

Marketing private equity funds

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The success of a private equity fund depends initially on a manager's ability to obtain capital commitments from investors. Unlike hedge funds, which are permitted to reinvest investment proceeds unless an investor elects to withdraw, private equity funds must distribute proceeds from investments (with very limited reinvestment rights), and fund managers of private equity funds must engage in marketing of new funds every few years to be able to continue making new investments. Therefore, marketing is a fundamental driver of the private equity industry:

- To fundraise successfully, managers must navigate through operational and legal challenges.
- Operationally, fund managers must identify sources of capital, provide enormous amounts of information to prospective investors and negotiate fund documents.
- Legally, fund managers must comply with applicable securities laws, as the issuance of interests in funds constitutes the sale of a security.
- In the US, fund managers must comply with the private placement laws under the Securities Act of 1933, in addition to the regulation of investment companies under the Investment Company Act of 1940 and the regulation of investment advisers under the Investment Advisers Act of 1940.
- Non-US jurisdictions, particularly the EU, impose their own regulatory regimes.

Despite the importance of marketing, the demands of investors and regulators have made raising capital extremely challenging. However, fund managers have opportunities to maximise efficiencies while marketing, even when faced with these challenges in the current fundraising environment.

Against this background, this article examines:

- Operational challenges to marketing.
- Legal challenges to marketing.

OPERATIONAL CHALLENGES TO MARKETING

IDENTIFYING SOURCES OF CAPITAL

The best source of capital for a manager has always been derived from existing investors or parties with whom such manager may have otherwise conducted business. Therefore, although an existing fund's partnership agreement is likely to contain restrictions on the formation of a successor fund, to be a successful marketer a manager must engage in informal, non-official fundraising constantly with current investors. Prompt delivery of ongoing reports and accessibility of a manager to investors should facilitate marketing. Conducting annual meetings with investors is also key to fundraising.

Forming a first-time fund continues to be the most difficult and requires a manager to tap into prior business relationships for capital commitments. Yet, material events could turn a new fund into something investors view to be a "first-time" fund, generally following a "key person" event. Changes to the investment team could have disastrous effects on fundraising. As a result, managers carefully evaluate decisions regarding termination of investment professionals, particularly "key persons", and cannot overestimate the value of incentives used to retain investment team members.

Placement agents continue to present an opportunity for capital sourcing. However, the number and availability of placement agents to raise capital for private equity funds appears to be shrinking. Further, many government pension plans restrict the payment of placement fees to placement agents. Therefore, expectations about fundraising by placement agents should be realistic. In any case, placement agents may be extremely effective in assisting in preparation of the private placement memoranda, responding to due diligence inquiries and guiding the fundraising process.



DELIVERY OF INFORMATION TO INVESTORS

The quantity of information required to be delivered to prospective investors during the marketing period has increased exponentially. Information is delivered in writing, both in hard copy and through website portals, and through on-site diligence meetings. All such information must satisfy anti-fraud rules under the Investment Advisers Act, meaning that information provided to investors in connection with marketing a fund cannot contain an untrue statement of a material fact or constitute false or misleading information.

PRIVATE PLACEMENT MEMORANDA

The primary document for conveyance of information regarding the offering of interests in a fund is the private placement memoranda (PPM). Even though a private equity fund may actually consist of several parallel funds, common practice is to prepare one PPM for all parallel funds, noting material differences among the parallel entities. A successful fundraising is not necessarily tied to a fund's PPM. Excessive redrafting of a PPM can actually result in lost capital commitments if an investor has time constraints on making fund commitments, or if an economic downturn occurs during excessive drafting. A manager is best served with:

- A clear, but concise, description of the fund's investment strategy, investment team, and track record.
- A summary of terms describing the fund's partnership agreement.
- Other relevant legal and tax descriptions.

Investment team track record. The investment team's track record has arguably become the most essential part of the PPM. Under principles adopted by the US Securities and Exchange Commission (SEC), the track record must be limited to investments attributable to the investment team managing the new fund. Given the volume of individuals moving from one firm to the next, attribution has garnered significant focus. If an investment professional wishes to report his investment performance from a prior firm, that individual must have had a significant role with respect to the investments being discussed in his new firm's PPM. There is no bright-line definition of the nature of such a role, but it is generally understood that the individual:

- Must have participated in the decision of a firm to make an investment as a voting investment committee member or managing member of the fund's general partner or investment manager.
- Should have had substantial oversight responsibility of the investment, such as sitting on the board of a company and regularly reporting to his firm about the progress of the company.
- Should have participated in negotiating the terms of the investment and, if possible, the terms of the disposition of the investment.

Pitfalls of track record reporting. The performance of a portfolio company for periods after the date of departure from a prior employer is not generally reported. Overlaying the above attribution principles are confidentiality arrangements with prior firms that require a former employer to approve the use of confidential track record information. Even if such approval is not necessary, investors are likely to seek verification of track record information during due diligence meetings, and information relating to prior employers will need to be substantiated.

Other pitfalls of track record reporting relate to the exclusion of relevant information:

- Generally, a fund manager should not include performance with respect to investments that fall outside the new fund's investment strategy.
- Conversely, investments that fall within the same strategy of a fund's marketing must be included in the reported track record, unless there is a justifiable reason requiring exclusion, such as the length of time elapsed since the investment was made, or contractual restrictions on use of the information. Poor results simply do not justify exclusion.

Performance data should also be presented net of management fees, carried interest and other expenses. Most private equity fund managers show both gross and net results:

- When a prior fund has used different fee levels for investors, it is recommended that the track record be computed as if all investors were charged the highest fee.
- Similarly, when no fees have been charged to certain investors, it is recommended that a hypothetical fee structure be imposed on the gross results to give a prospective investor an idea of what investors would have realised, had the prior investment vehicle been operated like a traditional private equity fund.

While it is not customary to include projected or targeted return of a private equity fund, performance information contained in a PPM generally includes a calculation of unrealised gains, which are based on recent valuations of existing portfolio investments. It is expected that such valuations will be subject to greater scrutiny by the SEC in determining whether a PPM contains misleading advertising, and assumptions used in reaching those valuations should be disclosed.

PITCH BOOKS

A fund manager will generally use a pitch book when pre-marketing a private equity fund. The pitch book is an abbreviated offering document that is often prepared in contemplation of actual meetings with investors. The placement agent may also distribute a pitch book to its clients to determine general interest in the fund.

- If the pitch book contains information that would be material to an investment decision, such information should also appear in the PPM.
- Pitch books should contain legends that direct the reader to the fund's PPM. They should also contain risk factors, especially if a placement agent is assisting in the sale of interests.
- Since a pitch book may be used as part of the first encounter with a prospective investor, a manager may elect to modify the content of pitch books on an investor-by-investor basis. This practice could result in inconsistent information being provided to prospective investors and should be avoided.

DUE DILIGENCE QUESTIONNAIRES

Despite the completeness of information contained in PPMs, investors regularly request information separately through individualised marketing questionnaires known as due diligence questionnaires (DDQs). Responses to specific investor DDQs have placed enormous

burdens on the fundraising process and may exceed the efforts to complete the fund's formation documents. Yet, many prospective investors will not proceed with due diligence of a fund investment or bring the investment to its investment committee for approval without receiving their own DDQs from the manager, leaving managers with no options to avoid DDQ requests.

Many questions raised in DDQs are addressed in the PPM, while other questions require extremely specific data regarding performance, personnel and operations at the firm. Other DDQs require summaries of litigation, whether or not material. Managers often choose to draft their own DDQ in contemplation of investor requests. Because such internally developed DDQs do not replace an investor's individual questionnaire, such internally prepared DDQs likely serve little purpose.

Unlike marketing materials distributed by the manager to all investors, a DDQ is generally not considered advertising by a fund manager under SEC principles, as a DDQ is prepared in response to an investor's request for information and is not provided to all investors. When a manager provides its own DDQ, however, such DDQ is likely to be considered advertising.

DATA ROOMS

Data rooms are generally structured as website portals made available to identified prospective investors (as opposed to the public generally) where documents expected to be requested by investors as part of their due diligence are posted. To obtain access to the data room site, a manager must clear the investor's access, and the investor will generally be required to acknowledge that all the information is confidential and cannot be disclosed to third parties.

Data rooms were established to facilitate due diligence and the marketing process. Instead of mailing hard copies of marketing materials and fund documents (such as the partnership agreement, subscription agreement and other ancillary fund documents), or sending scores of e-mails to different prospective investors with the same documents, managers have created data rooms to allow prospective investors easy access to these materials. The ease with which prospective investors can access materials on websites has, in turn, led managers to expand the amount and kinds of materials placed on data room sites.

Commonly, summaries of all investments made by predecessor funds, audited financial statements of predecessor funds, and other examples of reports to investors in predecessor funds, are made available in data rooms. Yet, once a document is placed on a data room portal, a manager must consider whether regulators will view the information contained in such document to be an advertisement for the fund, and thereby subject to the anti-fraud rules of the SEC.

Historically prepared documents will not have been prepared for the purpose of marketing a fund. Accordingly, some of those documents may contain statements that would not ordinarily be contained in marketing documents, such as projected performance of a portfolio company. It is recommended that any such materials be included in a data room with a clear legend that the document is included in the data room only for the purpose of illustrating actual operations of the firm.

PARTNERSHIP DOCUMENTS

Marketing a private equity fund involves the negotiation of core partnership documents, including:

- The fund's partnership agreement.
- Subscription agreement.
- Side letters.
- Other ancillary documents such as the clawback guarantee and the investment management agreement.

Negotiations with investors over documents are unpredictable and could result in a prolonged marketing process. This process is facilitated when a single point person interacts with fund counsel to reach positions with investors.

Side letters are now the most challenging aspect of completing a fund's documents. To the greatest extent possible, side letter provisions should be minimised. For example, provisions that are not specific to an investor, such as reporting obligations, should be contained in the partnership agreement. Side letter provisions addressing the same subject matter should be drafted consistently across all letters.

LEGAL CHALLENGES TO MARKETING

Obtaining capital commitments from investors must be accomplished in compliance with applicable securities laws. Information provided to investors in connection with marketing a fund cannot contain an untrue statement of a material fact or false or misleading information (see above, *Operational challenges to marketing: Delivery of information to investors*). Both investors and the SEC are expected to subject fund managers to growing scrutiny regarding the accuracy of marketing documents. In addition, regulatory developments regarding private placement rules and required registration of managers in the EU have added to the burdens of marketing.

JOBS ACT

In the US, the SEC recently modified the private placement rules by adopting new Rule 506(c) under Regulation D of the Securities Act of 1933, under which the ban on general solicitation and advertising has been lifted. This change was intended to facilitate fundraising. Fund managers can now choose, with respect to each fund offering, whether to engage in general solicitation. To use the new public solicitation option, fund managers must indicate such election in the Form D notice filed by the fund with the SEC.

Despite the availability of this new rule, there are still several impediments from private equity fund managers taking advantage of general solicitation:

- If a manager chooses to use the new Rule 506(c), it must take reasonable steps to verify that each of its investors in the fund formed under such rule qualifies as an accredited investor. Such verification requires the manager to take greater action than obtaining representations in a subscription document, but the SEC has not determined the actual level of inquiry required of managers. The duty to make such inquiries is likely to deter most managers from using Rule 506(c). In fact, such inquiries could be viewed as making marketing less efficient.

- In conjunction with the release of the final rules implementing new Rule 506(c), the SEC proposed additional requirements for fund managers relying on Rule 506(c). Among other things, the SEC proposed to require fund managers to submit materials used for general solicitation to the SEC, and to use certain prominent legends and other disclosures. While this and other rules have only been proposed, given the uncertainty as to how any future requirements would affect existing offerings involving public solicitation, fund managers may prefer to wait for final rules before determining whether to take advantage of the new rule.
- Managers seeking to use general solicitation must still comply with all foreign restrictions on general solicitation. Since many forms of general solicitation, such as the internet and newspaper advertising, could be deemed to be engaging in general solicitation in foreign jurisdictions, fund managers may prefer to wait until there is additional clarity regarding what is and is not permitted.
- The SEC has yet to clarify rules regarding aggregation of offerings. For example, it is unclear whether a fund manager can switch from a Rule 506(c) offering to an offering that does not involve public solicitation or whether a waiting period is required.

Given the above and other burdens and uncertainties associated with the JOBS Act, managers are likely to refrain from engaging in a public solicitation of investors.

BAD ACTORS

The SEC has also adopted Rule 506(d) under the Securities Act of 1933:

- This disqualifies issuers from relying on the exemption from registration under the Securities Act of 1933 provided by Regulation D if they have committed or experienced (or who have a relationship with certain categories of persons who have committed or experienced, such as placement agents) one or more of an enumerated list of bad acts and actions.
- An issuer can still rely on Regulation D if a bad act occurred before 23 September 2013 and is disclosed to investors.
- The "bad actor" rule applies to issuers whether or not they are engaged in a public solicitation under the JOBS Act.

Under Rule 506(d), among other persons, an issuer is disqualified from relying on Regulation D if an "affiliated issuer" is a bad actor. Under guidance issued by the SEC, an affiliated issuer is limited to an entity that is an affiliate (as defined in Rule 501(b) of Regulation D) of the issuer that is issuing securities in the same offering. Therefore, portfolio companies are not affiliated issuers. Managers were also reminded if "in the same offering" the integration concept in Rule 502(a) of Regulation D is picked-up, they should analyse that point in appropriate situations.

At the time of this article, a limited partner who has committed at least 20% or more of the capital commitments to a fund would be considered to be a covered person under the bad actor rule. Therefore, bad actor representations are often included in subscription agreements to determine whether any such 20% limited partner has engaged in the misconduct covered by the rule.

The SEC has clarified that the termination or modification of an employment relationship can preserve an issuer's prospective ability to rely on Regulation D. With respect to the termination of a placement agent, the SEC has stated that the terminated solicitor may "not receive compensation for the future sales" and that an issuer conducting a continuous offering is not required to provide Rule 506(e) disclosures with respect to compensated solicitors who are no longer involved with the offering.

Some of the "bad acts" listed in Rule 506(d) do not specifically identify geographic restrictions (for example, the disqualification for a person "subject to any order, judgment or decree of any court of competent jurisdiction . . . [that] restrains or enjoins such person from engaging or continuing to engage in any conduct or practice in connection with the purchase or sale of any security . . ."). The SEC has confirmed that a Regulation D disqualification will not result from convictions, court orders, injunctions in a foreign court or regulatory orders issued by foreign regulatory authorities.

The SEC has also confirmed that it does not intend to employ a narrow construction of the scope of "participation" in an offering and has stated that participation "is not limited to solicitation of investors . . . [it includes] participation or involvement in due diligence activities or the preparation of offering materials . . . providing structuring or other advice to the issuer in connection with the offering, and communicating with the issuer, prospective investors or other offering participants about the offering".

The SEC expects that funds will send all investors disclosures on placement agent prior bad acts to all investors, not just to those introduced by the placement agent making the bad act disclosure.

NON-US MARKETING

Managers cannot assume that the sale of a limited partnership interest to a non-US investor is permitted under non-US regulations. While it is impractical to hire local counsel in each non-US jurisdiction where a manager wishes to market, a manager should seek relevant advice before accepting a subscription from a non-US investor. Marketing in the EU has become subject to broad legislation restricting marketing.

AIFM DIRECTIVE IN THE EU

The EU Directive 2011/61/EU on alternative investment fund managers (AIFM Directive) now covers all EU countries. The AIFM Directive sets out rules for authorisation, operation and transparency. It applies to most US and other non-EU private fund managers (defined under the AIFM Directive as an alternative investment fund manager, or AIFM) that market private equity funds (EU or non-EU) to investors in the EU.

With limited exceptions, for a US manager to market a private equity fund in those EU countries which permit the private placement of interests:

- Required disclosure must be provided to investors and regulators on an ongoing basis.

- Co-operation or exchange agreements must exist between the regulators of the EU countries where the fund is marketed and the regulators of the country where the fund and manager are established.
- Neither the non-EU manager nor the non-EU fund should be established in a country which is listed by the Financial Action Task Force on anti-money laundering and terrorist financing as a "Non-Cooperative Country and Territory".

Notably, jurisdictions differ on determining what constitutes marketing, and the nature of documents handed out to investors (for example, pitch books versus PPMs) could be determinative.

REVERSE SOLICITATION

The AIFM Directive explicitly states that marketing activities by an AIFM are only covered by the AIFM Directive's rules where the marketing is done "at the initiative of the AIFM or on behalf of the AIFM". "Reverse solicitation" or "passive marketing" (marketing which is at the initiative of the prospective investor) will continue to be permitted under the AIFM Directive, meaning that EU investors can continue to seek out, on their own initiative, and contact US AIFMs about investing in non-EU AIFs. In such a situation the above requirements would not apply. Many managers rely on this exception to avoid the numerous requirements of the AIFM Directive. Managers should retain all e-mails, letters or other evidence from an EU investor to show that the marketing relationship with that EU person was as a result of a reverse solicitation.

Given the difficulties with respect to marketing in the EU, US managers are likely to avoid such efforts, unless investors present sizeable commitments or reverse solicitation exemptions are available.

CONCLUSIONS

The level of due diligence conducted by investors before committing capital to funds, and increased regulatory scrutiny of fund managers, are understandable in light of frauds against investors in recent periods. This focus has increased the time and energy required of all parties to form a private equity fund, but can be managed by maintaining investor loyalty and taking an efficient approach whenever possible.

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