

The problem with casual

By Heidi A. Lawson and Elizabeth G. Kurpis

The global economic downturn has put into question the adequacy of the current state of risk management within the private equity industry.

Some studies have shown that the difference between "what went wrong" and "what went right" in the recent financial crisis centered around what companies knew about risk and what they did about it. Precautionary measures designed to monitor and reduce risk have existed for years, but gone are the days when directors and fund managers can manage such risk through policies and procedures that are only casually followed and enforced.

In the last year and a half, regulators have stressed the need for better risk oversight and a greater degree of risk awareness in the broader investment community. What is the common idea inherent in most, if not all, of the rule changes and enactments that have stemmed from their efforts? The "tone from the top" is most crucial -- measures taken by top-level management trickles through a corporate hierarchy, which results in a successful tone for risk oversight.

In addition to recent Delaware case law and emerging industry guidelines, new laws and regulations are quickly coming into force. For example, in early 2010, the Securities and Exchange Commission adopted rule and form changes that seek to improve corporate disclosure regarding risk. More specifically, the changes require registrants to make new or revised disclosures about, among other things, the board of director's role in risk oversight. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which mainly focuses on the regulation of financial institutions, addresses corporate governance policies with respect to risk committee structures. Also, the Dodd-Frank Act calls for each nonbank, public financial company supervised by the Board of Governors of the Federal Reserve System to form a separate risk committee,

as well as public bank holding companies with total assets in excess of \$10 billion.

Lastly, the Walker report -- an extensive assessment of corporate governance practices in the major U.K. banks, financial institutions and other organizations -- emphasized through various recommendations the need to achieve a higher level of corporate and risk governance that is reflective of the complexity, systematic importance and the inherent nature of such organizations' risk-taking activities. The recommendations from the Walker report are making their way into various rules and regulations in the U.K. and are, quite frankly, laying the groundwork for the international "gold standard" in risk oversight.

In order to establish sound risk oversight principles, it is necessary to recognize the risks particular to the private equity industry and effectively monitor and manage those risks. Some guidelines suggest, and limited partners are now starting to demand, better disclosure as to what fund managers are (or are not) doing to oversee risk at the fund and portfolio company level.

The monitoring of risks at the fund level should focus on private equity fund commitments, the progress of the portfolio companies and their financial performance, and, in many cases, risk oversight and compliance policies and practices. For

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example, investors are starting to ask what fund managers are doing about the new significant exposures the U.K. Bribery Act 2010 will mean to the fund manager's business and its portfolio company investments. At the manager level, the concentration should be on the manager's adherence to the investment strategy, governance structures, compliance with the terms of the partnership agreement and the value contribution to the portfolio.

Furthermore, in light of the emerging legal landscape, it is obvious that risk management should not be limited to a designated risk manager, although some fund managers are now hiring their own risk officer to help facilitate information flow and manage risk on an ongoing basis. Everyone involved in the investment process, from the CEO and board members of the portfolio companies to the fund manager and general partner, should be focusing on risk oversight.

The legal landscape surrounding risk oversight is quickly evolving. As more laws come into effect and guidance is issued, it is becoming clearer what is now expected of portfolio companies, fund managers and general partners with respect to their risk management or monitoring procedures that must be in place. One thing is certain: If fund managers and general partners want to maximize their return on investment, one of the lessons from the recent financial crisis is that they must be able to recognize risks before they occur and take a more proactive role in their management rather than a reactive one. ■

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