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Recasting Private Equity Funds after the Financial Crisis: The End of 'Two and Twenty' and the Emergence of Co-Investment and Separate Account Arrangements

Law Working Paper N° 231/2013
November 2013

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This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-231-2013

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ECGI Working Paper Series in Law

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Abstract

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Keywords: AIFMD, carried interest, co-investment rights, limited partnership agreement, management fee, private equity, separate accounts

JEL Classifications: G01, G24, G32, K20, K22, L22, L25

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Topics in Corporate Law & Economics 2013-6

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Joseph A. McCahery and Erik P. M. Vermeulen

I. Introduction

Why has the alternative asset sector been subject to the less regulatory scrutiny than the broader financial sector? (McCahery and Vermeulen, 2008). Prior research provides insights into the contractual mechanisms that protect investors and compensation arrangements (also known as "two and twenty") as the most effective means to align the interests between the fund managers and the private equity investors (Fleischer, 2008; Litvak, 2009, Metrick and Yasuda, 2010). However, scholars are increasingly redirecting their attention to answering basic questions regarding the optimal level of regulatory intervention in the alternative asset market. The global turbulence in the credit markets, triggered by the turmoil in the subprime mortgage market in the United States in 2007-2008, brought an end to the private equity bonanza as well as the laissez-faire era in the alternative asset sector. In response, governments introduced legislation that subjects fund managers to a registration requirement and provisions targeted at improving fund monitoring and accountability.

According to analysts, the economic downturn has had a severe impact on all aspects of the private equity industry. Yet, if we compare the total amount of cash raised

by private equity funds on a global scale in 2005 and 2012, the industry has not significantly changed. According to available data (Preqin, 2013c), the aggregate annual fundraising amount in 2005 was $362bn. In 2012 this amount was $373bn. What has dramatically changed is that the economic downturn has affected the level of private equity fundraising and investment activity,[1] particularly in Europe. Market forces also continue to alter the dynamics of the private equity market. It is estimated that there were 601 funds in the market in 2005 (Preqin 2013c). By 2013 there are more than 2000 funds engaged in fundraising activities, and it is evident that the economic downturn unleashed a wave of fierce competition among private equity funds. The increase of the average time to the final closing of a fund, which was approximately 11.3 months in 2006 and 17.8 months in 2012, is clear evidence of the competition in the private equity industry. The second important change is the increase of scrutiny of private equity funds from regulators and policymakers, but also from investors (especially in the area of the compensation arrangements) (Mulcahy, Weeks and Bradley, 2012).

From this discussion, we ask the question what can be done to increase investors' interest in private equity while at the same time increase managerial responsibility? If we focus on Europe, the reliance on a regulatory overhaul for many has been the core response to the effect of the financial crisis on the private equity industry. Having assumed that interventions should aim at increasing transparency towards investors and stakeholders, the approach by regulators has been to introduce a set of harmonized rules

[1] See also State Street (2013). 82% of 391 alternative investment managers indicated that fundraising would be the most challenging activity over the next five years.

and regulations imposing stringent registration and reporting requirements for alternative investment fund advisers/managers. These regulations seek to reduce the systemic risk emerging from the operation of private equity funds and promote the stability and efficiency of the financial markets. The Alternative Investment Funds Managers Directive (AIFMD) offers a good example of these regulatory initiatives.

So, what can we expect from the post-financial crisis' legal and regulatory interventions? There is no easy answer. The response can be separated into two different categories. At the one extreme, many have argued that the AIFMD addresses the inconsistencies and gaps that currently exist in the fragmented European regulatory framework, thereby reducing risks and stimulating growth for EU fund managers. At another extreme, others expect that the AIFMD will increase costs and create regulatory uncertainty (Burrows, 2013). Some argue that the regulatory burden is overwhelming. For example, the one-off costs are estimated to range from $300,000 and over $1 million (Wang, 2013). Indeed, the concern over high costs is likely to deter non-EU fund managers from portfolios to European investors and induce EU fund managers to shift offshore (Marriage, 2013). The result might be that the AIFMD will significantly crowd out private equity investments that are (particularly in a declining stock market) necessary to create economic stability and jobs. In fact, there is some regulatory support for the latter view. The architects of the AIFMD have acknowledged that strict application of the stringent and costly rules and regulations would be detrimental to the formation of smaller private equity funds (that often operate as venture capital providers).

As a consequence, the AIFMD includes certain exemptions that are applicable to venture capital funds.[2]

Against this background, there is a general belief that the AIFMD will negatively impact the private equity industry in Europe. However, we take a different view. Those expecting a nightmare (or a miracle) from the AIFMD should not hold their breath. In the end, it is highly questionable whether the proposed regulatory initiatives will form the basis of a coherent and effective regulatory regime that sufficiently protects the interests of most sophisticated investors. For this reason, we predict that the AIFM label will just become a necessary 'boilerplate' formality to raise funds in the future. In fact, we already observe that most of the private equity funds take measures to deal with the regulatory requirements of the AIFMD by either enhancing their back office capacity or outsourcing their compliance units to specialized consultants (Duffel, 2013).

The question that remains is: will the AIFMD make fundraising more efficient? The experience with fundraising during the financial crisis suggests that the fundraising levels per private equity fund will continue to lag behind the pre-financial crisis levels in Europe. Recent empirical evidence shows (Prequin 2013b) a number of trends in private equity finance and investments in the post-financial crisis era. One development is immediately noteworthy: the 'survival of the fittest' trend. To be sure, there are signs of a fundraising recovery in 2013 (Winfrey, 2013). However, only high quality funds with impeccable track records seem able to attract new investors. The results are clear. Another trend is the significant decline in the number of successful closings of private

[2] See Articles 3(2), 16(1), 21(3) second subparagraph, and 26(2)(a) of the AIFMD

equity funds in the post-financial crisis era (and there are no indications that this trend will change any time soon).

In this paper, we focus not only on the value of the AIFMD's new secondary reporting and transparency requirements, but also on the other factors that may influence investors to commit funds to private equity investment. This approach is supported by the evidence that compensation arrangements in the private equity agreements between investors and fund managers may require updating and retooling in order to better deal with the high degree of information asymmetries. Although the literature has followed the pre-crisis trends, our evidence shows that investors are demanding the inclusion of more investor-favourable compensation terms and conditions in the private equity fund agreements. Thus, the benefits ascribed to the new contractual terms provide investors with more favourable management fee and profit distribution arrangements, but also give them more control over the fund's investment decisions (Donato, 2011), as well as more straightforward co-investment rights (Favas, 2013).

In addition to examining the role of investor-favourable terms and the impact of such provisions on the benefits for limited partners, this paper also studies the extent of general partners having more skin in the game as a natural market reaction to the pre-crisis transactions where they had little skin in the game. The economic reasoning behind top performing general partners making significant capital contributions to their own fund is that managers' interests can be better aligned with investors.

This paper is divided into four parts. Part II briefly describes the regulatory measures introduced by the European AIFMD. We also address the exemptions to the AIFMD. Part III begins with a discussion of the traditional contractual framework that

governs fund formation and operation, management fees and expenses, profit sharing and distributions, and corporate governance. It then discusses how the practice of private equity contracting is changing in the post-financial crisis era, making the dominant compensation arrangements obsolete (Private Equity International, 2013a). Part IV concludes.

II. The Regulatory Infrastructure of the Private Equity Industry in Europe

2.1 The Pros and Cons of Private Equity Regulation in Europe

In economics jargon, the private equity market is replete with information asymmetries. There is inevitably a high degree of information asymmetry between the fund managers, who play a relatively active role in the development (or restructuring) and growth of portfolio companies, and the passive investors, who are not able to closely monitor the prospects of each individual company. To be sure, national 'private placement' rules and regulations often offer some protection to investors. Here, private placement is understood as the marketing and sale of 'investment interests' in private equity funds to a limited number of professional investors, such as institutional investors and wealthy individuals. However, the downside of the application of these rules is that attracting investors significantly increases the compliance costs and fundraising complications. This is particularly prevalent in Europe where the regulatory systems of the member states are still fragmented and only harmonized to a certain extent.

In a controversial move, European regulators introduced a directive that (if implemented properly) will enable fund managers to obtain a European passport. A possible solution to the regulatory barriers of setting up a European-wide fund is to allow fund managers to ask for a European registration in the home member state, which would then automatically be mutually recognized in other member states. The application of a harmonized and uniform regulation that would govern the marketing and sale of 'investment interests' in private equity funds should make it easier for and provide incentives to investors to participate in foreign funds. The passport system would help defragment the private equity market, allegedly resulting in more cross-border oriented private equity funds. In the next section, we will turn to the AIFMD and explain the arguments in favor and against this type of regulation in Europe.

2.2 The Alternative Investment Fund Managers Directive (AIFMD)

The AIFMD provides a marketing passport for managers of Alternative Investment Funds (AIFs) that fall outside the scope of the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive, such as hedge funds, private equity funds and real estate funds. The rationale behind the AIFMD is to develop a uniform set of rules and regulations for AIFs that protects investors and other market participants. AIF managers that comply with the rules of the Directive and have obtained the 'passport' will be allowed to manage or market funds to professional investors throughout the European Union. Since AIF managers' decisions affect investors in different member states, the AIFMD aims to introduce a comprehensive and secure regulatory framework

that ensures proper monitoring and prudential oversight of alternative investments that pose systemic risk. Strict rules on transparency and disclosure, valuation, risk and liquidity management, the use of leverage, remuneration, conflicts of interest, and the acquisition of companies are expected to enhance public accountability and the protection of investors (see also Table 1). In order to further reduce the problems arising from information asymmetries, the AIFMD requires the AIF's assets to be safe-kept by an independent depositary, which is subject to high liability standards.

We conjecture that the strict application of the stringent (and costly) AIFMD rules is likely to have a decreasing effect on the supply of private equity, thereby seriously hampering the working of the private equity cycle. Not surprisingly, therefore, the AIFMD contains certain exemptions that are applicable to smaller funds.[3] Article 3(2) states that, besides certain registration and notification duties, the AIFMD does not apply to (a) AIF managers which either directly or indirectly (through a company with which the AIF manager is linked by common management or control, or by a substantive direct or indirect holding) manage portfolios of AIFs whose assets under management, including any assets acquired through use of leverage, in total do not exceed a threshold of €100 million; or (b) AIF managers which either directly or indirectly (through a company with which the AIFM is linked by common management or control, or by a substantive direct or indirect holding) manage portfolios of AIFs whose assets under management in total do not exceed a threshold of €500 million provided that the AIFs are

[3] In October 2013, the European Securities and Markets Authority (ESMA) published its final guidelines on the disclosure requirements for AIFMs.

unleveraged and do not provide for redemption rights exercisable during a period of 5 years following the date of initial investment in these AIFs.[4]

Table 1: The AIFMD in a Nutshell

Categories of Rules	AIFMD
Authorization and/or Registration Procedures	All AIFMs managing AIFs must apply for authorization with the authorities of their home MS (Art. 6 and 7 AIFMD). Disclosure of information concerning the AIFM, its members/shareholders, the managers of the AIFM, the program of activity and structure of the AIFM, remuneration policies and delegation/sub-delegation of functions (Art. 7(2) AIFMD), the AIFs, their investment strategies, leverage policies, risk profiles, countries of establishment, instruments of incorporation, appointment of depositaries and the additional information of Art. 23(1) AIFMD (Art. 7(3) AIFMD).
Initial Capital and Own Funds	For internally managed AIFs: at least EUR 300.000,- (Art. 9(1) AIFMD). For AIFs with an external manager: at least EUR 125.000,- (Art. 9(2) AIFMD). If the value of the portfolios managed by the AIFM exceeds EUR 250 million: additional amount equal to 0.02% of the value of the difference between EUR 250 million and the total value of the portfolios of AIFs managed by such AIFM (Art. 9(3) AIFMD).
Operating Conditions	(i) Fiduciary duties of AIFMs towards AIFs and their investors; (ii) restrictive remuneration policies; (iii) duty to identify, prevent and disclose conflicts of interest; (iv) duty to establish effective risk management systems; (v) strict rules on valuation and appointment of an internal/external valuer; (vi) strict rules on delegation/sub-delegation of functions; (vii) appointment of depositary for each AIF whose function's delegation is restricted (Arts. 12 to 21 AIFMD).

[4] The AIFMD provisions slightly deviate from the registration measures introduced by the Dodd-Frank Act in the United States. The US counterpart of the AIFMD significantly extended the registration requirements under the Investment Advisers Act of 1940 to include advisers of private funds, such as hedge funds and private equity funds. The rationale behind the Dodd-Frank Act is, similarly to the AIFMD, to reduce financial market failures or systemic risk. Venture capital funds are exempted, because they do not threaten the stability and continuity of the financial system.

Transparency Requirements	(i) Audited annual report with audited financial statements for each managed AIF, to be disclosed to each of AIF's investors and to authorities of home MS of the AIFM (and of the AIF if applicable); (ii) pre-investment disclosure towards prospective investors of all material information items concerning the managed AIF; and, (iii) regular reporting duties to authorities of AIFM's home Member State on the markets and instruments in which it deals and the principal exposures and most important concentrations of each managed AIF (Arts. 22 to 24 AIFMD).
Rules on Fund Managers managing specific types of AIF	Exemption of AIFMs managing AIFs that acquire control of non-listed companies that are SMEs (Art. 26(2)(a) AIFMD). AIFMs managing VC funds exempted.

It should be noted that if the investors are to benefit from the harmonizing effect of the proposed regulatory measures, we would expect an increase of the investor confidence and interest in the private equity industry throughout the European Union. More specific details on the state of the trends in the private equity industry emerge from the examination of fundraising. Data provider Preqin observed that the aggregate amount of capital raised by funds closed was $78bn in 2012, which is more than the $62.4bn in 2011 and $58.9bn in 2010 (Preqin, 2012b). It is striking, however, to observe the number of private equity funds that had a final closing declined from 414 in 2007 to 110 in 2012 (see Figure 1). Note that his trend continued into early 2013, but ended with a sharp upturn in fundraising during the second quarter of the year. While this increase reflects a renewed confidence in markets, closer scrutiny of the deal volume (463 deals announced with an aggregate deal value of $37bn in Q2 2013), suggests that general partners will most likely find fundraising hard going in the future unless they can effectively locate new investments with significant aggregate deal value. Here it should be noted, however, that the high quality funds appear to receive continuous funding for their investment activities. This is confirmed by data derived from Dow Jones LPSource (which is based

on multiple closings). The result is that the median fund size has significantly increased in Europe (see Table 2).

Table 2: Private Equity Fundraising in Europe (based on multiple closings)

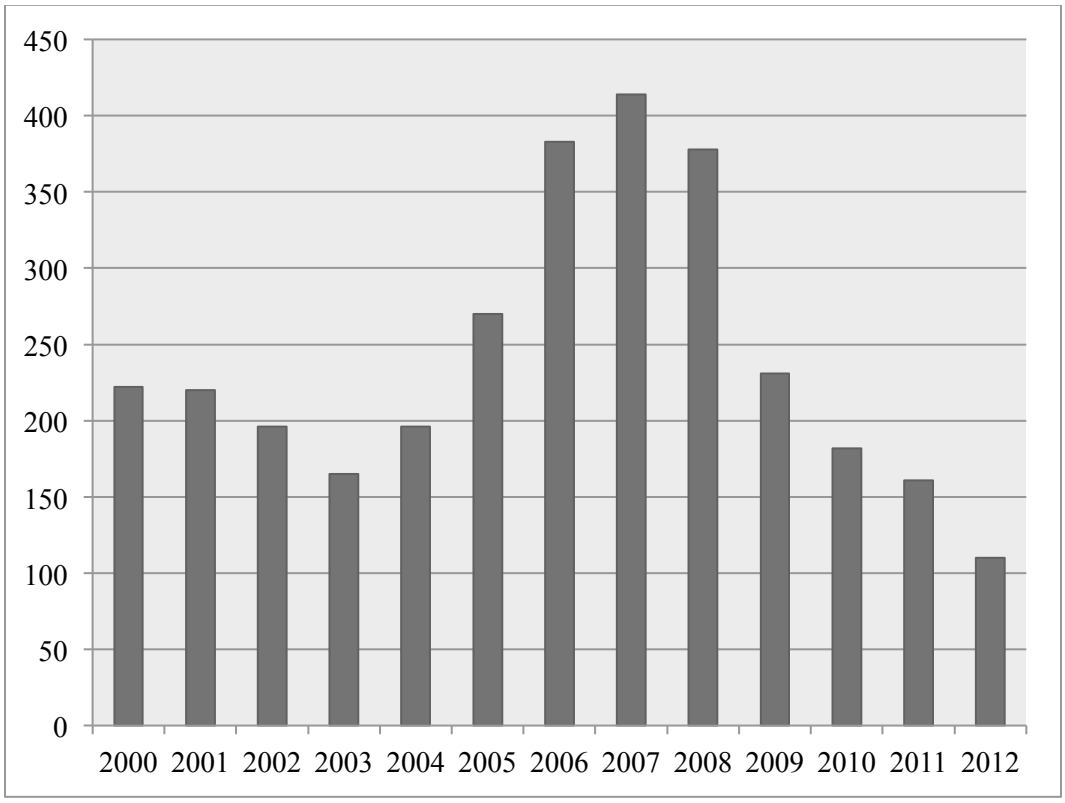
	Funds Raised			Number of Funds			Median Fund Size		
	2011	2012		2011	2012		2011	2012	
United States	$133.2b	$160.4b	+20%	453	426	-6%	$250m	$310m	+24%
Europe	$59.2b	$58.1b	-2%	182	157	-14%	$207m	$300m	+45%

Source: Dow Jones LPSource

This brings us to the question whether it is reasonable to expect that financial governance reforms, such as the AIFMD, can stimulate private sector investments in the private equity industry. Does the directive deal with the key investment issues? Attempts to answer this question have generated a great deal of discussion in the literature. On the one hand, optimists will argue that the AIFMD label will not only help reduce uncertainty and information asymmetry in the industry, but also provide an international stamp of quality. If they are correct, institutional and other investors will be more inclined to invest again in private equity (and not only high quality funds). We claim, however, that the improved fundraising view is too optimistic. Our view is supported by a recent empirical study conducted by data provider Preqin (Preqin, 2013a). The study shows that only 19% of the 450 responding private equity investors (42% of the respondents were European investors and 40% were located in the United States) expected a positive impact from

regulatory initiatives, such as the AIFMD. Not only did 41% state that an increasingly regulatory approach would not benefit the industry, but the other 40% were still unsure.

Figure 1: Closings of Private Equity Funds in Europe



Source: Preqin

In addition to showing that European investors are not overly optimistic about the benefits of regulation aimed at contributing governance improvements to the operation and efficiency of funds, the data indicates that, in order to deal more effectively with the post-financial crisis challenges of uncertainty, information asymmetry and opportunism,

investors in private equity funds are becoming tougher in negotiating the terms and conditions of the funds (Prequin 2013; Burrows, 2013). Predictably, the more active approach of investors is likely to bring about a cultural change in the private equity industry. We already see a trend towards the demand of greater clarity in private equity fund terms. In our assessment, investors increasingly prefer to invest in private equity funds that are willing to better accommodate their specific concerns, particularly related to co-investment rights and compensation arrangements and disclosures. Potentially, the emergence and standardization of new disruptive contractual practices in the private equity industry will be quickly adopted to ensure better firm performance and productivity. The next section will provide an overall assessment of the changing fundraising landscape in more detail.

III. The Contractual Infrastructure of the Private Equity Industry

In Europe and elsewhere, the limited partnership form (or an equivalent flexible business form) is the dominant legal vehicle used in private equity structuring. The popularity of this form is due to its contractual nature that allows the internal and external participants to reduce opportunism and agency costs. Indeed, the limited partnership structure permits fund managers (general partners) to achieve extensive control over the operation of their funds subject to few intrusive legal obligations. Other features, such as tax benefits, the flexibility surrounding its structure and terms, and its fixed life, contribute to its continuing viability as the business form of choice for collective investment vehicles. The limited partnership has other important advantages as well. First, it is familiar to most

investors and intermediaries, which contributes to its enduring popularity. Second, there is a risk that other business forms, operating internationally, could be treated as a non-transparent foreign entity and taxed as a corporate body.

In order to obtain fees and shield the individual managers from liabilities of the fund, two entities are usually created: a limited partnership and a management company, which is generally organized as a corporation. Moreover, the management company is either a separate entity from the general partner or affiliated with one of the general partners, or is a subsidiary of a bank or insurance company and, accordingly, will exercise effective control over the limited partnership. With a management company, the day-to-day management is separated from the fund which may assist in resolving some tax issues while limiting doing business and other concerns.

We have seen that the flexibility of the limited partnership plays a critical role in aligning the interests of venture capitalists and investors. This brings us to the contractual provisions that are typically employed by the private equity investors in Europe (as well as in the United States).

3.1 Private Equity Contracting and Compensation Arrangements

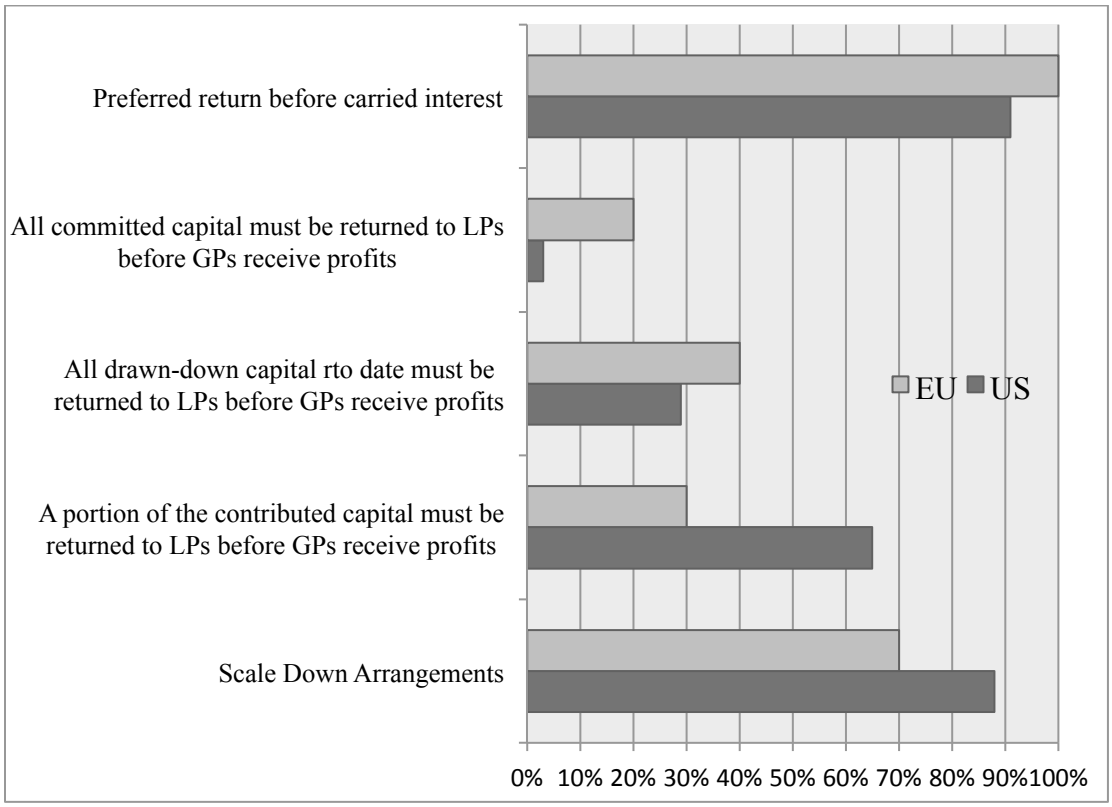
The relationship between the limited partners and general partners is, as we have seen, usually characterized as a principal-agent relationship. In order to make this work, legal practice tends to include boilerplate clauses in the limited partnership agreement that are designed to reduce the agency costs by aligning the incentives of the general partners with the interests of the investors. The boilerplate arrangements in private equity limited

partnerships can roughly be split in three separate categories (1) fund formation and operation provisions, such as limits on the fund-raising period, the lifespan of the fund, and the required managers' contribution, (2) management fees and carried interest, and (3) the governance structure to ensure that the fund is organized and managed in the most effective manner.

For example, a fund's duration is usually ten years with a five years investment period, making it possible for investors to estimate with reasonable accuracy when the private equity firm can make fresh investments and, most importantly, when they ultimately will be able to recover their investments, including profits. In order to align interests between the investors and the managers, the latter are also required to make a capital commitment. Typically the managers invest between 1% and 3% of the fund's total commitments. Another key contractual technique is the compensation arrangement between the fund managers and the investors. Compensation usually derives from two main sources (the so-called 'two and twenty' arrangement). First, fund managers are typically entitled to receive 20% of the profits generated by each of the funds, the carried interest. A second source of compensation for the fund managers is the annual management fee, usually 2% to 2.5% of a fund's committed capital.

Arguably, the tried-and-tested compensation arrangements in the limited partnership agreement lower transaction costs and offer contractual transparency necessary to induce investors to make their money available for the investments in start-up companies. However, limited partners are more and more convinced that they have mistakenly believed that the boilerplate 'two and twenty' rule ensures a proper alignment of interest and incentives.

Figure 2: Differences between EU and US Limited Partnership Agreement



Source: Dow Jones Private Equity Partnership Terms & Conditions, 2009 Edition

It should therefore come as no surprise that provisions in the limited partnership agreement increasingly include provisions that protect investors from managerial misbehavior. What is interesting in this respect is that European funds demand more protective clauses than investors that operate in the more mature US private equity market (see Figure 2). A plausible explanation for this is that the attention to the contractual and organizational structure of the fund arguably increases when the private equity market, which is prone to violent cyclical movements, lacks the implicit

mechanisms against opportunistic behavior and misappropriation that are found in mature markets, such as trust and reputation.

Figure 2 shows that European funds can generally be distinguished from their US counterparts in terms of the stricter rules regarding the distribution of profits to managers and the preferred return to the investors. Yet, despite these differences, the increasingly global nature of the private equity industry as well as the financial crisis apparently may lead to substantial convergence of contractual arrangements in European and US in a number of important ways, particularly in the area of management fees and profit distribution.

A key contractual technique, for example, is the scale down compensation arrangement between the fund manager and the investors. This example is common in the United States, but is also more and more employed by European private equity funds. What is a scale down arrangement? Historically, a significant majority of funds assess management fees as a constant percentage of committed capital. This is where the scale down arrangement comes into play. There has been a decrease in the management fees in recent years due to a number of economic factors. In particular, some funds are more likely to have a fixed fee of 2% of the funds assets which is paid annually for 5 years and then decreases by 25 basis points for the next 5 years period. Other fund managers will allow reductions of the fixed fee based on a change from committed capital in years 1 to 5 to net invested capital in year 6 to 10. Given these changes, a substantial proportion of buyout firms' median compensation has been reduced to 12% of the committed capital.

Another example of convergence in contract terms is the profit distribution provision for the preferred return (or hurdle rate) arrangement. Due to this arrangement

profits can only be distributed to fund managers after a certain profit threshold – a minimum annual internal rate of return – has been satisfied. The preferred return rate ranges from 5% to 10% and can usually be found in European limited partnership agreements, but, as mentioned, are increasingly included in the limited partnership agreements in the United States. The convergence is reflected in the introduction of such a provision by the Institutional Limited Partners Association (ILPA) (www.ilpa.org).

These profit distribution arrangements are an attempt to maximize fund managers performance, which means that profits can only be distributed to the managers after a certain threshold has been reached. Clearly, these arrangements, which, as mentioned earlier, usually require private equity managers to first provide a preferred return to the investors before being able to distribute the 'carry,' significantly reduce the chance that managers receive more than their fair share of the profits. In order to keep the managers focused and incentivized, most priority returns arrangements have a catch up provision, which permits a reallocation of the profits to the general partner after the priority return has been distributed to the investors. In short, the catch-up provision entitles fund managers to receive most of the profits until the contractually agreed profit-split between the investors and the managers has been reached. Certainly, if at a later stage it transpires that the general partners have received more than their fair share of the profits, investors will be entitled to call upon the clawback provisions under which the managers have to pay back the excess carry distributed earlier.

Overall, the contractual mechanisms for determining the general partners' compensation include both a profit sharing arrangement that balances investors' concerns regarding pay-for-performance, and a distribution scheme to investors to limit overall

fund risk-taking. Moreover, there are a variety of factors that affect fund manager compensation. First, the private equity fund's focus and characteristics can result in quite different outcomes for fund managers. For example, funds focusing on venture capital investment are more likely to require professional staff and expertise which leads to lower yields and higher performance fees to align interests. Conversely, larger funds, such as buyout funds, are more likely to have lower fixed compensation because they require less staff than funds focusing on venture capital. Second, the type of institutional investor and their risk appetite may influence the fixed and variable fee structure of fund managers.

The question is whether we can expect to see more dramatic revisions to the fee and profit distribution provisions, rejecting the long-standing contractual practices. We will address the critical issues involved with this question in the next section of the paper.

3.2 Post-Financial Crisis Trends in Private Equity Contracting

It follows from the previous section that private equity investors are increasingly successful in finding ways to improve the management fee and profit distribution arrangements (Jannarone, 2012). This is confirmed by empirical evidence which found that 59% of the investors who were interviewed in June 2013 indicated that investor-favorable fee and profit arrangements were on top of their priority lists (Preqin, 2013c). One year earlier, this percentage was still 68%, which is an indication that private equity investors are increasingly successful in negotiating more favorable terms. Moreover, our work shows that an increasing number of investors still seek a higher degree of control

and bargaining power over the terms of the limited partnership agreement or attempt to avoid the payment of management fees altogether (McCahery and Vermeulen, 2013).

Consider Blackstone's Tactical Opportunities, which is a portfolio of separately managed accounts (Witkowsky, 2012a). Separate accounts, for example, are different from the organization of traditional funds in that an investor's capital contribution will only be invested in accordance with its specific investment strategies and interests. From the perspective of the limited partners the benefits are twofold. First, separate account arrangements are flexible in the sense that they are usually tailored to the investors' risk appetite and diversification needs. Second, and perhaps more importantly, it is obvious that the direct and close relationship between a single limited partner and a private equity firm enable investors to bargain for better terms and conditions, including 'disruptive' and investor-favorable management fees and carried interest provisions (Kelleher, 20113; Canada, 2013). Also, it is only to be expected that institutional investors be more inclined to invest in separate accounts in the future. For instance, 19 out of 100 surveyed institutional investors have set up a separate account arrangement in 2013, a significant increase compared to the 7% of the investors who invested through a separate account arrangement in 2012 (Preqin, 2013a).

Of course, it could be argued that these separate account arrangements should be viewed as a style or strategy that will gradually disappear in the aftermath of the financial crisis (Moix 2004). But since segregated accounts appear well designed to reduce investors' risks, it is unlikely that investors will change their preferences so long as the structure meets their needs. The evidence is consistent with this view: 64% of the investors that currently invest in separate accounts believe that these arrangements will be

a permanent feature in the relationship with fund managers (Preqin, 2013a). Particularly, small and medium investors, such as many family offices and wealthy individuals, are more and more being lured to invest in a fund that offers separate account arrangements (Myles, 2013). Unsurprisingly, therefore, these arrangements promptly gain popularity. According to a recent survey among approximately 100 private equity fund managers from the United States, Europe and Asia, 7% of the respondents have already set up separately managed accounts, with another 10% planning to do the same in the next five years (State Street, 2013).[5] This also explains why lawyers and advisors are attentive to separate accounts. In order to avoid conflicts of interests between the separately managed funds and the traditional (co-mingled) funds, they assist in setting out clear investment and disclosure policies for the separate accounts (Dai and Canada, 2013).

These findings point to investors' search for greater control over both the investment decisions of general partners and the negotiations of the fund terms, which has also led to an increase of direct investments in private equity opportunities. We would like to stress that the uncertainties and information asymmetries often deter institutional investors from investing directly in high growth companies. We observe, however, in an attempt to make investments in the best performing companies more lucrative (without the need to negotiate thorny compensation arrangements), an increase in private equity deals with institutional investors piggybacking on the due diligences and

[5] Please note that separate accounts arrangements are already common in the area of hedge funds and real estate funds. The State Street Study (State Street, 2013) shows that 35% of the hedge funds managers have set up separately managed accounts (another 22% have indicated that they intend to follow suit. For real estate funds these percentages are 26% and 16% respectively.

selection efforts of their fund managers by demanding the ability to pursue a co-investment strategy. Recent studies show that co-investments gain in popularity. A study by Dineen (2012) indicated that co-investment rights provisions are already a must-have for institutional investors Empirical evidence supports this view: (1) 32 out of 100 investors invest as a co-investors with their fund manager and (2) 97% of these investors expect that they maintain (44%) or even increase (53%) their co-investment strategies (Preqin, 2013a).

It is also likely that investors' increased demand for greater control over their portfolios will lead to a greater use of alternative fund structures, such as pledge funds (Blake and Judd, 2012). Pledge funds offer investors the opportunity to make investment decisions on a deal-by-deal basis. In order to get access to investment opportunities, investors must pay an annual fee and carry is calculated based on the amount invested. Although admitted investors can review potential portfolio companies, they are usually not obliged to participate in the deal. If the managers receive sufficient commitments from the 'member investors,' they can prepare and negotiate the deal documents on behalf of the fund – in most cases a separate limited partnership is set up to make the investment. Again, the advantages are clear. Besides the greater control over portfolio acquisitions, the pledge fund alternative also provides investors the possibility to avoid high management fees and carried interest. The downside is that the newly designed pledge funds structures usually come with higher transaction costs (Jesch, 2010), and may suffer lower returns on investment due to lack of diversification and cherry picking problems by general partners.

So far we have focused on the empirical research that shows that investors take an increasingly active approach in the negotiations about the compensation terms of the limited partnership agreement. But there is more. Besides demanding 'improvements' to the limited partnership agreement, we observe that investors want to see more skin in the game from the managers/general partners. Recall that the industry norm is 1% to 3% of the committed capital. By requiring the general partners to make significant capital contributions to their own fund, the investors can reasonably expect that the managers' interests be better aligned. It appears that 'higher-than-average' capital commitments (ranging from 5% to 10%) are gradually becoming the norm in the private equity industry (Witkowsky, 2012b). This view is confirmed by a poll conducted among general partners during the Private Equity International's Forum in January 2011 (see Table 3) (Mitchenall, 2011).

Table 3: Skin in the Game in the Private Equity Industry

In the future, how much will management contribute to your own funds?	
Contribution as % of Committed Capital	Respondents
<1%	21%
1%-2%	28%
2%-5%	35%
>5%	16%

Source: Private Equity International

4. Conclusion

This paper analyzed the regulatory alternatives for the private equity industry. We discussed important regulatory checks that limit managers' misbehaviour and misconduct. In this context, we examined some of the recent proposed changes introduced by the Alternative Investment Fund Managers Directive in Europe.

Having explored the benefits and costs of a regulatory regime, we then turned to review the typical contractual measures in place and designed to align investor and fund manager's interests. This paper argued that the fundraising landscape has evolved and changed significantly in the post-financial crisis era, leading to 'new' limited partnership compensation arrangements. The evolution of new limited partnership terms can largely be attributed to the major problems in private equity fundraising and returns.

In response to increased LP bargaining power, this paper has identified two strategies that are currently deployed by private equity fund managers. The first strategy relates to the negotiation of improvements to the 'two and twenty' compensation arrangements in the traditional limited partnership agreement. The adoption of scale down provisions and preferred returns provide substantial protections to potential investors. The second strategy involves the creation of 'innovative' private equity structures that constrain fund managers' discretion to make investment decisions. Greater customization through separate accounts arrangements and deal-by-deal investment opportunities will significantly increase investors' bargaining power and the possibility to negotiate more effective compensation arrangements. Together these results are consistent with the view that the 'end' of the traditional two and twenty rule will arguably

have a more positive impact on the private equity industry than the need to comply with the cumbersome AIFMD rules.

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