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# Alternative Investment Funds 2019

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# Operating Private Funds in 2019: Transparency is Key

Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates

Greg Norman

In 2019, the private fund industry seems to have regained, and exceeded, its pre-crisis position at the forefront of the financial services industry. In the years preceding 2018, private funds achieved record-breaking years of fundraisings as an increasing number of investors redoubled their allocation or made allocations for the first time to private funds. 2018 saw the fundraising landscape show some signs of market divergence; whilst large funds have experienced further growth, smaller funds and first time managers have not always been as successful in their marketing efforts. Nevertheless, many were expecting 2019 to herald a new record year of deal-making and activity from private funds, as some reports set dry powder (the amount of unspent capital commitments held by private funds) to be at a record $2 trillion. Despite this, private fund activity has arguably been rather muted. In the UK, it has been quasi-impossible to pass a day without reading about Brexit. At the time of writing, the UK was due to leave the EU on Halloween under the leadership of a new Prime Minister – it remains to be seen whether he will have any nightmares on 1 November. Looking to the global macro-economic environment, the uncertainty regarding US-China relations and elsewhere seems to have had a dampening effect on world trade.

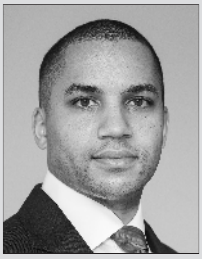
Against that backdrop, it seems that 2019 may be memorable for other reasons. For the private fund community, increased focus on information and transparency appears to be a recurring theme. In 2019, information is king (or queen). Outside of the private fund world, we have seen the EU's General Data Protection Regulation (the **GDPR**) start to bite, with various regulators across the EU opting to hand out record breaking fines. Most recently, British Airways received a fine of £183 million from the UK Information Commissioner's Office.

Private fund managers were never meant to be high on the list of "targets" for the GDPR, but nevertheless it has been high on the agenda for most operations teams within private fund sponsors. For such teams, enhancing or improving internal systems and controls, including those relating to data security, has long been on the agenda. 2018 highlighted a number of operational failings in fund management and other financial services businesses, particularly with respect to the systems and controls procedures. For example, in one instance a manager's systems and controls failed to prevent the comingling of investors' cash with that of the fund manager.

Investors in private funds are also focussed on increased information. Due diligence by investors, particularly on new fund managers, has intensified as more detailed information, site visits and time with key staff are requested. Private fund sponsors are having to allocate more time and resources to ensure that their systems and controls are able to manage this level of scrutiny. With the speed of change in technology and related regulation, it is no small challenge for fund sponsors who would have become adapted to a relatively stable period of regulation relating to private funds.

In addition, 2019 has also seen the Institutional Limited Partners Association (**ILPA**) publish an update to its principles for transparency, governance and alignment of interest in private equity. Since the first publication of the ILPA Principles, there has been a strong line taken on alignment of interest and its implications for private equity fund economics. The third edition of the ILPA Principles shows a clear trend towards increasing transparency, including in areas such as fee and expense reporting, notification of key events such as significant personnel changes (going beyond just key man changes) and disclosure of standards of care. The ILPA Principles have not been broadly adopted by fund sponsors, particularly given that most of the significant private fund sponsors have long established terms for their fund documents that are routinely accepted by investors. Nevertheless, a number of the suggestions, particularly with regard to transparency and reporting would appear to be a sensible benchmark – not least because many fund sponsors are already providing much of this transparency in one form or another. As investors become more sophisticated and contribute greater allocations to private funds, the desire for standardised reporting and information is only likely to increase.

The private fund industry may also do well to consider some form of self-regulation in this area. In early 2019, the European Securities and Markets Authority (**ESMA**) published a report exploring whether the objectives of the Alternative Investment Fund Managers Directive (the **AIFMD**) had been met. ESMA commissioned KPMG to produce this report and its contents seem to signal that "AIFMD II" may be just over the horizon. One of the core aims of the AIFMD was to improve investor protection, particularly by increasing information and disclosure. As the report published by ESMA shows, very few investors feel that this aim has been achieved. Instead, fund sponsors have had a significant increase in regulatory reporting obligations, but regulators have been unable to do anything with the information, and investors have not seen any tangible benefit while having to bear the increased costs associated with this compliance. It seems likely therefore that one focus of any successor to the AIFMD will be to seek to harmonise and increase reporting by private funds. One lesson that can be taken from the process through which the original AIFMD developed, was that having demonstrable self-regulation can actually have a positive impact: if the private fund industry can successfully demonstrate that it already provides investors with appropriate levels of transparency and reporting, then the impact of any regulation in this area may be mitigated, not least because appropriate standards will already be in place.



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