EMPEA

Legal & Regulatory Bulletin

26

Issue no. 26 | FALL 2018

CONTENTS

About EMPEA

EMPEA is the global industry association for private capital in emerging markets. An independent, non-profit organization, the association's membership comprises 300+ firms representing institutional investors, fund managers and industry advisors who together manage more than US$5 trillion in assets across 130 countries. Our members share EMPEA's belief that private capital is a highly suited investment strategy in emerging markets, delivering attractive long-term investment returns and promoting the sustainable growth of companies and economies. We support our members through global authoritative intelligence, conferences, networking, education and advocacy.

For more information, visit **empea.org**.

Publication Editorial Team

Ann Marie Plubell
Vice President, Regulatory Affairs

Production Assistance

Ben Pierce
Pierce Designers

EMPEA Legal & Regulatory Council

EMPEA

EMPEA | The Watergate Office Building | 2600 Virginia Avenue N.W., Suite 500
Washington, D.C. 20037-1905 USA
Phone: +1.202.333.8171 | Fax: +1.202.333.3162 | Web: empea.org

To learn more about EMPEA or to request a membership application, please send an email to **membership@empea.net**.

A Letter from the Council Chair

The regulatory environment continues to move at a fast pace. What was previously considered market practice has moved rapidly to become negotiable, an array of issues are likely to give rise to disputes in relation to private equity investments. Many entities doing business in the European Union have not only updated their procedures in light of the General Data Protection Regulation, but are taking the opportunity to improve the way they manage personal data generally. Increasing interest in evergreen funds invites novel questions. The current Legal and Regulatory Bulletin offers thoughtful discussion of aspects of each of these developments.

Topics Covered in this Bulletin:

EU General Data Protection Regulation—A Primer for Funds and Portfolio Companies: Data protection is a fundamental right in the EU. This article addresses how private equity funds are addressing the new regulations and what are the extraterritorial applications as well as other implications and consequences of compliance failures.

Permanent Capital Vehicles: This article deals with the liquidity quandary. Evergreen funds aren't a new concept, but absent a fixed termination date, what are some innovative approaches investors take to address liquidity issues these funds raise?

Structuring India Focused Funds: This article highlights rising trends in negotiations among investors and fund managers in India. With overall investments in India gaining, the dialogue around traditionally "market practice" terms are increasingly open to negotiation. What are some key fund terms and trends?

Disputes in Relation to Private Equity: With deal activity on the rise so is the risk of disputes. What are some areas of dispute and recent examples?

In addition to providing industry resources like the Bulletin, EMPEA has filled the upcoming calendar with events of particular value to our readers. I look forward to meeting many of you in London on 23 October 2018 at the Sustainable Investing in Emerging Markets Summit and on the 25th at the EMPEA Private Equity Masterclass.

I welcome your thoughts at any time and invite you to share them with me, Mark Kenderdine-Davies (mkdavies@cdcgroup.com) and with Ann Marie Plubell, Vice President, Regulatory Affairs at plubella@empea.net.

Best wishes,

Mark Kenderdine-Davies
General Counsel, CDC Group plc
Chair, EMPEA, Legal & Regulatory Council

EU General Data Protection Regulation: A Primer for Funds and Portfolio Companies

By Friedrich Popp, Associate, Debevoise & Plimpton LLP

Fund managers, investment advisers and portfolio companies doing business in the European Union have recently been required to adjust their procedures for data handling in light of Europe's new privacy law, the General Data Protection Regulation ("GDPR"). While this process has required the investment of significant resources, many businesses have taken the opportunity to improve the way they manage personal data more generally.

Data protection: a wide ranging fundamental right

Data protection is a fundamental right in the EU and from May 2018, the GDPR protects the personal information of individuals in the EU irrespective of their citizenship. Importantly, the new rules do not protect data relating to legal entities like corporations or funds.

The Regulation replaces the existing patchwork of EU data protection rules with (almost) uniform law across the EU and restricts member state discretion to certain limited areas such as employment law. Not only do individuals have several new rights to put them in control of their personal data, but the new rules are also backed by strong enforcement, including civil liability.

Processing of personal data

The GDPR will apply whenever personal data is processed. Funds process a variety of personal information, including data relating to its partners, employees, portfolio company management teams and investors. Portfolio companies also hold data relating to their customers, employees and other individuals. Some of that data may also come into the possession of the fund, including during due diligence on prospective investments, as well as during the life of the investment itself.

> "Not only do individuals have several new rights to put them into control of their personal data, but the new rules are also backed by strong enforcement, including civil liability.

The broad definition of personal data includes any information relating to an identified or identifiable individual, including their name, address, but also bank account details or investments made. Special categories of data, for example, health data, enjoy an even higher standard of protection. While anonymization of data can bring the processing outside the scope of the law, breaking the link between the individual and their personal information is in practice not easy. Processing, the second element of the trigger, is virtually any use of data, including the collection, storing, sharing, transfer and erasure.

In other words, private equity fund sponsors will routinely "process" a wide variety of personal data and, as a first step, now need to understand what they hold and where.

While the GDPR was primarily intended to address concerns arising from data handling by large internet companies, the law does not distinguish between industries or take much account of the size of the business. European data protection authorities have made it clear that they expect all businesses to address data protection.

Extra-territorial application

The new rules do not only apply to businesses established in the European Union. Businesses with no physical presence in the EU are bound by the rules when they offer goods or services to individuals in the EU (even if no payment is required), or monitor their behavior, for example, by using webtracking tools for profiling purposes. In particular, using a website that is available in German, French and English and providing for payments in an EU currency may be characterized as reaching out to individual investors in the EU. If the GDPR applies to the non-EU business, it has to appoint a representative in the EU as a contact point for data protection authorities and individuals, unless the processing is only occasional and does not affect special categories of data.

Data controllers and data processors

The GDPR imposes obligations on both the data controller, the person responsible for the method and purposes of the data processing and the data processor, the person who processes data on behalf of the controller (which would include, for example, the provider of a virtual data room or a payroll service provider). The controller must enter into a written contract with the processor, specifying certain minimum privacy and security requirements. The controller also has joint and several liability with the processor if the processor infringes the GDPR. Therefore, the selection of reliable service providers is key and companies should look again at the data protection terms in existing contracts to check that they comply with the regulation.

Guiding principles

Several principles guide the GDPR, including the overarching principle of accountability: the new law not only requires compliance with the rules, but also the ability to demonstrate compliance, for example, by documented procedures. Personal data must be processed in a manner that is transparent to the individual and privacy notices should inform individuals specifically about the way in which their data will be handled. Further, the principle of purpose limitation requires the controller to use data only for specified, explicit and legitimate purposes and does not permit further processing that is incompatible with the original purpose. This principle makes it unlawful to collect customer data and then pass it to third parties for marketing purposes without prior consent. Data that is no longer needed must be deleted and data protection authorities expect businesses to have a policy detailing the time limits for erasure of different categories of data.

Do I need consent?

The GDPR provides several legal bases for data processing, including consent of the individual concerned. However, consent has to be freely given, specific and informed by a statement or a clear affirmative action (no pre-ticked boxes) and must not be hidden in lengthy terms and conditions. Consent can be withdrawn at any time and the individual has to be informed of their right to withdraw consent before giving it. Consent obtained prior to the GDPR can only be used if it demonstrably meets the new requirements. That means that, in practice, many businesses have had to seek fresh consent – explaining the volume of "opt-in" emails received in the run-up to 25 May 2018.

Processing is also lawful if it is necessary for the performance of a contract with the individual, which may, for example, include the use of contact details for correspondence with an individual investor. Processing is permitted if necessary for compliance with European legal obligations, to which the controller is subject, which causes some headaches for firms that have to comply with non-EU obligations. The use of "legitimate interest" as lawful base may be most appropriate if the processing is not required by law but of clear benefit to the business and there is only a limited privacy impact on the individual, in particular, in case the individual should reasonably expect the use of its data in that way.

> "Businesses with no physical presence in the EU are bound by the rules when they offer goods or services to individuals in the EU (even if no payment is required), or monitor their behavior, for example, by using webtracking tools for profiling purposes.

Individual rights

Individuals have a number of rights, including a right to detailed information about the data processing and access to their data. Businesses have to comply with these requests without undue delay and in any event within one month. The same timing applies to requests for rectification of inaccurate data, the right to erasure and the right to data portability, which permits an individual to receive their data in a format that allows them to transfer it to another business. Compliance with these sometimes tedious requests within relatively short timeframes requires an established procedure.

> “Compliance with these sometimes tedious requests within relatively short timeframes requires an established procedure.

Internal processes and data security

Every data controller is required to maintain a record of processing activities with certain minimum content, including the purposes of the processing and the categories of data and the European supervisory authorities have emphasised that they expect compliance from all businesses, even very small ones.
The GDPR requires the implementation of state of the art technical and organizational measures to address data security, including tested procedures to ensure the integrity of personal data. This duty is underscored by a strict regime in case of a data breach: the controller must inform the data protection authority without undue delay, but at the latest within 72 hours of becoming aware of the breach. Furthermore, if the breach results in a high risk for the affected individuals, the data controller must also tell the individual without undue delay. Companies subject to the GDPR need to have a cyber incident response plan in place.

High risk processing

If a type of processing is likely to result in a high risk to data protection rights, for example, customer profiling, the controller must, prior to the processing, carry out an assessment of the impact of the proposed processing on the protection of personal data. This data protection impact assessment should describe the processing that is envisaged, assess its necessity and proportionality and explain how risks to the rights and freedoms of natural persons will be managed. The controller is required to consult with the supervisory authority before processing if the assessment suggests that the processing is high risk.

Controllers or processors that engage as their core activity in “regular and systematic monitoring of individuals in the EU,” or large-scale processing of special categories of data, must appoint a data protection officer reporting to the most senior level of management. EU member states may lower the threshold and Germany, as an example, requires the appointment of a data protection officer if there are at least ten employees dealing with automated data processing.

Transfers of data

A transfer of personal data to non-EU countries is only permitted if the Third Country either provides for an adequate level of data protection. The EU-US Privacy Shield enables transfer to the United States (subject to conditions) and transfers to Switzerland and certain other non-EU countries are also permitted under an adequacy decision. If there is no such decision, the parties can use the EU Commission’s Standard Contractual Clauses or other approved mechanisms to facilitate lawful transfers. Unfortunately, there is no exemption for intra-group data transfers and authority-approved binding corporate rules, a GDPR-mechanism binding all group members to EU data protection compliance, are meant to facilitate transfers to group members outside the EU. In practice, many transfers rely on an exception, for example, on the individual’s explicit and informed consent. If there are proceedings before a non-EU regulator or in other litigation, data may be transferred outside the European Union to the extent necessary to defend legal claims.

Supervision and penalties

Independent supervisory authorities in every EU member state monitor data protection compliance within their territory. If a case affects several EU member states, a lead supervisory authority coordinates the other supervisory authorities. However, businesses established outside the EU cannot rely on this one-stop-shop mechanism and have to deal with the regulator in every member state in which they are doing business.
The supervisory authorities enforce the Regulation, handle complaints lodged by an individual and conduct investigations. Such investigations can take place in the form of data protection audits and supervisors can obtain access to any premises of the controller or the processor. The authority issues warnings, orders compliance and can also impose a temporary or definitive limitation, including a ban on processing or transferring of data.

The GDPR specifically provides for the cooperation of supervisory authorities, including mutual assistance and joint operations, to address panEuropean risks. The Regulation seeks to ensure the consistent application of the Regulation throughout the EU and abolish the forum shopping of more relaxed regimes. Further, representatives of supervisory authorities of all EU member states convene in the independent European Data Protection Board to ensure the consistent application of the

GDPR; while the guidelines and recommendations issued by this body are not binding for local authorities or courts, practitioners closely follow guidance given by this forum.

An individual has the right to raise a complaint with a supervisory authority and challenge its decision before a court. Importantly, he or she can bring a civil lawsuit not only before the courts of the controller or processor, but also before the court in the member state in which it has its habitual residence. While there is a tendency in the EU to facilitate collective redress, there are no US-style class actions yet.

An individual who has suffered physical or financial damage as a result of an infringement of the Regulation has the right to receive compensation from the controller or the processor.

In accordance with the principle of accountability, it is the controller or processor who has to demonstrate that it is not responsible for the event giving rise to the damage.

The supervisory authorities can impose sanctions in accordance with criteria set out in the Regulation, which include the nature, gravity and duration of the infringement, as well as whether it was intentional or negligent. The maximum fines are very significant: the higher of 2% of the total group turnover or EUR 10 million. In addition, more serious offences, such as data processing on the basis of invalid consents, or violations of the data transfer rules, could result in fines of up to 4% of the total group turnover or EUR 20 million. Criminal liability may also attach to violations if stipulated by the local law of the EU member state.

About the Author

Friedrich Popp is Associate at Debevoise & Plimpton LLP

So, what should I do?

Going forward, it is clear that the GDPR will have a dramatic effect on the way organisations handle their data. While it may seem like a daunting task, businesses can establish competitive advantage through rigorous and effective compliance. So, what should be done now?

1. Determine to what extent your organization is subject to the GDPR
2. Consider hiring a data protection officer (although it is generally not advisable to have a formal DPO unless it is required by the Regulation because it imposes further responsibilities)
3. Update fair processing and privacy notes
4. Assess (ongoing) validity of consents previously obtained
5. Consider conducting a data protection impact assessment
6. Implement a data breach response plan
7. Review and update data processing agreements
8. Be prepared to comply with new and enhanced individual rights, including subject access requests and the right of erasure
9. Identify your supervisory authority
10. Train staff

Permanent Capital Vehicles: Dealing with the Liquidity Quandary

By Cindy Valentine, Partner and George Metcalfe, Supervising Associate, Simmons & Simmons LLP

Although not a new concept, permanent capital vehicles (PCVs) remain a relatively underused vehicle for private equity funds in emerging markets. Investor demand for conventional structures, where commitments are invested and proceeds distributed within a defined period of time (ordinarily invested over 5 years and a 10-12 year fund life), remains strong. However, interest in PCVs has increased significantly in recent years in the African market in certain sectors.

What structure is used is very much dependent on the nature of the underlying investments, the type of investors and the exit plan. Drivers for setting up an evergreen vehicle include the ability to:

- implement longer strategies and 'ride-out' short and medium-term market volatility;
- continue fundraising without the need to structure and raise successor funds;
- keep a steady capital base to invest without needing to return it back to investors;
- offer investors variations on the conventional 2 and 20 fee model which can be better suited to longer term investments; and
- utilize alternative exit strategies such as listings and redemptions.

The key concern around the use of evergreen funds is certainty of liquidity. Absent any fixed termination date, investors need to ensure that they will be able to exit at a suitable point in time. Put more simply – investors need liquidity.

We have seen a variety of innovative approaches taken to address the issue of liquidity, which we discuss briefly here.

Liquidity Basics – A Brief Reminder

Primary liquidity through redemption of interests involves investors realizing their investment by redeeming their interest in a fund by way of buyback, which is generally financed by the manager in three ways: (i) realizing underlying investments, (ii) borrowing from a third party, or (iii) taking in new subscriptions – or a combination of the above. The manager uses the cash proceeds to fund the redemptions (or at least maintain the fund's NAV).

> The key concern around the use of evergreen funds is certainty of liquidity. Absent any fixed termination date, investors need to ensure that they will be able to exit at a suitable point in time. Put more simply – investors need liquidity.

These financing options raise their own issues. Selling underlying fund assets to raise funds for redemptions is problematic as the underlying assets are usually not readily disposable – it may take an extended period of time to find the best buyer or exit option. In addition, tension can arise when deciding which assets are to be disposed of – selling the 'best' or 'easiest-to-sell' assets could be prejudicial to investors remaining in the fund and this conflict of interest must be well managed.

Borrowing by the fund exposes non-redeeming investors to greater leverage risks. Moreover, borrowing in private equity funds is usually very tightly controlled and normally only bridge finance or relatively small working capital facilities are permitted. Incoming investors often prefer their commitments to be put in new investments, rather than buying into an existing, static portfolio and watching their cash walk out the door with a redeeming investor.

In order to protect the fund and investors, investors' ability to redeem, if it exists, is often limited by gates (i.e. restrictions on amounts which may be redeemed at a given time and the frequency at which investors can redeem), lengthy notice periods, payment deferrals and suspension powers in case of market stress or runs, all of which reflect the inherent illiquidity of private equity assets. More widely, managers suffering erosion of the asset base have less capital to put to work in investments, and for less time, making hurdle rates and performance fees more difficult to attain.

Secondary liquidity involves investors selling their interests, either to another investor in the fund or a third party. Sales to third parties can be achieved in several ways, for example (i) through the private secondaries market, (ii) listing the fund on a public securities exchange or (iii) 'tokenizing' the fund interests. However, like the primary liquidity options, secondaries also have their shortcomings.

- The secondaries market, whilst long established, does not function particularly efficiently for market participants looking for a quick exit. The process can be slow and cumbersome, often fails to provide selling investors a 'clean break' and is, ultimately, dependent on a manager being willing to take credit risk (and other risks) on a new investor.
- Listing a fund is notoriously expensive, so it is normally only a viable option for larger funds. It will also need to be part of the investment proposal from the fund's launch. Also, disclosure and transparency rules can hinder a private equity or venture capital manager in conducting business.
- Tokenizing a fund, by initial coin offering or otherwise, is a new process—effectively a hybrid of the private secondaries market and the public securities market. Banks, fund service providers and, importantly, investors are generally cautious about dealing with fund interests (or tokens) on a digital currency/blockchain platform. Regulators are also catching up with this new technology, which creates considerable uncertainty for managers operating in an unpredictable regulatory environment.

Hybrids

As neither primary nor secondary liquidity alone offers a clear, workable solution to investors' needs for a reliable exit option, a variety of approaches are being taken in PCV structures to offer investors liquidity. Some are relatively simple, some are more complicated and often involve a combination of liquidity options.

In emerging markets, notably Africa, there is a significant trend towards an ultimate objective of listing as a natural exit. Investors, however, still require certainty of exit. Accordingly, although a PCV may be evergreen, if its investment mandate is to exit by listing then investors will likely require that the manager must seek to achieve an initial public offering (IPO) once the fund's NAV has reached a certain (predetermined) point (or if that NAV is not reached by a certain point in time, when a fixed time period has passed). If an IPO is not achieved within the time/value constraints, investors will likely require the fund to be wound down.

Listing the shares in this way gives investors some comfort that they should, if the fund is successful, be able to sell some or all their shares in the fund on the open market. If unsuccessful, they will have whatever capital is available, returned to them. Equally, on an IPO, investors can keep their investment, or even increase their stake by buying shares from investors which are selling shares. This is a simpler option than re-upping into a successor fund of a conventional fixed term real estate or private equity fund.

We have also seen funds use a combination of liquidity solutions operating in tandem, in hybrid vehicles. Such structures aim to occupy the space between pure open and closed ended structures, through methods such as redemption windows or liquidity events.

An example of this is providing investors with the ability to approve a listing after a certain time period (i.e. there is a lock up), or inserting a requirement that a listing is completed within a certain time period (other than obtaining of a certain NAV as explained above) Like the example mentioned above, this gives investors a secondary liquidity option, allowing them to realize their investment at that point by selling their shares on the open market (to the extent that, in practice, there is a ready market). It also gives investors control to approve a listing in their discretion at the time, rather than being bound by pre-set conditions put in place during the initial fundraising which may no longer be in their best interests. In addition, after the lock-up, where there is no listing, investors can redeem their shares year-on-year up to a certain limit, giving investors a second (albeit partial) exit option, using a primary liquidity mechanism. Although not providing 'immediate' liquidity as might be seen in a conventional hedge fund, given that shares in listed funds often trade at a discount to NAV, having the choice to redeem some shares at a price equal to NAV (less costs) is clearly desirable for investors. Also, limiting redemptions in this way allows the manager to manage any asset sales sensibly, lessening the need for any asset fire-sales or cherry-picking, or suspension of redemptions, as well as use income generated from underlying assets that would otherwise be distributable.

We have also seen several long-term funds structured with no fixed term, but which have a continuation vote after an initial period of ten or twelve years, allowing the fund to continue for a further ten or twelve years thereafter. Other funds, for example in the infrastructure space, hold continuation votes more frequently (every three or five years) after the fund has been running for ten or twelve years. Either way, this approach gives investors greater control over their exit and allows them to judge the prevailing market conditions and fund performance to date at the relevant time.

"Liquidity is a key issue and managers need not be tied to any single approach to providing it. However, it is the case that PCVs which offer a clear exit option for investors are more likely to appeal to a wider group of investors.

Alternatively, some long-term funds have been structured to continue automatically if certain fund performance thresholds have been reached, failing that an investor vote will be determinative. Other funds simply have no fixed term and all that is offered by way of secondary liquidity is an obligation on the manager to use reasonable endeavors to assist investors with finding buyers for their interests. However, such terms have often been less popular with investors, who are then subject to wider market liquidity forces, confidence in the valuation of the interests being sold and, ultimately, manager engagement.

Market Trends

The increasing use of PCVs and hybrids in emerging markets, notably Africa, suggests a growing sophistication of managers and investors operating in that space. Although conventional private equity fixed term funds are likely to remain predominant, a PCV provides a sensible alternative.

Liquidity is a key issue and managers need not be tied to any single approach to providing it. However, it is the case that PCVs which offer a clear exit option for investors are more likely to appeal to a wider group of investors. PCVs with less focus on investor exit may only attract capital from investors which are willing (and able) to lock up capital for the long-term. As such, funds using a combination of liquidity solutions which operate in tandem can be a workable solution, as they can cater for a wider range of investor exit requirements.

Of particular note is the issue of investor control. PCVs commonly grant significant control to investors to determine the timing of, and means by which, they exit, at the time of exit. In so doing they have built in considerable flexibility. This is especially true of PCVs established by smaller, less well-established managers. Generally speaking, PCVs sponsored by long established managers with strong track records (both in terms of managing conventional fixed term funds and PCVs) are likely to be able to retain control over the process.

Ultimately, whatever the manager or investor base and however liquidity is offered, liquidity is a fundamental investor concern with PCVs (including hybrids) and careful thought should be given from the outset as to the best solution for both the manager and investors.

About the Authors

Cindy Valentine is Partner at International Funds Team

George Metcalfe is Supervising Associate at International Funds Team

Trends in Structuring India Focused Funds; LP-GP Negotiations

By Richie Sancheti (Head, Investment Funds) and Nandini Pathak (Senior Associate, Investment Funds), Nishith Desai Associates

Introduction

In 1H 2018 India focused funds saw a hectic fundraising and investment levels that was 44% higher than 1H 2017.[1] Several topics came to the fore as fund managers raised their subsequent funds. India continues to be a significant recipient of DFI allocation. With one or more DFIs or sovereign investors in the mix, the fund terms continue reflecting a more LP tilt in balance even for fund managers raising a Series III or a Series IV fund.

New investment funds with more focused strategies are seen coming up[2] as India introduces favorable policy and regulatory changes such as introduction of the Insolvency and Bankruptcy Code, passing of a single goods and services tax (GST), tax initiatives for Small and Medium Enterprises, policy initiatives for the insurance sector and increased focus on technology driven payment mechanisms. We will subsequently (in this article) discuss some of these changes, and their impact on the Indian investment funds.

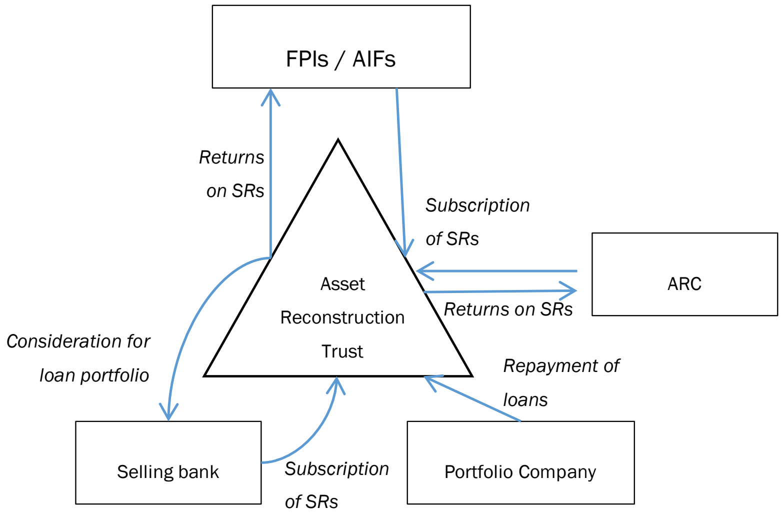
In this article, we share some observations on the above trends, followed by specific discussion points (currently in focus in India) on key fund terms during LP-GP negotiations.

Distressed assets inspiring new structures

The recently introduced Insolvency and Bankruptcy Code has enhanced the mechanisms to recover from borrowers.[3] As per the Securitisation and Reconstruction of Financial Assets and Enforcement of Securities Interest Act, 2002 ("**SARFAESI**"), an asset reconstruction company ("**ARC**") is required to establish securitization trusts for the acquisition of stressed assets and issuance of Security Receipts ("**SRs**") to pass on the economics arising therefrom. The securitization trusts acquire the stressed assets from 'Selling Banks'. Investment by non-resident entities into SRs can be made by overseas entities that are registered as Foreign Portfolio Investors ("**FPIs**"). SRs can also be listed on a recognized stock exchange that has enhanced its liquidity and attractiveness as an asset class.

1. EMPEA (1H 2018 India Data Insight)
2. https://www.bain.com/insights/india-private-equity-report-2018/
3. https://www.livemint.com/Opinion/DzvsgPI3OHFQzvpAYxSabM/Distressed-asset-investments-in-India.html

Asset Reconstruction Trust Structure



Recently, the Reserve Bank of India classified certain investment vehicles (i.e. Category II and Category III Alternative Investment Funds ("**AIFs**") registered with the Securities and Exchange Board of India ("**SEBI**")) as 'qualified buyers' for investing in security receipts issued by the trusts of asset reconstruction companies.

Other structuring avenues for this asset class include investments in non-banking finance companies.

However, AIFs are being preferred as an option due to their tax pass-through nature, light touch regulations by SEBI and their ability to be treated at par with domestic investors (despite having foreign investment) as long as they are owned and controlled by Indian resident citizens.

Certain complications continue to exist despite choosing AIFs as the investment vehicle, as strategic investors look to get involved at the portfolio level, the ability of AIFs to take leverage is restricted.

Consequently, structures involving different types of investment vehicles (which include AIFs) are cutting across different regulations and authorities, as investors look to tap this asset class in India.

Co-investments as a sub-class of the main fund

Overseas institutional investors are increasingly looking for co-investment opportunities from their fund managers to reduce the agency cost and yet enhance their investment exposure. Traditionally, co-investment opportunities which are accepted by investors are consummated either directly by such investors or through a side pocket vehicle being managed by the same fund manager.

Investors in the main fund are circumspect about co-investment structuring largely around enhanced informational rights for select investors eligible for co-investments, allocation of deal expenses between main fund and co-investors, conflicts of interest for the manager, double-dipping on fees, etc.

Indian fund managers are looking to structure the main fund vehicle in a manner which allows co-investments to also be consummated through the main fund vehicle but as a separate class.

The upside for the manager is to avoid incurring set up and operating costs for a new vehicle and offer greater transparency to investors. Licenses and approvals are invariably required for flexibility in structuring investments. The use of fundamental fund platform allows investor participation alongside main fund with limited weightlifting on the structure and licenses.

It is required that liabilities are not comingled, expense sharing ratio is maintained at fair levels and the documentation sufficiently caters to the difference in investment as well as distribution ratios, along with the other fund terms, for two different pools operating within the same platform.

Secondaries

By and large Indian funds continue to struggle to achieve desired portfolio exits with identified fund terms and LP-approved extended terms. In line with global practices, this is leading to GP-sponsored LP secondaries and fund restructuring exercises. There have also been instances where the fund manager offered to buyout the LP stake at a haircut.

Variations in Structuring

Key Person Events

Existing India funds are seen grappling with key person clauses given the reshuffling of investment management personnel (including spinoffs and formation of new ventures)[4]. Many large PE fund managers of India focused funds have recently seen senior level officials quit to start their own ventures.

GPs are exploring ways of identification of key persons and related (proportionate) consequences, as LPs look to be as inclusive as possible while determining time commitment of key persons. While the corporate execution at the "Chief" level of personnel continue to be relevant, LPs also expect the GP team to take a haircut on its economics if it is unable to retain talent at the investment management team level. Concepts of 'super key person' and 'standard key person' are increasingly becoming common.

4. https://economictimes.indiatimes.com/news/company/corporate-trends/why-are-so-many-indian-fund-managers-quitting-private-equity-firms/articleshow/65369255.cms

> From a governance perspective, SEBI has been actively examining AIF applications, and paying due attention to each of the documents. A manager to an AIF must now tread more carefully with both the regulator and the investors.

Consequences of key person events are not expected to be limited to suspension of investment period anymore, but if uncured, may also trigger consequences that are at par with removal for cause events.

Removal of GPs

'For cause' removal typically refers to the premature termination of the manager's services to the fund by the LPs, owing to events of default – mainly fraud, willful misconduct, and gross negligence.

The relevant question in the context of some of the recent funds has been on who determines whether a 'cause' event has occurred. Global LPs are circumspect about the determination standard to be applied by Indian courts, because of the perception that dispute resolution by way of litigation in India may take unreasonably long to conclude.

Carried Interest

While the taxation of carried interest remains unclear globally, several Indian GPs are considering allowing their employees (who are entitled to carry) to track the carry directly from the fund, including through structures such as employee welfare trusts.

Excuse Rights

Domestic insurers continue to remain a significant source of asset allocation. Indian insurers regulated by the Insurance Regulatory and Development Authority of India are required to ensure that their capital contributions are not invested outside India. Likewise, other statutory / state-aided Indian institutional investors impose similar conditions while making commitment to a fund. Investment programs for several DFIs too require that they be excused from certain deals if the fund were to explore certain opportunities.

As a result, excusal provisions are becoming extremely important in the Indian context for managers to balance all pools of capital within the same fund.

Conclusion

This article only summarizes a few of the many discussion items which have gradually shifted from being 'market practice' to 'negotiable' in a matter of a couple of years with respect to India focused funds. More variations in structures are expected in the coming months as the industry makes more representations to the Government.

From a governance perspective, SEBI has been actively examining AIF applications, and paying due attention to each of the documents. A manager to an AIF must now tread more carefully with both the regulator and the investors.

While inventive terms are being considered to build better investor relations, given the recent observations by regulators in sophisticated jurisdictions, Indian managers must not lose sight on the disclosure as well as fiduciary norms.

Accordingly, while experimenting with structures, attention should be given to articulating adequate disclosures in the fund's marketing documents and carefully designing the investment policies. Fund documentation should ensure insulation of fund managers from unintended exposure to legal, tax and regulatory risks, while providing adequate disclosure and information to potential LPs.

About the Authors

Richie Sancheti heads the Investment Funds practice at Nishith Desai Associates

Nandini Pathak is a Senior Associate in the Investment Funds practice at Nishith Desai Associates

Disputes in Relation to Private Equity

By Ruth Crowley, Partner and Andrew Reeves, Senior Associate, Norton Rose Fulbright LLP

Summary

Low interest rates and the search for greater returns have led to increased private equity investment: deal activity in the US and UK has been at its highest level since 2007. While this growth is good news for the industry, disputes are becoming more frequent as a consequence, particularly given the surge of investment into emerging markets and increased regulatory action. In this article we explore the types of disputes that typically arise in relation to private equity, set out recent examples and explain why recent trends in private equity have led to an increased risk of disputes.

Increased private equity activity

Recent years have seen an increasingly strong private equity market following the financial crisis. Through the second half of 2016 and into 2017, the private equity industry has experienced a sharp rise in the levels of fundraising from investors, with money being invested by funds in an increasingly diverse set of international markets.

Buyouts in Europe reached USD159.8 billion in 2017, a 22 per cent increase in value from 2016. US buyouts amounted to USD190.8 billion (a 12% rise). This increase in investment correlates with record levels of private equity acquisitions since the financial crisis, as investors seek strong returns during a period of low interest rates. Not only are we witnessing high levels of overall activity, but there has also been a return to some mega-acquisitions, for example PAG's USD1.4 billion purchase of Yingde Gases in March 2017, the Bain-led consortium's USD18 billion deal for Toshiba's memory chip unit in September 2017, and Carlyle's USD11.5 billion acquisition of Akzo Nobel's specialty chemicals business in March 2018.

An increasing amount of capital is being invested in emerging markets, with a total of USD22 billion invested in the first half of 2017 – an almost 50% rise from the same period in 2016 according to EMPEA data. Investment has focused on Asia and in particular China, India and South Korea. Latin America, Eastern Europe and CIS have also experienced leaps in investment.

> "While this growth is good news for the industry, disputes are becoming more frequent as a consequence, particularly given the surge of investment into emerging markets and increased regulatory action.

Types of disputes that typically arise

In addition to the generally strong outlook for the private equity market, we are seeing an ever-increasing number of disputes. Private equity transactions tend to give rise to certain types of disputes, for example:

- ***Disputes relating to the investments themselves***
  These disputes include breach of warranty or misrepresentation claims, indemnity claims and disputes in relation to inflated projections and forecasts. In short, disputes tend to arise when the investee company turns out to be a substantially different or less valuable company to the one the fund thought it was investing in.
- ***Shareholder disputes***
  In many cases shareholder disputes simply come down to investors having different objectives and goals. The risk of disputes tends to be heightened where founders of the company remain significant shareholders. This commonly leads to disputes about short and long term goals and about the way in which the company is run, particularly in emerging markets (see below).
- ***Mismanagement of funds***
  Mismanagement allegations can arise even in relation to established private equity houses.
- ***Issues arising from breaches or termination of material contracts***
  For example, Helios Towers Nigeria Limited, backed by private equity group Helios Investment Partners, sued Telkom South Africa in 2011 for what it argued was wrongful termination of a ten-year lease agreement.
- ***Claims against fund managers***
  These claims are in relation to non-disclosure of expenses, fees and conflicts of interest. Such claims often result in, or arise out of, regulatory scrutiny (see below).
- ***Mismanagement and fraud***
  The 2016 collapse of Kenya's Chase Bank resulted in a panic run on deposits, which led to twelve Kenyan banks allegedly failing to comply with Kenyan banking regulations, and losses to a number of emerging market private equity firms. The collapse of both Intercontinental Bank and Oceanic Bank in Nigeria in 2009 amidst allegations of fraud have led to substantial losses amongst leading private equity backers.
- ***Disputes in relation to growth capital transactions***
  These disputes (as opposed to secondary M&A transactions) are common in particular where the founders effectively misappropriate the growth capital. Private equity firms need to consider carefully the protections they put in place in relation to their investment and ensure they have appropriate visibility and control over the use of growth capital.

Reasons for increased dispute risk

In part, the increase in the number and size of private equity acquisitions has resulted in a corresponding increase in the number of related disputes and many matters arose from the financial crisis. However, particular features of the growth in private equity activity over recent years have also increased the risk of disputes, in particular: (i) increased investment in emerging markets; (ii) increased investor expectations; and (iii) increased focus by regulatory authorities on investment advisors.

(i) Increased investment in emerging markets.

Investing in emerging markets can yield substantial returns but comes with significant challenges, such as geopolitical instability, regulatory issues, compliance risks and the slow pace of criminal and civil legal processes. These risks are compounded where, as is common in many emerging markets, portfolio companies are originally family-owned. Such companies may be run by related parties without the necessary professional and technical management experience required or that would be expected in a typical US or UK company, with potential issues around conflicts of interests, transactions with related parties, and individuals appointed to management positions based on their relationship to the founders or majority shareholder and not on technical capability or experience. At the time of the billion dollar collapse of Oceanic Bank in Nigeria, the bank was headed by a family member who was reportedly without any formal banking education, training or experience (save for her time working in the same bank).

Fraud and corruption present significant risks in emerging markets, particularly in sectors such as oil and gas and telecommunications where the key assets of a business will usually have been purchased from governments. Civil and criminal litigation frequently arises in relation to the historic acquisition of such assets in emerging markets, which can substantially undermine the value of the business and the time the disputes take to resolve can scupper the fund's exit strategy.

The case of Lilliput Kidswear, an Indian-based clothing company which was acquired for USD86 million by Bain Capital and TPG in 2011, acts as a warning to other funds. The discovery of alleged financial irregularities in the business post acquisition has led to civil claims left pending for a considerable period in the Indian courts. Bain Capital has pursued the company's auditors in an attempt to recover alleged losses totalling approximately USD60 million.

> It is essential that managers have strong communication networks to each of their investors so investor expectation is managed in situations where returns are below those anticipated.

With around USD500 million of private equity investment tied up in legal disputes in India alone, the slow pace of the legal process in many emerging market jurisdictions is a serious consideration for funds looking to invest. Conducting thorough due diligence, structuring transactions to benefit from protections afforded by bilateral, multilateral and other investment treaties as well as drafting the transaction documentation so as to gain direct recourse to the investment state (typically via arbitration) are likely to be key as the private equity industry invests more heavily in infrastructure, mining, energy and other large projects in emerging markets. Corruption issues can in turn lead to money laundering risks relating to dividends, to loss of investment value, and to civil disputes (e.g. claims from investors/shareholders against the fund, against directors appointed to the portfolio company and between the portfolio company and counterparties/competitors).

Disputes in relation to emerging markets investments usually involve complex multi-jurisdictional issues and it is important that the conduct of disputes is carefully managed between local and global counsel. Equally, it is important that careful thought is given at the time of investment to ensuring that contracts provide for disputes to be settled in accordance with the most appropriate governing law and in the right jurisdiction.

(ii) Great expectations

Low interest rates and record levels of available capital have increased competition between funds, increasing purchase prices and expected returns. Due to an uncertain economic climate, companies may not always be able to deliver on expectations. Underperforming portfolio companies may lead to disputes between managers and investors. While underlying losses may form the basis of such a dispute, it is more likely that investors will only make formal claims against managers where there is a failure to appropriately address and explain those losses. Managers reacting promptly to poor performance and being alert to how relationships between managers and investors are managed is likely to help to mitigate the risk of formal actions ultimately being pursued. In an increasingly competitive environment, it is critical that managers retain the trust of their investors such that they feel they are acting in their best interests; communicating quickly and acting decisively in situations where the fund performs below investor expectations.

Equally, increases in capital being raised in markets where there is relatively low available leverage applies pressure to managers to maintain strong return ratios and in turn meet investor expectations. It is essential that managers have strong communication networks to each of their investors so investor expectation is managed in situations where returns are below those anticipated.

(iii) Focus by regulatory authorities

Regulatory authorities, particularly in the US, are focused on investigating the activities of investment advisors to funds generally. This, in turn, tends to lead to follow-on civil litigation against the investment advisors. Approximately 20% of all enforcement actions pursued by the Securities and Exchange Commission (SEC) were levelled at investment advisors. In October 2015 Blackstone settled an SEC enforcement action at USD39 million (without admission of liability), brought in relation to alleged failures to disclose benefits that Blackstone private equity fund advisers obtained from accelerated monitoring fees paid by portfolio companies prior to the companies' sale or IPO and which allegedly reduced the value of the portfolio companies. Hedge funds have also been a focus for US authorities: civil and criminal fraud charges were brought by the US Department of Justice in December 2016 against the founder, president and other executives of Platinum Partners, regarding the alleged overvaluation of its assets and alleged concealment of a liquidity crisis at the fund; and the SEC brought a lawsuit alleging insider trading against Leon Cooperman and hedge fund Omega Advisors Inc., which was settled for USD4.95 million in May 2017.

About the Authors

Ruth Crowley is Partner at Norton Rose Fulbright LLP

Andrew Reeves is Senior Associate at Norton Rose Fulbright LLP

