PRIVATE EQUITY WIRE

INSIGHT REPORT



Clear Intent:

Private Equity's New Regulatory Landscape Awaits

JUNE 2022

SUPPORTED BY:

ACA™

EXECUTIVE SUMMARY

Private equity is about to get less private. Since the financial crisis, regulation has increased in the industry but not by much. In 2011, US financial regulator the Securities and Exchange Commission (SEC) acknowledged that many private equity funds remained outside of the Commission's regulatory oversight even though they managed large sums of money for hundreds of investors.

Tweaks to existing legislation have finally snowballed into a full-on review under the leadership of SEC chair Gary Gensler, who was appointed last year. Speaking at an industry event last November, he was reported as saying: "It is worth asking ourselves at the SEC whether we're meeting our mission with respect to this important slice of the capital markets." His mission has become increasingly clear in the months since then.

SEC proposals earlier this year show a clear intent to increase the level of transparency and disclosure, for example in what fees GPs charge to their investors and how financial performance is recorded. According to some of private equity's largest fund managers, this information is already disclosed in many cases – just maybe not in the way the SEC would like to see.

More fee transparency should favour smaller investors unable to negotiate discounts for higher allocations, but GP critics argue that a more standardised approach will increase their costs and limit their flexibility. They may be right but standardised fee templates have already been around for years and performance metrics assessing the environmental impact of their investments were developing long before this year.

The SEC has already extended the public comment period for proposals into mid-June and long response letters have been written in opposition (with some support too). It may still take many months for implementation, but with rules continuing to evolve in Europe and the UK on fundraising, sustainable investment and deal-making, private equity's regulatory journey has a long way to go yet.



COLIN LEOPOLD
HEAD OF RESEARCH & INSIGHT

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METHODOLOGY

Private Equity Wire surveyed over 50 private equity industry stakeholders during May 2022 on the subject new and changing regulation in the asset class. Of that group, over 50% were fund managers or GPs, with the remainder split roughly equally between investors and service providers.

KEY FINDINGS

NEW REGULATIONS LOOM FOR PRIVATE EQUITY, BUT INDUSTRY IS PUSHING BACK

36% OF THE INDUSTRY

Only 36% respondents to a Private Equity Wire survey believe there needs to be stricter regulatory oversight of the industry

24% OF GPs

Among GPs, only 24% of respondents agreed with more regulation while lobby groups have called new proposals costly and unnecessary

FUND MANAGERS HAVE BUILT UP MORE TRUST IN THE INDUSTRY

38%

OF SURVEY RESPONDENTS BELIEVE THAT LPS TRUST THEIR GPS MORE NOW THAN FIVE YEARS AGO

16%

BELIEVE THE LEVEL OF TRUST HAS DECREASED IN THE SAME PERIOD

DEAL-MAKERS FACE UP TO A MORE COMPLEX M&A MARKET

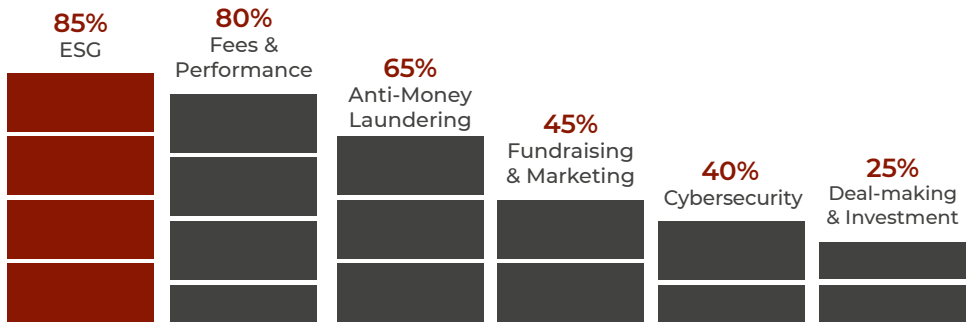
Although only 25% of survey respondents expect deal-making to face more regulation, record numbers of mega deals in 2021 are playing into national security and anti-trust concerns

2011 mega-deal volume **60**

2021 mega-deal volume **200**

INCREASING DISCLOSURE SEEMS AN INEVITABLE PART OF THE ESG JOURNEY

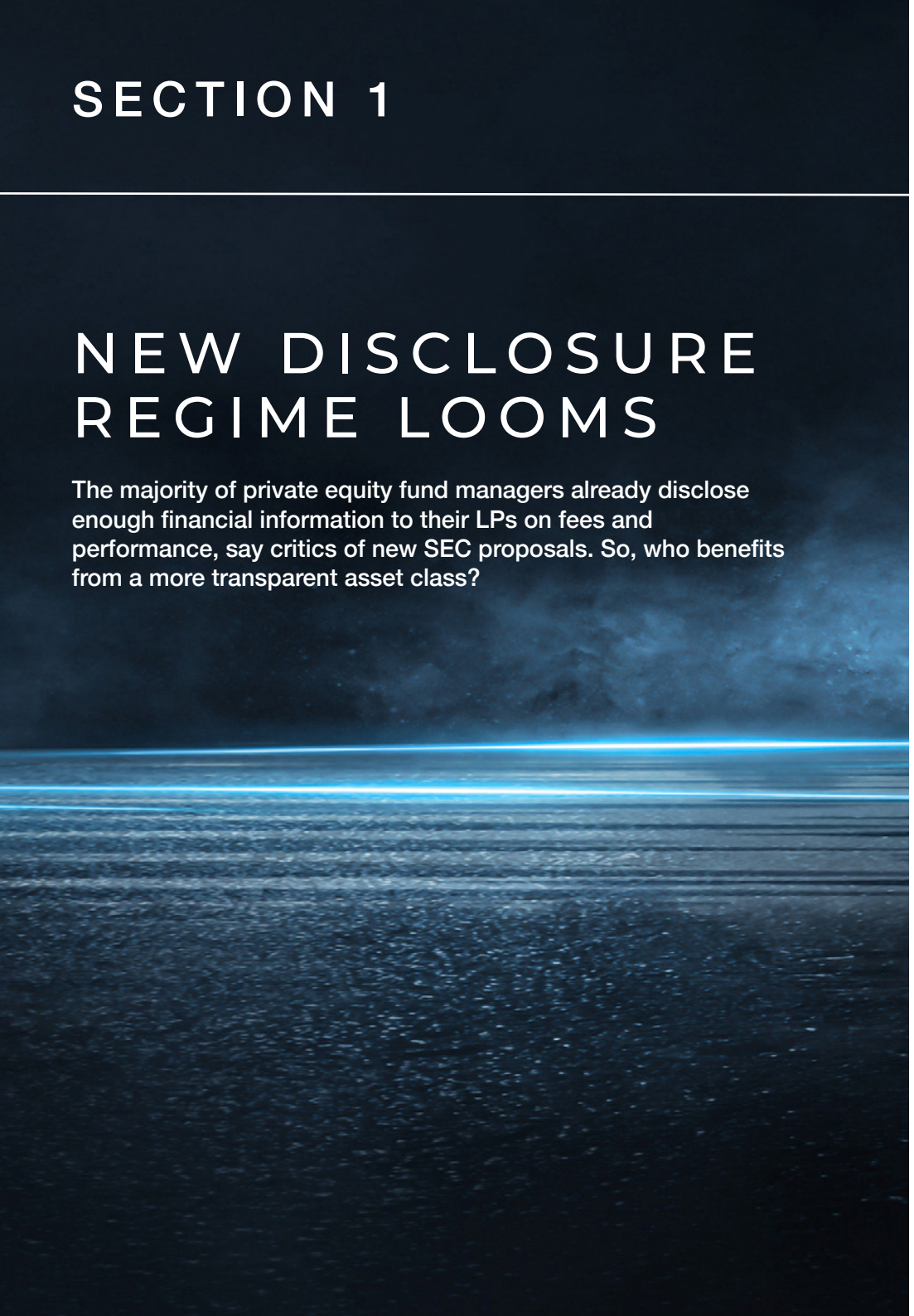
Despite some regional divergence on climate risk disclosure, respondents expect ESG to receive the **most regulatory focus** globally in the years to come



SECTION 1

NEW DISCLOSURE REGIME LOOMS

The majority of private equity fund managers already disclose enough financial information to their LPs on fees and performance, say critics of new SEC proposals. So, who benefits from a more transparent asset class?



With private assets under management at an all-time high and recent shocks such as the pandemic putting a spotlight on portfolio performance, regulators are pushing fund managers to increase the amount of financial information they are disclosing on their private equity investments.

In the US, the Securities and Exchange Commission (SEC) wants to increase the frequency and speed with which private equity funds report on Form PF – a disclosure document adopted as part of the regulatory overhaul post-financial crisis. It wants to spot potential flashpoints building up in the fast-growing private markets and potentially use this information to increase examinations and enforcement.

New proposals may require managers to disclose more information to their LP investors, and in different ways; information on fees and expenses, fund performance, changes to key personnel and strategy – in some cases reporting these changes within one business day. The SEC also wants to prevent or limit perceived preferential treatment of some LPs, for example on fees, but also in the GP-led secondary market where fairness opinions by independent third parties have been identified as a way to further protect LPs.

With the compliance deadline for the SEC's new marketing rules due in November and other guidance globally calling for more disclosure from GPs, the burden on private equity fund managers is set to grow considerably in the long-term.

In the UK, the Financial Conduct Authority (FCA) is moving ahead with its adjustment of European Union (EU) regulations post-Brexit alongside implementation of its own sustainable investment requirements, while the EU pushes its own regulatory agenda with the reworking of the Alternative Investment Fund Managers Directive (AIFMD) and the second phase of its Sustainable Finance Disclosure Regulation (SFDR), the first of which came into effect last year (see page 9 in this report).

Slow and uneven

The impact of the increasing regulatory burden on GPs will be slow and uneven, say industry sources. For the vast majority, quarterly financial statements are already commonplace, followed by more detailed annual reports and investor meetings. Side-letters – while not standardised – are also frequently used to respond to individual LPs seeking specific financial information, many of which face their own burden of regulatory compliance.

In many cases, the disclosure of financial information is already comprehensive across the industry, say both GPs and LPs. In an industry survey, conducted in May by Private Equity Wire, only 36% of respondents said there needed to be stricter regulatory oversight of the private equity industry. Many more (46%) had concerns about greater regulatory scrutiny of their business. "When you're not in these funds it's very easy to

point the finger and say how murky it looks," says a large North American LP.

What is expected to change is the format and level of detail required in some of these disclosures, particularly in areas such as performance, remuneration and fees, where some GPs may eventually be judged differently by their investors. The way some fund managers present a fund's IRRs has been criticised in the past, particularly where credit lines are being used in lieu of investor commitments. Changes to fund strategy and key personnel may also become more transparent. In a recent note to the industry, veteran investor and co-founder of Ardian Vincent Gombault wrote that the fast evolution of the private equity market has created instances where managers have deviated materially from their mandated investment strategy, for example with European buyout funds investing in North America.

"There have been times when changes in fund strategy have not been so clear," agrees Claire Madden, managing partner at London-based investment manager Connection Capital, "but there is usually a rationale there somewhere. Given the recent fundraising environment, managers with a widening remit are probably worth keeping an eye on – if you're a new investor in one of those that would worry me as the risks or illiquidity may be greater than presented."

Still in their proposal stage, the SEC rules on increased disclosure could look very different in their final form, say lawyers in the industry. Their timeline for implementation could also be longer than expected, particularly if litigation is involved.

In Europe, where AIFMD II is considered more of an evolution than a change in mood, says Andrew Poole, director at governance, risk, and compliance advisory firm ACA Group, requirements for quarterly reporting to investors of direct and indirect fees and charges allocated to the fund or to any of its investments have also been identified, along with the disclosure of side-letters. However, lawyers say implementation may not happen until late 2024 or 2025.

In the US, there has been strong pushback from parts of the industry on the SEC proposals, and some support from LPs and pension funds.

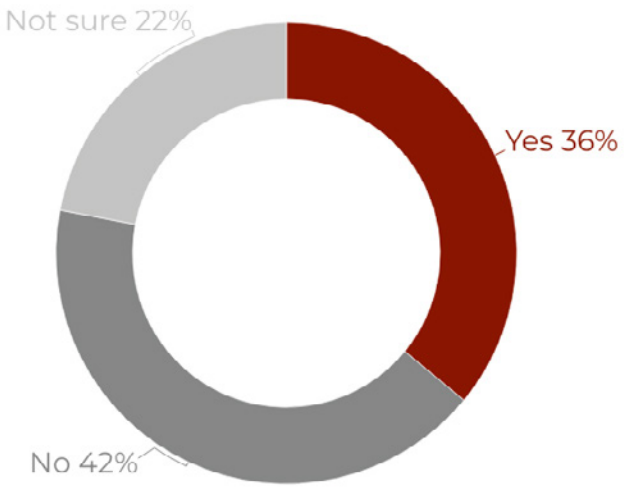
Power grab

US-based private equity lobby group The American Investment Council wants the regulator to drop the proposed changes, describing them as intrusive and unnecessary. It believes the requirements could ultimately reduce returns for investors and limit their options for exit and liquidity in the GP-led secondary market. The Canadian Venture Capital and Private Equity Association has said the SEC proposals will negatively impact Canadian investors.

These objections have been echoed in the mainstream. An editorial in the Wall Street Journal recently described the SEC move as "an enormous power grab for an agency whose purpose is to protect mom-and-pop investors from fraud – not sophisticated investors from risks they willingly take".

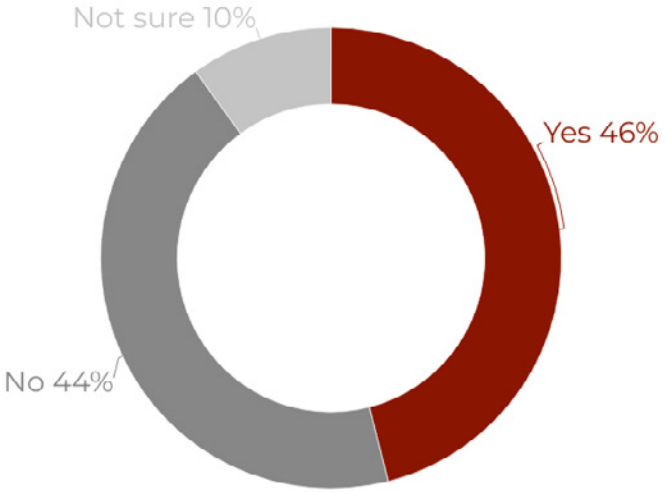
Of course, not all private equity investors are equally sophisticated – while many of the larger

Figure 1.1: Do you agree that there needs to be stricter regulatory oversight of the private equity industry?



Source: Private Equity Wire survey, May 2022

Figure 1.2: Do you have concerns about greater regulatory scrutiny of your firm/fund?



Source: Private Equity Wire survey, May 2022

and more experienced institutional investors have their own internal systems and templates for assessing fund performance and costs, newer entrants to the asset class face more challenges in their back-office accounting. To what extent retail investors are protected is also on the mind of regulators.

With record levels of allocation to private equity globally, greater transparency on fees and performance could ultimately shift the balance of power from GP to LP.

"It has been a GP's market over the past five years, where they have been free to negotiate their fee arrangements with different investors," says Chris Good, investment management partner at law firm Macfarlanes in London. "But there's all sorts of interesting tensions because you've got a lot of market power with popular GPs, who are thinking 10-15 years ahead that they are going to have to take more retail money and getting ready for that point in time."

In the UK, recent policy has been focused on making investment in private markets easier for DC pensions which are typically used to passive tracker funds with very low fees, says Good's colleague Lora Froud, investment management partner at Macfarlanes.

"I think there'll be a lot of pressure on private equity managers to think about different fee models and lower fee models," she says. "And the question, of course, is will the private managers want to play in that space given the fee sensitivities?"

Although there have been attempts to standardise disclosures on fees, such as ILPA's fee reporting template, a lack of specificity in some areas has allowed private equity managers to disguise their costs relative to peers or the wider market. But if regulators enforce too much of a standardised approach to disclosure, they risk stifling innovation among LPs or service providers with access to this data.

Holy Grail

"Data is the key topic. Everybody's looking to get a clean, central repository," says Poole at ACA, "but it remains a Holy Grail. I think it is still developing. Everyone's trying to kind of do something on it so it's definitely a growth area. We wait to see if someone can unlock that code."

For private equity houses with large compliance teams and above-average performance, an increase in regulatory burden may have a silver lining: keeping a lid on competition from new start-up managers worried about costs.

Responding to a question about increased regulation from the SEC on a fourth-quarter 2021 earnings call, KKR co-chief executive Scott Nuttall said: "I think the level of regulatory scrutiny of our space is probably a positive for larger players that are more institutionalised. And so, there's aspects of how the regulatory environment is developed that I think the barriers to entry in our space have gone up, and that's good for incumbent players."

Global GPs with a European base or fund structure can benefit from marketing passport

Private equity and the IFPR



ANDREW POOLE
DIRECTOR, ACA GROUP

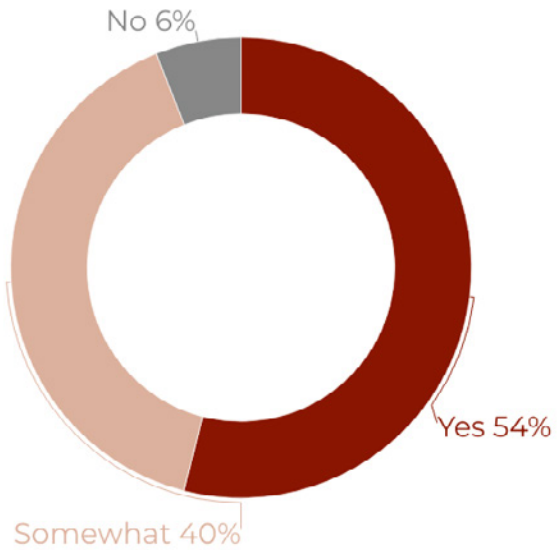
GPs typically classified as “exempt-CAD” firms by the UK’s FCA are now subject to far more complex and onerous capital, liquidity, reporting and governance requirements under the Investment Firm Prudential Regime (IFPR). Many GPs are also required to hold significantly greater levels of regulatory capital and, given the fund sizes we see being raised at the moment, far more onerous remuneration disclosures await. Additional requirements, especially the ongoing quarterly reporting, have put additional strain on GPs as calculations often centre around the performance of tasks alien to the private equity industry such as daily trade flow. Navigating this terminology is key, as misinterpretation can have a significant impact on further reporting requirements.

rights under AIFMD, allowing them to fundraise more freely across the region. MEPs are considering proposals to broaden the scope of the AIFMD marketing passport so that alternative funds can be passported across the EU, not just to professional investors, but also to high-net-worth individuals and family offices, says Froud. Those without these rights are going to face “some strategic decisions about how they run fundraising,” adds Good.

One private equity manager based in Europe believes the “first-movers” who have already embraced fuller disclosure on ESG performance are now best placed to handle an increase financial disclosure. Others may be less successful in handling the burden.

“PE managers are businesses at the end of the day and if [new regulations] makes it impossible to run their business, then smaller firms will be disadvantaged,” says Madden. “There needs to be

Figure 1.3: Has there been an increase in the level of transparency provided by GPs over the past two years?



Source: Private Equity Wire survey, May 2022

recognition that there is a vibrant, smaller end of the market or that will just go. Look at what happened in wealth management, the financial advisory market consolidated and there were less bespoke options around as a result." The real winners of a more transparent asset class could be service providers and fund administrators, say sources. "All this points to either bulking up the back-office or more outsourcing. For service providers this is their bread and butter," says Simon Crown at Clifford Chance.

Poole agrees that outsourcing offerings such as ACA's can absorb, automate, and streamline some of the more repetitive compliance checks but ultimately it comes down to how open and organised a GP might be. "We rely on the information that comes from the GPs. We don't know what their performance is, we will rely on them who rely on the fund administrators and fund accountant so it becomes a circular conversation." ■

KEY TAKEAWAYS

- **For GPs**: Fund managers that can demonstrate their transparency ahead of proposed SEC regulation have an obvious advantage over new and emerging managers with smaller back offices
- **For LPs:** With more financial information made available to investors, many are learning new ways to aggregate it quickly and efficiently to make allocation decisions
- **For service providers:** Fund administrators, consultants and outsourcing firms are watching closely how regulation evolves so they can better service GPs and LPs burdened with new rules



DELANEY BROWN
HEAD OF FUNDS & SECONDARIES, CPPIB

"Our GPs have always been transparent with us"

Do I think that we are moving in the direction of more transparency? Yes, absolutely, for a number of different reasons. Firstly, there's an increasing number of private equity firms going public so there's different levels of disclosure requirements required there anyway, just based on the nature of their underlying ownership structures. There's also, slowly but surely, an increasing wave of various forms of retail money coming into the asset class. That, in itself, will lead to an increased level of disclosure and transparency, very comparable to what happened in the public markets and ETFs.

But, as an LP in a large number of leading and largest private equity firms for a long time, we've never actually had any problems getting access to information. Maybe that's a function of the size that we are. But I think generally once you are an investor in these funds, the level of access and information is always been pretty good. I don't really recall a GP that's never not responded to a request and provided the data that's been asked for and often they've gone above and beyond in terms of what's been asked for.

The challenge for us is sometimes processing all of the information to make sure we've captured it all because there's a lot that comes back, especially as most of the GPs have really staffed themselves up with a large number of people in that regard to honor all the requests that come in from all the different LPs.

What the GPs are doing more and more, also, is having sessions where there may be more than one LP in the room for diligence access, for example, but the total hours that an LP could spend with a GP and the specific professionals could be comparable, whether you're a small or a large investor.

We have a large team but do engage consultants on operational due diligence at specific times, almost to sanity check some of the conclusions that we would have from the reporting we've had from the GP. But a lot of this is done in-house, because we have a very large portfolio, with over 100 different GP relationships. My guess is there'd be a lot more outsourcing in the lower and mid-market.

SECTION 2



ESG RULES GO GLOBAL

Europe has led the way on sustainable finance regulation with the SFDR. As the US and UK step up their own guidance, some regional divergence means fund managers are customising their approach

It has been over a year since Europe's Sustainable Finance Disclosures Regulation (SFDR) was brought into force. Since then, around 1,800 funds have been upgraded from Article 6 (funds which do not integrate sustainability into the investment process) to Article 8 or 9, or from Article 8 to Article 9, according to data from Morningstar's 2021 review of funds published earlier this year.

Though some fund managers have simply formalised an existing ESG strategy or continued with a business-as-usual approach, others have rebuilt their investment strategy or launched new bespoke fundraising vehicles tied to the categorisation.

The first phase of SFDR has been generally perceived as a success on a global level, but what follows it in Europe and elsewhere is less clear.

In a survey of the industry by Private Equity Wire, around eight out of 10 respondents expected ESG to be an area of greater regulatory focus, within a list of other priorities. But with the inevitable delays in these regulations, there is the potential for SFDR to turn into a fund product label and revert to being a marketing tool, says an advisory source. Subsequent regulations, if implemented incorrectly, run the risk of devaluing the entire ESG proposition, the source adds.

The next stage – or Level 2 – of the SFDR (which should introduce more detailed and prescriptive disclosure requirements under Articles 8 and 9 and principal adverse impact of investment decisions) has been repeatedly delayed, most recently into January 2023.

Climate risk

In the US, the SEC wants to increase disclosure requirements for companies on climate-related risk but has extended the period for public comment up to June 2022 amid a wider pushback. The regulator wants firms to disclose how they identify and manage climate risks including scenario analysis and wants updates on progress towards meeting any climate pledges, including the use of carbon offsets or renewable energy certificates.

In the UK, Task Force on Climate Disclosures (TCFD) rules came into effect in April but under a phased approach, with only the largest UK-registered companies and financial institutions required to disclose climate-related financial information on a mandatory basis. Expansion of the rules is expected in 2023.

Although the SEC's proposals are aligned with TCFD, a proposed classification approach in the UK through the FCA differs slightly from Europe's SFDR, potentially adding to the cost and complexity already faced by many fund managers in meeting new regulatory requirements.

The UK's forthcoming taxonomy – due at the end of 2022 – is also uncertain. It may classify North Sea gas extraction as a 'green investment', according to a newspaper report in May citing government sources, while the EU labels natural gas power plants as 'transitional'.

"The fact is that ESG means something totally different wherever you are," says Andrew Poole, director at ACA Group. "So that spread of focus is causing GPs concern - 'If I deal with one thing, does that mean I'm missing out something else?' They may be running a regulatory triage to keep one regulator happy while irritating another."

The risk of regional divergence on ESG regulations has been well documented but the impact on how GPs fundraise and deploy capital once rules are implemented is hard to predict. "In terms of ESG regulation, you've got to have a certain amount of locality," says Poole. "So the idea that you can take a global approach on something may not be the right way to do it."

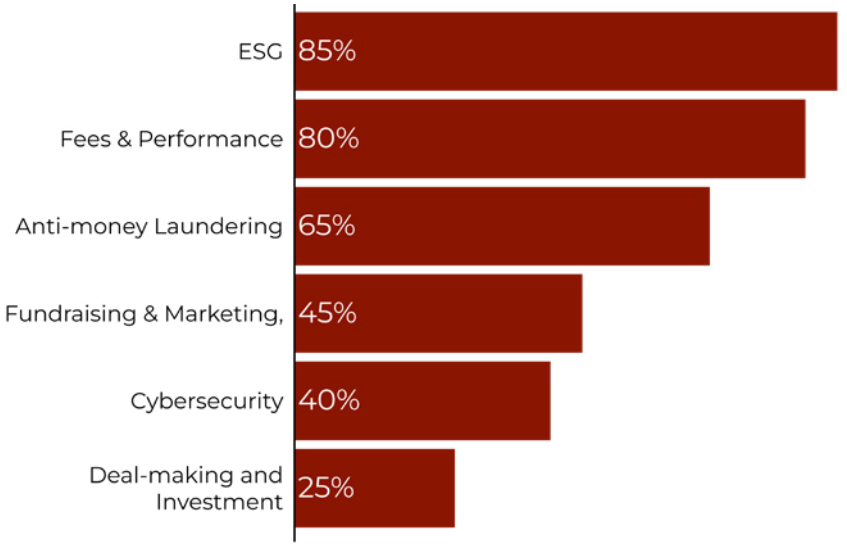
As with increased disclosure on fees and financial performance, greater standardisation is one way forward and provides a growth opportunity for service providers to the industry. "Fee reporting feels very much more standardised now but the next area that we're beginning to see a lot more focus on standardisation is around all things ESG-related, and so that will be D&I and the metrics that are being measured there, climate, and emissions across the portfolio," says Delaney Brown, Head of Funds & Secondaries at large Canadian pension fund investor CPPIB. "There's nothing yet fully standardised but there's a lot of initiatives in place to standardise that level of information and reporting."

Standardisation

As explored in Private Equity Wire's February Insight Report 'Creating Values', more than 100 GPs and LPs globally have now taken part in the ESG Data Convergence Project, which seeks to standardize ESG metrics and provide a mechanism for comparative reporting across the industry. Data is currently being collected across six categories: greenhouse gas emissions; renewable energy; board diversity; work-related injuries; net new hires; and employee engagement. "Standardisation around climate is really probably the big initiative that's happening right now and over the next 12 months or so," says Brown, "and that would really be at the forefront of what we're thinking about."

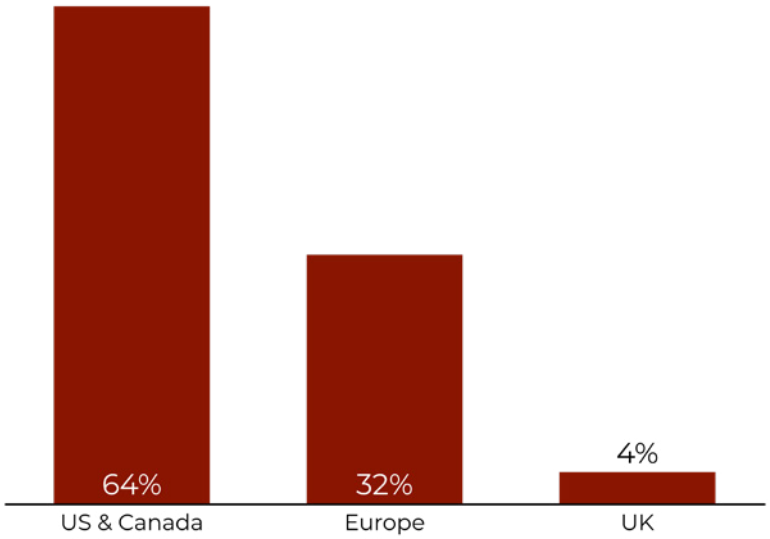
According to Marc Moser, head of impact at Lightrock – an early adopter of impact investing with what it describes as a "comprehensive" approach to ESG measurement, around 75% of what the firm does on ESG is standardised, with the remaining 25% customised or tweaked for different regions and their requirements. "We do see quite a lot of differences," he says. "And we have to actually take the approach to tailor and customise not only geographically, but also thematically – it helps us and makes us more

Figure 2.1: Which areas do you expect to see greater regulatory focus?



Source: Private Equity Wire survey, May 2022

Figure 2.2: Which of the following regions do you expect to see most regulatory action over the coming 12 months?



Source: Private Equity Wire survey, May 2022

efficient, which is especially important working in impact investment."

In a survey featured in Private Equity Wire's 'Creating Values' report, almost half of more than 60 responses said financial returns or value creation were the most important factor in their ESG monitoring and behaviour, rather than regulation. One respondent commented: "I think the biggest challenge facing organisations is linking ESG initiatives and strategies to financial returns. It's one thing to measure these metrics, it's another thing to accurately predict the financial gain or elimination of loss tied to these actions and metrics." Blackstone's head of ESG Jean Rogers even argued that private equity funds have such a level of engagement with their investments that they can get the information they need without spending years coming up with the standard. "There are some universal issues – decarbonisation and diversity," she said, "but beyond that it really comes down to what strategy you are driving and the data, is it specific? We can't always wait five years for a framework."

Wait and see

Some private equity firms are further ahead than others on disclosing their ESG performance and therefore more ready to meet new regulations while others are employing a wait-and-see approach.

"There are firms that are specialising in going out on site, kicking the tires, peeling the paint off, measuring how much lead is in the paint, that is a very detailed way of doing it," says Poole. "And that might be right for some firms. But it's finding that right kind of level of matching up with what you've got internally versus what's required. So some firms will be very handily placed but we just we have to wait and see how things come in from regulators." ■

KEY TAKEAWAYS

- For GPs: One year after the SFDR, the SEC wants to increase disclosure requirements for companies on climate-related risk. The UK's Task Force on Climate Disclosures (TCFD) rules came into effect in April
- For LPs: Investors are seeking ways to standardise ESG metrics and provide a mechanism for comparative reporting across the industry but regional regulatory divergence could be an obstacle
- For service providers: Increased reporting obligations and greater ESG standardisation provides a growth opportunity for service providers with innovative data platforms



SECTION 3

HAND OF REGULATORS REACHES INTO M&A

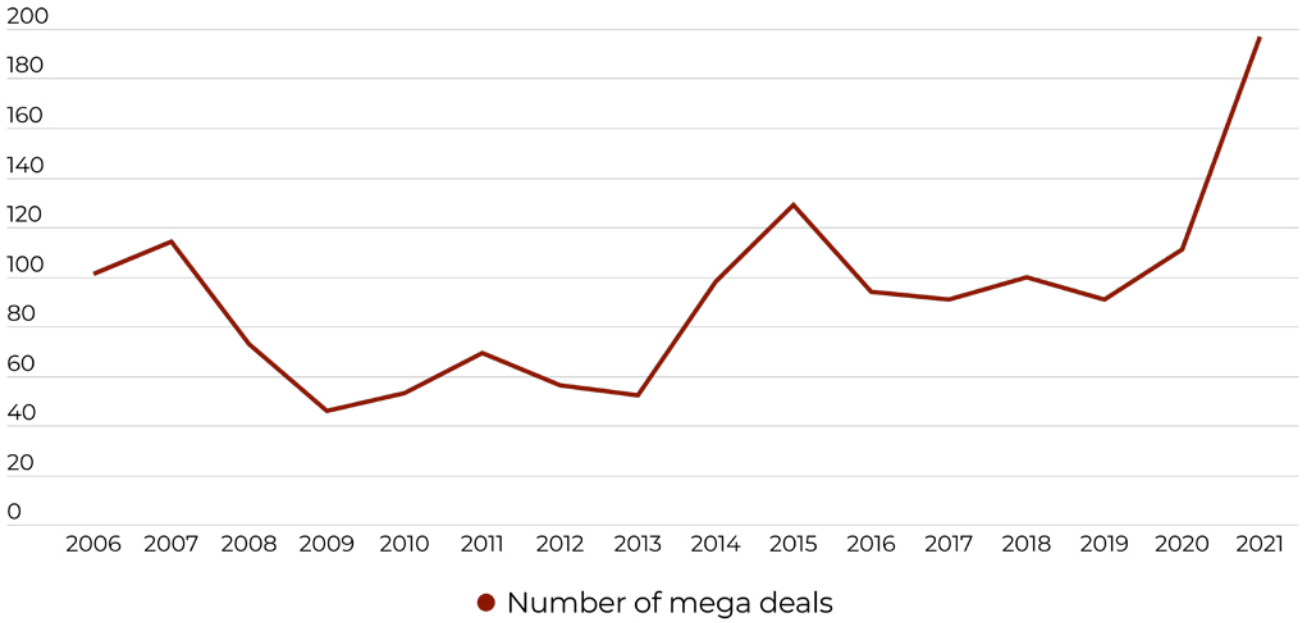
With deal volumes at an all-time high in 2021, merger controls have increased along the lines of national security, anti-trust and corruption. Extra scrutiny may slow some high-profile private equity-backed deals this year

M&A volumes reached a record high in Europe, the US and UK last year, driven by years of a cheap debt and a quick return to business after the pandemic. In Europe, private equity accounted for around 40% of all acquisitions. In the US, private equity M&A in 2021 was more than double the previous year's total.

Yet, according to lawyers and dealmakers, regulatory scrutiny around national security and anti-trust could slow down the progress of some deals in 2022. In May, Jonathan Kanter, head of antitrust at the US Department of Justice, signaled a crackdown on private equity buyouts which "hollow out" an industry. More information is being sought upfront from buyers before regulatory approval in other jurisdictions too. "Changes in regulation have made the M&A process more complex over the past year," said John Reiss, Global Head of M&A at White & Case in February. "Now more than ever, dealmakers need to understand early on where there may be regulatory hurdles to clear, and potentially pre-empt these with filings at the term-sheet stage."

Towards the end of last year, conversations restarted between GPs and consultants and service providers to take some of the strain out of deal-making, says Andrew Poole at ACA. These conversations considered anti-money laundering to reviews of financial service companies that might have been acquisition targets, he says. In the US, hurdles include an increasingly aggressive stance by the Committee on Foreign Investment (CFIUS), changes to antitrust policy and the Federal Trade Commission's implementation of pre-consummation warning letters as potential

Figure 3.1: M&A 'mega deals' by volume, 2006-2021



Source: Mergermarket Data

causes for longer deal timelines or investigations post-transaction.

Critical sectors

During the first six months of the Biden administration, the focus of CFIUS has remained on the technology sector and critical infrastructure. In 2020, 122 transactions out of a total of 313 transactions reviewed involved acquisitions of US critical technology companies. However, while the landscape for foreign investors in the US has grown more complex, it has been applied more to Chinese and Russian buyers and not caused major challenges for private equity firms based in allied nations, such as Europe, UK or Australia, say dealmakers.

"There's been some instances where CFIUS has certainly come into play, so the universe of potential buyers for an asset could be smaller than you would have expected five or six years ago," says a source at a large private equity buyer in the US, "but generally we have been on the right side of most of these things."

Regulatory attention in the US has also shifted to governance concerns in cross-border M&A, as the pandemic may have disrupted usual compliance procedures at large multinationals and limited the potential for in-person audits and investigations due to travel restrictions. In December last year, the US unveiled its first-ever national security strategy memorandum focused on corruption, after a 25 percent increase in whistleblowing reports regarding Foreign Corrupt Practices Act (FCPA) violations in 2021.

According to law firm Alvarez & Marsal's Threatscape 2022 report, "President Biden

> “Where CFIUS has come into play, the universe of potential buyers for an asset could be smaller”

has significantly increased resources to fight corruption and has appointed a record number of FCPA prosecutors. We foresee that the number of cross-border investigations and related sanctions will accelerate in 2022 and reach new peaks in the coming years... Private equity and other acquirers are now demanding forensic due diligence from third parties to ensure that the companies they are courting are operating in a lawful and ethical manner. This is particularly an issue for cross-border transactions in China as international travel to the country remains exceptionally challenging.”

Screening time

Regulatory scrutiny of M&A appears to be tightening in Europe and the UK too.

New guidance was published last year on Article 22 of the European Union’s Merger Regulation, which provides a mechanism for EU Member States to request the Commission to examine a concentration that does not meet the EU turnover threshold for merger control. The EU Digital Markets Act, expected to take effect in 2023, would require big tech companies to report all digital-sector-related and data-related M&A transactions, regardless of their size, giving the European Commission increased ability to investigate whether these transactions restrict competition. As in the US, big tech and digital infrastructure are key areas of focus, with regulators keen to step up traditional enforcement and seek new ways to intervene, say legal sources.

In the UK, a new screening regime under the National Security and Investment Act (NSIA) was introduced at the start of this year which allows the government there to review certain transactions linked to national security and potentially block

China wields ‘Cyber Sword’

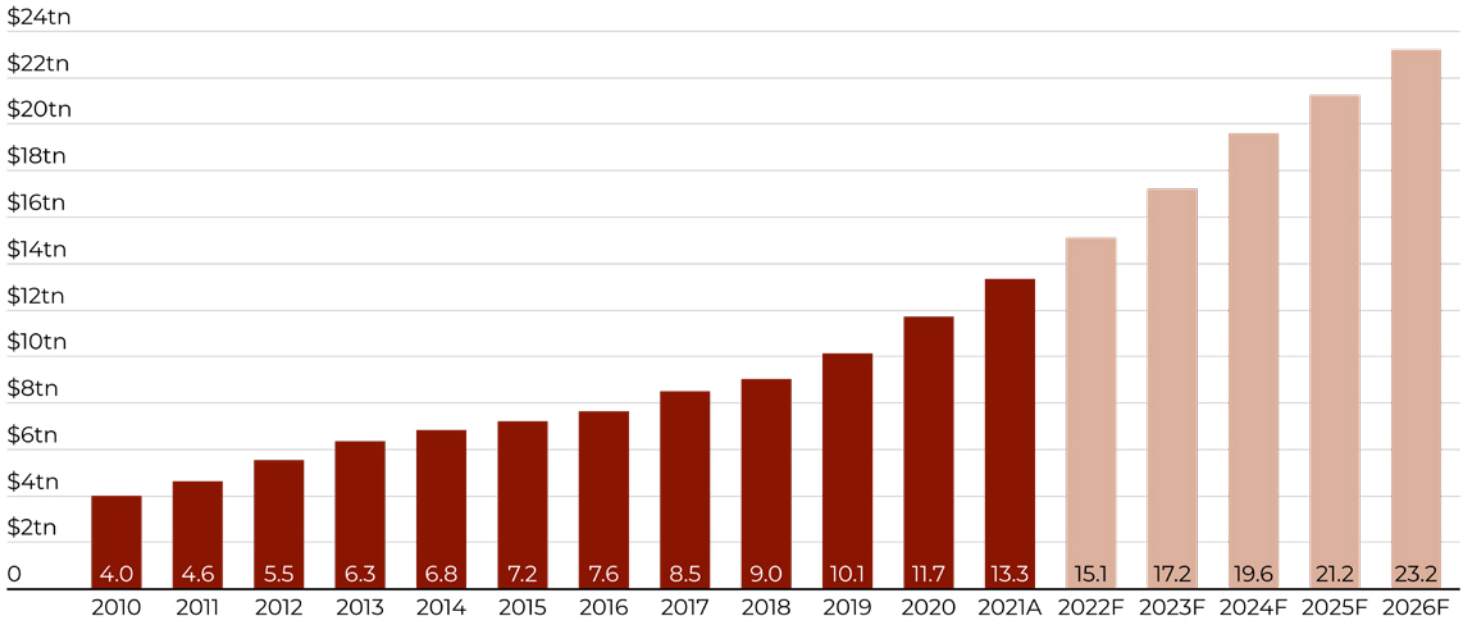
Late in October 2020, when China and much of the world was still in the grip of the Covid-19 pandemic, a wide-ranging crackdown on China’s tech sector began. Known as ‘Operation Cyber Sword’ it eventually resulted in billions of dollars in fines for hundreds of companies, the removal of many well-known Chinese apps from digital platforms and the disappearance of China’s richest man at the time, Jack Ma, for several months.

The moves prompted a global sell-off in Chinese tech stocks and forced international private equity and venture capital investors to review their strategy for the country, particularly as some of the companies affected were also listed in the US. Private equity fundraising by China-focused funds is now at its lowest level in 13 years, according to Preqin data.

Like Europe’s GDPR regulation, China’s government has focused on data protection, but it is also worried about anti-trust – seeking to rein in the power of its tech giants. New regulations restricting the use of algorithmic recommendations have followed and came into effect in March, but economists now believe the worst of the tech crackdown is over as China tries to balance tighter regulation with economic growth.

But China’s regulatory overhauls have not been limited to the tech sector. Greater scrutiny of foreign investors and new rules on how much financial information Chinese companies must share with foreign regulators have also been reported. A new approach to monitoring the risks buried in the portfolios of life insurers (known as C-ROSS II) was also brought into effect this year. Though it remains to be seen, the new solvency rules could have a far deeper and longer-term impact on large Chinese investors in private equity such as Ping An and China Life.

Figure 3.2: Alternative Assets under Management and Forecast, 2010 - 2026F*



Analyst note: Analyst note: 2021 figure is annualized based on data to March. 2022-2026 are Preqin's forecasted figures

Source: Preqin

or unwind them. Transactions falling within 17 "sensitive" sectors of the UK economy may now require government clearance prior to completion. The 2021 edition of Latham & Watkins' Private M&A Market Study, which examined more than 320 European deals, found that FDI approval continues to grow as a factor in deal completion - reflecting the increased number of jurisdictions with FDI approval regimes and the high value, high profile, and strategically significant nature of the deals surveyed. This trend will continue and accelerate with the advent of the NSIA, it said.

Another hurdle

Some see no particular regulation hindering or impeding deal-making in the UK currently, aside from the vagueness of some of the definitions in new NSIA guidelines and increasing amounts of change of control approvals going through the Financial Conduct Authority as private equity firms expand. One London-based private equity lawyer says the vast bulk of private equity transactions don't present any national security concerns but with increasing sanctions on Russian investors due to the war in Ukraine "there is still some ground to be developed in terms of how the [regulatory] regime operates and how far it looks into the investor base sitting behind private equity funds". Instead, the same lawyer points to the UK's Competition and Market Authority (CMA) as greater hurdle to UK dealmakers in the current market, saying that on one end there is a risk it may deter some investors from certain sectors but increasingly, in the private equity industry at least, it is being viewed as a procedural hurdle that needs to be overcome.

Indeed, as private equity investment increases in increasingly strategic parts of the economy, the role of the CMA has expanded too. In January, it opened an investigation into Clayton, Dubilier & Rice Holdings LLC's (CD&R) £7.1 billion purchase of supermarket chain owner Morrisons. The authority found that the takeover could lead to a loss of competition and potentially higher petrol prices for drivers in 121 areas. CD&R offered to sell off 87 petrol station forecourts to appease the regulator. The buyers of the sites would also have to be approved by the CMA, according to reports in May. "It seems certain that as regulators and governments push to introduce or enhance a wide range of rules impacting investments in multiple sectors, dealmakers should expect that the hand of government will be felt in M&A deals, even for businesses not traditionally viewed as 'regulated'," said Latham & Watkins lawyers earlier this year. "In our view, such enhanced regulatory focus is here to stay and dealmakers must now address how best to tackle the implications and minimise the impact of regulatory interventions in deals." ■

KEY TAKEAWAYS

- **For GPs:** As private equity moves into more strategic parts of the economy, regulators want to see more financial information before deal approval
- **For LPs:** On large cross-border M&A facing regulatory scrutiny, a smaller universe of buyers or the risk of non-completion could impact valuations or exit for fund LPs
- **For service providers:** National security screening regimes are having limited impact on cross-border M&A lawyers who see it is as another hurdle to overcome for buyers

SPACs in the firing line

In April, US regulator the Securities and Exchange Commission (SEC) proposed rules to combat what it considers to be an "unprecedented" surge in special purpose acquisition companies (SPACs).

Around since the 1980s, SPACs boomed during the pandemic amid market volatility. By the middle of last year more than 300 listed SPACs were generating gross proceeds of more than USD 100 billion – around 10% of these were backed by private equity firms, quick to see an opportunity in raising capital, realising investments or making bolt-on acquisitions.

But along with the boom grew concerns about the potential for conflicts of interest, inadequate levels of disclosure or due diligence and sponsor compensation being out of sync with investor returns. SEC Chair Gary Gensler wants to align SPACs more closely with how IPOs are regulated, particularly in terms of disclosure, marketing practices and gatekeeper and issuer obligations.

The irony of these proposals in 2022 is that SPAC mergers are currently at their lowest level since the onset of the pandemic. In the first quarter of 2022, there were 34 global deals where a SPAC combines with a target – roughly half the number of the previous quarter.

When they return, the regulations are expected to have limited effect in dampening appetite for the structure.

"I think there will be a little bit more nervousness, but I still think SPACs are going to be a viable option," said lawyers at Freshfields in April. "You're not likely to have a repeat of 2020 or 2021 anytime soon, but we don't think SPACs are going to disappear. To paraphrase Mark Twain's often misquoted lines: reports of SPAC's death are greatly exaggerated."

SECTION 4

REGULATION WILL 'LEGITIMISE' PRIVATE EQUITY FOR INVESTORS

Some limited partners are arguing for a more tailored approach from regulators, but new rules on transparency will also help to make underlying pension holders more comfortable with the asset class in the long-term

Private equity firms' reputation used to be wholly dependent on the returns they delivered to their LPs, but this is no longer the case. A recent LP survey from Edelman, which received 400 responses from across Europe and the US, revealed overall returns as only the fourth most important factor in trusting a GP, behind transparency, reputation, and having a good quality leadership team.

In the US, the SEC is calling for improved protection of LPs after it found certain GPs fail to seek consent for conflicts of interest; fail to seek consent until after a transaction occurs; and fail to provide complete information to LPAC members. It also wants to see more "fairness of opinion" for LPs during the valuation process of a GP-led secondary deal. If approved, will the changes increase the level of trust between LPs and their GPs?

In a survey by Private Equity Wire in May, only a third of respondents believed the level of trust from LPs in their GPs had increased over the past five years. Around 20% said it had decreased.

"Private equity's historically smaller size in Europe has meant it hasn't drawn as much attention from regulators here in the past, compared with what we're currently seeing in the US," says Jessica Gill, director, private capital, Edelman. "While pension funds may have previously only allocated a small percentage of their portfolio to private equity, this percentage has steadily risen over the past few years, and the onus is increasingly on the LP to justify and show a clear understanding of where exactly the money is going."

LP demands

UK pension fund Nest, a £24 billion pension scheme representing around a third of the UK's total workforce, recently announced that it estimates it will have at least £1.5 billion in PE investments by early 2025 and has set itself a longer-term allocation target of 5% of its portfolio. Head of private markets, Stephen O'Neill, says:

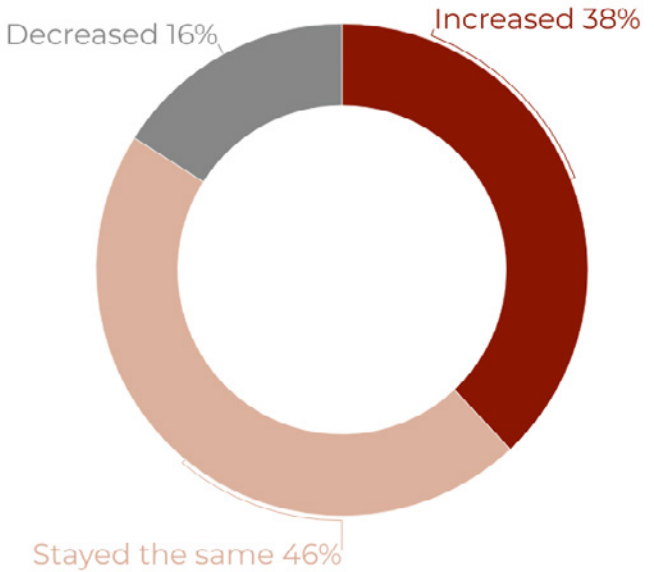
"We need regulators to produce more tailored regulation in PE which is adapted for different types of LPs – or, at the very least, regulation which distinguishes between institutional and individual types of investors."

Other forms of regulation, such as the live debate concerning the UK government's 0.75% charge cap which looks to protect pension holders in DC schemes from high fees in private equity, have limited some allocation to PE from pension funds, causing schemes to argue against the government's influence on pension asset allocation decisions. O'Neill says that, while returns are important to Nest, other factors are also high on the agenda. "We especially require sufficient investor protection, as well as liquidity provisions, that protect us since the nature of defined contribution schemes means there is inherent uncertainty about how much money will be accessible on a given day," he says.

According to a large US pension fund, the biggest issue facing LPs in terms of a GP's transparency is the generic nature of information which is shared by the big PE houses, which often isn't relevant to the broad range of investors entering the asset class. The pension fund wants to see appropriate regulation according to investor status rather than a blanket approach. Smaller and mid-sized LPs have complained privately that larger LPs sometimes receive preferential treatment from GPs. Representatives at the Los Angeles Fire and Police Pensions and Los Angeles City Employees' Retirement System have been cited in reports calling for full disclosure of different or preferential treatment to all other LPs. They proposed full transparency in order to increase confidence in GPs and avoid investors from being treated differently. While sounding ideal in theory, it might be more difficult in practice. The unamed US pension fund believes that GPs will always dedicate more time to the clients who are larger (and therefore more valuable to them).

LPs are also increasingly holding their GPs accountable and increasing demands with regards to ESG and diversity, with some US LPs now sending separate diversity and inclusion surveys to GPs. But it has typically been institutional investors, rather than private wealth and family offices, that

Figure 4.1: Has the level of trust from LPs in their GPs increased, decreased, or stayed the same over the past 5 years?



Source: Private Equity Wire survey, May 2022

> “Investors may want more regulation because of something more nuanced than regulation for regulation’s sake; it legitimises the asset class”

have led the calls for more transparency here. Nevertheless, the SEC is expected to increase its focus on ESG regulation and climate risk disclosure in the coming years.

The definition of ‘transparency’ has expanded in the past five years and continues to broaden from the perspective of LPs as more money moves into the asset class.

Increased regulation looks to be an inevitability as the asset class continues to experience growth. “If you’re a pension fund looking to invest more in private equity, one way to make your stakeholders comfortable with this is by showing you’re working with well-managed firms, and regulation, like ESG and DEI, is a component of that process” says Edelman head of capital markets for EMEA, Alex Simmons. Gill adds: “Investors may want more regulation because of something more nuanced than regulation for regulation’s sake; it legitimises the asset class.”

The latest Global Private Equity Barometer report from Coller Capital, a global investor in the private equity secondary market, shows that 59% of LPs believe that the PE industry will be forced to self-regulate in the coming years, due to mounting societal pressure from investors and increasing



FRED SHAW
CHIEF RISK OFFICER, HAMILTON LANE

“LPs will need to drive the format for disclosure”

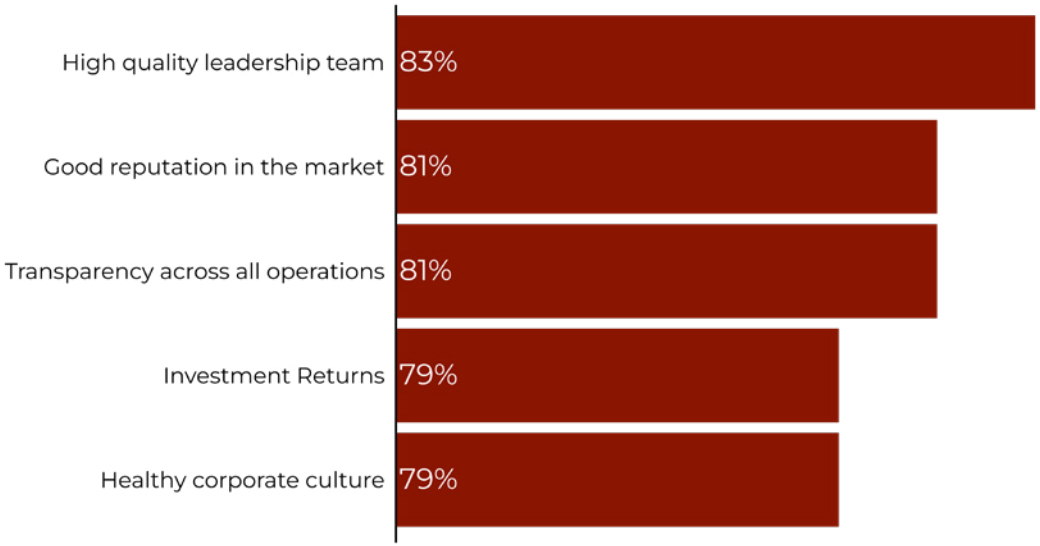
There’s definitely a greater push for information from LPs, and that’s at the institutional LP level. On the wealth management side, they are expecting their advisors to be doing that level of diligence on their behalf.

I think there are a large number of GPs providing a certain level of transparency higher than the standard minimum but most GPs are going to need technological solutions to do this. The firms that are forward-thinking and that are partnering with the strongest fund administrators who are really investing in their technology, to handle these greater disclosure requirements, are going to be the ones who have an easier time with it. And for GPs who are smaller or don’t have the proper technology in place, it will be tougher.

In terms of [transparency on] a fund’s performance, LPs have already got the information to do IRR and benchmarking analysis, it’s just a question of what additional insights are you going to get [from it]. At Hamilton Lane, we’ve already done a lot of the investing in technology and systems that are needed to do the reporting that will be asked of us, so we’re really just double checking our systems.

In terms of information around fees, it’s tough to legislate standardization, and some LPs don’t care about the ILPA template [on fees]. So LPs will need to drive what they want to see in terms of the format with which GPs present the information. But if you go to 10 different law firms and ask the question, you’re going to get the same answer 10 different ways. I think it is very hard to get the critical mass needed to truly come up with a standard template [on financial disclosure].

Figure 4.2: What drives LP trust in GPs?



Source: Edelman Private Equity 2021 LP Survey

demand for the asset class. This is not the first attempt that has been made to regulate the industry more on behalf of LPs. Since the launch of the Institutional Limited Partners Association's (ILPA) template on fees disclosure in January 2016 to promote more standardised reporting and better practice across PE, the association continues to advocate for greater regulation and transparency in PE. This template has been adopted by over two thirds of LPs as of December 2021.

The ILPA has been working closely with the SEC as it prepares to issue a final ruling and provided the following statement when asked about the template: "We are pleased to see that adoption has increased in the years since its release in 2016. However, we continue to believe that the state of reporting can be improved; consistent, detailed cost disclosures are not yet universal across the private equity industry". ILPA confirmed it has "no formal plans to evolve or amend the template" but is in "ongoing, active dialogue with both LPs and with end users, (i.e., GPs, fund administrators and technology providers) about opportunities for enhancement and clarification in the future." ■

KEY TAKEAWAYS

- With research from Edelman showing investment returns as only the fourth most important factor in trusting GPs, regulation looks to prioritise transparency to legitimise private equity for LPs.

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