

EXPERT COMMENTARY **BNY MELLON**

REGULATION

New operating models needed

As new regulations change the way the market functions, private equity must evolve to meet fresh challenges, write Daniel Amir and Brian McMahon

Today's private equity marketplace presents significant challenges for the traditional operating model of general partners (GPs). To remain competitive, fund managers need to navigate a dynamic landscape that includes increased regulation, strong demands for transparency and governance by limited partners (LPs), as well as the emergence of a more globalized private equity asset class.

Despite the fact that the industry has evolved and matured significantly over the last 30 years, PE managers need to continue to focus on these new pressures and implement solutions that translate them into tangible strengths. This effort will require careful analysis and an honest evaluation of their core strengths. While GPs are rightly focused on their own business models, it is important for them to recognise that there are tools and partners in the marketplace that can facilitate their need to realise a sustainable business practice that includes a sound operational model, as well as their need to deliver a meaningful return on investment.

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Amir: industry must focus on new pressures

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recognise that regulation, in its various forms, is here to stay and will have a fundamental impact on the operation of PE firms. It is also important to note that efforts focused on effectively reducing systemic risk should benefit investors across asset classes, thus creating a healthier global economy.

For the purposes of this article, we will focus on the most significant regulatory requirements impacting both Europe and the US, and identify what they mean for PE practitioners.

EUROPE: DOES ONE SIZE FIT ALL?

In Europe, the Alternative Investment Fund Managers directive (AIFM) continues to evolve, as EU member nations are expected to transpose the directive into law by July 2013. With its one-size-fits-all approach, AIFM has alternative investment fund managers, including PE GPs, bracing for impact. While its objective is to restore investor confidence and mitigate counterparty and operational risk, its implications for the sustainability of a PE operation could be troublesome. Substantial resources will have to be spent administering adequate risk management policies, validating valuation procedures and putting into place the technological capabilities to

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satisfy transparency requirements for both the regulator and investors.

AIFM also requires the appointment of a depository, a significant and potentially costly measure particularly for those unaccustomed to managing funds in regions, such as Luxembourg and Ireland, which already have similar requirements in their regulatory framework.

But despite the industry's perception of the constricting nature of AIFM, there will be some substantive benefits. Most significantly, the 'passport' concept will foster cross-border activity within a common framework, reducing the expenditure of resources that might otherwise be necessary to navigate each individual EU member nation's regulatory regime. Thus, over time, the potential to increase the effectiveness of cross border, intra-EU marketing and fund raising may even be improved. Some early signs certainly support this proposition, as different participants consider how to create funds and potentially transfer assets to maximize this potential.

Service partners such as fund administrators, depositaries, and others can provide considerable expertise and guidance through this evolving regulatory process. In particular, those that have established themselves in comparably regulated jurisdictions, such as BNY Mellon with over 1,000 employees in Luxembourg and Germany, offer valuable experience in assisting in compliance efforts. Such partnerships could serve as the path of least resistance and offer a cost-effective approach. This may allow GPs to realize the Directive's benefits earlier on.

US: SWEEPING CHANGES FROM DODD-FRANK

In the US, the Dodd-Frank legislation, signed into law in July of 2010, created sweeping changes across US financial markets. The fund registration process itself is proving to be a monumental task for GPs, imposing increased operational expenses. As a consequence of registration, GPs must comply with the Custody Rule 206(4)-2, which seeks a strong measure of investor protection by formalising the verification

and safekeeping of documentation evidencing investment. Many GPs have questioned the Rule's applicability to their own asset class, while others have embraced the opportunity to enhance operational control, a perspective that is no doubt viewed positively by both existing and prospective LPs. Either way, GPs are largely being directed to engage a qualified custodian.

This process is not a high-cost service and many GPs have relationships that they are able to leverage to effectively partner with a custodian and comply with the Rule. It is imperative, though, that they be thoughtful about this process and not simply apply a quick fix. Rather, they should ensure that they partner with an institution that understands the PE asset class

and that has the financial strength and stability that puts investors and regulators alike at ease.

Furthermore, for large GPs, the added focus on the implementation of Form PF is forcing them to implement new workflows and technological solutions to capture what's estimated to be over 80 fields of data to be reported to the SEC on an annual basis. This is yet another regulatory measure that is prompting GPs to commit even more resources to the operation of the PE firm.

While there is still ambiguity as to how the global regulatory initiatives will continue to be rolled out, what is certain is the need to expend resources, implement new practices and, in some cases, fundamentally alter business models. To facilitate this process, GPs can leverage the expertise and core competencies of qualified custodians, fund administrators, independent valuation agents and others to fully assess the costs and benefits of outsourcing these key functions versus continuing to maintain and build them in-house. In fact, these regulatory initiatives may help to institutionalise and standardise the industry, providing added controls, particularly in the eyes of institutional investor relationships. Herein lies the ultimate challenge: within the new global regulatory paradigm, GPs will have to maintain a dual focus of servicing their LPs while producing the returns those LPs expect.

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Engaging with strong, expert service partners to assist in executing operational compliance may well be the best way to achieve a sound business model without allocating resources away from the core investment competencies that have made GPs successful.

GPS AND LPS: THE EVOLVING RELATIONSHIP

Another critical component affecting the durability of the private equity investment firm is the dynamic of the relationship between GPs and LPs. The fallout from the credit crisis caused LPs to focus firmly on their PE allocations and manager selection, thus disrupting traditional GP/LP collaboration. It is important, however, to examine this carefully in the context of relationships that, given the very nature of the PE asset class, have been in place for decades.

Historically, there has been a significant element of trust amongst GPs and LPs, unlike that seen in most other asset classes, conventional or alternative. The PE industry has had fewer public relations issues and there has been a sense of tangible value creation, engendering a stronger relationship between managers and investors. There is also an increasing need, particularly for pensions, endowments, and others, to meet long-term liabilities, the path to which does not seem to be achievable relying on public markets alone. Today the 20 largest public pension funds allocate \$223 billion to PE investments, approximately 11 percent of their aggregate AUM, according to Preqin, indicative of confidence in the role of PE in pension portfolios.

To maintain the trust they have rightfully earned, it is incumbent upon GPs to continue to cultivate relationships with their LPs. This may mean embracing, as applicable, the guidelines issued by the Institutional Limited Partner Association (ILPA), or even being proactive in engaging similar influential investor groups. It will most certainly require providing more data to fulfill calls for transparency around valuation processes, accounting procedures and reporting. This is another area in which engaging with trusted service partners like administrators, custodians, auditors, and valuation agents will facilitate the process of meeting these demands. The key for GPs will be to engage such partners that have a unique mix of industry leading expertise, technology and stability while also offering the tools that allow them to effectively manage their LP relationships.

PRIVATE EQUITY GOES GLOBAL

A third factor that continues to be an integral theme for the progression of the PE business model is the globalisation of the asset class. This process has brought about tremendous opportunity for GPs and LPs alike, but not without its own set of challenges. As institutional LPs look to geographically diversify their exposure, the spotlight continues to shine on regions like Asia-Pacific, specifically China, as well as Latin America and Africa. China has seen explosive growth in private equity, raising over \$31.1 billion in the past decade, and holding an estimated \$18.5 billion in uninvested capital (according to Preqin). This activity accounts for roughly half of the capital raised for the entire Asia-Pacific region in 2011. In Latin America, there has been a strong focus on opportunities in Brazil. However, the Emerging Markets Private Equity Association notes a marked increase of over 50 percent in Latin American PE investment ex-Brazil.

Clearly, the challenge for non-resident GPs in gaining access to foreign markets is to maintain sensitivity to local culture and language. This requirement has a fundamental impact on the way fundraising is conducted, how technological resources are implemented and how GPs communicate with LPs. Both managers and investors will access foreign markets in a variety of ways. Large, global firms are either establishing a presence themselves locally or are partnering with resident GPs to help execute their strategies. The latter allows them to maintain a thoughtful approach in being mindful of local customs. It may mean sharing in the growth opportunities, but it will certainly enhance credibility on the fundraising trail. In other cases, local GPs are creating investment vehicles that facilitate both foreign and domestic investment from institutions seeking greater exposure to the private equity asset class. In each of these cases, class leading and globally recognized service partners will greatly enhance the perception that the market, particularly LPs, has of globally-based GPs accessing local markets or of local GPs seeking outside investment.

PRIVATE EQUITY: A PROPENSITY TO FLOURISH

The long-term, value-oriented nature of the PE industry, relative to other asset classes, has engendered strong, trusting relationships between LPs and GPs. However, new issues brought on by an evolving regulatory landscape, increasingly discerning investors, and the globalization of PE require that GPs not rest on their laurels. By the very nature of their own

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investment theses, they consistently explore ways to enhance the fundamentals of their portfolio company investments and introduce operational efficiencies.

Some application of their investment expertise to their business models will offer appropriate guidance through the current market reform. This may even mean taking a ride on their own j-curve, expending resources to create ultimate value in a sustainable business model. GPs will have to push geographic boundaries while being mindful of local cultures, customs, and languages. Most importantly, though, they will have to continue to partner and collaborate with their LPs to deliver the appropriate level of transparency alongside the performance expected of them. This process may be an arduous one depending on the GPs' resources, but industry leading tools and service partners that have become increasingly vital can help to facilitate the growth, scalability, and sustainability of their business practice, further cementing PE as a critical component of the global economy. While all this appears to be a tall order, history has shown us that the leaders in this industry are some of the smartest on the street, which is why we believe that this asset class will continue to flourish. ■

WHO'S HELPING YOU?**GLOBAL****Marina Lewin***Global Head of Sales*

US: +1 212 815 6973

UK: +44 20 7163 6323

marina.lewin@bnymellon.com

EMEA**Brian McMahon***Managing Director*

+352 2452 5469

brian.mcmahon@bnymellon.com

AMERICAS**Mike McCabe***Managing Director*

+1 732 667 1378

mike.mccabe@bnymellon.com

Daniel Amir*Vice President*

+1 212 815 4388

daniel.amir@bnymellon.com

APAC**Aidan Houlihan***Managing Director*

+852 2840 9756

aidan.houlihan@bnymellon.com

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