



Citi OpenInvestorSM

Evolving investor relations: Alignment of interests and the impact of regulation

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Introduction

Change is often driven by crisis, government intervention or a combination of both. This is certainly the case in the private equity arena where the current dynamic between fund managers and investors is being reshaped with investors desiring and needing increasingly granular information and a significantly evolving regulatory environment.

The gap between what the limited partner (LP) wants and what the general partner (GP) is able or willing to provide is not a new phenomenon but current market conditions are shining a brighter light on this disconnect and solutions are now required. The perceived balance of power has swung toward investors. This article discusses the main factors driving this trend including the fallout from the recent financial crisis, the Institutional Limited Partners Association (ILPA) efforts to encourage increased transparency, consistency and disclosure, and a number of key regulatory developments.

Private equity is an inherently complex industry and there are notable differences in the approaches being taken to provide even some of the most basic industry information

to private equity investors. This is further complicated by the obvious conclusion that whatever the series of outcomes in addressing these evolving needs, there can be no one-size-fits-all model to address the vast degree of differences across the managers that will need to implement these changes and the investors who will ultimately invest capital in them.

While the exact future of private equity investing and the relationship between managers and investors has yet to be written, the evolution of a long journey ahead is most certainly under way.

Drivers for increased reporting and disclosure

The financial crisis

Before the financial crisis, investors in the private equity asset class were more accepting of a lesser degree of transparency from their managers. This was due in large part to the high rates of return that the best managers were able to generate for investors. Furthermore, given the demand for access to the elite managers, LPs typically did not “rock the boat” by being overly demanding of managers or making onerous requests for information. This changed considerably in 2008.

As capital markets dried up, private equity investments were impacted on multiple levels. The dearth of transactions led initially to fewer distributions, greater uncertainty regarding future cash flows and eventually reduced returns for investors. Continuing capital calls for expenses, new and add-on investments exacerbated the liquidity crisis that investors were feeling across their entire portfolios. For recent entrants to private equity investing, the lack of clarity around cash flows was even more challenging. Investors attempting to gauge their exposures to markets or various economic factors found it difficult to assess risk at the portfolio level if they could not understand the credit, counterparty, sector and market risk of their investments.

The financial crisis has, therefore, led investors to scrutinize private equity performance metrics more critically. As a result, increased disclosure is no longer a nice-to-have option that fund managers may or may not provide to their investors, but rather a basic requirement to get past the due diligence of most investors. Furthermore, a willingness to disclose information and data can be a factor that GPs use to differentiate themselves from competitors.

Industry changes and investors as agents of change

The growing complexity of the industry coupled with the fact that investors are more sophisticated and accustomed to private equity investing is facilitating the need for closer alignment and dialogue with fund managers. It also means that investors are less reticent about asking for data and information from GPs or about expressing a wish to exert more control over what they do and how they invest money.

Sophisticated investors, for example, are seeking products that provide more liquidity, shorter duration and more control in various bespoke solutions. Separately managed accounts and direct coinvestment vehicles are increasingly popular among investors that do not wish to be commingled with LPs that have different objectives or that want to have an enhanced degree of control over how their capital is allocated as well as increased visibility into those investments.

The largest institutional investors are putting additional options on

the table. With \$44 billion of its \$110 billion total allocated to private investments, Texas Teachers has struck strategic partnerships with large private equity managers that “affords us greater flexibility and more control...[and] the opportunity to closely inspect the practices of these firms and get a grasp for how they consistently outperform the public-equity markets.”¹

Alternative investment asset managers themselves are creating additional complexity in reporting and transparency with the increasingly blurred lines between private equity structures and investments and more actively traded instruments.

Family offices that manage the affairs of very wealthy families have long had interest in private equity investing. Many have made their fortunes through entrepreneurial activities, often as the founders of privately held companies. They are long-term in nature and understand the value of patient investing. Given the talent available as Wall Street firms grapple with profitability pressures and the terms of the pending Volcker Rule,

many family offices have built teams to manage private equity internally.

Importantly, diverging approaches to improving transparency differ not only across vehicle and client type, but also across investor segments. Old-school private equity investors have a long-term, historical view of the asset class and may not as quickly question the need for deep transparency in this asset class. Newer investors, by contrast, may have more experience with listed equities and more traditional markets and have been immediately horrified by the lack of transparency in their private equity portfolios.

Ultimately, LPs of any ilk are looking for some level of industry standardization in order to be able to maximize their ability to analyze performance, risk and other metrics across their entire portfolio. However, this can be more challenging in an industry that has different requirements and, therefore, does not necessarily speak with one consistent voice.

¹*The Wall Street Journal* (February 16, 2012), “Private Equity Keeps Public Pensions Sound.”

The role of ILPA

Investors are also driving change through ILPA, which is playing a significant role around improving transparency and is helping to direct the industry toward an increasing level of standardization. With over 250 members collectively managing over \$1 trillion in private assets globally, ILPA² has established operating guidelines to drive consistency in the manner in which GPs are reporting certain information to their investors. Its Private Equity Principles center around an alignment of interests, improved governance and increased transparency.

The principles include the suggestions that:

- fee and carried interest calculations be transparent and subject to LP and independent auditor review and certification;
- detailed valuation and financial information related to portfolio companies should be made available as requested on a quarterly basis; and

- GPs should reinforce their duty of care beyond the minimum standard for indemnification.

ILPA took a further step toward facilitating reporting consistency in October 2011 when it issued the *Quarterly Reporting Standards and Capital Call and Distribution Notice Templates*, but while the templates are highly instructive, they are not meant to be definitive.

ILPA is a trade group, however, not a regulator, and therefore its recommendations are nonbinding. This has led skeptics to question the extent to which managers would voluntarily embrace such standards, given their pedigree and their ability to attract new investors that might not insist on implementing ILPA's guidelines. However, large managers seem to be leading the way in terms of responsiveness. Although these managers have strong reputations, some are trying to use their willingness to improve their disclosure as a source of differentiation from competitors in order to attract

new capital. Perhaps some GPs are responding directly to their current investors' demands for compliance with the ILPA guidelines. CalPERS, for example, has formally announced that starting March 1, 2012, GPs will have to comply with its new ILPA-style terms on capital calls and distributions.³ It may also be the case that the largest managers have the resources (people and technology) available to change their communications – not just the actual reporting, but the approach to collecting data and ensuring its quality.

While there are clear signs of evolution in the dialogue between GPs and LPs, the clear and consistent consensus is that one solution will not fit all of the needs of the industry's constituents. Even ILPA itself recognizes that "a single set of terms cannot provide for the broad flexibility of market circumstance."⁴

²Institutional Limited Partners Association website: <http://ilpa.org>

³*The Wall Street Journal*, (February 27, 2012), "CalPERS standardizing general partners' reporting form."

⁴ILPA Best Practices, ILPA website: <http://ilpa.org>

The impact of regulation

In the United States and Europe, regulators have taken significant steps to improve transparency through a series of new regulations. The Dodd-Frank Act in the U.S. and the Alternative Investment Managers Directive (AIFMD) in the EU are particularly salient. A critical component of these reforms (see “Summary of key regulations in the U.S. and EU” on page 6) is that unlike any concessions advocated by industry groups such as ILPA, these regulations are mandatory, absolute, standardized and treat all investors alike.

While many of the provisions of AIFMD and the Dodd-Frank Act are aimed specifically at reducing systemic risk in the wake of the financial crisis, they are likely to reinforce the drive toward increased transparency and the control being sought by many private equity investors. As a general rule, regulatory oversight leads to more investor confidence: Investors may take comfort in the fact that someone is watching over their managers.

Although these regulatory changes and additional disclosure should improve transparency for private

equity investors, other issues still remain. The lack of clear standards for valuation, risk management, performance measurement and benchmarking of private equity investments compared to traditional and even hedge fund investments still exists.

The challenge will be managing these changes into and throughout the industry in a systemic and efficient manner, coupled with the potential unintended consequences of the impact of certain evolving regulations on private equity managers and investors alike.

Perhaps the most significant question to be answered is whether this changing landscape will cause the long-term returns for the asset class to suffer, since part of the theoretical appeal of private market investing is that information advantage leads to superior returns. With complete transparency and therefore less information advantage (regardless of cost of implementation), will returns suffer and begin to more closely mirror public market returns, making private equity investing a less attractive asset class?

The evolution has only just begun

All evidence indicates that alignment between fund managers and investors is moving in the right direction. Managers are building processes and capabilities commensurate with the increasing needs of their investors. It remains to be seen whether the increasing impact of a regulatory overhang stunts or fuels that progression.

CFOs and COOs are on the front line of this information revolution. They are required to set up the back-office functions, the processes and the infrastructure essential to meet the increasing reporting and information needs of investors. They are also responsible for weaving this into an organizational structure of risk management, compliance and oversight to address the new and evolving regulatory environment that is taking place across the globe and achieve this manner that also aligns with their investors' compliance requirements.

There are many players who will have a role in this evolution beyond the GPs and LPs themselves. Technology must play an increasing role in capturing,

managing and reporting the hoards of data captured for both internal and external reporting purposes. Firms continue to invest heavily in technology to meet these increasing needs and, as a result, technology providers are increasing their presence in the private equity space.

In order to improve risk management and control, the historical focus on core accounting and reporting has necessarily expanded to include portfolio transparency, benchmarking, enhanced investor reporting tools, data feeds and aggregation of portfolio information with other asset classes.

Other industry constituents will also play increasingly important roles in areas such as assisting with regulatory compliance in the new landscape, advising and consulting on operating platforms and procedures and creating a more consistent outsourcing model for the administration of funds in accordance with evolving industry standards.

There is ample evidence to suggest that investors remain committed to the asset class. Moreover, given low expected returns for most of the developed world for some time, investors are unlikely to add to their traditional investments at the expense

of their private equity allocations. Despite the pressures from investors and regulators alike, the future of private equity has yet to be fully written. While there are demands for a certain level of standardization, there is not a one-size-fits-all solution. Some investors will rely on the regulators to set these standards, others will negotiate directly with fund managers and others still will rely on new investment structures to meet their goals. Although the precise vision of the future remains cloudy, it is clear that there is no going back.

Summary of key regulations in the U.S. and the EU

U.S. overview

The Dodd-Frank Act is the most significant recent regulatory development in the U.S. Under this Act, private equity firms with more than \$150 million in assets under management are required to register as investment advisors with the Securities and Exchange Commission by March 30, 2012. In addition, they must comply with the Advisors Act and will be required to implement a compliance program, designate a chief compliance officer (CCO) and create a written compliance manual setting out the firm's procedures for portfolio management, maintenance of books and records, employee conduct guidelines and regulatory reporting protocols.

Another requirement under Dodd-Frank is that SEC-registered firms are required to periodically file a reporting form called Form PF, which may require a firm to include some or all of the following information:

- details of valuation policies and practices;
- extent of leverage incurred by their portfolio companies;
- size and scope of any investments in financial institutions;
- types of investors in the funds; and
- information related to the funds' service providers.

EU overview

The two key regulations are: the Alternative Investment Fund Managers Directive (AIFMD) and Solvency II.

AIFMD

The directive applies to private equity and hedge fund managers operating in the European Union and requires them to do the following:*

- designate a depositary for the safekeeping of fund assets and take on a fiduciary duty in their approach to safekeeping;
- disclose use of leverage to investors and comply with forthcoming limits to be defined by regulators;
- disclose any preferential treatment offered to specific investors (without revealing their identities), particularly with regard to liquidity management and gating;
- appoint either an independent entity or a functionally separate unit of the AIFMD to value the fund's assets; and
- establish risk management systems, which will be functionally separate from portfolio management and subject to annual review.

Firms with total assets under management of less than €100 million (leveraged) or €500 million (unleveraged) escape the full registration and reporting regime under the AIFMD. Full implementation of the directive will not take place until 2013 at the earliest.

Solvency II

The proposed Solvency II framework is designed to reduce systemic risk. The three main pillars are:

- Pillar 1 includes quantitative requirements (Solvency Capital Requirements, estimates of the liabilities and risk margin and a minimum capital requirement).
- Pillar 2 sets out requirements for the governance and risk management of insurers as well as for the effective supervision of insurers.
- Pillar 3 focuses on disclosure and transparency requirements.

At a macro level, there is a concern that these stress tests on private equity assets may drive insurers to de-risk and move out of private equity toward assets that are perceived as safer. The European Commission has also argued for applying Solvency II standards to pension funds, given the size and duration of their liability profiles. This could prove to be a blow to private equity managers, given pension funds' historical private equity capital base.

*See Articles 12 to 17 and Article 19 of the AIFMD.

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Joe Patellaro is a Managing Director and the Global Head of Citi's Private Equity Services business unit. He is responsible for the global strategy and evolution of the Private Equity Services business and interacts with many internal and external constituents worldwide in staying current on industry, technical and regulatory matters. Joe has led or participated in many industry-related conferences, panels and events on topics including the evolving regulatory landscape, fair value/ASC 820, outsourcing and other topics. Joe has been in the professional services industry since 1987 and has been with Citi since 2002. Prior to joining Citi, Joe spent over 15 years at Arthur Andersen, most recently as an audit partner and the partner-in-charge of the emerging markets practice in the Stamford, Connecticut office. Joe is a graduate of Hofstra University.

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Citi OpenInvestor for Private Equity Managers delivers customized private equity administration solutions through experienced management, client service teams with great industry knowledge and a client-centric service model. Our focus has been dedicated to private equity funds and investors for over 18 years, servicing a variety of types of investors and funds, including buyout, fund of funds, venture capital, real estate and mezzanine debt.

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