Weil, Gotshal & Manges LLP

Private Equity ALERT

September 2003

# Secondary Investing in Private Equity Funds — Primary Issues for General Partners

By Paul Cohn and John Aiello

The rapid growth of secondary investing in private equity funds during the last few years has given rise to a tension between the interests of the general partners of such funds and limited partners seeking liquidity for their investments.

The nature of tensions between the general partners of funds and the limited partners desiring to transfer their interests may vary depending upon, among other considerations:

- the ***type of investor*** that the transferring limited partner is (*e.g.*, financial or strategic),
- the ***size of the interest*** being transferred (*e.g.*, a controlling interest or a relatively small economic or voting interest),
- the ***legal and tax status*** of the transferor and the transferee (*e.g.*, U.S. or foreign, tax-exempt, ERISA plan, bank, insurance company or other regulated entity and legal qualifications as an accredited investor, qualified institutional buyer or qualified purchaser),
- the ***form of organization*** of the transferee (*e.g.*, single party purchaser, secondary fund of funds buyer or securitization vehicle),
- whether the transfer will affect the ***accounting treatment or tax structure*** of the fund or its investors, and
- how the transfer will affect ***confidentiality*** of fund information, the ***voting dynamics*** of the limited partners as a group, ***governance*** of the fund and the general interplay between the general partner and the limited partners.

## Who's calling the shots?

During the past few years, the secondary market for private equity interests has diversified greatly. While a large portion of secondary trades are still effected by means of the transfer of private equity interests in a fund (or, more recently, in pools of funds) to a financial or strategic buyer for its own account, the recent emergence of funds established to acquire private equity interests in the secondary market (*i.e.*, secondary funds of funds) and securitizations of portfolios of private equity interests has expanded the liquidity of limited partners. Not surprisingly, a plethora of brokers and private placement agents has emerged in response to the growing volume of transactions in the secondary market.

Secondary fund of funds transfers and securitizations involve new, and generally more complex, concerns for general partners. For instance, securitizations typically involve several new parties such as trustees, servicers, credit facility providers, insurers, swap counterparties and rating agencies. The attributes of ownership of the securitized interests are allocated among these parties in a fairly complex manner.

Which party is "calling the shots" with respect to obtaining waivers, soliciting amendments, determining future transfers of the interests, foreclosing on the interests and meeting capital calls varies from deal to deal and is often quite limited by the operative indentures, operating agreements, servicing and security agreements, credit facilities, swaps, insurance policy "wraps" and other transaction documents. Accordingly, a general partner may have difficulty obtaining a timely response to matters that are fairly routine for a single owner of a limited partner interest. Even if the correct party responds diligently, the operative documentation may tie the hands of the respondent in a manner that effectively prevents decisions from being made in what would otherwise be the owner's best economic interest.

For example, several securitizations have been accomplished using qualified special purpose entities ("QSPEs") in order to achieve sale treatment for accounting purposes. In order to achieve the accounting goal, QSPEs generally must be "brain dead" entities, which as a practical matter translates into removing virtually all discretion from the servicer as to voting, disposition and other matters that an owner would ordinarily use to protect its economic interests. In most instances, these fundamental ownership decisions are "hard wired" at the onset of the transaction (*e.g.*, effective disenfranchisement through required voting *pro rata* with other limited partners on most matters, required voting against certain amendments relating to capital commitments and the term of the fund and forced auctions of fund interests in specified circumstances) and cannot be changed during the life of the deal, even if such change would make compelling economic sense. For the general partner, this may complicate or prevent what might otherwise seem like fairly straightforward waivers or amendments.

## Preserving Confidentiality

Confidentiality also is more difficult to preserve in the secondary fund of funds and securitization contexts. Added to the typical concerns in providing diligence materials to potential buyers in the more traditional forms of secondary transfers (which can often be addressed adequately through confidentiality agreements) is the stark reality that the increased number of players in the secondary fund of funds and securitzation contexts makes it more difficult to maintain the confidentiality of proprietary fund information.

In the secondary fund of funds context, both the manager and investors will seek information as to the underlying funds' performance (and, possibly, the performance of the funds' portfolio companies), often increasing the amount of confidential information disseminated and the number of recipients thereof. Since the restrictions on the types of entities that may invest in the fund of funds and those of the underlying funds may differ, instances can arise in which certain types of investors in a secondary fund of funds (*e.g.*, pension fund investors or other investors subject to legal disclosure requirements) may be broader than those with whom the general partners of the underlying funds are comfortable.

In the securitization context, confidential information is likely to be obtained by the rating agencies, the servicer, credit enhancers, swap providers and insurers. Limited disclosure by a securitization vehicle to its securityholders will also be made. As the potential number of recipients of fund performance and other information grows in these instances, the "confidential" nature of that information decreases.

## Effects of Multiple Valuations

Another concern that arises from transfers to secondary funds of funds and securitization vehicles is the indicative valuations that the investment vehicles provide for their securityholders. Often, the methods used for such valuations are adjusted to reflect "haircuts" required by the rating agencies, credit providers and insurers or adjustments otherwise unique to the secondary funds of funds or securitization vehicles (*e.g.*, for determining management fees, the party controlling decisions, levels required by credit enhancers and other adjustments not necessarily relating to fund performance).

Accordingly, general partner valuations may not be the same (and generally will be higher) than those made by a secondary fund of funds or securitization vehicle. This may adversely impact the general partners with respect to credibility with their limited partners and may affect other limited partners that provide periodic valuations for regulatory, tax or accounting purposes or in connection with their own transfers of private equity interests.

**"As investors continue to seek liquidity for private equity investments in a secondary market that is growing in size and complexity, general partners are being challenged to balance this liquidity need with the responsibility to protect their funds from any resulting risks."**

## Creditworthiness of Transferees

In all secondary transfers of private equity interests, a general partner should assess the creditworthiness of the transferee before giving consent to the transfer. The level of concern may be somewhat ameliorated if the fund is almost fully invested, but may be elevated (i) if the fund is actively seeking portfolio companies and has large unfunded commitments or (ii) if distributions to date have been large and could be recalled due to the fund's remaining investments or wind down strategy. In any event, a general partner should give due consideration to any potential limited partner clawbacks or indemnity obligations as well as outstanding follow-on commitments, remaining management fees and anticipated fund expenses.

Once again, this assessment becomes more difficult in the context of secondary funds of funds and securitization vehicles because, in many cases, there are limited financial sources for future capital calls, clawbacks and indemnities. Generally, the sufficiency of such sources is determined across a pool of private equity interests and is determined when the deal closes (and, therefore, when these amounts may not be readily ascertainable). Sources of funding may include reserve funds, credit facilities, insurance policies or swaps. If the cash available from these funding sources is exhausted or if the funding sources do not make the required payments due to default or lapsing of their obligations to do so (which may be dependent upon deal structure or performance or other conditions unique to the deal), the limited partner is likely to default on its commitment.

## Allocation of Obligations and Granting of Releases

General partners should also carefully assess the allocation of rights and obligations between the transferor and transferee in a secondary transfer. Particular attention should be given as to how clawback, indemnification and similar obligations are split between a limited partner and its successor in interest. For example, an economic dislocation may occur if the transferor has recently been the recipient of large distributions, but the clawback obligations with respect thereto have been transferred to the successor in interest.

In some instances the transfer documents purport to release the transferor from some or all of its obligations and liabilities to the fund but do not provide for the transferee undertaking successor liability for such matters. This could result in a general partner unintentionally treating a transferor and its successor differently from other investors or leaving a potential economic hole.

Another area of concern for general partners is the characterization of secondary investments as transfers to affiliates that are not subject to general partner approval or are not otherwise subject to the same transfer restrictions as transfers to third parties. In many instances, so-called "affiliate" transfers raise some or all of the concerns of third-party transfers and, in highly structured deals such as securitizations, "affiliate" or "subsidiary" status may be open to interpretation.

## Side Letters and Special Arrangements

Some cornerstone, strategic or large financial investors may be granted special rights and privileges (and may exact additional restrictions on a fund's operations and governance) through side letters, co-investment vehicles or other arrangements. Whether and to what extent these types of provisions should survive a secondary transfer are questions that may generate another set of issues for a general partner. In particular, arrangements that are premised on strategic support rarely should remain in place if the strategic partner transfers all of its interests in a fund. Whether or not they should remain in place if a partial transfer occurs should be determined on a case-by-case basis.

Similarly, the granting of investment committee or advisory board seats and other involvement in the governance of a fund should generally not be transferable, especially if the transferee is a QSPE that cannot exercise such rights in the same manner as an investor that can make unrestricted, economically-motivated decisions.

## Mechanics of Transfers; Legal Requirements

Finally, although all secondary transfers should be accompanied by transfer documentation containing protections as to matters under the Securities Act of 1933, the Investment Company Act of 1940, ERISA requirements, money laundering regulations, the Patriot Act and similar matters, additional concerns may arise for funds that invest in portfolio companies or securities that are subject to special regulations (*e.g.*, investments subject to FCC, insurance or banking laws).

Moreover, in the case of funds having more than 100 investors, the general partner should be vigilant to ensure that any transfer not be treated as made on a secondary market or the substantial equivalent thereof within the meaning of the income tax regulations, lest the fund lose its status as a partnership for federal income tax purposes. To do so, either the transfer must come within one of a number of safe harbors set forth in the regulations or the general partner must obtain undertakings or opinions to assure that the transfer was not made in a proscribed manner. The details of such tax requirements are beyond the scope of this article.

Compliance with these matters is not always a straight forward matter, particularly if the underlying fund has itself been highly structured to navigate the murky waters of international tax, cross-border jurisdictional concerns or accounting characterization. An added level of complexity arises if the transferee is an entity (such as a secondary fund of funds or securitization vehicle) that makes it difficult to trace through to its investors in order to ascertain if issues exist.

## Recommendations

As investors continue to seek liquidity for private equity investments in a secondary market that is growing in size and complexity, general partners are being challenged to balance this liquidity need with the responsibility to protect their funds from any resulting risks. In searching for the appropriate balance, we recommend that general partners keep the following matters in mind:

- ***Maintain confidentiality*** of fund performance and other information through (i) confidentiality agreements with potential buyers and, if necessary, any servicers, trustees, swap counterparties, insurers and credit enhancers, (ii) limitations on the amount and form of information provided to investors in secondary funds of funds or securitizations and (iii) control over dissemination, directly or indirectly, to investors that may be subject to mandatory disclosures under applicable law.

- ***Establish the financial wherewithal of transferees*** and the adequacy of their funding sources, particularly for securitization or secondary fund of funds structures. As part of this evaluation, the allocation of rights and obligations between a transferor and its successor should be carefully assessed as should the effect of any explicit or implicit release of any party from its obligations to the fund.
- ***Re-examine special arrangements*** with strategic partners, cornerstone investors or other significant investors that are set forth in side letters, co-investment vehicles or otherwise.
- ***Assess the practicality of having the proposed transferee as a partner.*** Is the proposed transferee a QSPE or other entity that has restrictions on exercising voting, governance or other rights needed for the operation of the fund? Can the proposed transferee timely meet capital calls, indemnity obligations and limited partner clawbacks? Will the transferee make fund valuations that may differ from those of the general partner?
- ***Strictly adhere to all legal, regulatory, tax and accounting requirements in connection with the transfer of the interest.*** Subscription agreements, assumption agreements and legal opinions required by the fund documents should be obtained in order to ensure compliance with applicable laws and maintenance of the desired tax and accounting treatments.
- ***Obtain an up-front commitment from the secondary seller and buyer to cover all expenses of the general partner and the fund relating to the transfer.***

## The Regulatory Corner

*By Richard Ellenbogen*

*From time to time, Private Equity Alert will include information about regulatory developments that impact our private equity clients.*

***SEC Report on Hedge Funds.*** The long awaited Securities and Exchange Commission (the "SEC") Staff report on hedge funds was released to the public on September 29, 2003. Among other things, the Staff recommended that hedge fund managers be required to register with the SEC as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act"), regardless of the number of funds or clients they have under management. The Staff, however, recommended that any rule requiring registration distinguish between hedge funds and other investment vehicles, such as private equity, venture capital and structured financing vehicles. Registration would give the SEC the ability to conduct routine audits of hedge fund managers. Primary areas of concern about hedge funds emphasized by the Staff are the lack of SEC oversight, valuations of assets, the retailization of hedge funds, disclosure to fund investors, conflicts of interest and the manner in which funds are offered to investors. The Staff further recommended that the SEC permit general solicitation on offerings of Section 3(c)(7) funds that are sold only to "qualified purchasers." A future edition of *Private Equity Alert* will describe the Staff's findings and recommendations in greater detail.

***Investment Adviser Custody.*** The SEC recently adopted amendments to the custody rule under the Advisers Act in order to conform the rule to modern custodial practices. According to the SEC, the amendments were designed to enhance protections for client assets while reducing burdens on advisers that have custody of client funds or securities. The amendments become effective on November 5, 2003 and require full compliance by April 1, 2004. Under the amendments, fund managers who are registered with the SEC as investment advisers would be deemed to have custody of client assets, but will no longer be required to make custody disclosures in their Form ADV brochure or subject themselves to surprise audits. Fund managers will be required to maintain all fund assets with qualified custodians (*e.g.*, banking institutions or broker-dealers) and have an annual audit performed and audit results distributed to fund investors.

***Anti-Money Laundering.*** Earlier this year, the Treasury Department proposed regulations that would define all investment advisers (including unregistered private equity fund managers) as financial institutions, within the meaning of the USA PATRIOT Act, that are required to develop and implement anti-money laundering programs. The proposed regulations supersede a previous proposal that would have defined all private investment entities as financial institutions, but would have exempted most private equity funds. Indications are that a final rule may be issued by year end.

***Voting Client Securities.*** Rule 206(4)-6 under the Advisers Act provides, effective as of August 5, 2003, that it is a "fraudulent, deceptive, or manipulative act, practice or course of business" for a registered investment adviser to exercise voting authority with respect to any client securities unless the investment adviser has adopted written policies and procedures (i) reasonably designed to ensure that the adviser votes securities in the best interests of clients and (ii) addressing material conflicts of interest that may arise between the interests of the adviser and those of clients. The adviser is also required (i) to disclose to clients a summary of the policies and procedures and how they may obtain information from the adviser about how the adviser voted with respect to their securities, and (ii) to provide to clients a copy of the policies and procedures upon request.

***Privacy Regulation.*** The Gramm-Leach-Bliley Act (the "GLB") requires that all financial institutions ensure the security and confidentiality of customer information. Investments advisers, including unregistered private equity fund managers, are financial institutions subject to the GLB. Fund managers who are registered investment advisers are subject to regulations adopted by the SEC. However, fund managers who are not registered as investment advisers are subject to recently effective safeguard regulations issued by the Federal Trade Commission (the "FTC"). The FTC regulations require that such fund managers have in place a written security plan that involves (i) the designation of a compliance officer, (ii) the identification and assessment of risks to customer information, (iii) the design and implementation of a security plan and ongoing evaluation, testing and monitoring of the effectiveness of the security plan, (iv) the selection and contract of appropriate service providers as necessary to implement the security plan and (v) ongoing evaluation and adjustment of the security plan to take into account changes in the adviser's business and operations or the results of testing and monitoring of safeguards.

***Commodity Futures Trading Commission.*** The Commodity Futures Trading Commission (the "CFTC") recently adopted new rules that modernize and relax the regulation of fund managers who deal in futures contracts or other commodities contracts on behalf of their funds under management. Under the new rules, most private equity fund managers that use futures contracts or other commodities to hedge portfolio risks will be exempt from registration as commodity pool operators (each, a "CPO"). Newly adopted Rule 4.13(a)(4) creates an exemption from CPO registration for any manager of a fund that is exempt from registration under the Investment Company Act of 1940 by Section 3(c)(7). Additionally, newly adopted Rule 4.13(a)(2) creates an exemption from CPO registration provided either (i) initial margin and premiums required to establish commodity positions will not exceed five percent of the liquidation value of the fund portfolio or (ii) the aggregate notional value of commodity positions will not exceed 100 percent of the liquidation value of the fund portfolio. In either case, a claim of exemption must be filed with the CFTC.

Private Equity Alert is published by the Private Equity Group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, 212-310-8000. The Private Equity Group's practice includes the formation of private equity funds and the execution of domestic and cross-border acquisition and investment transactions. Our fund formation practice includes the representation of private equity fund sponsors in organizing a wide variety of private equity funds, including buyout, venture capital, distressed debt and real estate opportunity funds, and the representation of large institutional investors making investments in those funds. Our transaction execution practice includes the representation of private equity fund sponsors and their portfolio companies in a broad range of transactions, including leveraged buyouts, merger and acquisition transactions, strategic investments, recapitalizations, minority equity investments, venture capital investments and restructurings.

**Editor: Douglas Warner**
212-310-8751



Please address inquiries regarding our practice or topics covered in Private Equity Alert to your contact at Weil, Gotshal & Manges LLP or to the following persons:

**NEW YORK**
Barry Wolf
212-310-8209

Jeffrey Tabak
212-310-8343

**BOSTON**
James Westra
617-772-8377

**BUDAPEST**
David Dederick
011-361-302-9100

**DALLAS**
Glenn West
214-746-7780

**FRANKFURT**
Gerhard Schmidt
011-49-69-21659 700

**HOUSTON**
Steve Rubin
713-546-5030

**LONDON**
Michael Francies
011-44-20-7903-1170

**PARIS**
Claude Serra
011-331-44-21-9788

**PRAGUE**
Karel Muzikar
011-420-2-2140-7300

**SILICON VALLEY**
Richard Millard
650-802-3015

**SINGAPORE**
William Sievers
011-65-6535-3600

**WARSAW**
Pawel Rymarz
011-48-22-520-4000

**WASHINGTON, D.C.**
Robert Odle
202-782-7180

Visit our website at **www.weil.com**