

US PRIVATE EQUITY

Is the laissez faire era in US private equity ending?

BY TALBERT NAVIA

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Introduction

Prior to regulations adopted or pending in the US in response to corporate mismanagement and the terrorist attacks of September 11, 2001, the primary regulatory considerations for private equity funds organising and raising capital in the US were structuring the fund to meet exemptions from registration under the US Securities Act of 1933, as amended (the "Act"), and the Investment Company Act of 1940, as amended (the "Investment Company Act"), and taking steps to ensure that the fund's assets would not be subject to the onerous strictures of the Employee Retirement Income Security Act of 1974, as amended ("ERISA")¹. Furthermore, at the state level, most private equity funds were able to raise capital without being subject to any substantive review.

The 1980's cottage industry of private equity is now a trillion dollar industry where funds are raising billions of dollars from institutions, including public pension funds, and an ever increasing retail market. As a result, like mutual funds and hedge funds, private equity is under increasing scrutiny. Now regulatory and other concerns affect private equity funds during their formation/capital raising stage (e.g., disclosure documents and alternative organisational forms), their investment advisers (e.g., recent actions against hedge fund advisers) and their management of portfolio companies (e.g., the Sarbanes-Oxley Act of 2002 ("SOA")). Additionally, there are areas in private equity not currently subject to regulation, but which may be in the future (e.g., the movement toward uniform standards in valuation of portfolio companies).

Considerations in the Formation/Capital Raising Stage

Unlike the strict requirements on content in a "prospectus" used in a public offering under the Act, private equity funds raising capital based on private placement exemptions under the Act deliver to accredited investors and a limited number of sophisticated investors a private placement memorandum based on market practice which includes, among other things, infor-

mation about the sponsors (including their track record), risks involved in investing in the fund, the basic terms of the fund and the investment objectives and restrictions which will be applicable to the fund. In perhaps a precursor of future investor activism, at least one fund investor, The State of Connecticut, has brought suit against a sponsor, Forstmann Little & Co., based in part on claims related to the disclosure contained in the Forstmann Little funds' private placement memoranda. The State also claims, among other things, that Forstmann breached fiduciary duties by not disclosing to the State material information with respect to, among other things, the true financial status of a portfolio company and the value of funds in which the State invested and breached contractual duties by making investments not permitted by the fund's governing documents. This action underscores to general partners the importance of being clear and specific as to the investment objectives and criteria in the private placement memorandum and providing all material information so that an investor can make an informed decision. Moreover, it is a reminder that the private placement memorandum is not really a marketing document but a disclosure document for liability purposes.

As an alternative to raising funds through private placements, in a somewhat surprising development, sponsors have recently raised capital through public offerings of interests registered with the US Securities and Exchange Commission (the "SEC") under the Securities Exchange Act of 1934, as amended, in business development companies ("BDCs") which are subject to regulation under the Investment Company Act. The advantages to sponsors of organising a BDC include the ability to raise substantial capital from the public markets (without restrictions on the types of investors) in a relatively short time. However, there are additional regulatory considerations not applicable to a private equity fund. Two of the most significant rules are that first, BDCs are required to make available managerial assistance to the companies in which they invest, and, second, similar to public companies, BDCs must file regular quarterly and annual reports. BDCs may also typically

only invest in so called "qualifying assets" (i.e., investments in private companies, cash or cash equivalents, US government securities and certain debt instruments). Additionally, BDCs commonly elect to be treated as regulated investment companies under the US Internal Revenue Code, which requires that, among other things, the BDC distribute at least 90% of its "investment company taxable income" in each year. As evidenced by Apollo Management LP raising \$930 million in the first sale to the public of mezzanine funds through BDCs in April 2004 and since then approximately a dozen private equity firms have announced plans to launch public mezzanine funds through BDCs, it appears that some sponsors are not dissuaded by the highly regulated environment in which BDCs operate.

Additional regulatory concerns which sponsors and limited partners face during the formation/capital raising stage are the result of recent anti-money laundering regulations adopted in the US (the USA Patriot Act of 2001) and by other countries in response to the terrorist attacks of September 11, 2001 to prevent international money laundering and to stop the financing of terrorism. In connection with the Patriot Act, the US Treasury Department (in conjunction with the SEC) has proposed anti-money laundering regulations applicable to certain investment funds and certain investment advisers. While it does not appear that most private equity funds would be covered by the proposed rules, proposed rules with respect to unregistered investment advisers would likely subject the sponsors of many private equity funds to regulations which would require the investment adviser to establish an anti-money laundering program that includes (i) the development of internal policies, procedures and controls, (ii) the designation of a compliance officer, (iii) an ongoing employee training program and (iv) an independent audit function to test the program. Moreover, limited partners are being asked to make representations in the subscription documents about the source of funds being invested and about the ultimate beneficial owner of the investment, which information funds are being requested to supply when forming off-shore companies or opening bank accounts in the US and abroad. ►►

Considerations for Advisers

Private equity advisers have historically operated in a largely unregulated environment. Even after the issuance in September 2003 by the SEC staff of a report which urged the SEC to consider adopting substantial reforms to the current regime of hedge fund regulation, private equity funds seemed to escape unscathed. The most widely debated aspect of the report, however, was a recommendation expanding the registration requirements under the Investment Advisers Act of 1940 (the "Investment Advisers Act"). Under the current regime, an investment adviser need not register as long as, in addition to other requirements, such adviser has fewer than 15 clients in any 12-month period. The existing rules also allow advisers to consider an investment vehicle to be a single client for the purposes of such registration requirements. However, the report proposes to require advisers to "look through" investment vehicles and deem each separate investor to be one client. However, the SEC staff was explicit in stating that the sponsors of private equity and venture capital funds not be subject to such registration requirements. Rather, they would continue to be exempt from registration if they have fewer than 15 clients. Most recently, in a speech last May, SEC Chairman William Donaldson confirmed that the SEC staff is evaluating a form of registration and oversight regime for hedge fund managers.

However, the tides may be changing. Last December, the SEC sent a strong message to the advisers of all private funds when it brought an unprecedented failure-to-supervise action under the Investment Advisers Act against an unregistered adviser, an action historically brought only against registered advisers. The adviser's director of investments materially misrepresented the performance and the management structure of the fund while the principal of the adviser relied on such representations. Not only did the SEC find that the principal had failed to reasonably oversee the activities of the director, but also that he did not establish procedures to independently verify the statements made by the director or detect the fraud. This action clearly suggests that the SEC expects all investment advisers, both registered and unregistered, to create and maintain policies relating to oversight and independent review.

Considerations for Managing Portfolio Companies in the Post-Acquisition Stage

In response to instances of corporate fraud and as a means to restore confidence in the US securities market, Congress passed the SOA, which applies to US and non-US issuers required to file reports

with the SEC. Although it primarily affects public companies, the SOA affects the private equity market in connection with public offerings of portfolio company securities and private equity firms that invest in public companies. The most profound effects the SOA has on private equity are in connection with board composition and management incentives. Pursuant to the SOA, the New York Stock Exchange and NASDAQ have adopted director independence requirements that limit the number of non-independent directors on the board and expand the definition of independence. Private equity firms, for instance, which together with the founders constitute the majority of most private equity -backed firm directors, may be required to resign from such boards after the company goes public because their presence runs afoul of the independence requirements. As a result, many private companies must now reconfigure their boards.

The SOA also prohibits public companies from making loans to officers, directors and key executives. This prohibition would have an impact in the case of finance leveraged buyouts where high-yield bonds are frequently issued, private equity-backed companies may be considered public companies and thus subject to the SOA (despite the fact that their stock is privately held). Private equity firms in the public arena may be affected by other SOA provisions, including rules relating to audit committees, auditor independence and criminal liability for fraudulent activities. Accordingly, whether or not intended, the SOA does impact the private equity arena.

The issue of valuation is yet another gray area in the private equity arena. For many years, guidelines with respect to the valuation of portfolio investments did not exist. From a variety of valuation methodologies, including public company comparables, general partners of private equity funds choose the methodologies without any independent check. The resulting inconsistency in valuations is particularly relevant not on the "write-up" of a portfolio company's valuation but on the "write-down" as general partner management fees are no longer paid by investors on such written-down investments. However, some trends are worth noting. In its report on hedge funds, the SEC staff noted that the lack of independent checks on valuations in hedge funds was particularly problematic. The report included recommendations to require registered investment companies to establish policies and procedures providing that valuations be completed in a manner consistent with the Investment Company Act (i.e., providing for a fair market assessment of value in the event that market

prices for securities are not readily available). Later in 2003, the Private Equity Industry Guidelines Group ("PEIGG"), a group consisting of general and limited partners, published guidelines with respect to the valuation of investments and the disclosure of information to investors. The guidelines suggest that portfolio companies should be valued by using the best estimate of current fair market value and encourage firms to create independent valuation committees within the general partner entity to establish specific valuation procedures to which the general partner must adhere. Although the National Venture Capital Association did recommend that its members adopt the PEIGG guidelines, questions remain as to the number of private equity firms that will actually adopt the proposals. However, the mere fact that such guidelines now exist, and that they have been endorsed by at least one private equity association, may be indicative of significant reform to come.

Given the events that have occurred in recent years, the push towards enhanced and more uniform disclosure and concerns about valuation and adviser accountability, the largely unregulated environment long enjoyed by private equity firms may be slowly coming to an end. Most recently, the Forstmann Little case may be a watershed event as the poor returns generated by private equity funds which reflect failed telecom and other investments may lead to dissatisfied investors taking action against general partners who may have been aggressive in certain investments. In addition, the laissez faire environment in which managers operated may be in transition to a quasi-regulated and a more uniform industry. In the meanwhile, the adoption of new policies by general partners of private equity funds would be well-received by the investor community. The only thing that may be known at this time is that in the years to come, the private equity world may be a very different place than it is today. ■

¹ Typically private equity funds conduct their operations to meet exemptions from the ERISA regulations by (i) limiting investments in the fund by benefit plan investors to an "insignificant" amount (an amount constituting less than 25 percent of the fund's asset value) or (ii) operating the fund as a "venture capital operating company" (i.e., having 50 percent of its investments in portfolio companies in which the fund has specified contractual management rights and the fund actually exercises certain management rights).

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