PEI Alternative Insight

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private funds management

Issue 154 · September 2017 · www.privatefundsmanagement.net

FINANCE · LEGAL · COMPLIANCE · OPERATIONS · TAX

RACING AHEAD

REGULATORS PUSH ON WITH POLICY CHANGES

BATTLE STATIONS

HOW TO RESPOND TO A CYBER-ATTACK

LOCKED IN

THE IMPORTANCE OF KEY-MAN CLAUSES

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SAGE ADVICE
The LP association voices its opinion on credit lines

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Coming into focus

The UK summer has been uncharacteristically hot and sunny, so it is ironic that I'm opening this edition with the British phrase "it never rains, but it pours." While the seasonal slowdown has become something of a myth, sources from across the industry agreed that the past few months have been particularly busy compared with last year.

A couple of CFOs put it down to where we are in the market cycle and the desire to make hay while the sun shines, while service providers said they were being kept busy as their clients ramped up their fundraising and dealmaking activities.

While it's uncertain for how long the good times will keep rolling – whispers about an impending downturn are getting louder on both sides of the Atlantic – the one thing that is becoming clear is the future vision of financial regulators.

In the US, Jay Clayton's influence over the Securities and Exchange Commission is gradually beginning to show. His first big policy measure – extending the act which allows firms to register privately for initial public offerings – is one that supports capital formation as opposed to enforcement action (p. 12). The re-emergence of Hester Peirce as a candidate to fill one of the empty commissioner spots is also telling; the Republican's previous nomination during the Obama administration was blocked because of her staunch anti-Dodd-Frank Act stance.

In the UK with Brexit looming, and with it the increased likelihood of Britain becoming a 'third country' and requiring a passport, the Financial Conduct Authority has taken steps to protect its reputation as a gold standard regulator. Not only is it the only EU watchdog to extend the second Markets in Financial Instruments Directive to private fund managers (p. 11), it is also imposing a strict investor reporting regime on alternative asset firms (p. 9). Plans are also in the pipeline to roll out the Senior Managers Regime, which currently applies to banks and is similar to the US compliance rule, to all FCA-regulated managers including private equity firms.

Beyond regulation, we delve into the fund administration world. As businesses continue to merge, acquire or be acquired we look at what is driving consolidation in the market, and find out if there's still a space for the boutique operator (p. 14). Malcolm Pobjoy of Vistra spoke to us about the institutionalization of the asset class – and how fund managers are adapting (p. 28), while Tom Angell of WithumSmith+Brown discusses the double-edged sword of new reporting requirements for fund managers on (p. 36). Peter Cogan of EisnerAmper tells us about the increased complexity of private funds accounting (p. 32).

In our accounting special we also look at changes to partnership auditing rules (p. 24) and how firms should tackle unicorn valuations (p. 30). We also caught up with a lawyer with a sideline in wine, and cover changes to UK tax laws that could have implications for fund managers.

Enjoy the edition

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features

special report: accounting

expert commentary

commentary

also in this issue

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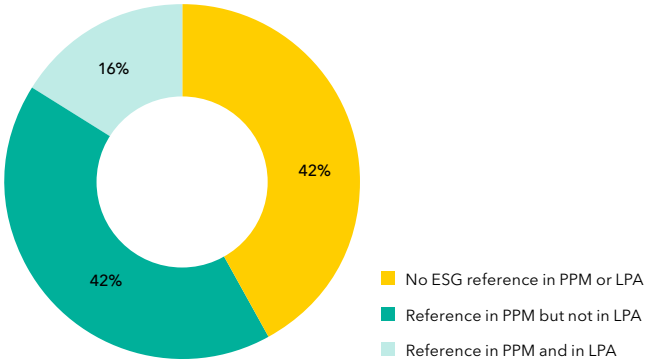
The news in numbers

The figures that matter to private funds managers this month

Silence of the PPMs

Almost half of managers with less than $1bn in assets have an ESG policy



Source: MJ Hudson

Inside the LP mind

American Investment Council members can access an exclusive feature of CEPRES's due diligence and portfolio analysis platform

3,355

Number of funds across which commitment decisions have been processed

$11trn

Value of transactions

SEC unveils 2018 budget request

The commission anticipates the number of investment advisor exams could rise 5% percent next year

20%

Expected increase in advisor exams in 2017

5%

Further increase in advisor exams in 2018

$1.6bn

Requested budget for 2018 fiscal year

100

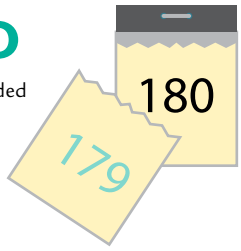
Staff reassigned to the examinations unit in 2016

Check the credit lines, ILPA tells LPs

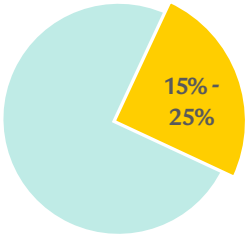
Quarterly reports to investors must be explicit on the use of subscription credit lines, says lobby group

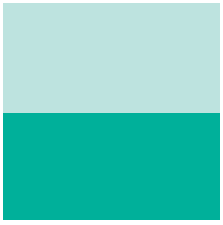
180

Recommended maximum number of days it should be outstanding



Recommended maximum value of credit as a percentage of capital called





100%

Increase in average length of a credit line

Garage sale: a bone of contention

RE firm fined over conflicts

Paramount Group paid a $250,000 fine to the Securities and Exchange Commission over claims it failed to reimburse costs to one of its funds following an asset sale to another of its funds.

Fund III sold a parking garage to the Residential Development Fund on the understanding it would be reimbursed for the money already spent on the asset. But after independent valuations pegged its value at over $64 million, the advisor decided RDF would not reimburse Fund III.

The SEC said the decision was not disclosed to Fund III stakeholders, adding the advisor had fiduciary duties to both funds, but its owning a larger stake in RDF created a conflict of interest.

Paramount agreed to the settlement without confirming or denying the charges.

UK tax proposal may hit PE

Tax on transfers of partnerships, restructurings and general reorganization of UK funds would increase under proposals from the independent UK government advisor, the Office of Tax Simplification.

The OTS said the extent to which stamp duty is payable on instruments transferring partnership interests should be considered, as should making stamp duty an assessable tax, which could increase the amount of tax collected in relation to partnership interests.

Current loopholes mean stamp duty can often be avoided when partnership changes are made, but under the advisor's recommendations, that the tax be digitized and combined with stamp duty reserve tax, it could become compulsory.

London: awaiting new tax law

Commission: downing barriers

EC eyes rules overhaul

The European Commission may change private funds marketing rules, administration requirements and regulatory fees.

Changes under consideration include harmonizing national marketing requirements, practices and what constitutes marketing; creating a central repository for information on regulatory fees; and linking the size of fees to the amount of supervisory work. The commission also intends to clarify the application of marketing rules for online distribution. For notifications, it is considering a central hub, as well as simplifying the update notification process and amending the criteria for when an updating notification is required.

The move follows a consultation which found variations between member states caused barriers to cross-border alternative investment fund distribution.

ALSO IN THE HEADLINES

The private equity real estate industry has taken its first steps towards standardized reporting with the publication of a digital dictionary. **The Global Definitions Database includes a common glossary** of non-listed real estate terms, both global and region-specific.

American Investment Council members are now able to analyze how an investor would see their track record **after a deal with due diligence platform operator CEPRES.** The operator has put together a best practice series of due diligence analyses, comprising the ones most commonly run by LPs on its PE Analyzer when decide on a buyout commitment.

Private equity funds with foreign investors are **no longer required to notify the Australian government** of each individual acquisition they make. Instead funds can apply for an exemption certificate in which the Treasurer can grant pre-approval for multiple purchases in one application. Funds will be subject to a series of legal tests, including a national interest test on the investor, the target business and relevant industry.

Private fund managers should ensure **an administrator's termination policy is clear** and comprehensive before its appointment, according to the Alternative

UK PE under threat of new rules

Private equity firms in the UK may be subject to senior management conduct rules starting next year, if the regulator extends a code of conduct to all FCA-supervised firms.

The Senior Managers & Certification Regime applies to senior managers of financial services firms and aims to strengthen investor protection and market integrity by "making individuals more accountable for their conduct and competence."

Senior managers would have to be certified annually for their "fitness, skill and propriety" for their positions.

In a note to its members, the British Private Equity and Venture Capital Association said the plans would need to be proportionate.

Bailey: FCA chair

Fees: still piling on

Strong demand keeps fees high

Increased LP appetite for private equity and infrastructure following the financial crisis has kept GP fees at a high level and investors at a pricing power disadvantage, research shows.

"If we don't like the fee, the next person in line will pay it," one US pension fund official said.

A study by financial services firm bfinance found fees have remained "intransigent" due to a limited number of institutional-quality deals.

Some GPs are flexible, reducing transaction and monitoring expenses in their fees – a nod to such inclusions no longer being standard practice, the report said.

Nick van Winsen, head of fiduciary management at Dutch pension fund SPF Beheer said, "I would even say we've seen some deterioration in terms, such as lower hurdle rates or no hurdle rates."

PE revamped in Ireland

A proposed change to Irish law would make it easier for private equity fund managers to establish operations there.

The Investment Limited Partnership (Amendment Bill) 2017 would allow for aspects such as carried interest and complex fund accounting, which are not directly available in the existing structure.

"The main challenges of the current private equity set-up is that they are usually corporate structures," one lawyer said. "There are lots of aspects of a partnership that don't fit into a corporate structure. Given a choice of Luxembourg or Ireland, a manager new to Europe will choose Luxembourg, as they've got the established partnership vehicle available. This [...] is the first step in making Ireland a natural home for private equity funds."

Ireland: natural home for private equity?

Investment Management Association. The industry body said a service provider should demonstrate it will collaborate with the manager to ensure all legal agreements are terminated, and the relevant regulatory bodies are informed of the end of the agreement.

Uptake of **the Institutional Limited Partners Association's fee-reporting template** among GPs will rise as more tech solutions to facilitate its use become available, the association told *pfm.* The ILPA said it was working on its implementation with GPs that have not yet adopted the template and will continue to meet with those that "have an interest but are lacking resources to make a switch."

The Office of the Comptroller of the Currency, which oversees US national banks, will **consult banks affected by the Volcker rule** limiting a bank's private equity investments to 3 percent of Tier 1 capital. It could be the first step in dismantling the regulation.

Securities and Exchange Commissioner **Michael Piwowar has criticized the Fiduciary Rule** implemented by the Department of Labor, calling on it to "reconsider this misguided rulemaking."

Do you have a news tip?
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ALTERNATIVE INVESTMENTS

Investcorp, a global alternative investment firm, has appointed **Mohamed El-Erian** to its advisory board. The ex-PIMCO chief executive and co-chief investment officer was chief economic advisor at Allianz and chairman of its international advisory board.

Palamon Capital Partners, a European private equity firm, has made two appointments to its board of advisors: **Oliver Hemsley,** the founder and former chief executive of Numis Securities, a London-listed small and mid-cap capital markets specialist; and **Josayne Gold,** a former fund formations partner at law firm King & Wood Mallesons.

Highlander Partners, a US mid-market private equity firm, has promoted **Ben Slater** to vice-president of its private equity team. Slater joined the firm as investment and operations lead. He is also responsible for the firm's expansion into Europe. Before joining Highlander, he was a senior analyst at Tipp Hill Capital Management, a US hedge fund. He also spent three years at Carlyle subsidiary AlpInvest as an associate.

Xavier Gutierrez has been appointed as managing director for operations, client services and strategy by US private equity firm Clearlake Capital. He joins from Meruelo Investment Partners, an investment firm, where he was president and chief investment officer. He previously sat on the advisory committee on small and emerging companies at the Securities and Exchange Commission.

SERVICE PROVIDERS

The International Private Equity and Venture Capital Valuation Board has appointed six new members.

Paul Cunningham of Helios Investment Partners becomes EMPEA representative and chairman, while **Karla Bullard** of Madison Dearborn Partners is the new American Investment Council representative. 3i's **Neil Harding** will represent Invest Europe. **Michael Weaver**, who works for Sunsuper, is the Australian Private Equity and Venture Capital Association representative.

Daniel Gregor of Allianz Capital Partners and **Karin Lagerlund** of HarbourVest Partners are also joining.

Christian Mouillon has joined corporate finance and valuations firm Duff & Phelps as its global senior advisor. He comes from professional services firm EY, where he was global vice-chairman.

Chuck Lowrey has re-joined Alvarez & Marsal as a managing director of its private equity performance improvement practice, which he helped co-found in 2009. He will focus on expanding the firm's private equity energy investor clientele. He joins from BearingPoint, a business consultancy firm.

LAW FIRMS

US firm McGuire Woods appointed **Jeremy Davis** as a corporate partner. He specializes in cross border M&A and joins from the London office of K&L Gates. The firm also brought on **Lorraine Vaz,** a leveraged finance lawyer, as partner in its London office. She advises private equity firms, as well as debt funds and banks on fund finance and restructurings. She joins from King & Wood Mallesons, where she was a partner.

Winston & Strawn has added nine new partners in its New York office, specializing in mergers and acquisitions, capital markets, financings, private equity and fund formation, joint ventures, corporate reorganizations, and international arbitration and litigation. All the partners previously worked together as the Latin America practice from Chadbourne & Parke in New York. The team is led by corporate lawyers **Talbert Navia** and **Allen Miller**.

Alpa Patel, former chief of the division of investment management at the Securities and Exchange Commission, has been appointed partner at Kirkland & Ellis, a global law firm. She joins the investment funds practice in the Washington DC office.

IRR calculations remain under SEC spotlight

Fund managers must be explicit in disclosing their calculation methodology to investors, or face the wrath of the regulator, writes *Vivek Pingili,* vice-president of compliance at Cordium

Many private equity firms have yet again started to review their IRR calculations and disclosures since it emerged the Securities and Exchange Commission had subpoenaed Apollo Global Management for additional information on its calculation methodology in December.

While IRRs have long been used by investors to measure a private equity firm's performance and draw comparisons between firms, to date there has not been a standard industry-wide calculation and reporting methodology. The inclusion or exclusion from fund IRR calculations of the following can have a material impact:

1. Reinvestment of capital (ie, recycling of distributable proceeds)
2. Capital sourced from subscription lines of credit or other lending facilities to make long-term
3. The performance of capital accounts of the fund sponsor and/or its affiliates.

Insufficient disclosure could implicate the broad anti-fraud provisions of the Investment Advisers Act, under which investment advisors have a fiduciary duty to avoid misleading their investors. Violations can trigger enforcement action, as has been demonstrated by various SEC actions against private equity firms over recent years.

Subscription credit lines

Historically, private equity firms have used subscription lines of credit as bridge loans to quickly close time-sensitive deals without having to wait to receive capital called from investors. Such loans have traditionally been repaid within a few weeks upon receipt of investor commitments. Several reports indicate a recent uptick in the use of subscription lines for longer-term borrowing early in a fund's lifecycle to make acquisitions.

Pingili: review and enhance disclosures

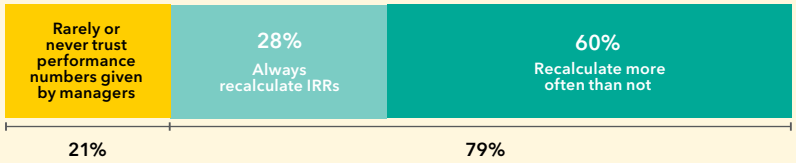
Longer-term borrowing creates potential for a firm to boost its reported IRR early in a fund's life and receive carried interest before the firm would otherwise have been entitled to do so. Regulators and certain investors are concerned that this could impede the ability of investors to meaningfully compare the performance of fund managers who use subscription lines with those who do not. The impact of this practice on a private equity fund's IRR calculations should be adequately disclosed to current and prospective investors.

The SEC has started scrutinizing these practices during its examination of private equity firms. To date, it has focused on whether a firm has adequately disclosed the impact of subscription credit lines on a fund's reported IRR, the other risks and/or conflicts of interest associated with such practices, and the accompanying costs.

As with any other practice that impacts a fund's reported IRR, private equity firms should carefully review and, where necessary, enhance the disclosures they provide to current and/or prospective investors relating to the use of subscription lines to ensure that the impact of such subscription lines on fund performance reporting and related risks and conflicts are adequately disclosed. ■

Checking the numbers

Investors on IRRs



Source: eVestment

Clause for thought

Do key-person provisions achieve what they are supposed to?

by TOBY MITCHENALL

Private equity is a people business. As such, key-man clauses are among the most important sections in a limited partnership agreement.

"For the LP clients that we represent, it is near the top of their diligence and terms lists for funds that they are considering investing with," says Heather Stone, a funds lawyer at Locke Lord in Boston. "It is the starting point for the LP's diligence on team, incentives, track record and succession planning."

The clauses identify a person or group of people who, were a prescribed number of them to leave, trigger a suspension of the investment period and allow the limited partners to decide whether the fund should have a future.

With Vista Equity Partners' recent $10.5 billion fund, for example, an event is triggered if either of the co-founders, Robert Smith and Brian Sheth, "cease to devote substantially all their time" to the business, or if a proportion of nine top execs were to do the same, according to documents prepared by StepStone for a client.

Protective embrace

So it is a perfectly sensible investor protection, right? Not everyone thinks so. To an outsider, they can seem unnecessary or even counterproductive.

Sister publication *Private Equity International* recently interviewed chairman Carlo Pesenti and chief executive Mario Fera from Italy's largest domestic private equity firm Clessidra.

Both arrived from outside private equity, having been part of Italmobiliare, the investment holding company that bought Clessidra following the death of the firm's founder Claudio Sposito.

Both criticised key-man provisions. Sposito's death had led to nine months of uncertainty. "That would have almost certainly destroyed most firms of that size," says Fera.

Pesenti argued a credible succession plan should make the provisions unnecessary.

Someone with direct experience of the key-man clause is UK investor Jon Moulton, who trigged one when he left the firm he founded – Alchemy Partners – in 2009. These provisions are "mostly stupid," he says.

"If the key man takes to the bottle or the secretaries, or gets a criminal investigation, or simply stops trying, the key-man clause becomes a major obstacle to sorting things out."

In the case of Clessidra, the story had a happy ending: the firm is today investing its €607 million third fund. Alchemy Partners is also still investing.

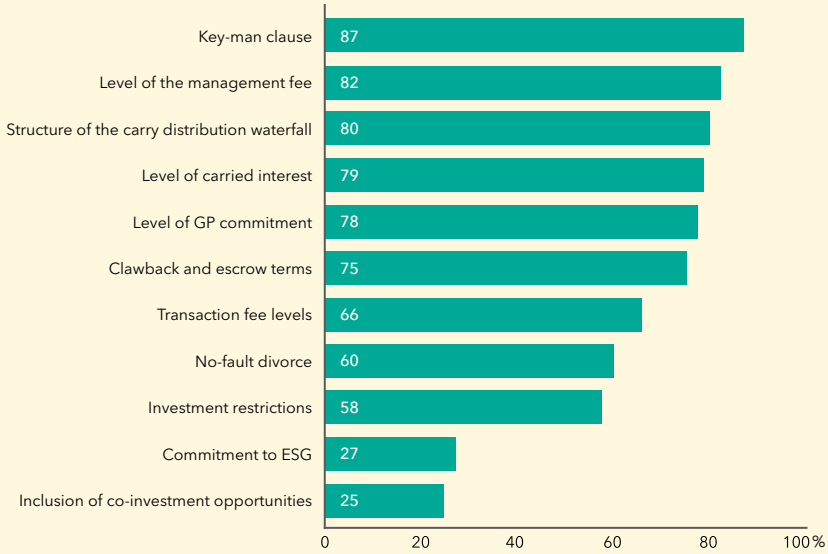
So is are the provisions unnecessary? No, but they do need to be thought through before fundraising begins and "before third parties – ie, LPs – become involved in the conversation," says Stone.

Some clauses are better drafted than others. "There are as many key-men clauses structured with nuances as there are GPs with nuanced investment strategies," says Klaus Bjorn Ruhne, a partner at ATP Private Equity Partners, which invests on behalf of a $113 billion Danish pension fund.

The jury may be out on key-person clauses – investors have differing and strong views – but they are here to stay. In the words of one LP, "It's definitely a case of better to have one and not need it versus the other way around." ■

Must-haves

The clauses investors insist on in limited partnership agreements



Source: Private Equity International

Con-templating the future

The Financial Conduct Authority will insist UK private equity firms use a standardized reporting template, but it's crucial they learn from their US counterparts

by CLAIRE WILSON

Private equity firms in the UK were dealt a blow when the country's regulator said they would have to use a standardized template to report their fees and charges to investors like other asset managers. That template, however, is not yet in place; a working group appointed by the Financial Conduct Authority will be responsible for drafting it and industry bodies including the British Venture Capital Association are expected to be involved.

The reform is part of a transparency drive triggered by the FCA's two-year review of the asset management industry. Alternative assets were initially excluded from its scope, but retail managers complained the sector was "particularly opaque."

FCA: wants to make private equity transparent

One size fits all?

In essence, a version of the Institutional Limited Partner Association's template on fees and expenses will be made compulsory. It makes sense on paper; a template allows general partners grappling with reporting requirements to plug numbers into specified categories and produces an investor report that presents an extensive range of data in a known format.

> "It's important to strike the right balance between complexity and transparency"

But ILPA's template, issued in 2016, has gained limited traction. Just 12 percent of delegates polled at this year's *Private Equity International* CFOs & CCOs forum said they had adopted it, with more than one-third saying they have no plans to do so. Others are using aspects of the template, but adapting it to their own specifications.

Uptake has been limited by a number of factors. For smaller firms, implementing the template is just too big a task. Other fund managers say investor demand for data is so individual it is difficult to standardize. Some investors even require more data than the template, and in their own formats.

As one lawyer pointed out, it's important to strike the right balance between complexity and transparency when it comes to reporting; a GP shouldn't have to spend time preparing reams of data for an LP that neither understands or requires it.

But GPs do believe the template has at least provided a benchmark for transparency, and this is at the heart of what the FCA is trying to achieve with its new regulation.

UK firms should learn from the experience of their US peers, and use this knowledge to their advantage. They may not be able to escape this regulatory requirement, but they will have a chance to shape its outcome. That is not an opportunity they should pass up. ■

No traction

Proportion of GPs who have adopted the ILPA template

What to do when the worst happens: cyber-attack

Two recent security breaches mean it's time to examine how private fund firms should act if they become victims

by CLAIRE WILSON

Two private equity service providers had to put their cybercrime response plans into practice in June when they were affected by a global malware attack. Systems at fund administrator TMF and law firm DLA Piper were infected by a virus that spread to 64 countries.

While prevention is of course better than cure, no cybersecurity program is 100 percent impenetrable. So what should you do if the worst happens and your firm is the victim of a cyber-attack? *pfm* asked legal and technology sources to find out.

Mobilize the incident response plan

The importance of keeping the incident response team and plan up to date is evident as soon as they are triggered. Private fund firms should ensure the team includes a cross-section of employees so that breaches across the business can be responded to effectively. It should also include staff from the organization's legal team and possibly external counsel.

Secure systems and ensure continuity

Securing systems will ensure that the breach is contained. The organization may have to isolate or suspend a compromised section of its network temporarily, or shut down the entire network.

Conduct an investigation

The firm should nominate someone to head an investigation and ensure they have the right resources. All steps taken during the investigation must be documented as they may be required by regulations, law firm Herbert Smith Freehills says.

Manage public relations

Poor communication following an attack can have worse consequences than the attack itself, according to Deloitte. Management's response can contain or escalate an incident.

Address laws and regulations

Compliance teams should be aware of their obligations and the time frame in which they are required to report a breach. They may also be required to notify individuals whose data have been compromised.

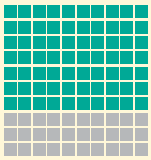
Response plans should be constantly evolving, but the more comprehensive and tested a plan, the better the management of an incident will be. While the advice doesn't need to be followed to a T, a firm should bear the response guidance in mind if – or when – they fall victim to a cyber-attack. ■

Turn to p. 24 for more on cybersecurity

Survey says

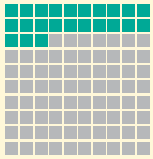
Sister title *Private Equity International* and eSentire asked 100 private equity firms about their readiness

70%



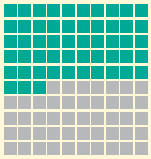
Believe cybersecurity is a high risk to their business operations

23%



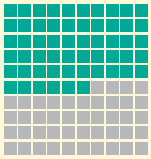
Have a fully operational and compliance cybersecurity program

53%



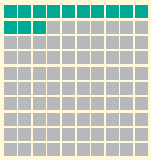
Have been a victim of cyber-attack

56%



Do not have a security policy for outside devices

13%



Have suffered a hacking breach

Source: *PEI*/eSentire

Standing out: the FCA may be the outlier on regulation, but others will catch up

First among equals

The pain UK-domiciled fund managers are feeling from the Financial Conduct Authority will be worth it in the long run

by CLAIRE WILSON

Any hope private fund managers may have harbored of a post-Brexit regulatory bonfire has been extinguished by the Financial Conduct Authority, which has continued its crackdown on the alternative assets industry.

Unlike its European peers, the UK regulator has extended some requirements of the second Markets in Financial Instruments Directive to alternative investment funds. In June it also unveiled new investor reporting obligations applicable to all asset managers, including private fund houses, to improve transparency.

There has been criticism from the industry that the extra requirements go too far, according to regulatory lawyers. But they argue that from the FCA's point of view, there is no reason to treat private fund firms differently from their retail counterparts, as they manage investors' money.

Concerns fund managers have that the FCA's rules will create regulatory arbitrage have also been quashed. What is written into one directive often makes it into the next, and so the consensus among regulatory lawyers is that the agency is pre-empting MiFID II principles being incorporated into the next incarnation of the Alternative Investment Managers Directive. Any perceived competitive disadvantage is therefore only likely to exist for a short period of time.

As for the timing of the new regulatory requirements, which will come into force as firms assess their future in the UK ahead of Brexit, legal sources say there is no "good time" to roll out new regulation. If regulation is required, as one lawyer said, it's required. Timing should not be a factor in its implementation. The new rules are not so onerous that they will impact a firm's decision to leave the UK, which will be squarely based on access to European investors.

What the new rules do is illustrate the UK's position as a leading alternative assets market, and show that once again the FCA is leading the charge on implementing measures that are likely, in time, to be applicable to firms across Europe.

London's heritage is as an international financial services hub, and years of regulation, tradition and business culture are ingrained in its DNA. For the FCA to embark on a regulatory rollback, or to stop moving forward, would be inappropriate, not least as it has promoted a 'business as usual' approach to implementing forthcoming EU regulation and encouraged regulated firms to do the same.

Firms aren't in the UK because it's cheap, or because of its light regulation, they are here because of the strong and supportive infrastructure it offers in which to do business. The FCA's recent action will help to ensure it remains that way. ■

37
Asset managers consulted for FCA asset manager study

0
Private equity firms consulted

Weathervane: fund managers are trying to anticipate Clayton's approach to reforms

Winds of change

The nomination of a Dodd-Frank critic as commissioner and the private filing of IPOs are just two signs of a new direction at the SEC, *Claire Wilson* writes

Jay Clayton has given scant detail of his intentions for the Securities and Exchange Commission, but evidence is mounting that the US regulatory body is turning its attention towards capital formation and away from enforcement.

Here are four moves that suggest the regulator is taking a new tack:

1 Extension of the Jumpstart Our Business Startups Act

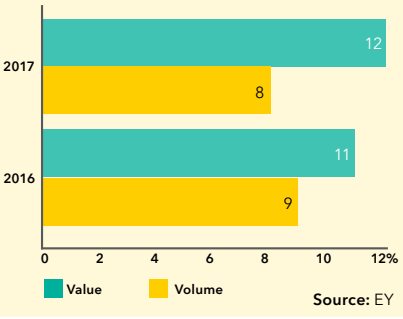
This was new chairman Jay Clayton's first big policy change.

A regulation allowing the private filing of initial public offering documents was extended to cover private equity firms with the aim of encouraging more IPOs.

"By expanding a popular JOBS Act benefit to all companies we hope that the next American success story will look to our public markets when they need access to affordable capital," Clayton said at the time.

Small but mighty

Private equity IPOs as a proportion of the market



Source: EY

Private equity IPO value fell 45 percent year-on-year in 2016, according to EY, and to its lowest level since 2012. But that looks to be rebounding as the first quarter of 2017 saw a 300 percent year-on-year increase in the number of PE-backed IPOs.

The SEC has expressed concern about the decline in IPOs, not just from the private equity sector. It argued start-ups going public are more innovative than large companies and "account for a substantial percentage of the jobs created each year."

2 The mixed message in its annual budget

The agency is on track to deliver a 20 percent increase in the number of examinations in 2017, Clayton told the Senate during his presentation of the agency's budget. But he has requested $1.6 billion for the forthcoming fiscal year, essentially the same as its 2017 total.

"It's going to make it extremely difficult to increase its current examination

cycle for investment advisors," says Duane Thompson, senior policy analyst for a fiduciary training and accreditation firm, adding that the SEC could hit a ceiling on the number of examinations it could perform given its budget request.

3 Nomination of a Dodd-Frank opponent as commissioner

President Donald Trump has nominated Hester Peirce, a staunch critic of the Dodd-Frank Act and the Volcker Rule to fill a vacancy on the SEC commissioner panel.

Peirce's name was thrown into the ring during the Obama administration, but her nomination was rejected by Democrats who objected to her views on regulation.

Peirce, a research fellow at a conservative think tank and former SEC attorney, said the Volcker Rule has taken up much regulatory and industry attention and resources "that could have been spent on pressing issues like cybersecurity."

She has also written positively about Clayton's overall approach to reform, saying he is "searching for better ways to ensure that our public securities markets are an efficient and safe place for investors and companies to meet their complementary goals."

4 Silence on enforcement division powers

Clayton is yet to say whether he will allow enforcement division staffers to issue subpoenas on their own authority, as they have in recent years. In February, acting chairman Michael Piwowar began requiring division directors to approve these requests.

Officials in the enforcement division usually issued subpoenas and negotiate settlements without commissioner participation, except in the biggest and most sensitive cases. Piwowar's policy was expected to reduce the number of compliance examinations.

The appointment of Steve Peikin, a colleague of the chairman at Sullivan & Cromwell, and Stephanie Avakian as co-heads of the enforcement division also cast doubt on the number of examinations.

Democrats fear Peikin's relationship with some of Wall Street's biggest names will make him go easy on financial misconduct, but Republicans argue his past as a prosecutor means he is unlikely to turn into a light-touch regulator.

The top man has remained tight-lipped on the general policy direction of the Securities and Exchange Commission under his stewardship, but evidence is mounting that its focus will move towards capital formation and away from enforcement. ■

Pieces of the puzzle

Clayton gave a few more hints about the future direction of the SEC at a panel discussion with the US Chamber of Commerce Center for Capital Markets Competitiveness at the end of July. Here are the points that will affect private fund managers

Enforcement: the Commission has increased the use of data to target exams, using it to consider which firms to look at, how to conduct the exam and whether the Commission is being effective.

Proxy reports/disclosure effectiveness: more disclosure does not mean better disclosure, Clayton said. It should be written to protect the investor rather than to hedge against legal action.

Reduction in number of public companies: the SEC will not do anything to inhibit private capital formation. Clayton said having both a healthy public and private equity market provides companies with financing options, facilitates capital formation and provides healthy and necessary market competition.

Costs of compliance: Clayton acknowledged the need to be aware of compliance costs when writing rules.

Co-ordination among domestic regulators: there should not be gaps or duplication between various regulations and regulators should not ask for the same information in different ways.

Cybersecurity: watchdogs should develop standards to respond effectively to incidents. Clayton added that if a company acts responsibly in terms of protections and disclosures, regulators should not punish them for being victims.

Clubbing together

Consolidation may be beneficial for the fund administration businesses, but is it in the best interests of the end user? *Rebecca Akrofie* explores the recent surge in acquisition activity and gets a CFO view on its impact

Consolidation in the fund administration market has been rife over the past 18 months. Neuberger Berman kicked off the trend in February 2016, spinning out its administration arm to Japanese financial group MUFG Investor Services. That deal was followed by the first of Sanne Group's five acquisitions, when it bought Chartered Corporate Services in Ireland the same month.

Among the most recent larger deals were Northern Trust's purchase of UBS's fund services unit in February. Estera was the latest firm to widen its net, acquiring Heritage, which has offices in Guernsey, London, Belfast and Malta, in June.

There are three main drivers of consolidation, according to market sources. The first two are the quest for scale and a global footprint, says Thomas Seale, chief executive of European Fund Administration, a Luxembourg-based firm.

Andrews: lack of scale is challenge in the US

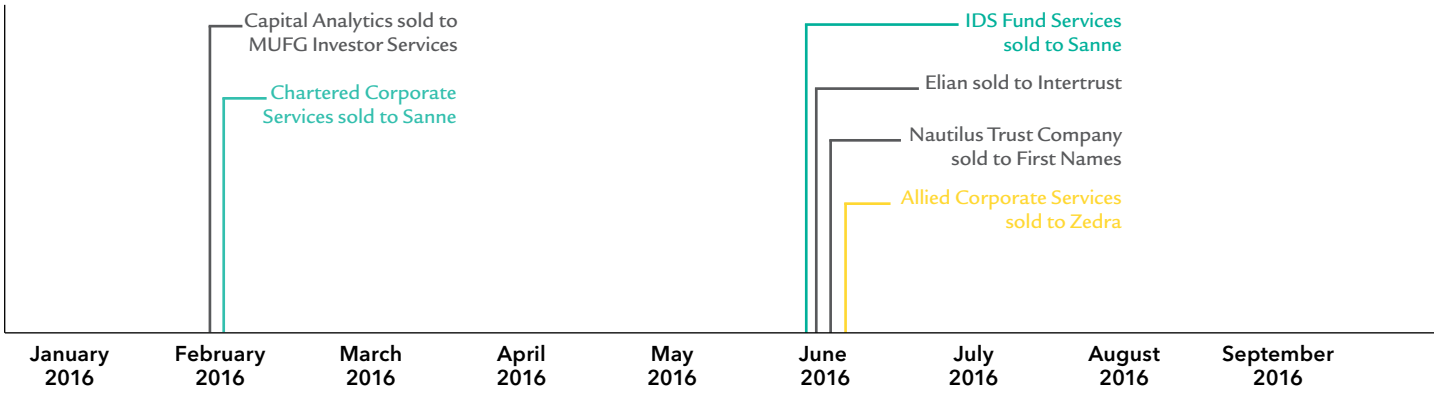
"A large part of the fund administration industry is securing economies of scale. It's a volume business," he adds. "Administrators want to establish strong businesses where their clients are. An example of this is the UBS sale of its fund services business to Northern Trust. Northern Trust had smaller operations in Luxembourg and Switzerland – the acquisition gave them the geographical reach they were seeking."

It's worth noting that, so far, this is largely a European phenomenon. In the US, where regulation has not had the same influence on managers, cost-efficiency has kept administration in-house. Only one-third of US managers outsource administration, says Tim Andrews, director of the iD register, an online platform for centralized due diligence and reporting, compared with two-thirds of European managers. But he believes this will change as more US emerging managers hit their growth spurts.

"The challenge in the US is that the fund administration market doesn't have scale. You can get away with

Shopping spree

Consolidation of fund administrators has been gathering steam in recent months



administrating small funds in-house, but not vehicles with thousands of LPs. That means larger GPs using a smaller number of fund administrators, but this has its limits," said Andrews.

The third factor driving consolidation is administrators' desire to expand their offering. Among Sanne's five acquisitions was a listed fund and corporate services firm, for example.

On the sellside, fund administration businesses are being divested because their valuations are high, says Ethan Levner, group head of corporate development at fund services firm Estera, which span out of Appleby Law in January 2016.

"Accountancy and law firms, such as Appleby, are focusing on their core advisory services and have come to the realization that they are no longer the right owners for the fund administration and fiduciary businesses. They are seeking reputable partners with the scale, resources and expertise to develop the business further," says Levner.

Levner: fund admins are ripe for divestment

Cherry-Seto: requiring firms to get on a platform is problematic

New frontiers

In the future, market innovation and technology will continue to drive the future development of fund administration, Seale says.

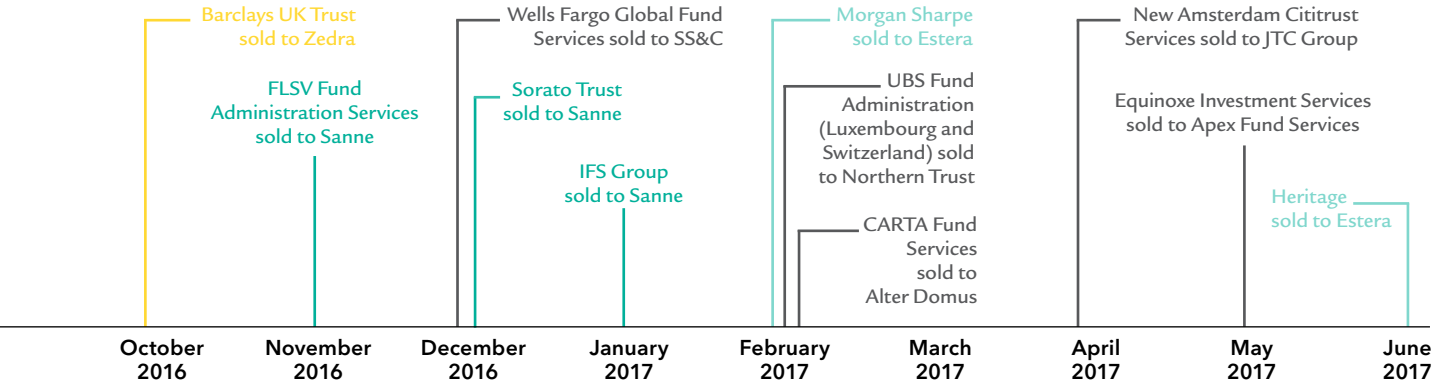
"Fund administrators are like the platform. The asset manager is the decision-maker. Innovation in the market, to me, looks like administrators expanding their services to reduce the workload for the manager. On service expansion, it's offering mid-office services, distribution management, regulatory reporting services, risk consulting," says Seale.

While automating processes is important, technology needs to go much further to retain clients.

"The information fund administrators hold on clients is increasingly standardized and regulation is driving the need for a standardized system," he says.

"You're never, as a fund administrator, in complete control over the whole industry. It's more interesting to have fund administrators talking to each other and making their processes more efficient as a whole. The fund administration industry has developed out of paper, PDFs and Excel sheets, to needing one central information exchange platform," Andrews adds.

Leading the pack in expanding client



technology are Heritage, Colmore and Augentius, who have all released tools this year.

Colmore, which spun out of private equity firm Capital Dynamics in January, launched an in-house fund reporting tool in April. The Fee Allocating Incentive Reporting service aims to tap into limited partners' desire for more transparency on reporting data.

Augentius's product, meanwhile, is predominantly aimed at GPs, assisting with data collection and workflow management.

"Where the technology needs to get to is GPs providing LPs with a pool of data, from which they can extract what's pertinent to them," a spokesman for Augentius says.

Client view

Expanding to full-service, full-capacity global firms may be the ideal for administrators, but what do their clients think? One chief financial officer says that administrators which chase larger managers leave mid-market managers with fewer options.

"We do have a desire and need to be working with an administrator who can send a mid-level person on site now and then," says Joshua Cherry-Seto, chief financial officer at Blue Wolf Capital, a US private equity firm.

"As an emerging manager to a growing group, there is a need to not just manage the books as they are, but to be a partner in building out and improving processes. A mega [private equity] shop may not have that higher-touch, relationship-management mindset. I do think some administrators are trying to figure out how to onboard more small shops to secure relationships which grow into large shops, but not sure they are there just yet," he adds.

On the technical side, administrators requiring investment firms to use their proprietary systems is also a potential downside for fund managers.

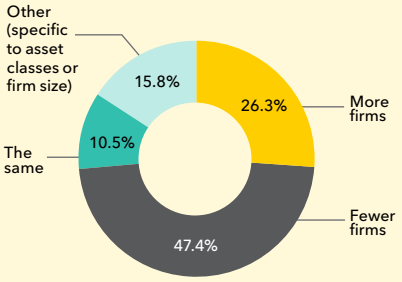
"Requiring managers to get on a platform is problematic; it is overkill. We're operating well with the simple systems we have," says Cherry-Seto. "Many large shops require onboarding to their platform as their compliance controls require ownership of the system and can't be more flexible. A concern is keeping control of your operations as you are growing, and third-party platforms adds unnecessary complication."

"For managers running pure private equity firms up to $1 billion-$2 billion in assets, niche strategic relationships with fund administrators are more helpful. As a small firm grows, the limited transactions don't warrant hiring internally, so it is the niche firm, personal touch in developing systems and scaling of resources that's required, rather than simply processing of transactions," he adds.

Fund administrators' ambitions show no sign of abating. In an environment of weak growth, more acquisitions should be expected. But in the race to expand their footprint and scale, fund administrators should remember to prioritize expertise and the specialist services that make their targets so sought after. ■

All the eggs in a basket

Fund administrators on whether the space will expand or contract



Source: eVestment Fund Administrator survey

Size matters

Large private equity firms are well-positioned to take advantage of the economies of scale enjoyed by growing fund administrators, but for new funds, or small firms, there are advantages to outsourcing to a fellow small operation, according to industry sources.

"As a boutique fund administrator we are able to give personalized guidance and support, and can act as an extension of the back office," James Orrick, managing director at Private Equity Administrators, tells *pfm*.

PEA adapts its own systems and processes to fit a new fund manager's needs and requirements and appoints a client relationship manager to each firm, who is responsible for all administrative processes.

"It's a relationship-driven business and we take on client risk, too; we don't require upfront payment so there are no immediate costs to the client. Upfront invoices can create barriers to entry to new market participants," Orrick says.

And even the rapidly expanding fund administrators recognize there will always be space for smaller firms.

"If a Big Four emerges in the fund administration business, we would want to be one of them. But there will always be a space for boutique firms," the private equity director of one large service provider tells *pfm*.

Weakest link: humans are the frailest part of the system

The enemy within

Fund managers hold huge amounts of data and sensitive information, so tackling the sharp rise in cyber-crime is a priority. *Zak Bentley* finds out how to defend against an attack

The WannaCry cyber-attack that struck Britain's National Health Service, Telefónica and Renault, among others, was billed by many around the world as a 'wake-up call.' For too long, commentators said, the business community and investors had been overly complacent about cybersecurity warnings, despite many listing the threat as one of their main concerns in recent years.

The threat, or at least awareness of the threat and its consequences, has certainly been growing in recent years. In the UK alone, the country's Financial Conduct Authority documented how in 2014 it received just five reports of cyber-attacks from the 56,000 firms it regulates. This figure increased to 27 in 2015 and to 89 last year, indicating a rise in reporting and in attacks.

Attacks have also become more large-scale and ambitious. If malicious hackers were to gain control of power stations, telecoms units and airports, lives could be put at risk as operators scramble to remedy the situation. But what are the risks at fund level? A wealth of information can be accessed in the event of a cyber-attack, but what would be at stake for both managers and their investors?

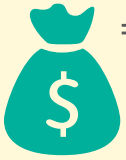
Data not assets

While 'assets' and 'funds under management' are the terms most often used when measuring the size of a fund manager, perhaps a more accurate description in this sense would focus on 'data under management.' Secure and sensitive information in a personal and a commercial sense about LPs is often held by funds, while performance information, specific asset data and either ongoing or planned company moves will also be at risk in the event of a cyber-attack.

"[At stake is] the loss of commercially sensitive information. For instance, M&A activity, information around portfolio companies or their strategy," says Peter Johnson, senior

$120bn

Potential cost of serious cyber-attack on the global economy according to Lloyd's of London



€20m

Top end of penalties EC regulations will seek to impose for a data breach

$10m

Damages sought by commodities fund Tillage after SS&C's data breach

vice-president and UK cyber-advisory lead at insurance and risk management firm Marsh. "If that was to get out, it could not only have a financial impact on the value of the assets themselves, but also have reputational damage for the fund itself."

The risks and the outcomes will largely depend on the motives of the attacker, which range from those looking to extort, those seeking information for personal gain and disgruntled employees or former employees. Recent examples seen elsewhere of state-sponsored attacks also cannot be discounted at fund level.

"An attack effectively enables somebody to have an insider trading position," Johnson continues. "There are many different permutations."

The loss, or just the unauthorized access of such data, is high among the worries of global institutional investors. In a survey last year, conducted by the US-based investment association CFA Institute, 45 percent of the 502 institutional investors surveyed highlighted a data or confidentiality breach as among the top five reasons they would withdraw from an investment firm. This ranked only below concerns over underperformance and an increase in fees but above issues such as a lack of communication and regulatory sanctions. In other words, investors will not tolerate those that are – or even perceived as – lax with their cybersecurity efforts. For fund managers, the threat is real.

PHISHING ATTACK
Impersonation of a business to trick you into giving out personal information

30%
Phishing emails are opened

SPEAR-PHISHING
Sending email from a known user to induce targets to reveal information

97%
Attacks initiated by a spear fishing email

BRUTE FORCE CRACKING
Trial and error method of decoding encrypted data such as passwords

65%
LinkedIn passwords can easily be cracked by brute force software

DRIVE-BY DOWNLOAD
A program automatically downloaded without consent or knowledge

50%
Sites serving drive-bys are more than five years old

RANSOMWARE
Malicious software designed to block access to a computer until money is paid

$679
Average ransom demand

Source: cybertraining365

Face the consequences

While issues surrounding data losses and confidentiality should not be treated lightly, the name of the game remains a financial one. So, when US-listed fund administration company SS&C Technologies last year released $6 million from the accounts of its commodities fund client Tillage Fund to what appeared to be representatives of Tillage, but were actually hackers from China, the fund was understandably furious and had to suspend its business. It launched legal action seeking $10 million in damages and accused the fund administrator of failing "to exercise even a modicum of care and responsibility in connection with known and obvious cybersecurity threats," an allegation SS&C denied.

"One thing we have definitely seen and would encourage other fund administrators to do is to enforce call-back procedures," says Samantha Rule, information security officer at fund administration firm Maitland. "If they receive a request for payment and perform the call-back, make sure the request is a valid one and confirm the entire transaction before making the payment." She adds that she sees a lot more attacks from email than anywhere else, with cyber-attackers aware "the weakest part [of the system] is the human part."

While cases such as Tillage do not always result in expensive court cases, financial authorities are beginning to add an extra layer of risk to ineffective cybersecurity measures with hefty punishments. While the

US Securities Exchange Commission's first cybersecurity ruling in 2015 only resulted in a $75,000 fine, it hit Morgan Stanley with a $1 million sanction following a data breach last year.

This pales in comparison with measures set to reach Europe in 2018 after they were approved by the European Commission. The General Data Protection Regulation will seek to impose penalties of up to €20 million for a data breach or up to 4 percent of turnover of the preceding financial year, whichever is higher. Those with their eyes off the ball when it comes to cybersecurity are now playing a high-risk game.

"If we have a look at how companies are generally looking at cybersecurity, we're seeing their thoughts mature from 'it's not a problem I need to deal with' to 'I need to spend more money on cybersecurity' and now they think they need to buy insurance," says Johnson.

His colleague Martin Bennett, the managing director of the Marsh infrastructure team, continues, "There are some who are very receptive to understanding their risk and others still at quite a preliminary stage in their journey in terms of recognising there is an issue but not necessarily having tackled it to the full level of depth."

Building the wall

However, it appears this hasn't quite hit home for some firms just yet. In the wake of the WannaCry attack, the SEC released some damning figures – 26 percent of 75 investment management firms surveyed did not conduct periodic risk assessments of cybersecurity threats, while 57 percent did not conduct penetration tests on critical systems.

"We do a lot of user awareness training, making sure users are able to identify what a phishing attack looks like, for example," Maitland's Rule explains. "There are new threats arising every day. We don't rely on one layer of defence to protect client information."

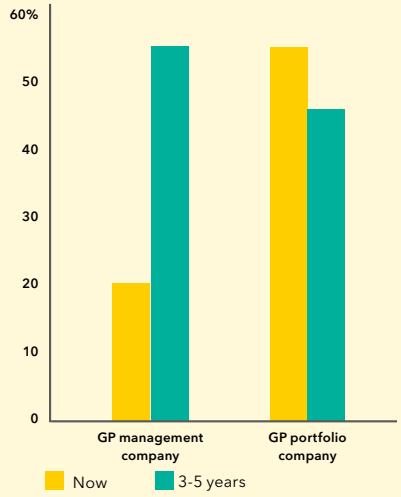
French fund manager Antin Infrastructure Partners created an IT directors' club across its portfolio companies that meets every quarter to share best practice. Similarly, French counterpart Ardian organizes regular meetings with its company chief executives to share opportunities and risks.

"You need to have an incident response team, so that people are trained and prepared and know what plan to follow when responding to incidents as and when they occur," Rule advises. "Back-ups, too, are important, but education means having knowledgeable first responders who know what steps to follow, rather than allowing ransomware to run riot across a network."

Unpreparedness is no longer an option. ■

Keeping investors happy

LP demand for cybersecurity risk assessment



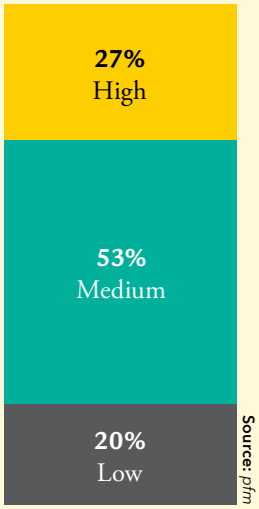
Source: Coller Capital

45%

Investors polled by CFA Institute that would withdraw from an investment following a data breach

CFOs on cyber

How important is your readiness to existing LPs?



Source: *pfm*

Toeing the line

Guidance unveiled by the investors' trade body on subscription lines comes as the industry is getting to grips with best practice on this now-controversial issue, *Thomas Duffell* writes

A brouhaha has broken out over fund managers' use of subscription credit lines in recent months. The Institutional Limited Partners Association has waded into the debate by issuing guidance to help ensure they are used appropriately.

The private equity investor trade body urged members to take responsibility for checking they are informed about a manager's use of these lines, specifically any impact they may have on performance. The association asked investors to dig deeper into how they affect firms' track records, and to compare levered and unlevered IRRs.

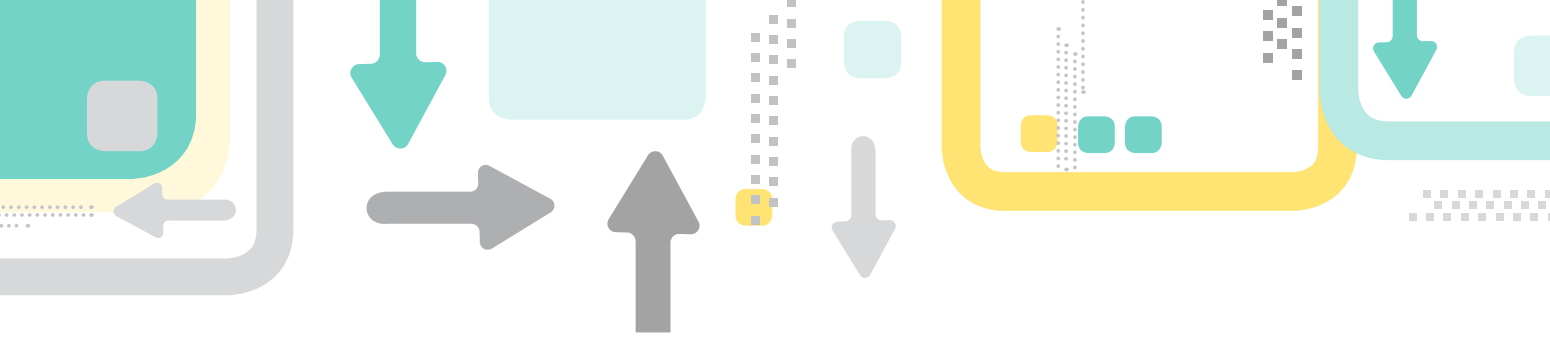
Some investors are already taking a firmer role in negotiating subscription finance provisions in their limited partnership agreements. At the Fund Finance Association conference in Hong Kong in June, fund managers and fund formation lawyers discussed how investors are increasingly dictating the time frames in which a subscription line should be repaid. In a hypothetical example explored at the event, should a repayment not happen within a predetermined time frame, an investor will be deemed to have funded its capital contribution for the purpose of calculating the IRR.

The lobby group also called for fund managers to agree to "reasonable thresholds" for the use of credit lines, such as establishing the longest period for which they can be used and a maximum percentage of the uncalled capital

Debt discussion: participants at the Fund Finance Association conference listen to views on subscription lines

6-12
Average duration, in months, of a subscription line

15-25%
Average share of uncalled capital a line represents



that can be borrowed against. Event participants said the length of subscription lines were already trending downward, with more flexible arrangements now having a six- to 12-month timeframe. Best practice today is for lines to reflect between 15 and 25 percent of a fund's uncalled capital, they noted.

ILPA also reflected on the use of these facilities when exiting investments, which effectively involves managers drawing capital from these lines once an exit is determined and then repaying the lines once it completes. This shortens a fund's hold period and further boosts its IRR, something ILPA points out should not be permitted. Some of sister publication *PERE's* sources have already distanced themselves from the practice, with one arguing investors would question lines used this way.

Tracking changes

The noise around fund managers' use of these lines has sharpened the industry's focus on how they are used. Provisions are even being made for the worried. One source said investors that communicate their concern can be given parallel levered and unlevered fund reports, meaning they can use whichever numbers best suits their purpose.

It's also a reminder that an astute investor's due diligence process is always being fine-tuned. One real estate head at a US public pension plan said that his chief investment officer circulated the ILPA report as a reminder that it should be asking all GPs about the use of subscription lines. The pension plan has also started periodic lunchtime briefing sessions to review best practices. Having the industry body give official guidance can only help. ■

What LPs will ask

ILPA has provided a specific list of questions for investors to ask GPs

- What is the stated purpose and intention of using the line?
- When is use of the line expected to end? When is it contractually required to end?
- What are the terms for the line?
- What was the initial size of the line and by how much could it be increased?
- How many current LPs cover the line?
- What is the cost to initiate the line, and how are those expenses reported to the LPs? What is the cost to renew the line at the end of the term?
- Does the line cross-default in the event one of the LPs defaults?
- Will performance (IRRs) be calculated with and without use of the line?
- Will leverage be disclosed with and without use of the line?
- If an LP whose commitment was used to secure the line needed to sell their commitment on the secondaries market, how would that impact the line, the ability of the LP to sell and the overall partnership?
- Under what circumstances, eg, regulatory changes, could the facility be pulled by the bank?
- Is limited partnership advisory committee approval required to open or extend the line? Does initiating or extending the line require any amendments to the LPA?
- In an event of default, what recourse does the lender have to the uncalled commitments or assets of included investors?
- What process was followed by the GP in the selection of a lender?

Bringing the back office to the front

Technology upgrades, operational due diligence and marketing compliance pitfalls were hot topics at sister title *Private Equity International*'s Investor Relations & Communications Forum. *Claire Wilson* reports on the key takeaways

Timing is crucial for tech upgrades

A positive culture, timing and employing easy-to-use systems are the keys to the successful deployment of technology at private equity firms, according to a panel of tech experts.

They agreed that while upgrading systems may seem like a huge task, the benefits of doing so do make it worthwhile. Established firms may be daunted by the prospect of overhauling their systems, but there are products available that can make the transition smooth and efficient, a technology firm's founder said.

"About three years ago we decided to review our approach and began working on a solution that brings together data that may be sitting on different systems and within different programs. Bringing technology up to date doesn't have to be a five-year task," the speaker said.

He added that the most successful technology transitions are made against a backdrop of firm-wide support.

"It's important that you choose the right time and the right project to implement the change," the chief technology officer of a large private equity firm agreed. "And if the senior management are not on board, it's unlikely to get far."

When choosing a solution, the speakers said firms should consider ease of use, including making sure staff can access the system from any device, anywhere.

"Simple things, such as making sure email is optimized for the iPad or a mobile phone, that it has functionality away from the office and that its operation is logical are all very important," the CTO said.

He added that if a firm does not have a dedicated technology team, it is wise to employ someone – internally or externally – before undertaking a technology upgrade.

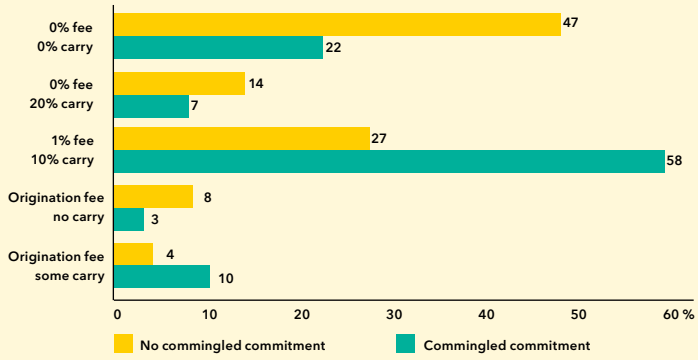
"You might have an IT helpdesk, someone who helps with your computer issues, but that person is not trained in security, they can't implement a cybersecurity policy for example, they're not trained to take on a system upgrade," he said.

An office expansion, or establishing a second or third operation, may also prompt a firm to hire a dedicated technology specialist.

"If you've one office and a small staff you probably don't need a dedicated CTO, but as soon as you start to grow, or expand into other geographies, things become more complicated," he added. ■

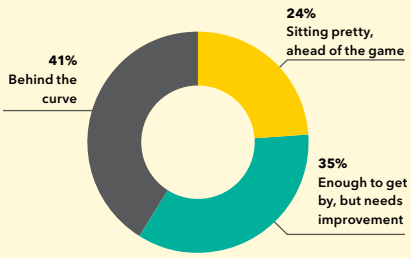
Where to share

Delegates prefer 1% fee, 10% carry for commingled vehicles



Short of a green light

Where attendees rate their ESG programs against LP expectations



Source: *PEI* Investor Relations Forum poll

LPs quiz CFOs during manager due diligence

Investors are doing more due diligence on back-office teams as a result of the regulatory crackdown on private fund firms, according to market sources.

A panel of investors and fund managers said operational due diligence has become almost as important as investment checks when a limited partner is considering a manager.

"We had a number of investors sending in separate teams to speak with our CFO, CCO and general counsel during our last fundraise, more than ever before," the head of investor relations at a global private equity firm said.

Operational due diligence teams wanted to be sure the general partner had everything in place for a Securities and Exchange Commission examination, and to understand what steps the firm was taking to ensure regulatory compliance, the IR head added.

"No firm is going to get a clean bill of health from the SEC, but investors want to be sure that the firm has the right policies and procedures in place, and that if the SEC does come in to examine them, there won't be any big surprises," he said.

The panelists said investors asked to meet the accountants and examined their valuation methodology.

Studying hard: LPs are examining back-office teams

As an investor, operational due diligence can put your mind at ease on regulatory issues, and helps you to build a better relationship with your GP partners, one LP said.

"We've been doing operational due diligence for a while. It means we know exactly who we need to ask if we have specific back-office questions, and it makes us feel like we are getting fantastic client service," he added. ■

Communication key to avoiding compliance pitfalls

Don't phone it in: think hard about marketing regulations

Customized marketing materials and a rush to get information out are the key causes of compliance issues in investor relations teams, according to a panel discussion on IR and regulation.

Slides or PDFs sent to one investor do not count as marketing under the regulations, but in many circumstances it is difficult to ensure that the content is going to a single person, the panel said.

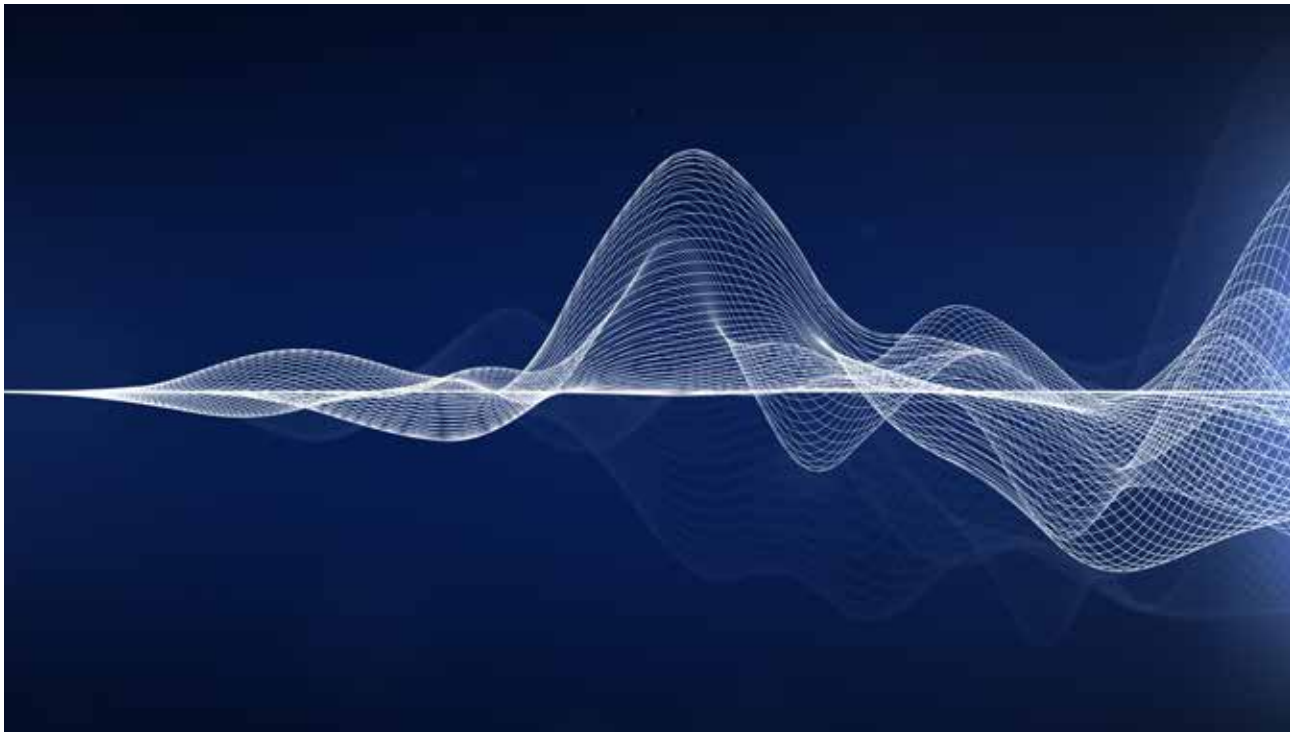
"You've got to be sure a piece is really only going to be seen by one person. It's not inconceivable for a slide to become popular and end up in a marketing deck, suddenly exposed to marketing rules," one compliance officer said.

In instances where it's necessary to get information out fast, attention to detail and accuracy can suffer, raising compliance issues, the panel also said.

"To avoid this, our firm allows time for an extra level of review in the case of ad hoc reports," a second CCO said.

During the review process the team applies a high level of scrutiny to ensure the appropriate disclosures are made, he added.

Ensuring there is an ongoing dialogue between the IR and compliance team can help a firm to avoid some of the marketing compliance pitfalls, the panel said. ■



Wave upon wave: new audit rules allow partnerships to push out tax

Ending in tiers

IRS rules for partnership audits are poised to take effect in 2018, but GPs still have serious questions about the new regime, *Rob Kotecki* finds

When the Balanced Budget Act of 2015 was passed, the private equity industry knew that it would change the way the Internal Revenue Service audits partnerships, though they were uncertain how those changes would be implemented.

The proposed regulations were introduced on January 18, only to be halted under President Trump's executive order freezing any new regulations. In June, however, they were reintroduced with minimal changes. The new regime is still expected to apply to fiscal year 2018, despite the industry having major questions.

Under the BBA, the IRS collects any adjustments that arrive from an audit at the partnership level, rather than collecting from the partners as they do now. But the service collects that tax on the year they complete the audit, which could levy charges on partners that were not present during the audited year. This makes general partners responsible for maintaining the tax attributes of limited partners, assigning deductions and liabilities to the appropriate investor. The IRS does allow GPs to use the attributes of underlying LPs to reduce the charge, but the process to do so is unclear.

> "The IRS has been reluctant to approve pushing out beyond one tier... [but it] is open to a roadmap for how multi-tier push-outs would work"
>
> **Todd McArthur**

The law allows a GP to push out the tax to the partners, but right now, that can only be done at one tier, preventing any underlying partnerships from pushing it out again to their partners. So GPs and LPs are busy reviewing fund documents to find the right balance of flexibility and protections for a regime that leaves a lot of room for interpretation.

> "I wouldn't hold out on any technical corrections this year. It's time for people to dust off their partnership agreements and think about what to do here"
>
> **Adrienne Baker**

Baker: clarifications may not arrive in time

Milkes: certain investors may not wish to amend prior filings

Even with those questions, market participants expect regulations are imminent. "It seems inevitable at this point that the rules will take effect in 2018," says Mike Hauswirth, a tax director at PwC. "A delay of the effective date probably would require an act of Congress, which seems unlikely, due in part to the potential revenue cost."

Ready or not...

The release of regulations in June was followed by a comment period that ended on August 14, and a hearing on the proposed regulations is slated for September. But there are questions as to how much the proposed regulations will change in the coming months.

What will not change are the broad parameters of the new regime, which allows the IRS to collect any adjustments at the partnership level. "The current system forces the IRS to collect underpayments that arise from a partnership audit from each individual partner, which can be an administrative burden," says Kevin Valek, a private equity funds leader with KPMG. But the new regime under the BBA shifts that burden to the partnership instead.

Now, the IRS collects the tax from the partnership once the audit is complete, which is called the "adjustment" year. However, that could be years from the "review" year which is the fiscal year under audit. But what if there are partner transfers between the review year and the adjustment year?

"It's not crystal clear who would bear the burden of that, so the default rule is that whoever is the partner at the time would suffer the burden of that adjustment," says Gerald Whelan, a tax partner with EY. "So, we're working with our clients and their fund counsel to make sure LPAs and other fund documents do this in an equitable fashion."

This implies the need for some mechanism to allow any such liability to be collected from a partner even after they leave the partnership. "Agreements will need a clawback or indemnification agreement from the partners, so the partnership can fairly spread the tax obligation," says Adrienne Baker, a partner at Dechert.

While GPs may be focused on being able to get taxes from the appropriate partner, LPs are focused on maintaining their tax status under the new regime. "Many tax-exempt and foreign investors want to ensure that GPs work with the IRS to import their tax attributes to reduce liabilities, and that the benefit of reduced taxes goes directly to them," says

45

Days after final audit in which GPs can push out tax to partners

2%

Increase in rate applicable if tax is pushed out to partners

Rafael Kariyev, a partner at Debevoise & Plimpton.

Such promises can be met, but it gets complicated when LPs have different priorities. "In the case of certain investors such as a fund of funds, they may ask to be exempt from amending prior filings," says Jay Milkes, a partner at Ropes & Gray. The work for such complex partnerships to amend filings may not be worth the eventual savings.

Most LPs will want the benefit of their tax status, but the current regulations are not clear on how exactly to do so. "The statute permits a partnership to reduce an imputed underpayment by taking into account certain tax attributes of its partners, including tax-exempt status, but there are questions regarding how to document and report those tax attributes to the IRS," says Todd McArthur, a principal with PwC.

Pushing past the problem

This new regime does give GPs an option to sidestep all these issues, by granting them the right to push out the tax to the partners of the year under audit, as long as they do it within 45 days of getting the final adjustment. Those partners would then include any adjustments to their current year's filing, though they would pay a higher interest rate of two percentage points. However, current regulations stipulate is that if the tax is pushed out to a partnership – say, a fund of funds – that underlying partnership cannot push out the tax again to its own partners.

"The IRS has been reluctant to approve pushing out beyond one tier," says McArthur. "Yet, in the proposed regulations in June it seemed aware of the issue, and are open to a roadmap for how multi-tier push-outs would work." Allowing unlimited push-outs may leave the IRS pursuing individual partners in the wake of underpayments, making the new regime irrelevant.

> "It seems inevitable at this point that the rules will take effect in 2018"
>
> Mike Hauswirth

"Essentially, the IRS wants the partnership to notify it which partners owe tax at those other tiers to help relieve the burden of collections," says Kariyev. Market participants stressed that while the IRS may be willing to consider a "roadmap," it doesn't mean one will be in place by 2018.

Yet, the regulations will be. "I wouldn't hold out on any technical corrections this year," says Baker. "It's time for people to dust off their partnership agreements and think about what to do here."

What makes that effort a priority is the new regulations indicate the IRS will be taking a much closer look at partnerships in the future. "There's an understanding that there will be an increase in partnership audits," says McArthur. "The reason the statute was enacted was because the IRS was having a hard time auditing partnerships and Congress wanted to give them a tool to do so." ■

The rise of the 'rep'

The BBA's new audit partnership regime also requires the appointment of a 'partnership representative' to deal with the IRS, replacing the current regime's tax matters partner. "The idea is that the IRS only wants to speak with one person," says Kariyev. The representative doesn't need to be a partner, but they have far more authority in dealing with the IRS than a tax matters partner ever did.

"The tax matters partner was more of a co-ordinator, whereas the partnership representative has the power to bind the partnership to any settlements that are reached," says Whelan. "So there are protocols being set up to better define the rep's responsibilities since the IRS gives them fairly unfettered authority."

The other quirk that may cause some headaches is that the partnership rep needs a substantial presence in the US. "What are foreign partnerships expected to do?" asks Baker. "They may have no service provider or investments in the US, but merely a single US partner. How do they find a partnership rep?" Several service providers suggested that a cottage industry of local partnership representatives may rise to meet that need. Like so many other regulations, the new audit regime might provide a windfall to service providers willing to take on the extra burden.

The institutionalization of private equity

With the growth of private equity and the wall of money flowing in, managers are struggling with the 'institutionalization' of the asset class. *Malcolm Pobjoy,* Vistra's group commercial director for North America, sets out what GPs need to do to deal with new investor demands

Q When you talk about the 'institutionalization' of private equity, what do you mean?

MP: With so much money being allocated to private equity, managers have to deal with transformation in governance and oversight being driven by investor demand. Vistra is helping private equity firms come to terms with this new institutionalized environment. We work with clients by helping them build the infrastructure and back-office capabilities they need to meet demands, while always taking into consideration the changing regulatory backdrop.

The institutional investors coming into private equity are really a major driving force for change. They remain focused on the ability of a GP to find opportunities to execute deals and deliver consistent returns – that has not changed – but our research tells us LPs are now looking for a lot more information around fund governance and oversight. In particular, they are focused on transparency, independence, costs and fees, diligence and globalization.

Q What do investors expect of managers in terms of transparency and independence?

MP: We see investors demanding a lot more information and data about their investments and fund performance, and the level of financial analysis expected has grown significantly. There is a lot of interest in new platforms that facilitate the ease of communication and information-sharing among GPs, LPs and administrators.

Pobjoy : LPs are getting more sophisticated

> "There is growing demand for transparency around decision-making, and for the more widespread use of LP advisory committees"

There is also growing demand for transparency around decision-making, and for the more widespread use of LP Advisory Committees, which enable investors to engage and get closer to that process.

As for independence, investors are looking to allocate to GPs that have independent advisors and administrators, and these investors are supporting the growth in the outsourcing of administration. We see private equity is a couple of years behind hedge funds in this regard, where virtually every hedge manager now has outsourced administration.

Q What about LP demands around costs and fees, diligence and globalization?

MP: The growth of co-investments is partially driven by LP demand for lower-cost options that allow them to gain access to deals. Investors are also focused on what is being charged to the funds, and again, that drives them to favor the GPs that use administrators rather than investing heavily in growing their own back-office function.

When it comes to diligence, LPs are looking to delve down into the robustness of the operations of both the manager and the portfolio companies. Cybersecurity is a big concern here, and investors are looking at scalability and the depth of expertise that managers have to make sure funds are being properly looked after, that regulations are being complied with across the entirety of their businesses, and that all their providers have the requisite expertise.

That leads to concerns around globalization: investors are backing private equity managers investing globally because they want diversification. That often means doing deals in multiple locations, but LPs are seeking reassurance that there is sufficient on-the-ground

expertise to deal with all the necessary administration compliance and structuring. Furthermore, they want GPs to be structuring their funds in the right domiciles, where there is a lot of interest in new jurisdictions like Luxembourg and Cayman, as well as cost-efficient solutions involving Guernsey and Jersey, for example.

Q How important is the back office in LP and GP relationships?

MP: Private equity allocations are still heavily weighted towards the top-tier players, and we continue to see the private equity industry growing, despite the large amount of un-deployed capital. And yet we do see competition to win mandates from institutional investors becoming more aggressive, and to win that competition, GPs need the right combination of performance, infrastructure and partners, so as to give those investors the right level of comfort that their investment is being well looked after.

We are helping GPs develop that infrastructure, transparency and high level of customer service that will drive better LP relationships. New investors continue to come into the market, whether they are endowments, state funds or others, and they are more cautious. There is more capital to be chased, but there are more people chasing it, and the people allocating it are getting far more sophisticated.

Q What should GPs be doing around vendor management and oversight?

MP: Historically, when private equity managers were operating on a global basis, they might have multiple vendors in different countries, and different vendors working with different funds. Now investors are pushing back on that and demanding vendor oversight and consolidation programmes, asking managers to demonstrate how they are able to effectively monitor multiple vendors for compliance, for good HR practices, and for more general corporate behavior.

As a result, GPs are reducing the number of providers that they work with, and showing a preference for those that can deliver multiple service offerings in multiple jurisdictions. In doing so, GPs are able to work with fewer partners, perform vendor oversight more efficiently and drive down the costs of that control.

This is very much a feature of traditional asset management, and is another example of the institutionalization of private equity.

Q How can managers achieve operational efficiencies?

MP: As private equity firms grow, it makes sense to constantly review and upgrade their operating models. Many have small in-house accounting teams that have grown up with the business, but as the scale of operations expand, firms can be exposed to single-person risk and an operating model that is not easily scalable.

For firms to pursue the larger institutional investors, it is necessary to have more robust operating models, and having single-person dependency becomes an issue – investors are looking for confidence that the operating model is strong enough to cope with growth.

Q What do you consider to be regulatory and accounting best practice?

MP: All of these investor demands are increasing at a time when regulatory and accounting compliance challenges are a constant backdrop. The Alternative Investment Fund Managers Directive is now well-established in Europe, while in the US, even if regulation is rolled back, it is the volume of regulatory change that presents the challenge.

> **"When it comes to diligence, LPs are looking for managers to delve down into the robustness of the operations of their portfolio companies when they are allocating money"**

At Vistra, we believe there will continue to be a strong current of regulatory change impacting the private equity industry globally. We know our clients and prospects view making sure they are up to date and their systems are fully compliant as a real challenge that is driving them to outsource these functions to a variable cost model.

In the case of accounting, we see an increasing collaboration across the private equity industry to agree on best practice, in terms of issues like what gets charged to the fund versus the manager, how performance returns are calculated and more. As the industry matures and institutional investors demand more comparative techniques, the market will collaborate and drive towards best practice, rather than continuing to remain fragmented. ■

Hunting the unicorn

The regulator is watching start-ups 'worth' more than $1bn, so private fund managers must ensure their valuation policies are compliant. *Claire Wilson* reports

The Securities and Exchange Commission has nudged unicorn valuations slightly higher on its watch list after concerns there was no consistency in methodologies used by private fund firms. The regulator wants to see more uniformity among managers when it comes to assigning a price to a start-up, but has not taken action – yet.

A study by the University of British Columbia and Stanford University found about half of private companies with valuations exceeding $1 billion – unicorns – would not have earned the title without the use of complex stock mechanics.

The study looked at 116 unicorns founded after 1994 with average valuations of $2.7 billion. Researchers found that 11 percent of companies used preferential stock to boost their valuations to more than twice what they would be worth using fair value estimates.

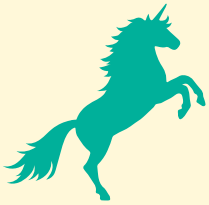
"Regulators will examine whether actual valuation practices were consistent with disclosures to investors, review gaps between stated valuation policies and practices, and scrutinize inconsistencies in applying those policies. The SEC is already focused on potential issues concerning auditor independence," law firm Proskauer Rose writes in a client note.

Headwinds increase the risk of issues. Discussion of a unicorn bubble will likely fuel SEC scrutiny of valuation practices, according to legal sources. Burst bubbles tend to turn the spotlight on securities laws and regulators, which are then criticized for being too passive and reactive. To counteract this, the SEC will train the searchlight firmly on a manager's valuations policy if there is a unicorn failure.

Playing it safe

Private fund firms should, first of all, review their general valuations policies and procedures and ensure their unicorn valuation methodology is in line.

"It's about doing things consistently, with the consistent application of the valuation technique. It's never bad to revisit your policies and procedures. Just make sure you feel comfortable there's sufficient detail to support your rationale and the conclusions you have reached," says Rajan Chari, a partner at Deloitte and co-author of the annual *Deloitte Fair Value Pricing Survey*.



200

Unicorns worldwide

$600bn

Aggregate value

Source: University of British Columbia and Stanford University

Being able to demonstrate you stuck to the methodology is vital if the unicorn is devalued.

"Any significant devaluation of unicorns is likely to amplify the scrutiny of valuation practices, particularly of funds with significant exposure to unicorns. Fund investors will almost certainly focus on sponsors' adherence to their own valuation policies, as well as discrepancies in valuations between private funds and mutual funds," Proskauer says.

One of the main differences between valuing unicorns and other companies is that the fund has few parameters and must determine for itself what a market participant would think, who those market participants are, and what the ultimate exit for the investment may end up being.

To avoid the wrath of the regulator, a fund manager must ensure they are being realistic about their unicorn valuations. ■

Top three unicorns with private equity investment

Ride-share behemoth Uber flagged down the top spot

Company	Sector	Valued at	As of	Investors
Uber	Ride-hailing	$62.5bn	April 2017	Tata Capital, Letterone Holdings
Palantir Technology	Big data	$20.3bn	November 2016	Kortschak Investments
WeWork	Shared workspaces	$20bn	July 2017	SoftBank

Source: CrunchBase

In the frame

The Mandatory Performance Framework could be coming to private funds accounting, but will the accompanying qualification catch on? *Claire Wilson* finds out

A framework outlining how to provide supportable and auditable fair value measurements is being touted as a possible turning point for private fund valuations.

The global Mandatory Performance Framework is designed to enhance consistency and transparency in fair value measurement methodology; it details how much valuation work should be done and how to document the calculations behind a fair value estimation.

"Over time, the application of the MPF should enhance a fund's valuation process and improve consistency and transparency," says David Larsen, a managing director at independent advisory firm Duff & Phelps.

The framework is part of the Certified in Entity and Intangible Valuations certification, which is now open to valuations professionals in public and private markets. The optional qualification was established by accountancy firms and industry bodies including the American Institute of Public Accountants and the Royal Institution of Chartered Surveyors as a response to the Securities and Exchange Commission's concerns over the lack of consistency in valuation methodologies.

Valuations experts choosing to become CEIV-certified have to comply with the MPF, but the framework will likely be extended to those who are not certified to create a "gold standard" in valuations.

Larsen: Funds are focusing on processes

Hill: CEIV may be a 'nice to have'

"Private funds, especially those who report using US GAAP, will likely be required to adopt the MPF," Larsen says. "Increasingly funds of all sizes are focusing more efforts on improved valuations processes. In future it may be difficult for LPs to justify investing with GPs that do not have a valuation process compliant with the MPF."

New auditing standards, which would include fair value estimates, currently being discussed by the US's Public Company Accounting Oversight Board may also encourage those involved in private fund valuations to adopt the MPF.

"One way to demonstrate to auditors that a fund provides information that is auditable under the new PCAOB proposals would be to comply with the CEIV and MPF," Larsen says.

1,500

Hours CEIV holders must spend on valuations within three years to keep the certificate

Whether private fund valuations professionals will become CEIV-certified is subject to debate; some industry sources say the process may be too admin-heavy for them to adopt it. In addition to initial training and assessment, those certified are subject to continued education requirements and must be engaged in fair value assessments for at least 1,500 hours over a three-year cycle. They are also subject to a quality control and inspection program and potential disciplinary action.

"Possibly [people involved in private fund valuations will become certified] as many of the funds are registered investment advisors and are subject to SEC oversight," Lindsay Hill, director at audit, tax and consulting firm RSA, says. "But unless there is a wide adoption it will probably be a 'nice to have' with an added administrative component that may make adoption too burdensome."

Valuation boutiques, large and small players are leading the charge to support the credential, Hill adds, while the Big Four accounting firms and other large national and international organizations are more hesitant and performing deeper due diligence before establishing plans of action. ■

Booking the value

As private funds accounting becomes ever more important, *Peter Cogan,* partner and co-leader of EisnerAmper's financial services audit and assurance services practice, tells *pfm* about the rising complexity – and the costs

Q Senior staff at private equity firms seem much more focused on their accounts these days. Why?

PC: A major cause is the requirement for many advisors to private funds to become registered as investment advisors with the Securities and Exchange Commission. This change, introduced in 2012, has put private equity funds' accounting practices under the regulatory microscope – and it's not just the fund. When the SEC visits our clients, one of its first questions is, "Who is your audit firm and audit partner?" The SEC will then come and talk to us.

Q What kind of things is the SEC concerned about?

PC: The SEC is looking for high-quality outputs from fund managers – not only more information, but also information delivered in a more timely manner. The areas of focus remain valuations, custody of assets, fees and compliance programs. Its staff commonly ask us about our audit procedures, our oversight of valuation, custody and fees, and our ability to get information independently of the client. Amid the expected questions, they will tend to throw in a few surprises.

Q If accounting has redoubled in importance, what does this mean for costs?

PC: Audit costs are in fact stabilizing. This is largely because private equity fund managers have been doing a better job of preparing the books for audit – the industry is more consistently good at putting together high-quality accounts. But overall accounting costs are on the up because we have seen a ramping up of tax compliance costs. Rises in tax compliance costs have far outpaced rises in audit compliance costs in recent years.

Cogan: audit costs are stabilising

> "Tax costs can skew the performance between the different funds in the group quite substantially"

Q Why are tax compliance costs on the rise?

PC: This is largely because of increased regulation, with rules such as the Foreign Account Tax Compliance Act, which requires US citizens to report on their foreign investments. Such regulations increase reporting requirements. They have also made the structuring of private equity funds more complicated, as fund managers respond and adapt. These days you do not just invest directly in a portfolio company's common stock. There might be two, three or four tiers of vehicles, including offshore holding entities. When you have four tiers of tax compliance the costs will clearly be higher.

To illustrate the increasing complexity, one of our tax partners likes to point out that the typical tax return for a private equity fund used to be about three inches thick. The same return could be 20 inches thick today.

Q What are the implications of these rising tax compliance costs?

PC: As long as the funds are able to generate high returns, after allowing for all these costs, I do not think there is a problem. But if the costs get exponentially higher this could be worrying for investors and general partners – particularly if the EBITDA multiples for private equity purchases continue to rise. Private equity funds would then face severe downward pressure from two separate sources; this could be a killer combination.

As accountants, we have seen some private equity fund structures where the portfolio return for the fund designed for US investors is higher than for the fund set up for foreign investors, because of the higher tax compliance costs of the latter. In other words,

tax costs can skew the performance between the different funds in the group quite substantially.

Q Private equity funds' accountants face another challenge: valuing the illiquid assets that make up the portfolios. What are your thoughts on this contentious issue?

PC: The further you get away from any market information that is relevant, the harder you have to work to come up with reasonable valuations. Let me illustrate with two examples.

The first is a company in the auto sector. There is a lot of auto debt and there are a lot of listed auto companies, so there is a large body of information for comparable businesses that allows you to compute valuations.

The second example is a tech company offering something relatively new and unique. There are ways of valuing early-stage tech companies, and there are large tech companies for which there is already a lot of useful information. For example, if a big ride-hailing tech company is already earning a lot of income from millions of customers, and is already showing strong positive EBITDA, it is easier to value. But what about the company in the middle stage rather than the early or late stage? It has invested a lot in developing the technology, but most of its earnings are in the future. It is harder to value that kind of company.

Q So is it straightforward to value a company owned by private equity which is in the same business as companies that are listed or have issued debt traded on the secondary market?

PC: In some ways it is, but accountants can rely too much on this. In 2008, the notional values of some portfolio companies were slashed because of the stock and debt market crashes. Funds' accountants even did this for companies with minimal exposure to debt markets. Some people said, "The debt market is down 30 percent and the stock market is down 30 percent, so the valuation should be down 30 percent." But I do not think the answer is as black and white as that. You have to look at the specific circumstances of each company. If the company does not need to access the debt market or seek a listing in the near future, you do not need to slash its value in line with these markets. Perhaps you only need to cut it by 20 percent. Following the same logic, you cannot necessarily increase the value of the portfolio company in line with the rise of public markets.

Incidentally, I have noticed a definite downside bias among accountants grounded in our historical training in 'conservatism,' which I think is ill-founded in reporting consistent with fair value standards: they tend to cut portfolio company values sharply when public markets are down, but to be more conservative when the market goes up. We as auditors have to fight that same bias when evaluating valuations reported by fund managers.

Q What does the increased scrutiny of private equity firms' accounting practices mean for finance professionals at private equity firms?

PC: If I were a CFO at a private equity shop, playing a key part in the operation of funds because of these new complexities, I would find it very challenging and rewarding. I think it is harder for junior staff: they bear the brunt of the cost pressures on private equity fund managers' finance functions because of the need to spend more on outside consultants who can help deal with these complexities.

On the other hand, it is possible for talented junior staff within private equity firms to work their way up to the rewarding position of CFO, even if the most common route is to work up to a senior role at an accounting firm before transferring to a senior finance role at a private equity firm.

Q If the accounting issues facing private equity firms are complex, what kind of external accountants do they need?

PC: They need specialists. There are issues that a non-specialist will struggle with, such as the valuation methodology, incentive allocations, offsets and special deals. There are a lot of concepts that are unique to private equity, so someone not familiar with the nuances in this area is liable to slip up. ■

Peter Cogan *is an audit partner with more than 25 years of audit, tax and advisory experience. He is co-leader of the firm's audit and assurance services practice as well as the co-chair of the firm's financial services group, leading the private equity group within that practice. In addition, Peter has been director of the Cayman Islands office since it was established in 2001.*

Prior to his current role leading the financial services practice, he served as audit partner for several of the firm's largest hedge and private equity fund clients. He has also represented clients as an outsourced private equity fund CFO through the firm's fund administration practice.

Five minutes to comply

Internal rate of return calculations are facing renewed scrutiny by the Securities and Exchange Commission following the regulator's subpoena of Apollo Global Management over its disclosure of IRR calculations in May. What are the key features of compliant IRR reporting?

What are your peers doing?

CONSULTING
Seeking advice on the SEC requirements for IRR calculations

TARGETED HIRES
Employing more external valuations professionals

REVIEWING
Studying internal calculation methods

COMMUNICATING
Briefing relevant staff on clear and meaningful IRR reporting

STANDARDIZING
Use a fund's interim valuations in investor marketing material

Action items

The Global Investment Performance Standards established by the CFA Institute emphasize the main elements of compliant IRR reporting

1. Value private equity portfolios monthly and when there are large cashflows
2. Calculate a since-inception internal rate of return. Do fair value assessments at least annually; quarterly is recommended
3. Calculate since-inception IRR using daily cashflows, based on the date of the capital call or distribution
4. Returns should be calculated after the deduction of transaction expenses incurred during the return period
5. Net-of-fees returns should be net of investment management fees, including carried interest

Ace your compliance

Have you done the following:

- [ ] Ensured correct IRR calculation methods and related disclosures in place
- [ ] Been able to explain why your firm uses its calculation methodology
- [ ] Ensured the actual valuation process matches the one promoted to investors
- [ ] Included clear and detailed disclosure about IRR calculations in advertising materials
- [ ] Reported the impact of debt financing on IRR

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Where the fund distribution community gathers

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Sally Wong
CEO
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Agenda topics:

- Overview of the **global fund distribution landscape**, distinguishing between distribution channels and distributor profiles by continent, region and country
- The case for global cross-border distribution: **local investment needs and international diversification**
- **Fintech for Distribution** - exploring a changing landscape for funds and how it impacts today's distribution model
- MIFID II target markets, costs & charges, oversight of financial intermediaries, etc… **what will regulation make of distributors in the not so distant future?**
- Open debate between global giants of the fund manufacturing industry and boutiques on the challenges they face in **Europe's changing distribution landscape**: Does scale matter?
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SEC's reporting modernization rules mark new era

New Securities and Exchange Commission reporting requirements will be burdensome for fund managers, but provide the agency with the power to aggregate and analyze information like never before, writes WithumSmith&Brown's *Tom Angell*

For registered investment companies, the Securities and Exchange Commission's investment company reporting modernization 'final rule' is so much more than a sign of the times. It signals the Commission's next move, as it becomes even more entrenched in the private equity industry and marks a new era for the fund industry as a whole.

By moving beyond its focus on requiring advisors at a certain registered-assets-under-management threshold to register with the SEC and implementing presence exams to assess issues and risks, the Commission is now focused on modernizing fund reporting information and overall transparency. On the surface, improving the quality and type of information provided to the SEC seems logical and innovative.

Historically, the SEC has been reliant on fund reporting and related filing information to monitor funds and detect risks, fulfill its role as an advisor to policy- and rulemaking bodies and facilitate its examination and enforcement activities – the latter have been ramping up since 2010. In issuing its final rule in late 2016, the SEC noted it has been challenged by the fund industry's evolution, most notably new fund products and investment techniques. This is especially applicable to exchange traded funds, targeted date funds and non-traditional bond funds. As a result, increased volume has been a pipeline for enhanced complexity in fund filings.

Angell: final rule is having a ripple effect through the industry

> "Once the final rule's structured data really starts to roll in, the SEC will be in possession of a potentially powerful new tool – the likes of which it has never seen before"

In the words of former SEC chair Mary Jo White, the final rule was designed as a "sweeping change for the industry by requiring strong transparency provisions and enhanced investor protections… collectively, these amendments will improve the information the Commission receives from investment companies." The statement also exalted how the new rules will protect investors; maintain fair, orderly and efficient markets; and facilitate capital formation.

New rule means new burdens and processes

Under the newly adopted investment company reporting modernization 'final rule,' funds must adhere to the following:

Form N-PORT, which nullifies Form N-Q

As the modernization initiative's centerpiece, this form requires certain RICs and funds to report information about monthly portfolio holdings to the SEC in a structured data format. By requiring portfolio-wide or position-level information using this format, the SEC is counting on greater efficiency and, in turn, a rapid response to market changes as well as fund-specific events.

- Portfolio-wide and position-level holdings data must be filed with the

SEC on a monthly basis, no more than 30 days after the close of each month
- Compliance date: June 1, 2018 (over $1 billion); June 1, 2019 (less than $1 billion)

Form N-CEN, which nullifies Form N-SAR

This requires registered investment companies – other than face-amount certificate companies – to report certain census-type information to the SEC in a structured data format annually.
- Updates required disclosure items for all funds and includes new questions tailored to specific fund types
- Compliance date: June 1, 2018 (all funds)

Regulation S-X, amendment

This requires standardized enhanced disclosure about derivatives in the RIC's financial statement.
- Amended disclosure requirements are intended to provide investors with access to similar information in a reader-friendly format and to promote comparability in derivatives. By standardizing the disclosures across fund, it will help investors to better assess funds' use of derivatives.
- Compliance date: August 1, 2017

Forms N-1A, N-3, N-CSR, amendments

This requires certain disclosures of the RIC's securities lending activities.
- Compliance date: August 1, 2017

There is no doubt the final rule is having a ripple effect throughout the fund industry. From the increased reporting burden – in terms of frequency and granularity – to implementing new processes to prepare filings utilizing Forms N-PORT and N-CEN, as well as the amended forms, industry and infrastructure challenges abound.

Speaking broadly, the industry has had – and continues to have – sweeping questions related to data sourcing and aggregation, implementation of a filing timeline that also is compressed and complex calculations. Furthermore, there are also infrastructure-related challenges posed when it comes to strategy, operations and – perhaps the greatest of these – technology.

To achieve even greater transparency, the SEC requires all information in a structured data format. What is this exactly? It is an extensible markup language file, commonly referred to as an XML format. This format enables the SEC to leverage today's technology to collect, aggregate and analyze information like never before. All of this is now being accomplished with modern-day speed and effectiveness.

Once the final rule's structured data really starts to roll in, the SEC will be in possession of a potentially powerful new tool – the likes of which it has never seen before. At the Commission's fingertips will be a database chock-full of information to assess risk at a fund-specific level, spanning different types of funds, across entire industries. This information can be used in limitless ways to access fund registration compliance, identify funds for examination, monitor risk and inform rulemaking bodies.

There is no telling where this new centralized database and enhanced knowledge will ultimately lead the SEC. However, one thing is certain: the Commission is continuing its review and consideration of Rule 30e-3, which was omitted from the final rule when it was adopted in October 2016. Under the proposed Rule 30e-3, a fund would be able to satisfy current shareholder report-delivery obligations via a fund's website. This only pertains to reports and certain other materials. With the proposed rule still under evaluation, all eyes are on the SEC. Of course, given the Commission's other priorities, the proposed rule has an uncertain future, at least over the near term.

Registered investment companies find themselves in a race to meet the new deadlines – and the challenges they inherently create – set forth under the new reporting modernization rules. This, it seems, is a sign of not only the times, but a sign of the SEC's future governance. ■

Tom Angell, *CPA, is a practice leader in Withum's Financial and Investment Services Group and head of the private equity and venture capital practice. In this role, he serves a diverse roster of private equity and venture capital clients, including domestic funds, offshore funds and fund of funds. From start-ups to long-established organizations, Angell spearheads a team of auditors, tax professionals and internal quality-control specialists who advance each entity's strategies and objectives while ensuring reporting standards and tax compliance. He also is one of the firm's authors of the* Emerging Manager Desk Reference Manual. *This details the various operational areas in which the fund manager needs to focus, such as building out the back office, outsourcing and service provider selection and organizational structure. His expertise also extends to raising financing and deal origination as well as organizational structure and operational issues.*

Firms in this issue

People in this issue

'I love the creativity and satisfaction'

Alexandra Poe, a private funds partner in the corporate practice of Hughes, Hubbard & Reed in New York, tells *pfm* about how she ended up in private equity law and the best week of her life

Q What's your role at Hughes Hubbard & Reed?

AP: I joined Hughes Hubbard & Reed in June as a private funds specialist. I represent investment advisors in private fund formation, regulatory compliance and managed accounts. I also advise institutional investors in investment and fiduciary matters; some have been seeders in amounts up to $750 million.

I often deliver onsite compliance training, tailoring my advice to a client's operations. For clients targeted in regulatory enforcement, I assist with meeting the Securities and Exchange Commission's settlement requirements, which often include passing muster with an independent compliance consultant.

It's hard to say which aspect of the work I enjoy the most. Governance and fiduciary advice feel like my highest value as a seasoned counselor, yet I love the creativity and satisfaction of helping clients with new fund launches as well.

Q How did you become involved in private funds law?

AP: During law school, socially responsible mutual funds emerged and I wrote about them for the school magazine. I then volunteered for the funds practice at my first Wall Street firm. I think they were quite surprised that I even knew what a mutual fund was back then.

In the 1990s I became US general counsel at Schroders, who were very well known as a manager of overseas pension assets, and I helped launch the hedge fund business. I loved working with these flexible product structures and managers who think outside the box.

Poe: versed in fund and wine vintages

200

Hours Poe spent becoming a sommelier

After Schroders, I went to US Trust, a private bank, which got me involved in private equity and other alternative asset classes.

I've formed funds in private equity, as well as funds focused on natural resources, energy, shipping and receivables.

Q You are a certified sommelier. What sparked your interest?

AP: I first studied wine professionally in 2004, at the Culinary Institute of America in Napa, California. The students were wine professionals, one wine collector – and then there was me! I suppose I did it to test my curiosity. I finished the program and thought, "This may have been the best week of my entire life."

I soon started representing my friend Henri Bungener's fine organic wines from Clos de Caveau, as a sort of brand ambassador at international wine fairs and other tastings.

In 2014, I enrolled at the International Culinary Center in New York for the 17-week intensive sommelier training, involving over 200 hours of study after work and weekends. I passed the Introductory and Certified exams given by the Court of Master Sommeliers in 2015.

Q Have you found there are links between law and wine?

AP: Many clients are interested in wine and they're happy to have a glass with me; they trust I'll add something extra to the experience of drinking nice wine.

Also, when you're learning to blind taste, it's necessary to engage all your senses, instincts and knowledge to identify the wine. Similarly, it's good to listen to clients and colleagues holistically, as well.

Vintners' journeys require patience, resilience and vision. Asset managers must also be nimble, attentive to harmonize constantly changing factors. One can think of each reporting period as a new vintage, wherein making the right choices today can deliver lasting rewards in the fullness of time. ■

Do you have an interesting sideline or story to tell? Spill the beans: Email **rebecca.a@peimedia.com**