

WHO'S WHO LEGAL

The International Who's Who of Business Lawyers

ROUNDTABLE

The International Who's Who of Private Funds Lawyers has brought together three of the leading practitioners in the world to discuss the key issues facing private funds lawyers today

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Paulus Hidén: In Finland the private funds industry has so far been unregulated, and it seems that the primary regulatory concern is not necessarily the requirement for more transparency, but the additional costs and administrative burden, and from an LP perspective, the fear that fewer funds would be available for investment. Most players also question whether additional regulation of funds mostly tailored for institutional investors really serves any interest that needs protection. This is of course not to say that disclosure requirements would not be a concern to some. This – and compliance with other additional requirements – would to some extent be reflected on portfolio company level, making transactions more complicated (or as some would say, unnecessarily complicated) and possibly also making the owners of some privately-held firms more wary of private equity funds becoming shareholders. Some fear the creation of an unlevel playing field to the detriment of financial investors.

John Broadhurst: Our guess is that any new US regulation will require more investment managers to register with the SEC and impose new disclosure requirements specifically tailored to investment funds. New rules probably would be only an annoyance (and an additional expense item) for larger managers, but would cause more of a disruption for smaller managers that lack the personnel and systems needed to comply. These requirements will also increase start-up costs for new managers, which will put a chilling effect on this entrepreneurial segment of the industry. We believe this is regrettable. There are studies showing that the smaller, newer managers outperform larger managers because they are nimbler and a few good ideas can have more dramatic effect on the portfolios they manage. So our sense is that aggregate investment levels into hedge funds wouldn't change, but the proportion of investments going to larger managers will continue to increase as some smaller managers drop out and start-ups are stifled. Regulation obviously leads to more work for private funds lawyers, but we certainly don't enjoy helping clients deal with new compliance burdens that we believe add little value.

EMERGING REGULATION

Who's Who Legal: *Recent legislative proposals in the US and the EU have gestured towards stricter private funds regulation, with greater emphasis on record-keeping and disclosure. If these regulations are adopted, what effect do you expect them to have on investment levels in these regions? How will this legislation affect the work of private funds lawyers?*

Patricia Volhard: Private fund lawyers will have to focus more on regulatory advice, building up know-how and expertise in this area. Dealing with regulatory authorities will be relatively new for many.



Paulus Hidén: For a private funds lawyer, stricter regulation could mean more work, but of a different type and not necessarily of the most positive nature. It is not far-fetched to say that these additional requirements will make clients and counterparties frustrated, which has rarely been a positive thing.

Patricia Volhard: Transparency requirements as such are welcome and, if correctly implemented, can have a very positive impact on investors' appetites to make investments on a collective investment basis, and thereby stimulate the fund industry altogether. Therefore, in the absence of legal requirements in certain European member states the private equity industry, for example, has itself already imposed certain disclosure obligations towards investors. Hence, whereas certain disclosure requirements in the draft Directive regulating managers of all types of alternative investment funds (AIFM Directive) reflect current market standards, others go far beyond such existing standards and should be revisited and clarified. For example, the manager (AIFM) should only be obliged to provide information to investors about the AIF in which such investor is invested and it certainly does not make any sense to provide for disclosure of liquidity risk management for a closed-end fund making long term investments.

The disclosure requirements foreseen in the AIFM Directive towards shareholders and employees of portfolio companies are very problematic. The draft Directive provides in respect of funds acquiring a "controlling interest" (which is deemed to be the case where a fund acquires 30 per cent or more of the voting rights of a portfolio company) disclosure of development plans for the non-listed company and of the policy for external and internal communication of the company, in particular as regards employees or their representatives and the other shareholders in such company. Such disclosure requirements distort the level playing field: not only that funds as such will be at a disadvantage compared with other investors acquiring larger stakes in portfolio companies, but the same is true for the

portfolio companies itself about which internal information will be disclosed as soon as a fund investor is being invested in such company. Moreover, there are practical obstacles to overcome:

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the AIF being "just" a shareholder is not in a position to disclose such internal company information, especially if it holds less than 50 per cent. In many EU member states such information could only be disclosed by the management of a company from a corporate point of view. Some of the information provided to investors may actually incur issues for the investor – for example, investors who are subject to Freedom of Information rules and are obliged to make public disclosure of information they receive. Such investors should be able to opt out of receiving information.

The draft Directive goes beyond mere disclosure and transparency requirements and provides also for other regulatory requirements like minimum capital, requirement of custodian bank etc. An important issue in terms of cross-border investments and fund-raising are the third country rules. The draft Directive provides that funds which are managed by non-EU managers can only be marketed into the Community if (among others) such third country provides for an "equivalent" regulatory regime. It's crucial that mutual recognition requirements do not fail to ensure genuine access to the relevant market. This will be at risk if the AIFM Directive requires non-EU-based managers to comply with the detailed Directive requirements relating to the structure of their business, eg, requiring the use of custodians, valuers and delegates or requiring these entities to be located in the EU. This issue would also arise if the European body charged with assessing the "equivalence" of the regulatory regimes applicable to non-EU managers failed to take into consideration that different regimes may have different approaches and if it were to consider a regime only as "equivalent" if exactly the same requirements were imposed, which would in practice never be the case. Similar approaches adopted by non-EU jurisdictions could pose problems for EU-based private equity firms.

Paulus Hidén: But it's still difficult to predict whether the regulations would actually affect investment levels. At least in the domestic market, a lot depends on the 'assets under management' threshold and how many of the private equity firms will be 'caught' by regulation. Smaller firms could be simply killed by regulation, and in this respect one worrying development would

be if institutional investors would adopt policies preferring regulated funds, thereby forcing smaller players to opt in for regulation.

FUNDS ACTIVITY

WWL: *What types of funds are currently most active in your jurisdiction? Are there any trends in the types of funds that are being formed? How has the current financial situation affected the lawyer's role in fund formation?*

John Broadhurst: We represent hedge funds and crossover funds (public/private funds) with a wide range of strategies, although a majority probably use a long/short public equities strategy.

Paulus Hidén: For us, the past few years have been an era of property funds – but, at least for the time being, this activity has turned down even faster than it started. Not to a complete halt, but to a clearly more deliberative phase.

John Broadhurst: As far as trends, some clients that were successful in 2008 continue to attract new capital, but we've seen a noticeable drop-off in new investment managers. Institutional investors are busy raising liquidity by redeeming from hedge funds (whether or not those funds performed well). They generally aren't investing in new funds. We are beginning to see some new fund launches, but those launches involve modest levels of capital. Of course, we're also seeing some specialised funds seeking to capitalise on specific sectors, such as residential and commercial real estate. Our role has expanded over the past year as we keep up with the rapid pace of regulatory changes (such as short sale rules that spring up overnight) and major changes in the prime brokerage/custody industry.

Luxembourg vehicles (SICAR, SICAV, SIF). The reason for the new tendency, to set up funds in Luxembourg may be the fact that it has a very sophisticated and advanced infrastructure, and tax neutrality expectations are best satisfied there. In a country like Luxembourg, which does not have a large investor base, and is not a classical target country for investments, it's politically easier to provide the requested neutral framework and parameters for fund vehicles.

Paulus Hidén: We've seen a lot of talk about a need for infrastructure finance or, once again, earlier stage PE/VC finance, but in the current financial situation there's really no reason to talk about trends. Most PE firms have not been actively investing, still have assets to invest and don't seem to rush for fund-raising before things turn for the better. This has also most obviously affected fund formation work for lawyers: whether on the LP or the GP side, there's been less fund formation work and some projects have been, to a larger extent, labelled by uncertainty and extended time schedules. On the other hand, there's been different types of fund work relating to, for example, an additional need to make follow-on investments, and some of the secondary transactions we've worked on probably wouldn't have taken place a few years back.

Patricia Volhard: I don't see a change in role as such of the fund formation lawyer. The financial crisis has led to a number of new and/or complex issues which need to be dealt with, ie, triggering of default clauses, restructuring funds, setting up annex funds etc. In that sense, the work of the funds lawyers has become less "routine work" but more demanding and interesting. Following implementation of the AIFM Directive there may be a further change in role: the private funds lawyer, which has advised the funds only in their structuring and fund-raising phase, may be assisting the fund more on an ongoing basis – assisting in dealing with such new regulatory requirements which the managers will have to fulfill once the AIFM Directive comes into effect.

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Patricia Volhard: The classical German closed-ended fund structure has been a German limited partnership, a GmbH & Co. KG. Recently, more and more funds are being set up as





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ACTIVE SECTORS

WWL: Which sectors are seeing the highest levels of investment in the current marketplace? Are there any jurisdictions in particular that are attracting investors' attention?

Patricia Volhard: We currently observe a certain tendency to private equity, real estate and infrastructure. Funds that typically attract international investors' attention are UK or Luxembourg-based funds, due to their tax neutrality.

John Broadhurst: We have not seen any particular trend in the regions attracting new investment. Most of our clients continue to focus on US investments, but we have a number of clients with significant investments in Asia, India, South America, Canada and Africa, among other regions.

Paulus Hidén: On the domestic market, the fact is that during the past months most fund managers have focused on their existing portfolios instead of new investments. Most of the investment activity has gone to support existing investee companies that have found it hard to gain access to bank finance. On a number of occasions investments have been made to remedy a breach of banking covenants. New investments have been made, mostly with pure equity, in anticipation of being able to refinance as the market recovers. LP appetite has been weak for almost all fund products. Some LPs have expressed an interest in returning to making domestic real estate investments directly, instead of supporting their existing GP relationships. Some LPs have expressed an interest on funds investing in the east.

FLIGHT TO QUALITY

WWL: One effect of the economic climate has been a 'flight to quality', with clients relying more heavily on the expertise of senior partners as opposed to associates and an increasingly complex process required to establish, restructure or close funds. How has this affected your practice and/or practice group?

Paulus Hidén: We perhaps have not seen this development as clearly as our foreign colleagues may have.

Patricia Volhard: Nothing has really changed in our practice in this respect. The responsible partner has always worked very closely with his or her associate, and is always and has always been available if a client wishes to speak to him/her directly. It is our aim that the client not only builds up a relationship of confidence with the partner in charge, but also with the partner's associate. Often, it will also be just as convenient for a client to talk to the associate, knowing that the associate will directly report to and work with the partner, and knowing further that the client could always speak to the partner directly if he or she considers the request to be urgent, complex or for whatever reason. We feel that clients have appreciated such organisation and continue to do so, also in terms of cost and efficiency.

John Broadhurst: Our clients have always expected to work mostly with our partners. One of the strengths of our practice is that we have about the same number of partners as associates and other attorneys. This means that each client gets a substantial amount of partner attention, regardless of the client's size. To maintain this high standard of partner-level service we purposely

limit client intake. Our focus on client service always has served us well, but it was especially important during the 2008 market crises, when clients needed immediate help with margin calls, short sale rule changes and Bear Stearns and Lehman-related issues. Fortunately, many of our clients are long/short managers and performed extremely well in 2008 relative to the S&P and other benchmarks, so we saw only a handful of fund closings last year.

Patricia Volhard: Of course, the more complex and new issues which come up in the course of the financial crisis (triggering of default clauses, restructuring of funds, annex funds etc.) divert from the "routine" fund structuring work of the past and require more partners' involvement. However, it is important for a firm to involve young associates in developing new products and practices from the beginning so that they can contribute their knowledge and build up their expertise. At the end of the day, associates are the potential of a firm and it is of key importance to integrate them early into the client relationship and make them part of it. Without doing so, a firm will not use its full potential and not create a basis for stable growth, both in terms of size as well as in terms of quality.

Paulus Hidén: Actually, the note on increasing complexity prompts only one remark: that fund managers and their legal counsel should avoid excessive 'creativity' in structuring a fund or drafting its terms. We have had a few cases where an LP that we represented was nearly ready to walk away, simply because the fund manager was either reluctant or unable to explain their complex terms that were out of market practice. Lesson: when a fund manager has created a new kind of fee / carried interest structure and tells you that they have no sample calculations to show you, he is either lying or not doing his job properly.

FIRM ISSUES

WWL: *What makes for a successful private funds practice in the current climate? Are mid-market boutiques performing better than established full-service firms in your jurisdiction?*

Patricia Volhard: I don't think that it is a question of mid-market boutique against full-service firm. The firm that's close enough to its clients and the market to identify upcoming developments, and to accommodate them by building up new

know-how on an ongoing basis instead of relying on its current reputation and practice, will have continued success. This is true not only in the current climate but generally.

John Broadhurst: In the current climate, it helps to have a stable client base. As I say, many of our clients are long/short managers and performed extremely well in 2008, relative to the S&P and other benchmarks, so we saw only a handful of fund closings last year. But in any climate, our practice thrives because of the focus on quality control and responsiveness.

Patricia Volhard: The current climate does make the need to be on top of things, and to be close to the clients' developments, more obvious and essential.

John Broadhurst: That's easier to achieve in firms structured such as ours, with low associate-to-partner ratios. We've been able to accomplish this within a full-service firm model. There are six partners that handle clients' day-to-day issues, but other members of the firm handle all types of matters for our clients – SEC enforcement issues, investor litigation to recover fund losses, real estate-related issues, acquisitions, etc.

Paulus Hidén: We really don't have boutique firms focusing on private funds. It's a small market and only few of the full-service firms have a credible private funds practice. In difficult market circumstances it's more important than ever to understand what the market practice is, as many LPs have limited patience for "reinventing the wheel". At the same time, structuring capabilities are more important than ever, as due to weak investor demand, all interested parties preferably need to be "effortlessly" facilitated. For a funds practice, one of the key issues is a strong tax group, and especially when it comes to leveraged property funds, the support of a first-class banking team.

John Broadhurst: Many hedge funds are small and have intermittent legal needs. It's difficult to build a stable practice in the industry by accepting only the multi-billion dollar managers. Law firms need to accept many small-to-medium-sized clients that have modest annual legal needs (until they succeed and grow). Large law firms seem to have a hard time servicing these types of clients efficiently with senior attorneys, so our size firm (58 attorneys total, of which 15 are in the investment adviser practice group) seems able to accommodate this part of the industry more effectively.

This is an extract from The International Who's Who of Private Funds Lawyers 2010, for further information please visit www.whoswholegal.com or call +44 20 7908 1187