RETIREMENT FUNDS INVESTMENT IN PRIVATE EQUITY FUNDS: SOME ISSUES TO CONSIDER.

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INTRODUCTION

Retirement funds, at least in the United States of America and in Europe, have increased their investment allocation to private equity funds. There is no doubt that retirement funds in South Africa may, in future, increase their allocations to private equity funds. In fact, draft regulation 28 issued by National Treasury on 2 December 2010 acknowledges the need to update the investment channels that retirement funds may invest in. One of the acknowledged investment channels is investment in private equity funds. However there will be some issues for trustees to consider before investing in a private equity fund.

This note explores some of the issues that trustees may want to consider when investing in private equity funds. This note will look at the following issues: the Pension Funds Act, 1956; structure and duration of private equity funds; management of private equity funds; fees; drawdowns; limitation of liability; most-favoured nation provision and documentation.

WHAT IS A PRIVATE EQUITY FUND?

A simple description is that a private equity funds is an investment pooling vehicle that invests in equity and equity related investments in private companies. Such companies would include: venture capital (start ups); public to private buy-outs; other companies whose shares are not publicly traded. Private equity funds will generally take a controlling stake in the underlying companies and actively participate in their management.

THE PENSION FUNDS ACT

The proper management of investments is an important component of the governance of a retirement fund. When investing the retirement fund's assets trustees are expected to take all reasonable steps to ensure that the interests of members are protected at all times and to act with due care, diligence and good faith. In essence trustees have a fiduciary duty to act in the best interest of the retirement fund members. In fact draft regulation 28 states that a retirement fund, its advisors and trustees are required at all times, before making an investment into and while invested in an asset, to perform reasonable due diligence taking into account risks relevant to the investment including but not limited to credit, market and liquidity risks.

Apart from the fiduciary responsibility, it is also important for trustees to be mindful of the prudential limits set out under the current regulation 28 regarding the amount which and the extent to which a retirement fund may invest in particular assets or in particular kinds or categories of assets, including private equity funds.

The current regulation 28 specifies, among others, the following maximum limits as percentages of total retirement fund assets that can be invested: (i) 5% in unlisted shares; and (ii) 2.5% of other assets. There is a view that the 5% limit when investing in unlisted shares would apply to the extent that a private equity fund invests in unlisted shares. However, it is arguable that the 5% limit would not apply to investment in private equity funds because making investment in such a fund does not entail investing in the underlying unlisted shares. It is more likely that the more applicable limit is the 2.5% limit applicable to “other assets”.

The position will be clearer when the draft regulation 28 is adopted. Under the draft regulation 28 it is proposed that a pension fund may invest in an investment fund that is not registered and regulated as a fund by the Financial Services Board, including a private equity fund. Such investment by a retirement fund may not comprise more than 10% of the aggregate fair value of the relevant fund’s total assets.

FUND STRUCTURE

The type of legal structure that will be used for the formation of a private equity fund depends on where the fund is based. Where the fund is based outside South Africa the structure will follow the law of the foreign jurisdiction. In South Africa private equity funds are structured as partnerships, trust or companies. Understanding the fund structure is important because it may have implications for the retirement fund’s liability and risk.

The partnership

The usual partnership structure is the *en commandite* partnership. The *en commandite* partnership is one in which there are two categories of partners, namely disclosed (this is normally be the general partner) and undisclosed or *commanditarian* partners (the limited partners). The partnership business is carried on in the name of one or more disclosed partners who are fully liable to third parties for the partnership debts, while the *commanditarian* partners undertake to contribute a fixed sum of money to the partnership business on condition that their names will not be disclosed to third parties. *Commanditarian* partners receive only a certain share of profits, if any are available for distribution, but if the partnership suffers a loss they are not liable to third parties. A *commanditarian* partner is however liable to the disclosed partners but only to the extent or value of the capital that he or she has contributed or has agreed to contribute to the partnership business.

Trust

A trust is a legal relationship which comes into existence when a person who wants to form a trust (the settlor / founder) hands over or undertakes to hand over the control of assets to another person (the trustee / administrator) to be administered for the benefit of another person (the beneficiary). A trust is not a corporate entity. Trusts are commonly used as the legal structure under which investments are held and managed in South Africa. The trust enables the legal ownership of property to be separated from the enjoyment of the benefits that flow from that property. The trustees will hold the assets on trust for the investors.

Companies

A private equity fund can also be structured as a company incorporated or registered under the Companies Act No. 61 of 1973. The company would have an authorised share capital. There are currently two types of companies in South Africa. The first is a public limited company which is required to have a minimum of seven shareholders. The second is a private limited liability company which may have between one and fifty shareholders and in which the right to transfer shares is usually restricted and offers to the public for the subscription of shares or debentures are prohibited. Under the company form of organisation, the ownership rights of an investor are similar to those of a shareholder.

Limited liability partnership

Private equity funds can also be structured as limited liability partnerships. The limited liability partnerships are typically domiciled in the United Kingdom, Channel Island, Delaware, Cayman Islands or Mauritius. Where trustees are considering investing in a private equity fund that is structured as a limited liability partnership they will have to seek advice on the implications of such a structure from advisors in the country where the fund is based.

Some concerns

All the above legal structures raise particular concerns for retirement funds.

For instance, can a retirement fund invest in a trust based structure which entails transfer of the ownership of the invested assets from the retirement fund to the trustees of the fund. This may, if not addressed, result in the retirement fund breaching section 5(2) of the Pension Funds Act, 1956, which states that all monies and assets belonging to a pension fund shall be kept by that fund. However, such assets and monies may be kept in the name of the retirement fund by one or more of the following institutions, stockbroker, long term insurer, a bank, a nominee company or a person approved by the registrar. A trust is not one of those persons. However, it is arguable that where the trust is set up as a *bewind* trust the concerns regarding transfer of ownership may not arise because there would be no transfer of ownership. The trustees or administrator of the *bewind* trust would simple have control or administer the invested assets. In that case the retirement fund would both be a beneficiary and owner of the invested assets. However if the retirement fund wants to get further comfort it may request a representation from the private equity fund that it is set up as a *bewind* trust and that by making the investment the retirement fund is not transferring ownership of the invested assets.

Where the private equity fund is set up as *en commandite* partnership the retirement fund must be aware that by making the investment it is becoming a partner. In this scenario limitation of liability is important. The general partner will be disclosed to third parties and the retirement fund, as a limited partner will not. In addition, the retirement fund will not be liable to third parties but will be liable to the general partner. The extent of liability to the general partner must be considered by the retirement fund.

A company structure is fairly well know and does not raise the same concerns as the trust and partnership based structures. The retirement fund will be treated like any other shareholder in a company.

The limited liability partnership can be set up in foreign jurisdictions. It is important for the trustees of a retirement fund to ensure that they get relevant confirmation about the status and regulation of such a structure before making an investment. Usually private equity funds that are set up in foreign jurisdictions would have requested opinions from attorneys in their country of *docimicle* dealing with their regulatory compliance. Trustees must request copies of such opinions in order to satisfy themselves about the regulatory compliance of the fund. If the trustees are not satisfied with the opinions obtained by the fund itself, the retirement fund may consider obtaining independent advice regarding the fund from lawyers in the fund's country of *domicile*. This may be expensive however if the retirement fund is considering making a significant investment in the private equity fund, such a due diligence may be crucial.

CAPITAL COMMITMENT PERIOD AND DRAWDOWNS

Private equity funds are highly illiquid. There is generally no way to disinvest before the end of the fund. The market standard term for a fund is 8 to 10 years or 10 to 15 years for a fund of funds. This is an important factor for retirement fund trustees to note when considering making an investment in a private equity fund.

The more relevant period is the capital commitment period of the fund. Investors make a capital commitment, which is a promise to invest up to a certain amount over the life of the fund. The market standard capital commitment period is 3 to 6 years.

The fund then makes drawdowns on capital commitment when money is needed for investments. Drawdowns are made during the investment period (as already mentioned 3 to 6 years). There are draconian penalties for failure to meet a capital call. The entire investment can be forfeited. As such it is essential to note the time period for responding to a capital call. Where a retirement fund anticipates that it may not be able to respond to capital calls, the trustees should consider not making the investment at all.

MANAGEMENT OF THE FUND AND FEES

Apart from the strategy offered by the fund, a retirement fund will be attracted by the management of the fund to make an investment. Therefore it is important for the trustees to understand the terms regulating the management of the fund. If the fund is structured as a partnership it is important to note the capital commitment of the general partner. The general partner usually contributes 1% of the aggregate capital commitment to demonstrate his confidence in the fund. As an important role player, it is also important to find out how much time the general partner is required to commit to the fund. Also, the retirement fund may consider what it can do, as an investor, in the event that key fund personnel leave the fund.

Another important point to consider is what liability the general partner and other service providers have to the fund. Current market practice tends to exempt the general partner and service providers from liability for all but gross negligence and criminal conduct. Material breach of the partnership agreement is sometimes included. Also, what indeminities are there in favour of the general partner and other service providers? Current market practice tends to indemnify them against all losses not caused by gross negligence or criminal conduct.

Fees are also an important consideration. The management fee covers the general partner operating costs and offset of other fees. The carried interest (which is the general partner's share of the profits) provisions are usually highly complex and an investment consultant should advise the trustees on their reasonableness, as part of their assessment of the fee structure of the fund.

LIMITATION OF LIABILITY

It is important to consider the liability that the retirement fund will have and what indemnities the retirement fund is required to provide. In this regard indemnities will be given to all investors on a reciprocal basis so that the retirement fund will have the benefit of the indemnities as well as the burden. Also trustees of a retirement fund have to be aware of any warranties relating to their knowledge and experience, the high degree of risk involved in the investment (which may include possible loss of all the invested assets).

MOST FAVOURED NATION CLAUSE

The retirement fund may want to consider whether the fund has a general most favoured nation provision. This is a provision that allows the investor to take the benefit of any terms given to all investors, or to other investors who have the same amount invested in the fund. The side letters are crucial because they may contain terms that have been specifically agreed with other investors which may be beneficial to the retirement fund. Such terms would vary those terms specifically set out in the constitutional documents of the private equity fund.

DOCUMENTATION

Ideally the trustees of a retirement fund may want to review the following documents in order to understand the investment terms: the constitutional documents e.g. partnership agreement if the fund is a partnership, trust deed in the event that it is a trust or the articles of association if it is a company; the placement or offering memorandum (in particular the summary of principal terms section) together with any amendments; investment management or advisory agreement; investor subscription agreement or booklet; all side letters agreed with existing limited partners; any guarantee agreements (relating to the general partner's carried interest clawback);co-investment agreements ;legal opinions obtained by the fund; tax opinions; and any other relevant documentation.

The purpose of reviewing the above documents is to ensure that the trustees understand the contractual terms that will apply to the investment. What is important is that trustees should only agree to terms that recognize that the investor is a retirement fund that has ongoing obligations to members. Also, the trustees have fiduciary duties imposed on them by law. Trustees should not simply accept terms because they have been informed that they are standard and have been accepted by other investors.

CONCLUSION

From the above it should be apparent that there are numerous factors to be considered by trustees before making an investment in a private equity fund. A legal and financial due diligence is critical. Ultimately, like any investment contract, the subscription agreement that is signed by investors when making an investment in a private equity fund is negotiable. However, what is crucial is for trustees to know what it is that they are supposed to be negotiating and agreeing with the private equity fund.