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

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Fund managers from emerging markets who have acquired solid private equity investment track records, through the management of proprietary capital or first-time funds with commitments primarily from regional investors, are increasingly seeking capital from international and, in particular, US investors in an effort to obtain desirable longer-term capital. However, attracting international investors requires different offering terms and raises new disclosure and legal issues. The key contrasts between marketing funds to regional investors and international investors are outlined below.

A. CHANGING TIMES… AND TERMS

Investors from more mature markets such as the US and Europe frequently seek investor-friendly fund terms and have increased leverage to obtain these terms, especially in the current difficult international fundraising environment. Notably, US investors are continuing to seek a traditional European style whole-of-fund distributions waterfall from their emerging market fund managers as opposed to a deal-by-deal waterfall. In addition, international investors, including the increasingly active sovereign wealth funds, typically expect: (1) appropriate alignment of interest between the asset manager and the investors; (2) termination and removal triggers; (3) investment and borrowing restrictions; (4) enhanced clawback protections; (5) comprehensive disclosure and reporting policies; and (6) the establishment of a limited partner advisory committee with formal procedures and a substantive role regarding the fund.

1. Alignment of Interest

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

(a) Distributions Waterfall and Management Fees. The traditional 2 & 20 fee structure (i.e., a 2 percent management fee and 20 percent carried interest) remains prominent, particularly with small-to-mid-size emerging market funds. However, international investors typically expect emerging market funds to return all capital contributions plus the preferred return to the investors before any carried interest is paid to the fund manager.

(b) Skin in the Game. The fund manager should have a substantial equity interest in the fund and acquire a high percentage of this interest through cash capital contributions (as opposed to deemed contributions made in exchange for a waiver of management fees). An equity interest of 1 percent of total commitments was previously viewed to be sufficient “skin in the game;” however, international investors are increasingly asking emerging market fund managers to invest at least 2 to 5 percent of total commitments.

(c) Deal Team’s Share of Fees and Carried Interest. International investors generally expect a predominant share of the fees and carried interest generated by the fund to be paid to the investment professionals of the fund manager who are specifically responsible for managing the fund. However, concessions are made on this requirement in emerging markets where more funds tend to be institutionally sponsored.

(d) Transaction Fees. At least 80 percent of any transaction fees received by the fund manager or its affiliates from the fund or its portfolio companies should be paid to investors, usually by way of an offset against the management fees. International investors are increasingly requesting a 100 percent offset from their fund managers.

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

2. Termination and Removal Triggers

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

(a) No-fault termination of the commitment period. Fund managers should expect international investors to seek the right to terminate the commitment period without cause, typically with a voting threshold of 75 percent. Fund managers should seek to ensure that the right is only exercisable after a sufficient period of time following the initial closing (typically two or three years).

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

(c) Cause removal of the fund manager / general partner. For-cause removal of the fund manager and/or general partner is usually limited to instances of serious misconduct, such as gross negligence, willful misconduct or fraud, although some international investors will seek a lower standard. A fund manager should be prepared to accept a "for cause" removal provision in the event of serious misconduct and should offer this type of provision at the outset.

(d) No-fault divorce or termination of the fund. Many emerging market fund managers have in the past resisted giving investors the authority to remove the fund manager or general partner of a fund without cause. However, international investors in emerging markets funds now expect the right to dissolve the fund or remove the general partner without cause with a super-majority vote of the investors (generally at least 75 percent). A fund manager should be prepared to accept a "no-fault divorce" provision but should ensure that the right can only be exercised after a sufficient period of time following the initial closing (typically two or three years) and should request compensation, typically in an amount equivalent to 12 months' management fees.

3. Investment and Borrowing Restrictions

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

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

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

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

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

4. Clawbacks

Private equity funds typically provide for the "clawback" of carried interest distributions that require the fund manager to return any profits that exceed its agreed-upon profit split (e.g., 20 percent) at the end of the life of the fund and also increasingly at interim stages during the fund's term. International investors expect fund managers to collateralise the clawback obligation(s) either in the form of a clawback guarantee from the sponsor firm or by providing for a significant portion of the carried interest distributions (typically 25 percent or more for a fund with a whole-of-fund waterfall) to be held in an escrow account until the end of the fund's term.

5. Disclosure and Reporting

Offering materials for an emerging market fund should include comprehensive disclosure regarding the fund manager and its background. International investors also require periodic financial and other disclosure during the life of the fund. The types of disclosure fall into the following categories:

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

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

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

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

6. Limited Partner Advisory Committee

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

B. LEGAL AND REGULATORY CONSIDERATIONS

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

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

1. Exemptions from registration / authorization

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

(b) US Investment Adviser Registration. As a result of the Dodd-Frank legislation recently enacted in the United States, many investment advisers (including some non-US investment advisers) previously exempt from registration with the SEC will be required to register no later than March 30, 2012. As a consequence of registration, these advisers will become subject to the substantive provisions of the US Investment Advisers Act and will be required to adopt compliance policies and undergo SEC examinations. Non-US advisers with activities in the United States or more than $25 million of assets under management attributable to clients in the United States should consult with counsel to determine whether SEC registration is required. Even if registration is not required, non-US advisers may be subject to SEC recordkeeping, exam and reporting obligations.

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

2. The EU AIFM Directive

After a protracted period of negotiation, the EU Directive on Alternative Investment Fund Managers (the "Directive") was finally approved by the European Parliament on 11 November 2010 and came into force on 21 July 2011, triggering the start of a two-year implementation period for each Member State to transpose the Directive into its national law by 21 July 2013. The Directive seeks to introduce a harmonized regulatory and supervisory framework across the EU for alternative investment fund managers (AIFMs) and will have a significant impact on the operation and marketing of funds in the EU. The regulatory effect of the Directive on non-EU AIFMs (such as emerging market fund managers) will differ depending on whether the emerging market fund is domiciled in an EU Member State (such as the UK or Luxembourg) or outside the EU (e.g., in the Cayman Islands, Jersey or Guernsey).

If the fund is domiciled outside the EU, the Directive provides that the non-EU AIFM will be able to market the fund to professional investors in EU Member States until mid-2018 by using the existing national private placement rules of the relevant Member State provided that: (i) it complies with the disclosure and transparency provisions of the Directive (but not the rest of the Directive), as well as any additional local requirements in that Member State, (ii) cooperation arrangements are in place between the regulator in the relevant Member State and the regulator in the country where the fund is domiciled, and (iii) the countries where the fund and the fund manager are domiciled must not be listed as a "non-cooperative country" by the Financial Action Task Force (FATF).

The Directive also contemplates the introduction of an EU passporting regime from 2015 pursuant to which non-EU AIFMs may seek authorization under the Directive to market non-EU funds under the cover of an EU passport. However, given the onerous compliance obligations associated with obtaining authorization under the Directive and the fact that private funds have historically been marketed by way of private placement both within and outside the EU, it is expected that most non-EU AIFMs will continue to rely on the existing EU private placement regime for marketing of their funds in the EU until mid-2018 when the private placement regime in the Directive is subject to review.

If the emerging market fund is domiciled in an EU Member State, the Directive provides that the non-EU AIFM may manage the EU fund until 22 July 2015 pursuant to the existing national authorization regime of the EU Member State and market to professional investors in EU Member States by using the existing national private placement rules of the relevant Member State. After 22 July 2015, a non-EU AIFM will only be authorized to manage the EU fund if it complies with the onerous requirements under the Directive relating to transparency and disclosure, limitations on leverage, employee compensation and other operational matters.

Emerging market fund managers seeking to raise capital in the EU should therefore give appropriate consideration to the Directive and the place of domicile for their fund and should be preparing for any operational adjustments that are necessary to address the new regulatory landscape.

3. Inaccurate or incomplete disclosure

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

C. CONCLUSIONS

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

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