## Appendix 2

## Public Comments Received by the Technical Committee on the Consultation Report *Private Equity Conflicts of Interest*

### List of Respondents

Association of the Luxembourg Fund Industry (ALFI)

Associazione Italiana de Private Equity e Venture Capital

British Venture Capital Association (BVCA)

CFA Institute (CFA)

Conseil déontologique des valeurs mobilières (CDVM)

Mr. Patrick Velay.

[Public Comment on Private Equity Conflicts of Interest]

**ALFI response dated 25th January 2010 to the IOSCO consultation report on Private Equity Conflicts of Interest dated November 2009**

## Introduction

ALFI represents the Luxembourg investment management and fund industry. It counts among its membership over 1,300 funds and asset management groups from around the world and a large range of service providers. According to the latest CSSF figures, on October 2009, total net assets of undertakings for collective investment were 1,778 trillion euros.
There are 3,454 undertakings for collective investment in Luxembourg, of which 2081 are multiple compartment structures containing 10,874 compartments. With the 1,373 single-compartment UCIs, there are a total of 12,247 active compartments or sub-funds based in Luxembourg.
According to September 2009 EFAMA figures, Luxembourg's fund industry holds a market share of 29.6% of the European Union fund industry, and according to 2008 Lipper data, 75.2% of UCITS that are engaged in cross-border business are domiciled in Luxembourg.

At the same time Luxembourg has developed a strong track record in alternative investment structures to be used for private equity and venture capital investment purposes. Besides the lightly regulated Luxembourg fund vehicles such as the SICAR and the SIF, Luxembourg has built its market share and its expertise in the private equity activity thanks to its non-regulated special purpose companies (such as the Soparfi or financial participation company), which are used for private equity investments either as non-regulated investment vehicles or as conduits for PE funds. As of August 2009, 229 SICARS and 910 SIFs were registered with the Luxembourg supervisory authority, a considerable number of which is used for structuring of private equity investments.

As one of the main gateways to the European Union and global markets, Luxembourg is the largest cross-border fund center in the European Union and, indeed, in the world. ALFI therefore welcomes the opportunity to comment on the IOSCO consultation paper related to private equity conflicts of interest.

ALFI agrees with IOSCO that the potential for material conflicts of interest among the parties involved in private equity sponsored transactions represents a key risk within the private equity industry.
The lifecycle structure approach of the IOSCO paper has the advantage of being easily understandable and implementable through the lifecycle of a PE fund.
However, ALFI would like to add two sources of potential conflicts of interest that are resulting from the assumptions of the IOSCO document.

**Conflicts of interest arising out of the corporate structure**

ALFI understands that potential conflicts of interest may arise out of the corporate structure predominantly used in the PE industry: the partnership; and finds it of particular interest that IOSCO has put emphasis on this structure in the report.

While ALFI agrees that this structure gives the widest powers to the general partner and thus allows for a very efficient decision making process, it comes at the price of potential conflicts of interest as the same decisional body of the general partner is representing its own interests among those of the investors.

A possible way to mitigate this kind of conflicts of interest would be to separate the decisional body of the fund from the one of the fund manager. This could be easily achieved by choosing a different corporate structure for the fund that would appoint an external investment manager and thus by abandoning the partnership as the corporate structure of the fund. A possible way to mitigate those conflicts within the partnership structure could be the implementation of an independent body within the partnership that is independent from the general partner and that represents the interest of the investors towards the general partner. This body would need to regularly consult the investors in order to best represent their interests. It would be appointed by the investors and would resolve upon conflicts of interest issues. It would have to represent the interest of all investors as a group, independently from the investor base at the time it was appointed. The general partner would have to follow its advice before taking the final decisions on investments and divestments. Moreover, it would monitor and control the daily activity of the general partner. Finally, this independent body might have the power to block further draw downs if the general partner should not follow its advice. A key element for the application of high standards of corporate governance is continuous transparency towards investors. Thus, for each major transaction, an investor report on potential conflicts of interest could be prepared that would clarify whether there have been conflicts of interest on that specific transaction and how they were dealt with. These reports could be part of the annual report of the fund or could be produced in a more timely manner.

**Conflicts of interest arising out of the remuneration scheme**

ALFI wants to point out that the remuneration scheme of the general partner or the appointed external fund manager may have a significant impact on the investment strategy during the life of the fund.

If the volume-based remuneration is too important, the general partner may seek to take investment decisions based on volume rather than on potential returns. Moreover, the general partner may choose to hold back volume in the portfolio for a time longer than needed.

On the other hand, if the performance-based remuneration is too important, the general partner may seek to increase risk of the portfolio. Moreover, the fact of having the first investments poorly perform in the portfolio (i.e. in a crisis environment) may lead the general partner to further increase the risk when

choosing the next investments in order to compensate the poor performance of the former.
While the awareness of reputational risk by the general partners might have a mitigating effect on the behaviour of some private equity houses, others might as well choose to increase the risk of their investments, especially in an environment of increased competition.
A way of mitigating the remuneration schemes problem would be to lower the impact of volume-based remuneration (i.e. by lowering the percentage, by adding a cap or by applying a fixed fee) while linking performance-based remuneration to the risk taken. For the latter, a practice seen in the market consists in leaving the performance-based remuneration within the fund until all investors have been reimbursed their investment (and the hurdle rate if applicable).
As indicated above, ALFI believes that an efficient approach to mitigate such risk is an independent body representing the interest of the investors as a group, monitoring the activity of the general partner or appointed external fund manager and resolving upon conflicts of interest issues. This body might have the power to block further draw downs.
This body could also represent the risk appetite of the investors as a group. Moreover, transparency by way of reports towards the investors on each investment would further increase the pressure on the fund manager and on the independent body to act in the best interest of the investors.

In general, ALFI believes that the best way to address conflicts of interest is to have the PE funds and the investors agree in the constitutional documents of the fund on how to deal with these conflicts. It appears useful to establish a number of principles, as proposed by IOSCO and the industry (i.e. the EVCA Code of Conduct and the EVCA Corporate Governance Guidelines), to which the PE fund's constitutional documents may refer, and which they may incorporate by reference (at least to some extent).

Finally, ALFI would very much appreciate if IOSCO could add the following text to the **Annex 1 – Typical Private Equity Fund Structures in various jurisdictions**:

**Luxembourg**
Luxembourg offers a large variety of possible vehicles for private equity investments, allowing a high degree of flexibility when structuring a fund.
Among the regulated vehicles, the most common Luxembourg legal regimes used for carrying out private equity activities are
the investment company in risk capital (*société d'investissement en capital à risque* or SICAR) in accordance with the Luxembourg law dated 15 June 2004 and
the specialised investment fund (*fonds d'investissement spécialisé*) or SIF in accordance with the Luxembourg law dated 13 February 2007.

**Investment company in risk capital (*société d'investissement en capital à risque* or SICAR)**
The SICAR is an investment vehicle specially designed for private equity and venture capital investments. A SICAR may adopt one of the following corporate forms: partnership limited by shares (*Société en commandite par actions*, SCA), a

private limited company (*Société à responsabilité limitée*, Sàrl), a public limited company (*Société anonyme*, SA), a limited partnership (*Société en commandite simple*, SCS), or a cooperative company organised as a public limited company (*Société cooperative organisée comme une société anonyme*, SCoSA). The SICAR is ruled by the SICAR law and by the corporate law of Luxembourg. Depending on the corporate form, the SICAR is either managed internally by its board of directors / managers or by the board of directors / managers of the general partner in case of a partnership.
A SICAR invests its assets in securities representing risk capital in order to provide its investors with the benefit of the result of the management of its assets in consideration for the risk which they incur. By risk capital is understood the direct or indirect contribution of assets to entities in view of their launch, their development or their listing on a stock exchange.
The SICAR is not imposed any investment diversification rules. Investment in a SICAR is limited to qualified investors which are institutional, professional investors and any individual who invests a minimum 125,000 euros or who has been assessed by a financial institution which certifies the investor's ability to understand the risks associated with investing in the SICAR.

**Specialised investment fund (*fonds d'investissement spécialisé*) or SIF**
Like the SICAR, the specialised investment fund (SIF) is not aimed at the general public but is reserved for qualified investors (the same definition as for SICARs applies).
The SIF may be set up as a common contractual fund (*fonds commun de placement* or FCP), an investment company with variable capital (*société d'investissement à capital variable* or SICAV) or with fixed capital (*société d'investissement à capital fixe* or SICAF).
If the SIF is organized as an FCP, it must - given that an FCP does not have legal personality- be managed by a Luxembourg-based management company. A SIF may otherwise be formed under any legal form also available under the SICAR regime. By comparison with the regime for undertakings for collective investment, a SIF has less strict publication requirements and is operationally more flexible in its activities. A promoter is not required.
Specialised investment funds may invest in a broad range of assets including, but not limited to, equities, bonds, derivatives, structured products, real estate, hedge funds and private equity investments. The SIF must comply with the general principle of risk diversification, but the law does not lay down any specific quantitative restrictions.

Both the SICAR and the SIF may have segregate compartments (sub-funds) within the same legal structure.

# AIFI remarks on the IOSCO Consultation REPORT "Private Equity Conflicts of Interest"

The Iosco consultation report on *Private Equity Conflicts of Interest* is strongly aimed to comprehend the contractual schemes currently applied to the private equity industry.

The Working Group of Supervisory Authorities, industry players and professional advisors sets out several interesting issues representing the recent evolution of the market.

In the meantime, it is to be underlined that many of the principles highlighted by the report seem to come from the same issues – regarding the impact of the conflicts of interest on the international financial markets – that pushed the need of an European regulation on private equity sector, whose implementation is, at the moment, under discussion as Alternative Investment Fund Managers (AIFM) Directive.

In fact, even if the AIFM is not specifically focused on the conflicts of interest issue, the proposal of European Directive published at the end of April in the last year talking about transparency requirements imposes to managers acquiring control of non listed companies the obligation to inform the company, its shareholders and employees of the policy for preventing and managing conflicts of interest. Furthermore, in the documents worked out by the European Council and by the *rapporteur* on the Directive to the European Parliament, some duties have been introduced in terms of transparency of the remuneration schemes of the fund managers. When adopting implementing policy on conflicts of interest is requested also that they are in line with rules on remuneration.

It would be therefore appropriate to develop the two documents, the Directive and the Iosco final report – despite the different purposes they pursue and the different timing – with coordinate efforts, in order to standardize the best practices in the international markets.

On the other hand, the document *Private Equity and Venture Capital in the European Economy – The Industry Response to the European Parliament end the European Commission*, prepared by the Task Force of the National private equity and venture capital Associations (www.evca.eu), encloses a detailed analysis of the possible risks involving the different counterparts of the private equity activity, such as funds, managers, investors, target companies and so on. This analysis reflects the careful consideration that, since long time, players and their representative

bodies have been trying to define the best practices in order to minimize the risks connected with the fund management.

More specifically, in Italy the MiFID, adopted by the "Regolamento Intermediari" (Consob Regulation n. 16190, Oct. 29th 2007) and the joint Regulation Banca d'Italia-Consob (Oct. 29th 2007), has been applied also to the private equity sector introducing some specific previsions on monitoring and managing conflicts of interest.

The wide application of the MiFID in Italy, in fact, imposed the adoption of a policy on conflicts of interest, aimed to analyse – with higher details than in the past – the possible critical situations. In the same direction goes the rule that forces the Italian management companies (SGR – Società di Gestione del Risparmio) to create a "register of conflicts", to be updated by the responsible of the compliance, reporting all the situations in which a conflict of interest has emerged or could eventually emerge.

As a consequence, Italian management companies have to formalize a document, reporting the policy to manage the conflicts of interest, in which the typical conflicts are identified in advance and, should they become real, managed. If the measures adopted are judged not sufficient, the management company must inform the investors of the general nature and of the source of the conflict.

Since March 2007 AIFI adopted a Code of Best Practices for Private Equity Management Companies, agreed by the players of the sector, which identifies possible operative solutions for the most frequent cases of conflict. Some of the best practices defined in the Code are even more strict than the ones in the Iosco report.

For example, according to the Code, the number of the independent Directors should be equal to at least a third of the total number of the members of the Board, with the presence of a minimum of two independent Board members.

Furthermore, in the specific case of Leveraged Buy-Outs, the structure of the transactions, by their very nature, provides for the use of a financial structure which comprises both debt capital and venture capital (equity). It is also normal market practice for the Italian management companies and its banking group of reference to offer, in the context of such transactions and within the limits of their respective competence, the amount of equity needed for the acquisition and the different levels of debt that make up the financial structure of the transaction. According to the Code, in this case, the debt and equity are included in the balance sheet of the target company (i) contemporaneously and (ii) under normal market terms and conditions, dictated by the spreads, applicable to the type of

subordinated debt used. In this case, therefore, for the purposes of correctly verifying the potential existence (or the non-existence) of conflicts of interests, it would be necessary to evaluate the simultaneous presence of the criteria of concomitance and normality of market resolutions.

As a matter of fact, even before the MiFID, the Italian Fund Rules (called "Regolamento") included many corporate governance clauses that the Iosco report classifies as typical of the more mature markets, for example the presence of an Advisory Board, representing the limited partners, in the decision-making process about target companies connected with potential conflicts of interest.

Talking about the specific provisions of the Iosco report, it is possible to highlight some peculiarities of the Italian market:

- ✓ **Fund raising stage**

  *Investment advisors*

  Since 1998 the Italian law imposes the rule that costs charged on the fund, including the so called "set up costs" and "set up fees", should be regulated in the Fund Rules, which must be approved by Banca d'Italia.

  *Size of fund*

  The Italian best practice, also in this case, is oriented towards the highest transparency, since the Fund Rules provide the minimum raising goal as well as the optimal size and define a clear discipline regarding both upsizing and downsizing. By the way, the same features meet the requests of Banca d'Italia.

- ✓ **Investment stage**

  *Transaction fees*

  Italian Fund Rules include the details on how to calculate and charge transaction fees.

  *Investment allocation*

  The restrictions in promoting "successor funds" is a common best practice for most of the Italian funds, in particular for the middle-big sized. Anyway the limitation lapses at the end of the investment period of the previous fund.

  The rollover issue does not represent a problem, in the Italian market, because it is rarely applied. Moreover when applied it is subjected to the mandatory approval of an Advisory Board as a typical investment or disinvestment in conflict of interest.

*Co-Investment by general partners*

Formulas adopted in the Italian Fund Rules usually request to general partner to underwrite specific kind of shares – commonly called B-shares – while A-Shares are underwritten by limited partners. Usually General Partners hold 1% or 2% of the total amount of the fund.

*Deal Co-Investment by limited partners*

The decision on the deal co-investment by limited partners is committed to the Advisory Board following international best practice.

✓ **Management stage**

*Other fees derived by fund manager*

The "soft commissions" are regulated, for the most of the Italian funds, by the Fund Rules. Clauses of offset between soft and management commissions are usually present.

*Allocation of management resources by private equity firms*

The *no fault divorce clause* is peremptorily provided by the Consolidate Act on Financial Brokerage Activities (Legislative Decree n. 58/98) and it is a strong deterrent against the depletion of the human resources dedicated to the fund. By now the key man clause is generally placed in the Italian Fund Rules.

*Enforcement of default remedies*

It is very common, specially for funds promoted in the last few years, during the financial crisis, negotiate in advance clauses aimed to minimize the effect of an investor default.

✓ **Exit stage**

*Extension of fund life*

According to the regulation of Banca d'Italia, an Italian management company must discipline the *grace period* in the Fund Rules. If the management company wants to invoke an extension of the grace period has to send a formal request to Banca d'Italia, that makes a decision considering the interests of the investors.

*Generation of market value fees*

The risk of overstate fund valuation in the Italian market is strongly mitigated by several factors:

- an overvaluation before the exit would induce a strong fiscal penalization, and this would affect the fund performance;

- it is forbidden to calculate the management fee on the non yet realized capital gains;
- the provisions of Banca d'Italia on asset revaluation are very strict;
- the financial sheet of the fund is subject to an independent audit.

*Secondary sales of fund interests*

In Italy the secondary market is not yet much developed, and it is not easy to assess how it works at the moment. In general, players usually avoid to apply "fair market value" for the reasons above.

✓ **Principles for the effective mitigation of conflicts of interest in private equity firms**

The base principles highlighted by the Iosco report to mitigate the risk of conflicts of interest are certainly reasonable and, regarding Italian market, they are included in the Code of Best Practices adopted by Italian management companies.

Finally, even if many remarks of the Iosco report are well known by the Italian general partners, the document gives some useful benchmarks to compare the Italian standards with the international ones, drawing a complete review about the best practices in the field of mitigation techniques of conflicts of interest.

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1 February 2010

Dear Sir

**Private Equity Conflicts of Interest**

This response is made by the Regulatory Committee of the British Private Equity and Venture Capital Association on the IOSCO Consultation Report issued in December 2009 on Private Equity Conflicts of Interest. The BVCA represents the overwhelming majority of UK-based private equity and venture capital firms. The UK private equity and venture capital industry is by far the largest in Europe and second only in size in the world to that of the United States.

We have the following comments:

1. We note that IOSCO does give some recognition in the introduction to the Principles to the fact that there will be variation between firms affected in terms of size, structure and operations. This is a very important point which we consider should be given greater emphasis. There are many firms which are neither multi-fund nor multi-strategy; the generalisation in the text of the paper will mean that there will be many funds which will not operate in exactly the same way or face the same issues as described. We consider, therefore, that the theme of the introductory paragraph to the Principles should be expanded by the addition of the following sentence (underlined below):

   "The Principles can be applied, however, to all private equity firms but IOSCO recognises that firms vary in terms of size, structure and operations. The management of each private equity firm, and their investors, should take into consideration the nature of the firm in question when seeking to apply the principles. <u>In particular, the Principles apply to the extent appropriate and proportionate in view of the nature, scale and complexity of the firm's business and the nature and range of services and activities undertaken in the course of that business and the nature of the investors</u>."

2. We agree with the approach taken to the scope of the report in respect of identifying the types of conflict to be addressed by the report. As a general comment, the paper refers throughout to mitigation of conflicts. In our view it is more accurate (and more reflective of current regulatory language) to use the term "manage" in respect of conflicts.

   We think it is important that the report recognises that some of the conflicts identified can arise across a range of types of fund and are not unique to private equity business.

3. We recognise that in the description of the activities of private equity firms, the structure of funds and potential conflicts, it has been necessary to adopt a high level descriptive approach to produce a general, rather than a precise, picture of the overall industry. This approach inevitably means that points could be made about the accuracy or general applicability of some of the statements made. We recognise that the purpose of the description is to set the context for the Principles. We did not therefore think it appropriate to make extensive detailed comments with a view to increasing the accuracy or comprehensiveness of the descriptions given. Generally, we think they are adequate for the purpose of the document. On that basis we had only the following comments on the descriptive sections:

- we disagreed with the reference to small investors at the end of the second paragraph on page 14 in relation to transaction fees. They will know the terms before they invest, and even if they have not influenced the issue, they will benefit from the position negotiated by other stronger investors;

- conflicting investment strategies (page 15) - we think the text should reflect that the limited partnership agreement or other documents are likely to deal with this issue;

- investment allocation (page 16) - we think the text could make it more clear that the issue of overlapping investment periods and the amount that can be drawn down is variable and very much a matter for agreement with investors at the outset. A successor fund is unlikely to be raised while a first fund is in its primary investment period and will not make primary investments until the first fund has ceased to do so. This reduces the scope for conflicts over investment allocation;

- multiple funds (page 21) - the reference to validation of price by investors would be more accurate if it referred to Advisory Committee approval of the approach used. Investors will necessarily be wary of approving a particular price and there are good legal reasons from their perspective as to why they should not go this far.

4. We are concerned that there are a couple of issues which are identified under the heading of "conflicts" where we do not think there is a conflict. Whilst we accept that the issue concerned may be one on which regulators have a view as to standards of conduct, it is nevertheless not appropriate to label something as a conflict when it is not. In this regard we refer to the paragraphs on:

- deal co-investment by fund investors;
- secondary sales of fund interests.

For there to be a conflict of interest, a firm must be in one of the following positions:

- it may owe conflicting duties to different persons;
- it may have an interest in a transaction which conflicts with its duty to a third party.

In either case it is an essential ingredient that a firm has a duty in respect of which a conflict can arise.

A firm has no duty to an investor to offer it a co-investment opportunity unless the firm has contractually agreed that it will do so, which is uncommon. Nor do we consider that <u>all</u> limited partners generally have an expectation to be considered for co-investment opportunities. There are many cases where a limited partner would not wish to be so considered, because of its own investment restrictions and policies. Therefore, whilst we agree that if there is the possibility of co-investment, it would be good practice for firms to ensure that all investors are aware that this may occur at the firm's total discretion, we do not think that the situation generally should be characterised as one giving rise to a "conflict", and the paper should recognise this.

Similarly, we do not agree that the secondary sale of a fund interest, where transfer of ownership requires fund manager consent, necessarily gives rise to a conflict of interest. In our view a conflict as such could only arise where the transferee is associated with the manager. On fund establishment a manager controls who is admitted as an investor and the position

should be no different on transfers. It is the manager who owes duties to the investors and he should not be effectively forced into a relationship he would not have chosen, which may have implications for the manager as well as other investors. The manager has a legitimate interest in the make-up of the investor base. A private equity fund is not established in the expectation that investors will transfer their interests, quite the opposite. The fact that the constitution recognises that it is possible for a transfer to be made, does not mean that is what is expected in the ordinary course.

In exercising its power of consent the manager has to have regard to the interests of the remaining investors, including to such factors as the likelihood that the acquirer will be able to meet any outstanding commitments. At this stage the interest of the departing investor is not the same as the interest of the remaining investors, and it is the fund manager's primary duty to protect those investors whose money it is responsible for managing. If the fund manager considers that a third party buyer is an inappropriate person to be in the fund (and would not have been admitted at the inception of the fund), then we do not agree that the manager has a conflict of interest. Whilst we do not object to the description of the arrangements for dealing with the sale of fund interests, we do consider that it is inaccurate to describe the situation as generally involving a conflict.

5. ***Comments on Principles***

*Principle 1*
We did not understand the reference to obligations owed by the fund manager to third party investors in the final words of the first paragraph. These should either be deleted or the intention clarified.

*Principle 2*
There is an inherent contradiction in the second sentence. There must be a possibility that if the policies and procedures are to be consistent with any local jurisdiction or laws, then it may not be possible for them to be applied consistently across all locations. We suggest that this point could be covered by the insertion of the following words (underlined) in the second half of the second sentence:

> "...jurisdictions in which the firm operates, <u>subject to that</u>, they should be applied consistently...".

*Principle 3*
The second paragraph duplicates the final paragraph of Principle 4. In any event, it is only substantive changes that should be made available to investors. Investors do not want documentation that is not material.

*Principle 4*
We believe that the cross-reference at the end should be to Principle 3.

*Principle 5*
In addition to our general comment on the use of the term "mitigation techniques", we have significant concerns about the statement that a firm should favour mitigation that provides the greatest potential for recourse in the case of investor detriment, because we think it is confusing and unclear as to its intent. In most jurisdictions with which we are familiar an investor would have recourse to a private equity firm which did not handle a conflict of interest between the firm and its investors, either:

- so as to eliminate actual investor detriment; or
- in accordance with a procedure to which the investor consented; or
- by disclosing the conflict and being permitted nevertheless to act.

It is simply not accurate to talk about a mitigation technique which provides the greatest potential recourse in the case of investor detriment. There is no particular technique which provides greater or lesser recourse for the investor - if the conflict is not properly handled he will have recourse. The concept is also self-contradictory, because if the mitigation technique used

is the optimal one, then there will be the least need for recourse. We suggest that the underlying theme of the comment would be better expressed as follows:

> "A private equity firm should favour policies and procedures which provide the greatest level of clarity to investors as to how particular conflicts may be managed and which effectively manage the risk of actual damage to investors' interests, and where the policies and procedures are not sufficient in any situation to provide reasonable confidence that damage to the interests will be prevented, the firm must make a clear disclosure to the investors."

This builds on the approach already inherent in much legislation that governs investment firms generally. It is also important that the paper acknowledges that the entire reason for disclosure and consent in some cases is precisely because some conflicts cannot be managed so as to avoid any potential detriment, which is precisely why proper disclosure is required.

*Principle 6*
The use of investor advisory committees is established through the fund constitutional documentation. It would be inappropriate for terms of reference to cover points such as expertise and availability of particular committee members when the appointment or designation of the members is as much a matter for the investors themselves as for the fund manager. We suggest therefore that the words in brackets are deleted. We welcome the recognition in the text that effective investor consultation models can take different forms and may reflect the size and complexity of the business model.

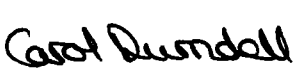
*Principle 7*
We believe that this should state that a private equity firm should disclose the "outcome of discussions" rather than the "substance of opinion". This would reflect the text set out below the Principle and is what should be disclosed to the investors, rather than individual opinions expressed in debate by different members of the committee. In our experience the members of Advisory Committees would object to the idea that their individual views would be disclosed rather than the outcome.

*Principle 8*
We think that you should add the following sentence before the last sentence:

> "In particular, given that some common conflicts situations may have been disclosed in advance, there will not necessarily be a need for disclosure on each and every occasion that the same generic issue arises, this is for consideration by the firm in the context of the actual situation and disclosures already made."

We would be available to discuss any of the above if that would assist. Please contact me in the first instance on +44 (0)207 295 3233 or at margaret.chamberlain@traverssmith.com.

Yours faithfully



pp. **Margaret Chamberlain**
**Chair BVCA Regulatory Committee**

Centre for Financial Market Integrity

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**Consultation Report on Private Equity Conflicts of Interest**

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on IOSCO's Consultation Report on Private Equity Conflicts of Interest (the "Consultation").

The CFA Institute Centre[1] (the "Centre") promotes fair, open, and transparent global capital markets, and advocates for investors' protection. We also support and promote open, fair, and transparent treatment of investors by investment funds of all types. To this end, we have published our *Asset Manager Code of Professional Conduct*. This code was developed to serve as a template for best fund practices,

Given our background in this area, we support IOSCO's decision to address the potential conflicts of interests unique in the private equity world. We also support attempts to provide greater transparency about such conflicts to better serve investor interests.

**Executive Summary**

The Centre agrees that proper incentive structures, sufficient transparency on the part of private equity managers and pre-investment contract/legal arrangements can go a long way toward addressing any conflicts of interest concerns investors may have about the private equity world. Above all else, all investors and potential investors must be informed of any potential conflicts of interests they may face by investing in that fund.

In the Consultation, IOSCO emphasizes a set of best practices. We support this approach instead of a prescriptive list of requirements, because the latter may not consider either the different circumstances of private equity firms and their investors, or the potentially very divergent regulatory structures that exist in each market in which this Consultation will be considered. A set of best practices, on the other hand, properly allows private equity firms and their investors to adapt the principles to their own circumstances without stifling competition among such firms and across multiple markets.

[1] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

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The best practices noted in the Consultation nicely summarize the key methods investors may use to mitigate a number of potential conflicts, including; compensation agreements, contractual agreements, disclosure and consultations with investor committees.

**Compensation arrangements**

The Centre endorses the best practice noted in the Consultation that would encourage private equity firms to only accrue performance-related remuneration on realized profits. It also would encourage such accrual only after fund investors have received a full return on their investment plus a cost of money hurdle.

**Contractual agreements**

Investors should be informed about whether the private equity firm in which they invest offers a *most-favored nation* clause. Such clauses may provide less influential investors with the ability to benefit from more favorable terms negotiated by larger institutions which have a larger stake in the fund. If the firm does allow smaller investors to enjoy such rights, they should also clearly be informed of the limits of those rights.

Private equity firms have a duty to their investors to strike the right balance between a level of transparency and confidential treatment of proprietary information, including investors' identities. Consequently, while the Centre believes that private equity firms must inform their investors of the existence of side letters and of the impact such agreements may have on other investors in the fund, we do not believe that all fund investors need to know the identity of those who have such agreements.

At the same time, and to ensure fair treatment of all investors, we believe private equity firms should make such side agreements available to all clients, even if at higher prices.

**Disclosures**

Private equity firms, like all investment firms, should provide their clients with a description and the costs—direct and indirect—of the products and services they offer. Private equity managers should communicate meaningful information about the riskiness of investments prior to delivery of a transaction to investors. Such disclosures will enable investors to assess whether the risks are acceptable.

Disclosure regimes should call on private equity firms to disclose the expected use of and acceptable levels of leverage in the investments that they will make. The Centre believes such clear and thorough disclosure about the uses of leverage in a given private equity fund allows investors to make efficient use of their capital. Ultimately, this serves the financial markets better than regulatory restrictions on the use of leverage.

All aspects of compensation arrangements should be disclosed to all fund investors and potential investors. As the consultation suggests, any fund that may have different disclosure regimes for different investors should implement policies to address the potential conflict raised by disclosure disparity among investors and must disclose such conflicts of interests to all investors.

**Consultation with Investor Committees**

The Centre agrees that it is best practice for private equity funds to establish an investor advisory committee, comprised of a small sample of fund investors, to review the firm's approach towards resolving all material conflicts of interest. Investors should take care to understand the influence they do and do not enjoy through representation on such an advisory committee.

We appreciate the opportunity that IOSCO has afforded us to comment on this important Consultation. We believe that the suggested practices enumerated in the Consultation offer investors and private equity firms a clearer path towards establishing a more transparent private equity market that works in the best interests of both private equity firms and their clients.

Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,

James C. Allen, CFA
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The CFA Institute Centre is part of CFA Institute[2]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association of nearly 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 139 countries, of whom more than 86,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

Our detailed comments follow the order of the Consultation's "Principles for the Effective Mitigation of Conflicts of Interest in Private Equity Firms".

**SPECIFIC COMMENTS**

**Our responses to the Principles for the Effective Mitigation of Conflicts of Interest in Private Equity Firms.**

***1. A private equity firm should seek to manage conflicts of interest in a way that is in the best interests of its fund(s), and therefore the overall best interests of fund investors.***

As noted in our *Asset Manager Code,* we support the need of investors for full and fair disclosure, particularly with regard to conflicts of interest. We believe the interests of investors should supersede all other interests, including those of investment advisers. Investors need clear and understandable disclosures to help them determine whether the conflicts facing the adviser and the methods used to alleviate those conflicts are sufficient to enable the adviser to work for their best interests.

***2. A private equity firm should establish and implement written policies and procedures to identify, monitor and appropriately mitigate conflicts of interest throughout the scope of business that the firm conducts.***

Again, we support this as a best practice. Investors need this level of transparency to accurately judge whether an investment with a private equity firm is right for them.

***3. A private equity firm should make the policies and procedures available to all fund investors both at inception of their relationship with the firm, and on an ongoing basis.***

Private equity firms should inform potential clients of the policies and procedures in place to manage conflicts of interest both before those clients invest with the firm and on an ongoing basis. Moreover, they should make these disclosures via clear statements in all relevant offering documents and prospectuses. Such firms also should take the time to ensure that potential clients understand these policies before they invest.

***4. A private equity firm should review the policies and procedures, and their application, on a regular basis, or as a result of business developments, to ensure their continued appropriateness.***

[2] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

The Centre supports the IOSCO proposals with regard to the review of a fund's policies and procedures. Best practice in terms of conflicts of interest policy evolves over time. It is therefore paramount that private equity firms stay at the leading edge of such practices in order to best serve their clients. Private equity firms also should inform their clients and potential clients as to when and how often these policies are reviewed and when they are changed. Relevant investment literature should be updated on a timely basis following changes to conflicts of interest policies and procedures so that investors can evaluate the continued appropriateness of such practices.

***5. A private equity firm should favour mitigation techniques which provide the most effective mitigation and greatest level of clarity to investors.***

Private equity firms should ensure that investors know and are comfortable with their mitigation policies before they are permitted to make an investment. When a number of different mitigation policies are available, investors should be informed of these mitigation options.

6. ***A private equity firm should establish and implement a clearly documented and defined process which facilitates investor consultation regarding matters relating to conflicts of interest.***

The Centre agrees with this suggestion. Private equity firms should implement such a process for mediating conflicts of interests and make sure that current investors understand the process, and that potential investors are aware of the process before they make an investment.

*7.* ***A private equity firm should disclose the substance of opinion given through the investor consultation process and any related actions taken to all affected fund investors in a timely manner (save where to do so would breach any other legal or regulatory requirement or duties of confidentiality).***

We support these proposals as an effective means of ensuring that fund managers know and understand the perspective of their fund investors. However, we believe that the results of these consultations should be made readily available to all fund investors in a timely manner, as well, and before any related actions are taken by the fund.

8. ***A private equity firm should ensure that all disclosure provided to investors is clear, complete, fair and not misleading.***

As noted in the *Asset Manager Code,* investors need an appropriate level of disclosure to help them with their investment decisions. In particular, fund investors need timely, relevant and standardized valuations, as well as information about the assumptions used to determine values for various fund assets and liabilities.

Likewise, market regulators need information from the private equity sector to help them understand potential systemic risks that might develop. Private equity managers, like other entities seeking capital from investors, have an obligation to provide financial and operating information and to make their records available for periodic regulatory review.

Finally, investors also require the same level and quality of disclosures from private equity funds as they do from other (non-alternative) investment funds or other private pools of capital. A recent survey of over 1,200 CFA Institute members in Europe[3] found that approximately 60% of respondents felt that managers of alternative investment funds should make the same level of disclosure as non-alternative funds about the operations and activities of the funds they manage, to both investors and regulators.

[3] The survey results can be accessed at http://www.cfainstitute.org/centre/news/surveys/pdf/alternative_investment_fund_results.pdf

## *IOSCO consults on principles to mitigate private equity conflicts of interest/*

## *CDVM Comments*

First of all, we would express our appreciation to the huge effort made by the IOSCO Technical Committee and all members of the working group to prepare such a comprehensive report on mitigants of private equity conflicts of interest risks.

Private equity markets are, especially within developing countries, in need of such effective and practical guidelines resulting from a wide range of practitioners' experiences. Hence, this report will enhance, to a large extent, the moroccan regulatory tools.

We would emphasis on the fact that we will particularly take profit from the fact that the report describes actual cases of private equity conflicts of interest. In fact, current moroccan regulatory tools are setting up global principles and instructions. These instructions are short of practical recommendations that could help to understand and to handle actual conflicts of interest cases, especially on behalf of the regulatory authority.

CDVM remarks related to the report will come up in the following paragraphs. We hope they could contribute to follow-up work on this report until the issuing of the final version.

**CDVM comments:**

1- The report emphasises on the information disclosure to be made on behalf of investors, as a part of the investor interest's protection. We think that the deepness and the frequency of reporting to be made to investors largely depends on the way investors are expected to intervene in the fund monitoring and in the decision making process. It would be suitable to

mention that three main styles of investors' behaviour could be distinguished:

* The first one consists on **autonomous management**: the investor does not tangle with the private equity firm decisions

* The second one consists on a **participatory management**: the investor intervenes in all firm decisions

* The last one consists on a **discretionary management**: the investor is consulted for advice before taking decisions.

Indeed, the extent of investor involvement is agreed in the early contractual agreement.

**2-** In developing countries, private equity firms are globally small sized (an average staff of 10 employees). As a matter of fact, the cost effectiveness of implementing strong organizational means to mitigate conflicts of interest risks is considered. The potential high cost of implementing procedures, policies and IT processes could divert the manager investment choices. Mastering conflict of interests' risks, among others, could not get priority for the private equity managers.

For this reason, we suggest it should be defined the outline of the approach that a regulatory authority should undertake to assess the adequacy of procedures implemented by the private equity firm in the scope of conflicts of interest risks.

**3-** The compliance officer and internal auditor functions should be more highlighted regarding conflicts of interest risks' mitigating. These are key

functions for securing an on-going implementation of policies and procedures related to the issue.

4- As far as contractual agreement is concerned, we suggest that it should include a well structured list of **covenants** as a matter of **restrictions** to the fund manager's latitude in taking decision regarding the main risk areas: the size of a portfolio company investment; the use of debt; the type of investment; new fundraising; co-investments; key man clauses…

Besides, In order to make a comprehensive set of regulatory principles, the list of principles (chapter 5) could be filled out by defining, not only operational measures to be secured by the private equity firm, but also principles related to contractual agreements or the whole governing of the relationship with investors.

Mohamed Ben Salem
Senior Policy Advisor
IOSCO General Secretariat
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Spain

Sent by e-mail to: privateequityconflicts@iosco.org

Monday 1 February 2010

**RE: "Public Comment on Private Equity Conflicts of Interest."**

Dear Mohamed Ben Salem

I welcome the opportunity to comment on IOSCO's consultation report on "Private Equity Conflicts of Interest".

The comments below are my own and should not be construed as endorsed by any current or past employers.

**Importance of managing conflicts of interest in the private equity industry**

I would like to highlight why in my opinion management of conflicts of interest is of prime importance within the Private Equity industry. Conflicts of interest typically exist when someone in a position of trust, such as a manager or an adviser within a private equity fund or private equity firm, has competing professional or personal issues. Such competing interests can make it difficult for private equity firm or a private equity fund, to fulfill their duties impartially or independently.

Besides, in practice, (unaffiliated) investors in private equity funds may have either limited or no power in influencing (or sanctioning) the persons holding a position of trust.

**My comments on the identification and monitoring of conflicts of interest (principle 2)**

I agree that situations that could give rise to conflicts of interest should be identified. However, I believe that the report does not stress out enough that risks of conflicts of interest may have roots to be found also outside the funds or the firms. Regarding the Principle 2, the comments could be completed to recommend that firms or funds should undertake a holistic review of their business including the consideration of the activities and structure of its wider group.

Also, I believe that carrying out a one-off mapping exercise for conflicts of interest might not be enough. Regarding the Principle 2, the comments could be completed to recommend explicitly to put in place arrangements to monitor existing conflicts and identify new ones.

**My comments on disclosure as a mitigant (Principle 8)**

I agree that disclosure to all investors should be clear, fair and not misleading. However, I would like to point out that disclosure may not be a perfect mitigant and may even have side-effects.

There are some experimental evidences[1] that, under some conditions, "disclosure may not have the intended effect because it provides individuals with moral license to engage in self-interested behavior, thereby exacerbating biases".

I thus believe that it could be useful to clarify the purpose of disclosure. It might also be interesting to limit the use of generic or hypothetical "Conflicts of Interest Disclosure" used typically in marketing materials.

I believe also that some types of disclosure may be not considered unconditionally as a mitigant *per se,* especially if the investor cannot act upon the information disclosed.

I appreciate the opportunity to provide comments to IOSCO on this consultation.

Sincerely yours,

Patrick Velay

[1] See for instance :
**Conflicts of Interest, Disclosure, and (Costly) Sanctions: Experimental Evidence**
Bryan K. Church and Xi (Jason) Kuang
The Journal of Legal Studies 2009 38:2, 505-532