



## *Kirkland & Ellis International LLP*

2009 Private Equity & Venture Capital  
adjusting to new market conditions



## ■ Use of Placement Agents and ‘Pay-to-Play’ Legislation

BY RICHARD WATKINS

In the state of New York, the chief fiscal officer, the state comptroller, is directly elected to ensure independence from the governor. One of the comptroller's primary functions is to operate, and act as sole trustee of, the New York state and local government retirement plans.

Alan Hevesi was the comptroller from 2002 to 2006. In March 2009, his former chief political adviser (Hank Morris) and chief investment officer (David Loglisci) were indicted by New York Attorney General Andrew Cuomo on 123 corruption charges. The indictment alleged that they had conspired to “sell access to billions of taxpayer dollars in exchange for millions of dollars in kickbacks and other payments for political and personal gain”. Both have denied the allegations.

In some instances, it was alleged that ‘finder’s fees’ paid by private equity firms had been used (among other things) to fund campaign contributions for Alan Hevesi. In return, those firms received substantial investment commitments from the New York State Common Retirement Fund (NYSCRF).

As a result of these investigations several private equity firms have paid or agreed to pay, in aggregate, tens of millions of dollars in ‘pay-to-play’ settlements negotiated with the New York attorney general.

Placement agent arrangements are under increased scrutiny by state and federal law enforcement and regulatory agencies, as well as public pension funds.

A new New York state comptroller policy prohibits NYSCRF from investing in private funds using placement agents or other third parties to ‘assist’ in obtaining an investment by NYSCRF. Because the language of the ban is ambiguous, NYSCRF may be prohibited from making investments in private funds that use a placement agent for any purpose. The New York state comptroller has concluded that private fund sponsors do not need placement

agents because all private fund sponsors will be afforded ‘open access’ to the NYSCRF investment staff and placement agents are not part of NYSCRF’s investment decision-making process. To secure NYSCRF as an investor, private fund sponsors must make legal representations that a placement agent was not used and grant NYSCRF withdrawal rights that may be exercised if such representations include a material misstatement or omission. Other New York pension plans have taken similar action.

### **Federal action**

The U.S. Securities and Exchange Commission is coordinating its federal civil and criminal investigations with the New York attorney general, and has filed civil charges against several people involved in the New York state probe. In August, the SEC published new proposed ‘pay-to-play’ rules that would effectively prohibit the use of placement agents to solicit public pension plans and limit political contributions by investment managers as it prohibits a public agency from paying fees or other compensation to any manager within two years of that manager or any of its principals or the majority of its employees (whether or not employed by the manager at the time) making or soliciting any political contribution other than, in certain limited circumstances, a de minimis amount. The consultation period ended on 6 October 2009 and the SEC is suggesting that the final rule may be in place in early 2010. More than 80 comment letters were submitted to the SEC, all of which are publicly available. The majority of comments from GPs, LPs and placement agents themselves object to the perceived placement agent ban. Notably CalPERS, one of the industry’s largest investors, has maintained a neutral stance on the placement agent ban and a number of private equity firms’ comments are supportive of the proposed pay-to-play restrictions and political contribution bans (although these may be problematic for GPs to police and enforce).

### Action by other states

State and public pension plans and other industry participants are sending inquiries to fund managers requesting disclosure of prior or current use of placement agents and the terms of such arrangements. There are now restrictions or bans on using placement agents in connection with seeking investments from certain public pension plans, notably Illinois, which prohibits fees payable contingently upon an Illinois plan investment. Other states, such as California and New Mexico, have implemented or enhanced disclosure requirements with respect to the engagement of a placement agent by funds in which public agencies invest. Some states are scrutinising their regulations relating to the acceptance of gifts and/or political contributions and certain public pension plans have terminated arrangements with Aldus Equity (a private equity firm that was closely associated with the pay-to-play investigations), which appears to have shut down.

However, some state plans have announced affirmatively that they will not be changing their policies, and others are delaying action with a 'wait and see' approach.

### Best practices

The U.S. regulatory landscape is evolving, more likely at a faster rate than Europe. General partners are dealing with numerous investor and third party enquiries, including in some cases investigatory requests for information or subpoenas, preparing themselves

for registration with the SEC pursuant to likely changes to the Investment Advisers Act, the resulting consequences of registration for their businesses and, in some cases, heightened scrutiny of US broker-dealer registration requirements.

Firms can take a number of steps to ensure that their use of placement agents follows best practice. Firms should consider developing policies, procedures and codes of conduct with regard to their use of placement agents (where permitted by legislation) and, more generally, interaction with potential investors, which might cover a number of areas. First, conducting greater and more detailed due diligence on potential placement agents prior to their engagement and only using placement agents who are FSA authorised (in the United Kingdom) or registered broker-dealers (in the United States). Second, ensuring that there is a written contract that specifies payment and services to be provided. Third, restricting solicitation by the placement agent of those investors who would be prohibited from investing if a placement agent were used. Fourth, prohibiting the placement agent from sharing fees with third parties or using sub-agents. Fifth, specifying the placement agent's legal compliance obligations. Finally, ensuring that placement agent arrangements are clearly and accurately disclosed in any private placement memorandum and other disclosure documents, and requesting that investors acknowledge these arrangements.

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## **Predictions on Post-2009 Growth of the U.S. Secondary Market**

BY MICHAEL D. BELSLEY

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The secondary market experienced unprecedented growth in recent years and by 2008, transaction volume was estimated at \$30bn, according to Cogent Partners 2008 Secondary Market Pricing and Analysis'. The economic downturn stalled growth in 2009, but the secondary market, a now accepted and widely used liquidity tool for private equity investors, will continue to evolve as

new participants enter the market and innovative, sophisticated transaction structures are introduced.

The fundamental factors that lead to the growth of the secondary market on the sell-side, illiquidity of private equity fund investments, unpredictable cash distributions, funding obligations and competing demands for investors' available cash, remain

unchanged. A liquidity-challenged investor's sale of a private equity fund interest benefits the investor by eliminating its unfunded obligations to make capital contributions to the private equity fund. Also, if the sale generates cash proceeds, those proceeds can be deployed by the investor to satisfy other financial obligations.

The sophisticated investment portfolio management activities of certain sellers will continue to fuel growth in the secondary market. Many sellers use the market to rebalance their investment portfolios and reduce the percentage of their portfolio composed of private equity fund investments. Other sellers use the secondary market as a mechanism to exit the private equity asset class (e.g., as the result of a shift in internal investment strategies). Investors seeking to divest non-performing funds also drive secondary sales. Almost one-third of the private equity investors surveyed in 2009 intend to reduce the number of their private equity fund relationships over the next two years, according to Collier Capital's 'Global Private Equity Barometer'.

The secondary market's most important function is providing liquidity for an otherwise illiquid asset. Unlike an investment in publicly traded securities that can be easily sold at any time, or a hedge fund investment that includes periodic redemption windows, a private equity fund investment generally is illiquid and expected to be held through the liquidation of the fund (typically a term of more than 10 years). The uncertain timing of distributions from private equity funds compounds the long holding period for these investments. In 2008 and 2009, many private equity funds did not divest their portfolio companies at a typical rate (the economic crisis battered the underlying portfolio companies' performance and complicated potential purchasers' ability to arrange financing), resulting in a dramatic decrease in distributions to their investors. The distributions drought continues into the fourth quarter of 2009 and has pressured liquidity-challenged private equity fund investors to explore options to: (i) raise cash to finance their cash needs (e.g., to fund operations or to fund other financial obligations); and/or (ii) obtain relief from their future funding obligations to certain private equity funds. Many investors anticipate that the slow pace of private equity fund distributions will continue through at least the end of 2010.

At the end of 2008, many predicted that secondary market transaction volume for 2009 would exceed the volume in 2008. However, the combination of large pricing discounts (in some cases exceeding 70 percent of net asset value) for private equity fund interests and a slowdown in the pace of private equity fund capital calls in 2009 mitigated much of the anticipated selling pressure. Many of the would-be secondary market sellers took a 'wait-and-see' approach. Still, many anticipate that the frequency and magnitude of capital calls for these investors will increase in 2010 as the economy recovers and private equity funds begin to invest again.

This increase in capital calls will be a catalyst for secondary market activity. Many of the liquidity challenged private equity fund investors previously sold off their more liquid assets in order to address prior liquidity crises. It is widely anticipated

that these investors will return to the secondary market as sellers to address their liquidity issues when faced with the next liquidity crunch.

On the buy side, the secondary market continues to expand and existing participants continue to grow in size. Historically, dedicated secondary market funds-of-funds were the dominant buyers. These dedicated secondary market buyers had both the size and scope of personnel and capital necessary to value and consummate large secondary market portfolio sale transactions. Since 2007, dedicated secondary market buyers raised \$20.2bn and seek to raise an additional \$30.9bn of new commitments, according to Prequin. As of the end of the third quarter 2009, many dedicated secondary market buyers had significant 'dry powder' available for investment.

Other institutional investors including traditional funds-of-funds, insurance companies, pension plans and high net worth family offices, are also active buy-side participants in the secondary market. Many institutional investors with available capital began dabbling in the secondary market in 2008, attracted by the combination of favourable secondary-market pricing, the ability to invest further along on a fund's J-curve and the ability to selectively increase such investors' exposure to particular private equity funds, often in one-off transactions involving a single fund or small group of related funds in which such purchasers already were investors. First-time buyers purchased more than 50 percent (by transaction value) of the 200 private fund interests marketed by Cogent Partners during the first six months of 2009.

Historically, sales of private equity fund interests were not structured as single stake sales, but rather as sales of a portfolio of fund interests. Prior to 2008, bidders in portfolio sales were typically required to bid on all of the funds included in such portfolio (or a defined subset of such funds), including any less desirable funds that may have been part of such portfolio. However, as supply in the secondary market exceeded demand in 2008, bidders began to bid selectively on individual funds rather than on the entire portfolio. Effectively, a seller may find that the more desirable funds are cherry-picked while the seller continues to own (and remains responsible for funding) the less desirable fund interests. For a seller, the transaction costs (including the seller's time and attention, and legal fees) of executing a sale of a portfolio of interests in a piecemeal fashion is higher than the cost of executing a transaction with a single buyer for the entire portfolio.

In response to seller angst to buyer cherry-picking in portfolio sales, more sophisticated secondary market buyers now offer creative liquidity solutions as an alternative to simple outright purchases of the underlying private equity fund interests. The use of such liquidity solutions gives secondary market investors the flexibility to create value for a 'seller' that may be incremental to the value the seller would receive in a straight secondary sale. These structured solutions have been favourably received by sellers. Often, these transactions involve the formation of a new joint venture vehicle – with the existing private equity investor (the 'seller') contributing its ownership interest in a portfolio of fund interests (and potentially agreeing

to also make future cash capital contributions) to such joint venture and a new secondary market investor agreeing to make cash capital contributions to such joint venture. Unlike a traditional secondary sale, the 'seller' retains an economic participation right in the portfolio, but its participation is typically subordinated to a priority return for the secondary market investor. If desired, the transaction can be structured to permit the 'seller' continued contact with the underlying private equity funds. These structures are flexible and can be customised to address the specific goals and needs of the participants. In particular, the economics of such joint ventures, including the funding obligations and distributions rights of the respective participants, can be tailored to address any unique liquidity needs of the 'seller'.

In contrast to a secondary portfolio sale where the purchaser may attribute little to no value to the seller's construction of its private equity investment portfolio, the construction of the underlying fund portfolio is of great importance in a structured liquidity solution. Among the benefits of a joint venture structure is the ability to tailor the composition of the underlying pool of private equity funds – either to create a particular focus (e.g., geographic or investment sector) or diversify away risk. Joint

ventures are particularly well suited to diversify away the liquidity risk associated with a single fund. Many joint venture structures involve the contribution of some less mature funds (i.e., typically funds from a more recent vintage with a large percentage of their capital commitments remaining to be called) to such joint venture provided that an appropriate number of more mature funds can also be contributed to help balance the expected distributions.

As we approach the end of 2009, the drop in transaction volume in the private equity secondary market should be a temporary anomaly as investors' need for liquidity will continue to drive transaction volume and growth of the secondary market. Other sell-side supply drivers of the secondary market remain just as applicable today as they were in 2008. On the buy-side, a large amount of capital is available for secondary market purchases and an ever-expanding group of potential purchasers seeking to participate in the secondary market. Furthermore, as a sign of the maturing of the secondary market, it is rapidly evolving and innovating to create liquidity solutions, including increasingly sophisticated and complex transaction structures, such as the joint ventures described above.

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## Investor Activism

BY MARK MIFSUD AND KATE DOWNEY

It has often been said that this period of turmoil has been marked by an upsurge in activism by LPs. Indeed, GPs have sought to portray themselves as the hapless victims of strident LPs who are champing at the bit.

How much of this is true and to what extent has the 'credit crunch' created or exacerbated this trend?

To analyse this issue it is useful to examine a snapshot of investor activism in the past 12 months and consider the stimuli that caused investors to act/react accordingly.

### *Liquidity constraints*

As has been well documented during the past year, the over-commitment strategies of LPs, coupled with the dearth of distributions from funds and the shortage of leverage have created a deadly cocktail for a number of LPs. All categories of investor have suffered, including large institutions, state pension funds, listed vehicles, endowments and family trusts. A number of notable names already find themselves unable to fund drawdowns, while many more face the burden of ongoing commitments and the plummeting value of their holdings.

LPs have sought a number of potential solutions to their liquidity problems, primarily: (i) requesting voluntary withdrawals / forfeiture from funds with a large unfunded commitment; (ii) requesting the reduction of undrawn commitments; or (iii) implementing secondary sales of their commitments.

Given the general freeze in M&A during late 2008 and 2009, it is perhaps easy to see why investors have regarded voluntary withdrawal or a scale-back of commitments as viable options in this market. GPs are unlikely to be able to fully deploy funds with large undrawn capacity and LPs are unwilling to pay management fees on unutilised monies, creating an impetus to shrink large funds raised immediately prior to the market collapse. The value of portfolios under management has also dropped substantially, making withdrawal an attractive option for LPs who may be under pressure to cut their losses rather than throw good money after bad. The largely unreceptive nature of the secondary market during 2009 has also been a factor pushing LPs towards requests for what is, effectively, a sanctioned default on drawdown.

The GP community, to some extent, appears to have been surprised by the aggressive manner in which some LPs, seeking to minimise downside or ensure survival, have pursued some of these strategies. The GPs have found themselves placed in a difficult position: release one troubled investor and you set a precedent for releasing them all. Permit withdrawal or scale back on any substantial level and you may be forced to scale back the management team to operate on a smaller cost base, whilst also reducing the ability to do deals when the market comes back.

The LPs, bruised by falling valuations and under pressure to find a resolution, have tried to exploit any commercial or legal leverage

they may have over the GP. In some cases this has resulted in bad-tempered stand-offs as an investor and the GP get drawn into a hostile situation for which neither are really prepared. Disgruntled LPs have on occasion sought to rally support from other investors to threaten the GP with removal from the fund and to push through their demands.

### *Unsettled GP houses and increased involvement of advisory boards*

The 'moral high ground' taken by many GPs in the face of the difficulties experienced by their investors has been somewhat eroded by the increasing turmoil within private equity houses themselves. Tensions have been high within a number of GPs as they struggle with troubled portfolio companies, low deal volumes and the departure of executives. Executive departures may have been voluntarily – the result of inequalities in the distribution of carried interest or differences in strategic vision – or involuntary – as houses struggle to cut costs. Both have proved unsettling for GPs. In the past month alone, the press detailed the impact of senior executive departures at PAI and John Moulton's departure from Alchemy. A similar focus on fundamental issues of management strategy and succession planning have been apparent throughout the industry over the past year.

Executive departures or keyman events tend to trigger either an automatic suspension of the fund or allow the fund's investors to consider suspension. This often results in the need for the GP to engage directly with the advisory board of the fund, which includes representatives of the majority of the largest or most strategically important investors. The advisory board has long been the body to which the GP must generally turn to assess conflicts, approve variations to investment policy and approve replacement keymen following executive departures. However, this role has historically been somewhat passive. During the boom fundraising years, with the intention of streamlining investor consent processes and keeping investor involvement to a minimum, the market-standard documentation moved away from a requirement for formal investor consents and instead placed a number of key 'investor' decisions in the hands of the advisory board. The board was generally perceived to be more supportive, more sophisticated in their approach to private equity and more able to move quickly. Thus, as GPs now find themselves confronted with a number of different issues concurrently, they are often required to turn to the advisory board. Ironically, the disenfranchisement of investors in favour of the advisory board has actually served to centralise and focus a number of key decisions in the hands of a small group of sophisticated investors. Many board members are widely invested in funds across the industry, allowing them to take a more strategic approach and encouraging them towards a more active role in driving GP policy and shaping fund restructurings. Some investors have become

accustomed to greater involvement in the GPs and funds in which they are invested.

Accompanying this increased activism is increased anxiety from advisory board members that they be protected from legal liability when making important decisions about the fund. On more complex fund restructurings, it is becoming more common for the advisory board to seek a mandate / support from a majority of investors in order to protect its members from undue exposure. Thus where there is dissatisfaction with the management team or the portfolio, the advisory board has also begun to emerge as a mouthpiece for the investors.

And yet what is perhaps most interesting is the still generally passive nature of investors. The market has not witnessed a wholesale unprovoked uprising from motivated LPs acting as a coordinated group. We have not yet seen high profile removals of GPs or aggressive litigation against private equity houses, even when considering, in some cases, the severity of some of the problems and the considerable loss of portfolio value. Funds still comprise a multitude of different investor groups who often have diverse (and sometimes conflicting) interests. Any GP who has been through fund restructuring in the last 12 months knows that LPs are not easily coordinated and are frequently distracted by their own internal issues or priorities. The recent difficulties faced by the GP community, including the BVCA, in rousing LPs to protest against the concerns raised by the impending EU AIFM Directive are a reminder that the slumbering mass of LPs will not be easily stirred. But this is starting to change. In fact, a number of European LP groups raised their case in Brussels against the directive, but to date this has hardly been indicative of the type of investor activism that might have been expected when confronted with such potentially significant changes to the fundraising landscape.

The past 12 months have been marked by an unprecedented degree of engagement between GPs and LPs. This engagement has driven LP education about the investment model, as they have been drawn into discussions with GPs regarding management incentives, succession planning, recycling and follow-on capital. The stagnation in the market has given LPs time to review their portfolios and management teams. The erosion of portfolio value and the liquidity crunch have given them the inclination to get actively involved in their investments. Many LPs have acquired a taste for a more active role, something which we can expect to continue and develop as the market begins to awaken. This is likely to be compounded by the drought in available capital for fundraising. There is no doubt that, unless a GP can point to an exceptional track record (or extenuating circumstances), the balance of power in relation to fundraising is now in the hands of the LPs and the industry can expect them to use this power to ensure that market terms are adjusted on a permanent basis. For example, the ILPA released its private equity principles, which in LP eyes suggest best practices for continued discussion to correctly align the interests between GP and LPs, enhance fund governance and provide greater transparency to invention. Some commentators have called the principles a 'laundry list', but the principles have been strongly endorsed by CalPERS, among others, and may be an indication of a real shift in the GP-LP negotiating position. Indeed, at the BVCA Conference in October this theme of 'realignment of interests' was a refrain heard repeatedly from investors. LPs may have been quieter than anticipated considering the difficulties experienced in 2009 but, when the fundraising market returns in earnest, GPs may be in for some further interesting times.

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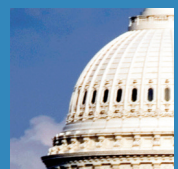
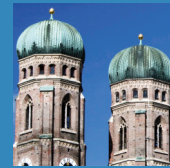
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