Managing conflicts

As fund formation becomes ever more complex, two partners from Schulte Roth & Zabel tell *pfm* how the regulator views conflicts of interest and how best to deal with them

Q As partners with your respective specialties and focus areas, how do you work together to advise private equity fund managers?

Joseph A Smith: Marc and I provide the yin and yang to advising clients on regulatory compliance matters, and I think it's imperative to have a team looking at it from two perspectives. The regulator is frequently examining clients, and it's critically important to have a partner like Marc, who is outward-facing toward the regulator and keeps his finger on the pulse of changes in enforcement practices. But similarly, I think it's critical for clients to be represented by counsel who is fully familiar with the folkways and history of private equity. Bringing history, industry knowledge and intimacy with business practices to bear when you're talking to the regulator is of paramount importance in representing clients effectively.

We used to call ourselves fund formation lawyers. Now we're also fund operations lawyers, because so many legal issues come up during the life of a fund, in the course of transactions. Fund lawyers need to continually be involved in a client's business.

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Q What has the SEC done so far with conflicts of interest in private equity?

Marc Elovitz: We find the regulators are working to get up to speed to try to understand the industry. There have always been some private equity managers who were registered as investment advisors, but before the Dodd-Frank [Wall Street Reform and Consumer Protection] Act, most weren't. So, the SEC didn't have years of experience getting to know the firms and how the business works.

One thing Joe and I have found very effective in representing our clients is to provide that perspective, background, the folkways, so the SEC can understand that and can incorporate it into its regulatory oversight program.

It has also often been helpful for the SEC to hear from limited partners about their knowledge and understanding of the industry, because disclosure is the centerpiece of the securities laws.

JS: The SEC's concern has been that LPs might not understand completely how the industry works and how general partners allocate opportunities, expenses, etc. Therefore, the SEC's request has been that PPMs be more explicit about these mechanisms. The regulator's basic concern is that the methodologies with which the GP exercises discretion need to be laid out for LPs to make educated investment decisions.

ME: The SEC staff have done outreach to different stakeholders in the industry to try to understand what their concerns are, and see what issues are bubbling up. When the SEC is looking at a particular issue, we have facilitated communication between LPs and the SEC staff to help educate the staff to say, 'look, the LPs understand this the way this is structured and this is what they want.'

Q Could you expand on how you've advised GP and LP clients on conflicts of interest?

JS: Again, it's critically important for the SEC to hear LPs say, 'yes, we understood this.' We, as fund counsel, could include an entire encyclopedia of how underlying businesses are operated as part of the PPM, but no one's going to read all of that. Ergo, what we try to do when we craft a PPM is to make sure we're specific enough that anybody who reads it understands exactly what the underlying business model is, exactly what the objectives of the fund are, and exactly how the fund will seek to create value. But it must be short enough to read! So much of what we do is translate.

Counsel for GPs and counsel for LPs negotiate, every day, the terms and conditions of a document that the parties believe will align interests, and these documents already provide mechanisms for LP consents. Hence, the issue becomes whether the potential conflicts that might appropriately give rise to the need for consents have been adequately described.

ME: It's not always obvious where to draw the lines for sufficient disclosure around conflicts. Enforcement actions are posted on the SEC website, and should be carefully studied, but you've really got to be seeing what's coming through the examination program to get more color on how the SEC is viewing these types of disclosures.

Q How are conflicts of interest viewed in the industry?

ME: There are a lot of situations where the LPs are happy to accept a business model including what could be viewed as potential conflicts of interest because they determine that it's in their interest.

JS: Conflicts occur all the time. The issue is how they're disclosed and how they are resolved. The classic conflict of interest everybody recognizes as such would be for two funds managed by the same manager to transact with one another. For example, one fund is investing in equity and another fund is investing in debt. That was Forstmann Little's classic business model – all disclosed, all well-understood.

In rare circumstances, you'll have a situation in which a fund managed by a given GP sells an asset to a fund managed by the same GP. That raises a host of valuation issues. Believe it or not, there are certain circumstances in which those valuation issues are adequately understood, passed by LPs, consented to and the sale occurs.

I think it is important to recognize that conflicts are part of life, and that managers sometimes have to weigh conflicting considerations relevant to even just their own interests, no less those of the LPs. Private equity is a business. The legal environment had long recognized this. For example, the VCOC exemption under the Plan Asset Regulation, as well as the exception of private equity funds from the definition of an 'Investment Company' under the '40 Act, are designed to permit parties to govern themselves under commercial, contractual arrangements and Delaware principles that recognize the role of business judgment, rather than stricter standards. The policy thinking was that this enhances capital formation and, ultimately, economic returns to investors. This is a history we should be proud of. That said, it is now clear that greater elucidation will be necessary going forward. A thorough understanding of the business is therefore a predicate to compliance.

Smith: much of what we do is translate

Elovitz: disclosure lines not always clear

Q How do you think conflicts of interest are best dealt with?

JS: I always thought the rules were awfully clear that you're not supposed to defraud people, and therefore the practice was to draft with the expectation that something was an institutional offering. Professionals come to the table with embedded training as to business practices. Now, the industry has been asked to be more explicit and I think the industry's doing an admirable job responding to that requirement.

It would sadden me if the regulatory approach were something not principles-based, simply because the creativity of our clients demands it. You'd be drafting new regulations everyday as types of deals evolved. So, I think it needs to be principles-based and I'm hoping it remains so. Any alternative approach I believe would stymie capital formation.

ME: There's nothing in the law that specifies what words you need to use in your disclosures. It's not in the Investment Advisers Act of 1940 or Dodd-Frank, and it's not in the regulations promulgated by the SEC or in the SEC guidance. You need to be familiar enough with both the business that's being regulated and the approach of the regulators. In an area where there are not a lot of specific technical requirements, it's principles-based.

JS: So, it's very important to have a cross-pollination of ideas between people who are advising the industry and regulatory authorities in order to make sure they understand each other, every step of the way. And I think that's the philosophy Marc and I try to bring to the practice. ■

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