



Sandra McAuliffe

## The benefits and risks of private equity investment from a compliance perspective

Sandra McAuliffe, managing director of Legis Fund Services (Isle of Man) Limited, explains some of the compliance/regulatory considerations regarding private equity investment.

### What are the benefits of private equity investment?

Getting a business started or expanding that business requires capital and the lack of capital for small- or medium-sized businesses has always been a barrier to growth, but never more so than in today's post global market crash environment where banks are still very reluctant to part with capital. Private equity is the provision of equity capital by financial investors, with the aim of developing the business and creating value. Private equity firms seek out companies with a good growth potential and can help businesses achieve their growth ambitions by providing the resources and capital to refine business strategy, expand the business and optimise returns, both in start up situations but also in subsequent development phases. Private equity firms are essentially intermediaries (between capital providers and companies in need of capital) seeking long-term value creation. Private equity investment can range from the seeding and development of smaller companies, right up to large leverage buy-outs (less predominant of late due to the liquidity issues which have decimated the private equity market over the last year)

### How do private equity investment funds work - types of structures

Private equity investment tends to be a medium- to long-term investment and for the most part the structures are closed ended, which prohibits fund managers/investors from exiting prematurely, provides financial stability and strengthens the ongoing commitment to grow the investee company. Commonly partnership structures are established around a partnership agreement between the investors (limited partners) and the fund manager (general partner). The general partner is responsible for the management of the private equity investment fund and has unlimited liability for the investment(s) while the limited partners (normally institutional investors/sophisticated or professional investors) are only liable for the capital invested and they do not play an active role in the management of the investment(s). Limited partners are invited to invest in the investment fund for a set period and the capital collected is used to invest in "high potential" investee companies.

On exit from an investee company (disinvestment), the capital recovered is not reinvested but redistributed to the institutional investors. The institutional investors receive the first part of the profit, which reflects an agreed target rate of return or "hurdle rate" ? essentially a reward for tying up their capital. If there is a surplus above the hurdle rate, then this is shared between the institutional investors and the fund manager. The split is commonly 80/20, with the general partner receiving 20 per cent and the limited partners receiving 80 per cent. The element paid to the general partner is known as the "carried interest".

### Do the regulatory/compliance considerations for private equity structure vary greatly offshore?

No. Most offshore financial centres meet internationally respected regulatory standards (as determined by the IMF) and have a well established and stable legal structure.

## **Private equity development cycles - regulatory/compliance obligations**

The life cycle of private equity investment normally includes a number of distinct phases (fund raising, investment, management of investments, disposal of investments, distributions to investors and liquidation of the fund) but these can generally be summarised in three distinct stages, with differing regulatory/compliance implications:

### *Seeding*

The fund raising /seeding stage normally targets specific types of investors and due consideration must be given to the suitability of the investment for the client and indeed any legal limitations as regards promoting to certain types of investors. Marketing presentations and any quoted track record must be accurate and not misleading. Due consideration must also be given to anti money laundering requirements including client verification and source of funds. It is common for certain investors to seek preferential rights and the extent to which specific investors are granted influence should be minimised, the ideal scenario being that all investors in the fund benefit from equal treatment. Where this is not possible, preferential treatment should be transparent to all investors. Fund documentation must fully disclose all material information and as a minimum encompass: legal structure of the fund, investment scope/policy, description of the management structure/investment advisory structure, carried interest arrangements, drawdown commitments, distribution arrangements, fee structure, valuation principles, risk factors, exit strategies and liquidation provisions.

### *Investment*

The fund manager must implement the investment fund's investment policy with due care, skill and diligence and sufficient information must be obtained to fully evaluate an investment proposition. This will normally necessitate the fund manager undertaking a detailed review of the investee company's business plan/strategy, their products and resources and growth prospects. Commonly this business proposition is pulled together by the fund manager and then evaluated by an investment committee, where a wider perspective and skills base can be brought to the table. The business proposition will normally include a recommendation as to how to structure the investment; i.e. will it be a passive minority holding or will substantial control be obtained by board representation or a defined shareholder agreement (where advance shareholder consent is required for certain commercial transactions). These transactions can include the approval of the annual business plan, material changes in the management structure, substantial capital expenditure or shareholder changes. It is prudent to ensure that these controls are adequately and properly captured within the shareholder agreement.

Likewise, where an investment has been syndicated or there are co investors who could make parallel investments, there is potential for the investment fund's interest to be prejudiced. The overriding principle in this regard is to ensure that the fund manager always acts in the best interests of the fund investors. Since private equity is heavily bias towards the growth of small- or medium-size companies (which are generally not listed) then investment monitoring/valuation can be challenging. Sufficient time and resources must be applied to monitoring the performance against the business plan and the timely production of agreed data measurement criteria is fundamental to the prompt identification of any failures to meet targets. Under performance must be investigated in a timely manner and a methodology for turnaround (together with any remedial action) must be agreed and measured. Regular meetings with the management of the under performing investee company is crucial, as is increased monitoring of the business.

### *Disinvestment*

Planning an exit route is a central and integral part of the private equity business. Establishing an appropriate point to dispose of the investment permits a fund manager to reimburse investors and determine the return payable. Additional considerations relate to whether cash is generated on the realisation of the investment or whether shares can be accepted. Any decision to accept a non cash disposal is likely to involve additional costs and risks (such as market exposure). Holding quoted investments can also result in the fund manager being subject to additional regulation, such as insider dealing and great care must be taken to ensure that market rules are adhered to. The liquidation of an investment fund generally means that assets are distributed to investors. At the point of liquidation therefore, a full assessment of any future claims that can be brought against the fund must be undertaken, so as to ensure that sufficient monies are held in escrow to meet such liabilities.

## **Corporate governance - private equity investment funds**

As defined in the OECD principles of corporate governance, "Corporate governance is a key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance also provides the structure through which the objectives of the company are set and the means of obtaining those objectives and monitoring performance are determined." Successful investment is dependent upon well informed decision making

and failures of governance can lead to failure in business. Private equity investment funds, by their very nature involve a great deal of shareholder/board participation in an investee company. This can lead to challenges for the private equity investment fund, where strong corporate governance is essential. The following steps can be taken to evidence good corporate governance:

- Any conflicts of interest with other shareholders must be identified, discussed openly, monitored and where possible, mitigated.
- There should be significant participation in developing, challenging and monitoring the corporate/business strategy of the investee company.
- Performance data provided by the investee company should be evaluated, monitored and reviewed in a confidential environment.
- Participation on the board of an investee company should be in the best interests of the investee company and only candidates with the requisite skills, authority and experience should be considered for board positions.
- Participation in the establishment and ongoing review of operational procedures and controls of the investee company are paramount to the successful operation of the business and the prevention of operational errors/ omissions.
- Sharing in the collective responsibility for the identification, assessment and management of risk in the investee company.
- Sharing in the responsibility for setting a remuneration package for senior key executives of the investee company which reward performance and control/mitigate risk.
- Ongoing monitoring of the corporate governance protocols/practises of the investee company to ensure that they remain effective and appropriate.

## Conclusion

While private equity investment can be complex, setting up compliance processes across the development life cycle and working within a good corporate governance structure will ensure that the requisite regulatory controls can be achieved.

Author Biography:

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