

REGULATION

Silver linings rulebook

The LP community may be sympathetic to GP complaints about their regulatory burden – but they also like the level of transparency this additional oversight is producing, says McGladrey partner John Hague



Hague: transparency is welcome

More regulation is rarely welcomed in this industry. As was often the case in the past, private equity firms would much rather operate free from meddling inspectors at their door, and without having to submit regular bureaucratic disclosure forms with government agencies. Private equity is, as its name implies, a private affair, fund managers insist – an arrangement made between sophisticated investors and fund advisors who share an alignment of interests.

Few in the industry understand this sentiment better than John Hague. A partner in the Chicago office of professional services firm McGladrey, Hague has accrued over 30 years of accounting and compliance experience in the financial services sector. His skill-set includes audit and consulting services for investment firms, as well as providing internal control reviews and regulatory consultations.

During his career, Hague has witnessed firsthand the various pieces of policy crafted in response to various market failures, including the recent global credit crunch – which are, for the first time, targeting private fund managers.

“In one respect, you could say the private equity industry was taken by surprise,” says Hague, referring to new rulemaking in the US, Europe and elsewhere written in the immediate aftermath of the market meltdown five years ago. “GPs made the fair argument that they weren’t responsible for the financial instability, yet are now paying the price for it in new regulation.”

The story of private fund advisors taking issue with burdensome regulation is a familiar one, Hague continues. The lesser-known

(and arguably more interesting) story is LPs’ response to the changing world.

“It’s more transparency, pure and simple. There are an incredible number of challenging regulations – either in effect or being proposed – that LPs should view as a catalyst for more disclosure.”

Hague regularly returns to the argument that private equity investors have a more ambivalent take on industry regulation than fund managers do. LPs acknowledge the compliance headaches fund managers must endure – after all, institutional investors are in fact facing new regulations themselves, including for instance the Volcker Rule and Basel III’s efforts to restrict the private equity activity of banks. But they temper their criticism with praise for the greater transparency that is becoming evident in the industry as a result.

The challenge then for private equity firms, Hague elaborates, is understanding how these new rules work, implementing the required changes efficiently and effectively, and communicating their impact to the LP investors – who know that such transparency will assist them in their initial and ongoing due diligence.

“This is a big issue right now. LPs are ramping up their due diligence of fund managers. They want to know that rules written to protect their interests are being properly monitored and followed.”

WHAT THE RULES SAY

The Alternative Investment Fund Managers Directive (AIFMD) – Europe’s grand project to enhance and harmonise regulations covering alternative asset managers

across the European Union – is a prime example of lawmakers pushing GPs to offer investors more transparency.

“The directive requires GPs to make a lot more disclosures relating to GP compensation, for example,” says Hague. “Investors will soon be informed about senior managers’ total pay packages, including a breakdown of their fixed and variable remuneration.”

And although the brunt of the directive affects EU-based fund managers, “managers outside the EU should assess their current investment management and marketing activities to assure compliance with the AIFMD,” Hague advises.

He explains that EU regulators are in the process of signing cooperation agreements with their foreign counterparts to allow cross-border supervision of fund managers covered by the directive. GPs with any marketing or investment activity in the EU will most likely be required to provide more disclosures in their annual reports, audited financial statements and other periodic disclosures, according to Hague.

“And there are many disclosures for these EU managers to consider; among them their access to professional indemnity insurance; preferential treatment to investors through

things like side letters or reduced fees, certain disclosures related to the fund’s liquidity, credit exposures and any material changes from their original prospectuses, including what the fund’s investment strategy is.”

On the topic of AIFMD, Hague adds that greater transparency on valuations is another area GPs will need to address. “Investors want to be convinced not only that written valuation policies are in place, but that they are being followed consistently. And the directive itself will require GPs to notify investors of any material changes to their valuation policies.”

Redirecting his thoughts across the Atlantic, Hague says the US is another major jurisdiction that illustrates the industry’s new era of transparency. “Take Form PF. This is a document that larger fund managers have to file with the Securities and Exchange Commission for systemic risk monitoring purposes. But as part of their due diligence, more and more investors will request access to these forms too. They provide very detailed information about the fund’s activities and portfolio companies that LPs find value in. The interesting question is whether funds will allow that access.”

In other areas, information on the fund will not come at the request of investors, but will be mandated by the SEC. “Disclosures is a major area of focus for the SEC right now,” says Hague, who adds that SEC inspectors want to know that investors are told upfront about how various fees and expenses are allocated – either charged to the fund or eaten by the management firm.

During closing thoughts, Hague mentions that some rules are not always being

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met by private equity firms. The SEC’s custody rule is an example of this. This rule requires fund advisors to safe-keep the fund’s cash and securities at a ‘qualified custodian’. As a further safeguard, the custody rule subjects registered GPs to an annual surprise examination by an independent public accountant to verify their funds’ assets.

However, if a fund distributes audited financial statements to LPs within 120 days of the end of each fiscal year (180 days for fund of funds), the GP generally can avoid the surprise exam – which most do. In a risk alert circulated earlier this year, the US Securities & Exchange Commission noted several instances where GPs had not followed the custody rules, including failure to demonstrate that copies of their audited financial statements were distributed to all investors during SEC presence examinations.

“Compliance is a challenge these days,” says Hague. “And at a time when LPs are making more effort to confirm fund managers’ compliance with both new and existing regulations, private equity firms will want to make sure they’re getting it right.” ■

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