JACKO LAW GROUP, PC
SECURITIES & CORPORATE COUNSEL

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Fundamentals to Recommending Private Equity Fund Investments

Introduction

The private equity industry has a very unique niche in the investment world that is receiving increasing attention within the financial industry. At the same time, more and more investment firms are seeking alternative products or services to offer their clients. As such, many investment advisers and broker-dealers are increasing their recommendation of investments in private equity funds.

An investment adviser's fiduciary duty requires it to recommend only investments that are in the best interests of a client. In addition, such investment must be consistent with a client's investment objectives, timeline, risk tolerance and any specific restrictions. Similarly, a broker-dealer has a duty to sell only an investment if that investment is suitable for the investor.

With this in mind, it is imperative that these firms fully understand both the general nature and the specific details of any private equity fund investment before recommending it. The following is a summary guide to some of the most common issues your firm should consider when conducting due diligence, advising on and selling such investments.

Speculative Investment Strategies

The typical investment strategy of a private equity fund is to secure majority interests in private companies, appoint members of its management team to the board, use its management expertise to help grow the profits increase and value of those companies and then ultimately sell off their interests either to other private investors or through initial public offerings. This strategy is highly speculative for a number of reasons. First, typical target companies normally require outside investment because they require capital to start-up or expand their business. There is generally no track record for such new or expanded business models, which makes it more difficult for fund managers to assess the viability of their investments. Second, such businesses often may be newly formed, or small in size or market share. Traditionally, such businesses are more likely to encounter financial difficulties or be unsuccessful than larger, more established firms.

Keeping this in mind, investment firms should only recommend private equity funds to investors with a high risk tolerance. Even then they should typically only recommend that the investor allocate a small part of its net worth to such investments. Finally, firms should perform extensive due-diligence on these funds and their management teams. A fund that only invests in certain sectors in which its management team has experience generally will be less risky than a fund that invests in anything without restriction.

Long Term Investments

Although investment strategies differ, most private equity funds will need to hold each investment for some time before they have grown it to a point where they can "bring it to market." This may take five, ten, or even fifteen years. With this, most funds will require their investors to commit capital for the duration of the investment strategy. Additionally, these funds typically offer strict terms, such as restrictions and prohibitions on withdrawing capital until individual holdings are sold or the investment strategy for the fund has been completed.

Therefore, investment advisers and broker-dealers should review each fund's investment strategy and the terms of investment carefully prior to recommending such investment to an investor. Such review should ascertain how long an investor will need to keep their investment within the fund. Once this information is known, they should only recommend the fund to those investors who will not need access to their investment until the anticipated end of the fund.

Capital Gains verses Income

Private equity funds typically purchase shares that do not pay out dividends. In the early years of the investment cycle a purchased company may not be profitable and as such, there will be no profits to distribute. As each company becomes more successful, it will often reinvest any profits it makes to fund further growth and expansion, with a view toward increasing the value of the company as much as possible. Consequently, the fund will not be able to pass on any income to its investors. Such investments will therefore not be suitable for investors who need to generate income.

Conversely, if a fund's investment strategy is successful, when it comes time to sell its holdings, it should in theory achieve substantial capital gains. As most funds are set up as pass through entities for tax purposes, its investors will have to pay tax on these capital gains. Although investment advisers and broker-dealers should not give tax advice, they should also know whether the potential for a future substantial capital gain is in keeping with an investor's overall tax planning strategy.

Risks Unique to Certain Funds

Many private equity funds will have risks that are unique to that fund or that type of fund. For example, a leveraged buy-out fund will (as its name suggests) use leverage to acquire its interest in the target company. Any money the fund borrows will need to be paid back and this could reduce the overall profitability of the fund's investment strategy. Further, although funds are usually structured so that investors are not liable for the debts of the fund, some funds obligate investors to make further capital contributions if called upon. If an investor is required to make such a contribution, it could end up losing more than its initial investment in the fund.

Investment funds will need to disclose such risks and the investor must be willing to accept those risks before investing in the fund.

Ponzi Schemes

Most private equity funds are legitimate investment vehicles operated by honest and dedicated management teams. However, just as a number of hedge funds have turned out to be Ponzi schemes, the same could be true of certain private equity funds. Before recommending any investment, firms should conduct sufficient due diligence to satisfy themselves that the fund is genuine. Although private equity funds are generally reluctant to give out proprietary information, if they are serious about securing outside investments, they should be willing to give out information that will enable investors to determine their legitimacy.

Conclusion

If advisory or brokerage firms recommend private equity investments, they should ensure that they have due diligence procedures in place which incorporate most, if not all, of the above considerations. In addition, it will often not be enough to merely consider these factors. Instead, firms should make sure they disclose and explain all of the relevant factors which affected their decision in recommending the investment. Just because they have determined that a particular investment is appropriate for an investor, it does not necessarily mean that the investor would make the same decision had they been in full command of the facts.

Should your investment advisory or broker-dealer firm need assistance or have questions in the creation and implementation of such due diligence procedures, please contact us at (619) 298-2880.

Authors: Matthew Shepherd, Associate and Jeffrey Martell, Legal Intern, Jacko Law Group, PC ("JLG"), Editor: Michelle L. Jacko, Esq., Managing Partner. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds and banks on legal and regulatory compliance matters. For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.