrieve the same documents. The more organised and formal the response, the more credible the firm will seem to exam staff.

Given the current climate, there can be a temptation to assume the exam staff will give managers the benefit of the doubt, or in the wake of an exam, to assume that no news is good news. But that would be unwise.

"The administration may change in two years, but cases can take five years to mature into enforcement actions," says Kaplan. "I've seen exam referrals turn into enforcement investigations years after they were completed." So managers should understand that a more sophisticated staff may also be a more vigilant one. ■

BREXIT

The jury is out on jurisdictions

Luxembourg is winning favour as a fund jurisdiction, but the UK still holds plenty of attractions for investors, say Sam Kay and Emily Clark of Travers Smith

It is now over 1,000 days and counting since the United Kingdom voted to leave the European Union. At the time of writing, as we sail past the original 29 March exit date, there remains a lack of clarity over when, how and even if Brexit will be implemented. As the UK is the largest centre for asset management outside of the US, with the Investment Association calculating in its 2018 survey that UK-based firms manage 35 percent of assets under management in Europe, this situation creates challenges and confusion for those of us who operate in the European asset management industry.

Despite this backdrop of Brexit uncertainty for the funds industry, we have seen a strong market for European private capital fundraising over the last couple of years. Although the markets were a little more circumspect towards the end of 2018, the longer-term trend has been very positive and the signs are that 2019 will also be healthy for fundraising activity.

Applying the old maxim of "If it ain't broke, don't fix it", one may expect that asset managers are trying to make as few changes as possible when approaching their next fund. However, the evidence points to a clear shift in where funds are being structured and domiciled.

In 2015, nearly half of all European-focused private capital funds were structured in either the UK, Jersey or Guernsey; by 2018, recent data from Preqin shows that this has fallen to just under one-third, whereas Luxembourg had jumped to 28 percent to become the most favoured jurisdiction for setting up new funds.

***Kay**: expect further creative solutions*

The numbers are more marked when one drills down to analyse what UK-based fund managers have done. The same published data shows that in 2015 over three-quarters of funds for UK-based managers were domiciled in the UK or the Channel Islands (45 percent and 32 percent, respectively) and only 9 percent in Luxembourg. By 2018, the number of funds set up in the UK had dropped to 41 percent and in the Channel Islands had dropped more significantly to 21 percent, while Luxembourg had leap-frogged the Channel Islands with 23 percent of all funds established by UK-based managers domiciled there. Although it is easy to read too much into statistics, that looks like a meaningful change and coincides with the period of Brexit uncertainty.

It is possible to argue that there are other factors at play here. Running a close second to 'Brexit' in the buzzword bingo stakes is 'substance', driven by the implementation of the Organisation for Economic Co-operation and Development's drive against Base Erosion and Profit Shifting (or BEPS).

Many asset managers are looking at their fund domicile through the lens of building up substance for all the economic activity that may be undertaken in a particular jurisdiction. Also, the increase in the number of private debt funds should not be ignored; for various tax and regulatory reasons, Luxembourg and Ireland are often preferred jurisdictions to the UK or the Channel Islands for private debt fund structures. However, Brexit considerations are clearly a strong contributing factor to changes in fund domicile.

Given this backdrop, what are the current options and issues for a private fund manager when deciding where to locate its next fund?

OPTION 1 – THE UK

The traditional UK limited partnership is still an attractive structure for investors. It is familiar to investors, having the same legal form and the same heritage as the vehicle used in other jurisdictions (such as Delaware, the Cayman Islands and the Channel Islands); the limited partnership provides limited liability for investors; it is flexible, so the terms can be adapted to reflect the commercial requirements; and recent reforms in the UK have made helpful updates, for example the private fund limited partnership (or PFLP) regime sets out a 'white list' of activities that will not constitute limited partners taking part in management. The UK also benefits from a sophisticated and trusted regulatory regime.

With the limited partnership's transparency for taxation of income and gains, and the ability to prevent VAT arising on management fees (by structuring arrangements

so as to include the UK fund management vehicle in a VAT group with the fund itself, through its general partner), the overall message is that the UK is still very much a "good" place from a tax perspective in which to locate a fund.

However, increasing effort is now required to ensure tax efficiency. For example, the UK has sought to counter perceived tax avoidance by restricting the circumstances in which managers are able to treat their carried interest as a capital gain (and so subject to lower rates of tax than income profits). Although capital treatment should still be available to managers in a fund with a traditional carried interest structure, the rules are complicated to apply and require on-going monitoring of the fund's activities by the fund manager.

The current primary issue for the UK, though, is simply one of perception. Because of Brexit, do investors want exposure to UK structures? Do asset managers want to give the impression of having a more pan-European business? What do investment professionals think about living and working in the UK?

From a more technical perspective, Brexit is also creating uncertainty around how a private fund managed from or located in the UK may be marketed on a pan-European basis. Absent any other arrangement being put in place (and there were no indications in the Brexit Withdrawal Agreement or Political Declaration that any alternative arrangements would be countenanced), once the UK leaves the EU it will be treated as a 'third country' for marketing purposes under the AIFM Directive. Funds domiciled in the UK will, therefore, lose the ability to acquire pan-European marketing passports.

Although UK asset managers should be able to make use of national private placement regimes (NPPRs) in many investor jurisdictions and possibly transitional relief in others, in the event of a cliff-edge 'hard Brexit' there is the short-term risk of dislocation, which could lead to brief marketing blackouts. UK managers will also need to consider local licensing requirements in relation to business development and investor relations professionals on a fact-specific, case-by-case basis.

OPTION 2 – THE CHANNEL ISLANDS

Similar to the UK, the Channel Islands (Jersey and Guernsey) have attractive limited partnership vehicles available and a long history of structuring private funds. Further, for over five years the Channel Islands have been successfully navigating NPPR requirements when marketing funds across the EEA and all the required co-operation agreements are in place, so there will be no direct marketing impact as a result of Brexit. The islands also have a strong network of experienced service providers and other professionals who have a positive and collaborative relationship with their respective local regulators.

> ***"The evidence points to a clear shift in where funds are being structured and domiciled***

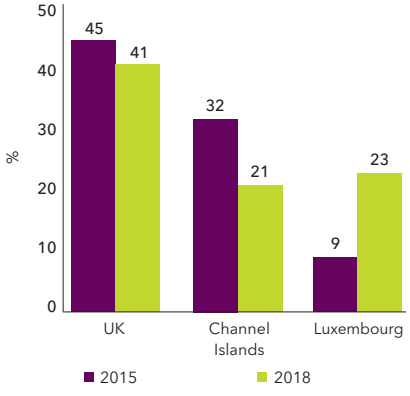
From a tax perspective, a Channel Islands limited partnership still offers tax efficiency, being transparent for the purposes of the taxation of income and gains and outside the scope of VAT. This latter point is still an advantage over the UK limited partnership, as it should allow a UK fund manager to recover the input VAT it pays on supplies it receives which are attributable to its own supply of fund management services to the fund (whereas the grouping route referred to above in the context of UK limited partnerships typically significantly limits input VAT recovery by UK fund managers).

All that being said, as an alternative to the UK, the attractiveness of the Channel Islands for many funds (and investors) is being challenged by the rise of Luxembourg. As well as a perception problem, there is also an indirect Brexit impact. Whereas previously a firm may have set up as an authorised and regulated investment adviser in the UK and then provided investment advice to a Jersey or Guernsey based GP, because of substance and other requirements that firm may now establish an investment management presence in Luxembourg or another European jurisdiction (such as Ireland) with the knock-on consequence that the domicile of the fund will follow where the investment manager has been located.

In addition, in recent times, as low tax jurisdictions, the Channel Islands have had a perception problem, with »

THE LURE OF LUXEMBOURG

Domicile choices of UK-based fund managers (2015 vs. 2018)



Source: Preqin

THE PROS AND CONS

Luxembourg

- ✓ Improved limited partnership structure
- ✓ New RAIFs are 'game-changer'
- ✓ Well-established as leading EU jurisdiction
- ✗ Additional substance requirements
- ✗ Signs of overheating as popularity grows

The Channel Islands

- ✓ Attractive LP vehicles available
- ✓ Long history of structuring private funds
- ✓ Outside the scope of VAT
- ✗ Tax avoidance perception problem
- ✗ EU investment management presence required

UK

- ✓ Familiar to investors
- ✓ Flexible terms
- ✓ Sophisticated legal and regulatory regime
- ✗ Short-term risk of dislocation
- ✗ Loss of EU marketing passports
- ✗ Increased tax efficiency effort required

"The uncertainty created by Brexit, particularly in the UK, has the potential to derail the positive fundraising environment that currently exists in Europe

» certain investors being concerned that investment in funds based there would be perceived as involving tax avoidance. In response, the Channel Islands will point to the increased "substance" requirements that they have recently introduced and the fact that, in March, they were removed from the EU's "grey list" (broadly, a list of jurisdictions which were required to make changes to their tax rules to avoid being blacklisted). However, the Netherlands' recent inclusion of them on its own blacklist must be set against that progress.

OPTION 3 – LUXEMBOURG

Luxembourg's development of its limited partnership structure in recent years, including the introduction of the common limited partnership (société en commandite simple, or SCS) and the special limited partnership (société en commandite spéciale, or SCSp), has given it an attractive model with similar benefits to a traditional Anglo-Saxon limited partnership: contractual flexibility, protecting the limited liability of investors, a quick establishment process, and, generally, transparency for the purposes of the taxation of income and gains.

However, the real game-changer for the private funds market was the introduction of the 'reserved alternative investment fund' or RAIF. Previously, the regulatory framework in Luxembourg tended to require the fund itself to be regulated (a process that was often more cumbersome, time-consuming and costly than options in other jurisdictions). But, with the introduction of the AIFM Directive, the RAIF was introduced, which allowed the Luxembourg regulator (the CSSF) to supervise the fund indirectly through the RAIF's alterative investment fund manager. As a model, this closely resembles the approach taken in the UK and the Channel Islands (and in other jurisdictions like the United States).

The RAIF still requires an 'alternative investment fund manager' and, to access all the marketing benefits under the AIFM Directive (eg, the pan-European marketing passport), this manager will need to be regulated by the CSSF. Building out a new regulated entity within a wider group structure is not something that a business will undertake lightly. It is also worth noting the circular issued by the CSSF in August 2018 sets out some detailed substance requirements for any Luxembourg-based alternative investment manager, including on governance, the responsibilities of senior management, delegation and staffing requirements. But there are two variations to be considered:

1. Rather than the asset management firm having its own regulated business, it may engage a third-party platform to act as the regulated AIFM for the fund. The asset manager (through the GP that it sets up) still has responsibility for and oversight over the management of the fund, but the third-party AIFM fulfils the regulatory functions required by the AFIM Directive. There are an increasing number of reputable AIFMs offering this service and it is becoming more accepted within the wider funds market.
2. The CSSF permits delegation of investment management/portfolio management and/or risk management activities to regulated businesses in other jurisdictions. It is, therefore, possible that the private fund may be domiciled in Luxembourg (eg, using its limited partnership structure) but the fund management is undertaken elsewhere. This could include a UK entity acting as the AIFM. Legislation submitted in Luxembourg earlier this year allows for UK AIFMs to continue to manage Luxembourg-domiciled

alternative investment funds for a maximum period of 21 months from the official date of a hard Brexit (only in relation to existing contractual relationships at the time of a hard Brexit). The uncertainty around what happens after this transitional period may prevent this being a long term solution.

In addition, Luxembourg is well established as a leading European jurisdiction in which to locate holding companies. A result of the BEPS project has been to place increasing emphasis on companies to show that they are carrying out genuine activities in a jurisdiction before claiming tax benefits that come from residence in that jurisdiction. This emphasis on "substance" in a jurisdiction is increasingly leading to fund management firms scaling up their presence there. A side effect of greater resource of being located in Luxembourg (to support the residency of holding (and other) companies located there) is that the fund managers are increasingly prepared to locate the fund itself in Luxembourg. However, a point to watch is that Luxembourg has recently implemented many of the requirements of the European anti-tax avoidance directive and will implement the remainder in due course. It is, as yet, unclear the extent to which this and recent case law developments from the Court of Justice of the European Union relating to substance will impact on Luxembourg's attractiveness.

Of course, in the event of a hard Brexit, the EU27 marketing passport will not facilitate marketing by a Luxembourg AIFM to UK institutional investors. So, a UK NPPR registration may be required. Also, the local licencing requirements for business development and investor relations professionals who are not physically based in Luxembourg or another EU27 country will also be relevant to this model on a fact-specific, case-by-case basis.

***Clark**: Ireland is one to watch*

Given the recent increase in the use of Luxembourg as a domicile for private fund strategies, there are some signs of overheating, such as increased costs, difficulties in securing suitable personnel to meet the substance requirements and processes taking longer to finalise. There have also been questions over whether all the same concepts apply in comparison to common law jurisdictions. But, given the flexibility with the structure and positive tax and regulatory framework, we would expect Luxembourg to continue to be attractive as a fund domicile for some time to come.

LEARNING TO ADJUST

The uncertainty created by Brexit, particularly in the UK, has the potential to derail the positive fundraising environment that currently exists in Europe. By the time this article is published, the UK may have crashed out of the EU, or the uncertainty may be prolonged for further weeks, months or years.

However, despite these challenges, the asset management industry is adjusting and one way it is doing so is by undertaking additional analysis on private fund structures and domiciles. As highlighted by the discussion above, this is making the art of fund structuring more complicated with a matrix of issues to be considered (for example different regulatory frameworks, tax considerations, past practice, future growth plans).

Clearly, Luxembourg is an attractive option for more and more asset managers. But, based on the statistics set out above, in 2018 over 60 percent of all UK-based managers made use of the UK or the Channel Islands for their fund domicile. Given the strength of the UK asset management industry, that is a significant proportion of the market.

It is also worth noting that, although the UK, the Channel Islands and Luxembourg are the most common options, they do not hold a monopoly on fund domiciles. Some European-focused funds, particularly for US managers, may be located in Delaware or the Cayman Islands, while other funds may be established in the same jurisdiction as the fund manager (e.g. a French FCPR or a Dutch CV). One to watch is Ireland, where a legislative process is currently looking at revamping their limited partnership structures. In due course, this may provide another attractive option for European fund managers. Given the sophistication of the industry, there are likely to be further creative solutions and adjustments in the years to come when considering fund structures. ■

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DATA SECURITY

7 crucial questions on California's privacy law

The California Consumer Privacy Act is coming, and the time for PE firms to take action is now, experts say. Brian Bonilla reports

The California Consumer Privacy Act comes into force on 1 January, 2020, with a one-year lookback provision, so it is essential private funds managers understand how it affects their data operations now. Here are seven key questions you need to be asking.

1 WHAT DOES THE LAW REQUIRE BUSINESSES TO DO?

The law requires companies to inform California residents which of their personal data the company collects or holds, the purpose for which it was collected, where the company got that information, how the information is being used, whether the information is being disclosed or sold and to whom the information is being disclosed or sold to.

Under the law, consumers have the right to request to opt out of a business selling their information, to access any personal information the business has stored and to request the deletion of any personal information the business has stored.

Businesses will also be obligated to provide an opt-out page or link on their websites' homepages that notifies consumers of their right to not have their personal data sold.

2 WHAT EXACTLY IS 'PERSONAL DATA'?

The average person may think of personal information as being just someone's name, email address and financial account number. In order to comply with the law, firms need to rethink what they see as personal information.

"You've got to get your head around the idea that IP addresses, device identifiers, inferences, smells, biometrics or really anything that could reasonably be seen as forming a trail of digital breadcrumbs back to the consumer or their household, are now all forms of personal data too," says Jeremy Feigelson, co-chair of Debevoise & Plimpton's cybersecurity and data privacy practice. "So, when you begin to think about designing your compliance programme, you've got to have a much more expansive view of what the programme has to tackle."

3 WILL PE FIRMS BE AFFECTED?

Yes, but as this law focuses on personal data, the biggest effect will be on portfolio companies, particularly if they operate in consumer-facing industries. GPs should pay close attention if they use a shared services model across their fund portfolio that centralises finance, accounting and other functions via a cloud-based system, says Karen Schuler, principal and data and information governance national leader at BDO. "In that case, the firm may have direct access to personally identifiable

***Be ready**: rules that start in California often spread*

4 IS THE CALIFORNIA CONSUMER PRIVACY ACT JUST A US VERSION OF THE EU'S GDPR?

While both regulate data privacy, the CCPA and GDPR have fundamental differences.

"The main difference is that the GDPR starts from the premise that data privacy is a fundamental human right and that every single time a company touches your data, every single touch has to be justified by some specific provision in the law," Feigelson says.

"CCPA doesn't go that far. It's much more about giving consumers improved disclosure of what kind of data is being collected and how it's being used, but it doesn't put that hurdle in front of companies of having to say, 'Mother, may I?' every time they touch your data."

The two laws also share differences on a micro level. One example being that with the CCPA, a business is required to comply if they have revenues over $25 million or data of 50,000 or more residents, households, or devices, or if 50 percent of your revenues are coming from selling personal information. In contrast, the GDPR applies to any company that's offering goods or services to EU residents, monitoring the behaviour of EU data subjects or is established in the EU.

The two laws also differ on fines. "The potential penalty for breaching GDPR is up to 4 percent of global revenues or €20 million, whichever is greater," Schuler says. "For the CCPA, it's $7,500 per violation plus the violating company will be subject to an injunction."

Another difference is in reporting personal data breaches. "GDPR requires a controller to notify supervisory authorities within 72 hours of becoming aware of a data breach of personal data," Schuler says. "Whereas California is saying without undue delay or as quickly as possible."

Lastly, GDPR requires the controller to respond to data subject requests within 30 days unless there is reason to extend the request by 60 days. This is unlike the CCPA where a company has 45 days to provide information to the consumer.

financial information of its portfolio companies' customers."

PE firms also directly collect and process personal information from their LPs, portfolio company executives, prospective targets and other external stakeholders, she adds. Individual employee data may also reside in HR and IT systems.

5 WHEN DOES IT COME INTO FORCE?

The law will come into effect on 1 January 2020. However, it's wise for firms to start preparing. Due to the CCPA's 12-month look-back requirement, consumers can ask companies for records of personal information collected in the 12 months before 1 January 2020, which makes it crucial for firms to start managing their data appropriately now.

The issue with this is that the law has a "crazy broad definition of personal information", says Feigelson. "Firms have to figure out what data they are holding and data they generate routinely that matches up with this definition.

"Figure out what kind of third-party transactions and relationships you've got that are going to constitute sales of that data under the crazy broad definition of sale. And then figure out from there what kind of changes you need to make to your policies, procedures, and your vendor agreements to get your house in order."

6 WHAT DOES IT MEAN FOR INVESTMENT DUE DILIGENCE?

The law increases the importance of due diligence for investments and for portfolio company M&A activity. Now firms not only have to worry about hackers getting into their network and affecting the value of the investment but also paying damage costs.

"California's new CCPA has a private right of action with an extremely high dollar statutory damages number per consumer, per incident, and the consequences of not doing adequate due diligence for your investment or M&A activity, from a cyber- and privacy-specific lens, are much greater," says Luke Dembosky, co-chair of Debevoise's cybersecurity and data privacy practice.

7 WILL OTHER STATES FOLLOW CALIFORNIA'S LEAD?

All three experts believe this California law will lead to other states adopting similar data privacy laws.

"California almost in and of itself makes it a 50-state rule, because California is so big and tends to set national standards just by making one-state standards," Feigelson says. "Sometimes, it's easier to just treat a California rule like a 50-state rule out of the box."

Leaders of the tech industry – Tim Cook, the CEO of Apple, and Satya Nadella, the CEO of Microsoft – have been outspoken about the need for data privacy regulation over the past year. With such big guns advocating for this it might be only a matter of time before the US adopts a GDPR-like countrywide law.

"Corporate America doesn't like regulation, but if it's going to be regulated, they want it to be uniform and a level playing field, and they want to be able to have one compliance programme and not 20. So GDPR very much looks like the wave of the future here in the US," Fiegelson says. ■

INVESTOR LITIGATION

When unicorns don't fly

In the wake of the Theranos scandal, some managers fret that when their own unicorns fail to meet expectations, investors may resort to litigation. It's unlikely, but that doesn't mean it's impossible, writes Rob Kotecki

Under examination: *Theranos has raised litigation concerns for unicorns*

There's an impulse to assume that Theranos, the failed billion-dollar blood-testing start-up, is an outlier: a rare undeniable fraud perpetrated by a telegenic, unscrupulous founder, enabled by a roster of star investors and public figures. But that discounts the chance that other companies may be generously calculating their sky-high valuations, or base their expectations on less than credible clinical trials. And when people lose a sufficient amount of money, there will be temptation to use the courts to recover some.

For the private funds industry, investors might not be so quick to sue if a unicorn underperforms. Current fund documentation does plenty to limit liabilities, and LPs are sophisticated investors well aware of the subjectivity of any valuation. Furthermore, they also have relationships with managers that go beyond a single company.

But that isn't to say that GPs have nothing to worry about in this post-Theranos world. The scale of monetary loss or valuation inflation can make these structural safeguards irrelevant. Egregious bad behaviour can still bring real consequences to managers.

"As a practical matter, I'd say the risk of a manager getting sued over an underperforming unicorn is relatively low," says Tim Mungovan of the law firm Proskauer. "But after Theranos, the risk isn't merely theoretical."

The odds of litigation rise sharply post-IPO, lawyers say. "It's safe to say investors don't appreciate being defrauded," says Joshua Korff of Kirkland & Ellis. "But a distinction needs to be drawn between pre-IPO unicorns and those companies that recently went public. A company is much less likely to face a lawsuit as a private company."

Korff cites numerous factors, including the fact that plaintiff lawyers find more opportunities with the higher number of securities laws governing public companies. "Private company investors tend to be more sophisticated by definition, and less prone to litigation," says Korff.

"There are also structural issues that make private fund investors less likely to sue, even if disputes arise from greater volatility around unicorn valuations," says Jim Windels of the law firm Davis Polk & Wardwell.

TRIGGER SHY

Lawyers stress that private fund LPs understand the subjectivity of any valuation. "Fund documentation has elaborate risk disclosures around valuations, and in general courts will uphold those disclosures," says Windels. But even if an LP was tempted to sue over one blown investment, there are other considerations. "The relationship between GPs and LPs often transcends a single investment; these same parties are often involved in multiple investments."

It should be noted that as soon as the portfolio company goes public, it's subject to a whole new set of securities laws; Korff suggests that lawsuits might still be rare against private fund managers, though. "People are so careful around IPOs, it's not easy to find a material misstatement," he says. "There are so many lawyers and bankers kicking the tires that disclosure for IPOs is as good as it gets."

This does not mean that GPs should feel that litigation is out of the question for companies with generous valuations and lousy results. "The magnitude of loss will play a factor, but lawsuits won't be filed simply because a manager valued a company at x rather than y in the absence of fraud," says Mungovan. "Instead, a lawsuit related to valuation will more likely be tied to a methodology or policy the manager promised to use, and didn't."

And perhaps the most likely situation for litigation is where that unicorn proves to be just a horse with a phony horn. Underperformance married with outright fraud will stay liable to legal remedy. "There will always be litigation in the event of fraud, or even in the event of an accusation of fraud," says Korff. "That's a safe bet." ■

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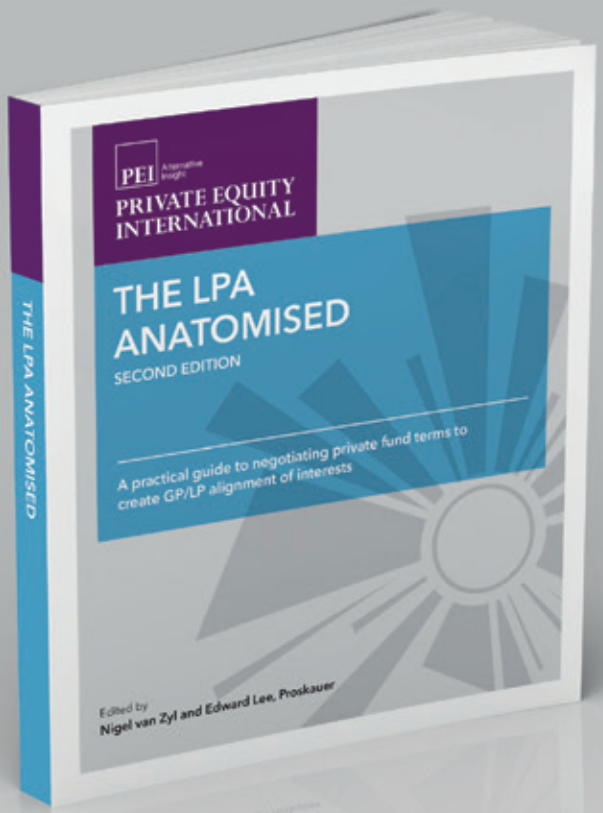

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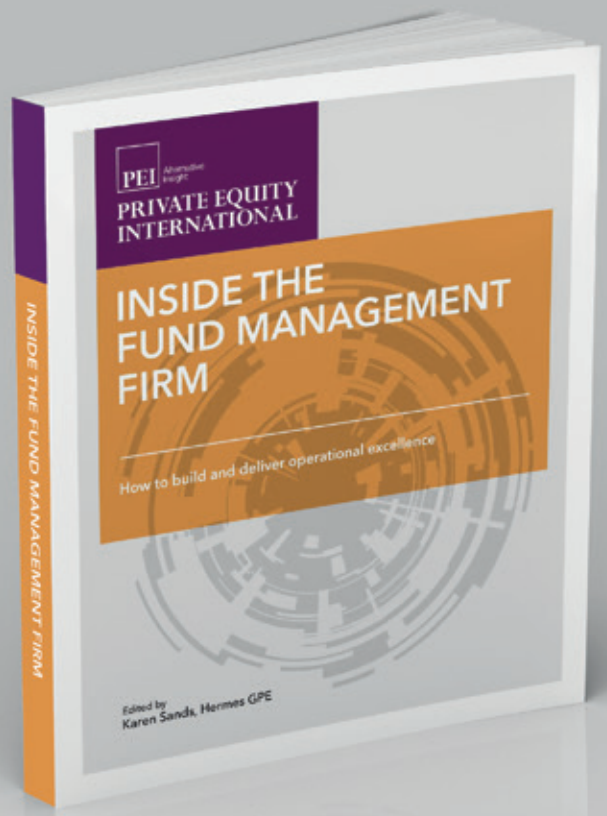

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