Key takeaways from the 10th Annual Markets Group Spring Conference

Recently, our US leadership team attended the 10th Annual Markets Group Spring Conference held in New York. Here, Debbie Reeve, outlines some key takeaways for managers:

Increased Regulatory Compliance: What Is the Bottom-Line Impact?

It was no surprise that the new and proposed SEC regulatory reforms were a major talking point. The reforms will significantly impact managers, but investors should also take note.

Amendments that have been proposed in respect of Form PF will require reporting to the SEC on timelines that are unprecedented for private fund advisors; for example, within 24 hours of certain material events, such as advisor-led secondary transactions

The threshold for reporting as a large private equity advisor would also reduce from $2 billion to $1.5 billion. Given the activity in the mid-market, a larger proportion of funds would be required to comply with the additional reporting requirements.

Investors should note that managers do not currently treat compliance with Form PF as a fund expense. However, the same treatment may not be adopted in respect of the cost to comply with the other proposals. Even if managers do not look to increase fund costs, some have already approached LPs to increase management fees by 25 bps to cover, which will detract from investor returns either way.

In respect of the new marketing rules, which will come into force in November 2022, investors will likely see different PPM material for successor funds, especially around case studies and testimonials. Managers will need to ensure that they are transparent about any sponsored testimonials and case studies can't cherry pick performance!

Transparency is a key theme of the new proposals and features strongly around preferential-terms and GP-led deals, with the latter needing to be accompanied by a third-party fairness opinion, which again will result in additional expenses.

Comment letters have been submitted by members of the PEI community to highlight that many of the proposals are too broad and not fit for purpose for private markets. Sentiment is that several of the reforms are unlikely to be passed as currently drafted.

Fund Formation: Lessons Learnt

Private markets have been so buoyant that certain LPs have been pushing back on the velocity of fund raising and are not willing to commit to each successor fund. Not only is prior performance and investor due diligence more important than ever before, managers need to act on lessons learnt from previous fund raises to ensure success.

Especially in the wake of the SEC proposals, LPA clauses for new funds should be drafted in a way that allow flexibility to respond to regulatory change, in part to avoid unnecessary advisory committee/investor consent to amend clauses at a later date One such example is around changes to the taxation of carried interest under IRC Section 1061. It can also be said that a number of the SEC proposals are somewhat of an ILPA wish-list, and therefore the ILPA template LPA would be a good place to start for future funds. Some other key areas of consideration are:

• Jurisdiction of funds, including what regulatory framework provides most flexibility.

• Does specialised resource need to be hired to ensure appropriate understanding of compliance requirements of chosen jurisdiction?

• Collaboration and co-ordination between key parties as soon as possible, especially legal and investor relations.

Looking forward, managers should also consider foreign and domestic tax changes and the impact it might have on future structuring. Although there is uncertainty what domestic tax policy will look like a year from now given the Green Book proposals, outside of the US, European legislation such as ATAD III and Pillar I & II will need to be considered for managers who have a global presence. However, it is unlikely that Pillar II in particular will impact PE funds given the revenue thresholds and consolidation requirements.

Not just the 'E' in ESG

It was refreshing to see the "S" and the "G" in ESG on the agenda.

Investors want to see that GPs are paying an appropriate level of tax, rather than adopting aggressive structuring to ensure no tax leakage. As a result, investors are looking for morality clauses in LPAs to ensure that a fair amount of tax will be paid, which clearly links back to the 'S'.

Straying into the territory of "G", Investors are increasingly insisting that managers avoid zero/low tax jurisdictions, such as Cayman.

From an environmental standpoint, decarbonisation remains a hot topic. To achieve net-zero targets by 2050, $150 trillion of investment is needed, of which $25-30 trillion is to be invested in wind and solar. However, it would be naive to think that investment in renewables alone is the solution.

The industry needs to look at negative carbon creation projects, such as carbon capture and storage, especially given that it is unrealistic in the short-term to remove all carbon emitting production processes from the supply chain (for example, carbon emissions are created during the wind turbine production process). Even the use of electric vehicles contributes to carbon emissions. Reassuringly, the US is at a near 25-year low for emissions, resulting from a switch from coal to gas driven by lower gas prices.

Reporting continues to be an important discussion point as far as ESG is concerned. It is clear a lot still needs to be done to achieve standardised reporting that will be fit for purpose for investors and regulators alike. Such reporting needs to show trends over time, not just static positions. The ESG industry is highly collaborative and US experts are working together to make progress around standardised reporting, with reference to other regulatory frameworks already in place.

Cyber-Security: How do Managers Manage Risk?

2021 saw a record number of attacks, estimated at one every 39 seconds. The number, intensity and variety of these attacks is expected to increase in 2022, as cybercriminals become increasingly sophisticated.

This growing security threat has led to investors in particular putting pressure on managers and third-party service providers to become SOC II compliant – the leading independent accreditation for information security.

Compliance requirements have also been tightened recently following the passing of The Strengthening American Cybersecurity Act of 2022. The Act requires managers to report cyber-attacks within 72 hours (reduced to 24 hours if a ransomware payment has been made).

Disclosure of cyber-events exposes an organisation’s weaknesses, so there is even more incentive for US managers to invest heavily in their IT security environment. Nonetheless, given the increased threat of cyber-attacks, managers will fare better should they adopt an ‘assumed breach’ approach and have an appropriate business continuity plan. It is also important that managers get the basics right – is the IT environment tested regularly, are passwords/multi-factor authentication used, do managers understand what data is important to them, are back-ups taken on a frequent basis? Managers should also work with operating partners that they can trust and who also have an equally robust IT security environment.

More should also be done to train employees around cyber-threats and how to best prevent attacks. This understanding should not only be embedded at GP level, but at portfolio company level as well. GP boards and Investment Committees should have strategic discussions around cyber-security on a quarterly basis and the boards of portfolio companies should be provided with training on the types of questions they should be asking those responsible for cyber-security within their organisations.

In the wake of new legislation and the increased risk of a cyber-security event, managers may also look to commercialise the robustness of their cyber-security environment.

Investor DDQs: More Individualized Than Ever Before

Investor DDQs are increasingly individualized, which means more resource and time is being spent by management teams on completion.

Due diligence on ESG, for example, will often involve investors not only reviewing a manager's policies, but scrutinizing associated data. We're even seeing investors request that clauses relating to ESG compliance be included in side-letters, placing even more pressure on managers to get on top of their ESG data.

Although ESG and deal-team specialists are now spending a significant amount of time on the investor DDQ process, it could be argued that managers should see the DDQ process as an opportunity to differentiate themselves from other GPs by demonstrating a more flexible and accommodative position when it comes to meeting investor preferences and requirements.

War for Talent

In March 2022 alone, 4.5 million US residents quit their jobs, with 11.5 million job vacancies opened the same month. There's a war for talent and the PE industry is no exception.

Embracing flexible working and enabling employees to achieve better work-life balance, while ensuring the office continues to play a critical role in fostering company culture and supporting employees' development will be key to attracting and retaining talent in an employees' market.

Unlocking the full potential of technology will also be key to thriving in such a high growth industry. Managers should be thinking about how they utilise technology to streamline and automate processes and procedures, enabling redeployment of resource to where people can add the most value.