# Private Equity Conflicts of Interest

## Final Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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# CONTENTS


| Chapter | | Page |
|---|---|---|
| 1 | **Executive Summary** | 3 |
| 2 | **Context and Scope of Report** | 4 |
| 3 | **Overview of Private Equity Markets** | 6 |
| 4 | **Identified Areas of Risk and Methods of Mitigation for Conflicts of Interest in Private Equity** | 10 |
| 5 | **Principles for Effective Mitigation of Conflicts of Interest in Private Equity Firms** | 22 |
| | **Appendix 1: Feedback Statement on the Public Comments Received by the Technical Committee on the *Consultation Report – Private Equity Conflicts of Interest.*** | |
| | **Appendix 2: Public Comments Received by the Technical Committee on the *Consultation Report – Private Equity Conflicts of Interest.*** | |
| | **Appendix 3: Common Private Equity Legal Structures** | |
| | **Appendix 4: Private Equity Working Group Members** | |

## Chapter 1 - Executive Summary

In May 2008, IOSCO published a report identifying potential risks emerging from the private equity industry and outlining how IOSCO intended to address these risks. One of the key risks identified by this report was the potential for material conflicts of interest to exist among the parties involved in private equity sponsored transactions. In light of this the report recommended that further work should be carried out to fully identify those conflicts of interest risks which are particular to private equity and to explore the extent to which these risks are subject to adequate methods of mitigation. This report provides a summary and the conclusions of the recommended follow-up work on conflicts of interest in private equity.

The scope of this report is limited to the risks posed to fund investors or the efficient functioning of financial markets from conflicts of interest which may exist within a private equity firm or within a private equity fund, particularly the potential conflicts of interest that may be faced by the manager of a private equity fund. It generally does not address potential conflicts of interest which are not particular to private equity business, any apparent conflict related to business tensions, or those conflicts which are not within the typical mandate of securities regulators, for example any issues arising from obligations owed by the director appointed by a fund to a portfolio company. However it is, of course, possible that some of the conflicts and risks identified may be present in other industry sectors.

The report sets out the conflict of interest risks encountered through the life cycle of a typical private equity fund which is managed by a multi-fund, multi-strategy firm, as identified by an IOSCO working group formed of industry participants and members of the regulatory community. Potential and common methods for mitigating these potential conflicts of interest are set out alongside the respective risks. Mitigation typically takes the form of alignment of interest through incentive structures, disclosure and legal agreements.

Finally, based on the mitigating measures identified by the working group, this report outlines a set of principles for the management of conflicts of interest in private equity. These principles are intended to be readily applicable to all private equity firms regardless of where they are organised or operating, their chosen investment strategy(ies), fund structure or other investment business activities. However, IOSCO recognises that private equity firms vary considerably in their size, structure and complexity, and this may impact on the applicability of one or more of these principles to a specific firm's business.

## Chapter 2 - Context and Scope of Report

In May 2008, IOSCO published a report identifying potential risks emerging from the private equity industry and outlining how IOSCO intended to address these risks.[1] One of the key risks identified by this report was the potential for material conflicts of interest between the parties involved in private equity business. In light of this, the report recommended further work should be carried out to fully identify those conflict of interest risks which are particular to the private equity industry and to explore the extent to which these risks are subject to methods of mitigation. This report provides a summary and the conclusions of the recommended follow up work on conflicts of interest in private equity.

The 2008 report also identified that a number of potential conflicts of interest that could manifest themselves within the private equity industry were not particular to this sector and therefore should not be covered by the specific private equity work. These risks have been, or will be, addressed by other IOSCO work streams. In particular, it was agreed that further focus would not be given to the potential conflicts that can arise during securities issuance, including the listing of private equity firms, as this had been substantively covered by the work of the Technical Committee Standing Committee on the Regulation of Market Intermediaries (TCSC3)[1]. It was also agreed that the report should focus exclusively on non-retail private equity activity, as direct retail engagement with private equity firms is extremely limited. Retail engagement with investment funds and vehicles has also been the focus of a significant quantity of recent work by IOSCO.

For the purpose of creating this report, the Technical Committee Standing Committee on Investment Management (TCSC5) established a working group of representatives of the global supervisory community and private equity industry experts to investigate fully the potential conflicts of interest in the sector and identify best practice in how the risk of these conflicts is mitigated. The list of members of the working group can be found in Appendix 4.

In line with the recommendations of the previous IOSCO report on risks within the private equity sector, the scope of this report is limited to identifying and suggesting best practice for mitigating conflicts of interest risks particular to this industry which have not been appropriately addressed by other IOSCO work streams. The focus of this work concentrates on risks to investor protection and the fair and efficient functioning of financial markets.

Given the scope outlined above, this report seeks to identify the conflicts of interest, of potential detriment to investors, that may arise between the manager and third party investors within a particular private equity fund or arise from obligations owed by a private equity firm to multiple funds. In the context of this document and the principles here-in designed to protect third party investors, these protections are aimed at investors who are unaffiliated with the private equity firm.[2] These are the conflicts which are of key concern to financial

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1 *Report on Private Equity - Final Report*, Report of the Technical Committee of IOSCO http://www.iosco.org/library/pubdocs/pdf/IOSCOPD274.pdf

1 *Market Intermediary Management of Conflicts that Arise in Securities Offerings - Final Report*, Report of the Technical Committee of IOSCO, March 2007 available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD257.pdf

2 Examples of affiliated investors would be, but are not limited to, investors in capital carried interest schemes which are commonly used within the industry to incentivise employees of the private equity firm and, where relevant, its group.

regulators. The report does not seek to evaluate those risks that may exist as a result of the firm's treatment of other stakeholders, such as investee companies or their employees, as these tend to be covered by local company and employment law and are outside the standard remit of securities regulators. Nor does the report focus on investors where there is no direct relationship with the private equity firm (for example where investors invest in a private equity fund via a feeder fund or a fund of funds).

As this report has been written to address regulatory concerns, it does not seek to address issues associated with general business tensions. For example, business tensions relating to club deals (where a number of funds act together to invest in a single company) or where competition exists between two similar companies owned by the same fund e.g. a fund owns two or more firms in the same industry sector, were not considered to be within the scope of this report. Such issues were not considered particular to private equity and reflect the more common business tensions that exist between the independent preferences of various parties to a deal.

As identified in the following chapter, the term *private equity* is a broad description of an industry that encompasses a wide range of activities that can differ in a number of fundamental ways, where funds can have differing investment strategies and legal structures. It should be noted that the common characteristics of private equity firms and fund structures can, and do, vary between different jurisdictions as does the level of regulatory involvement. More specifically, the degree to which the mitigation of conflicts of interest by private equity firms is regulated may be quite different from one jurisdiction to another, as the mitigation of conflicts may either be required pursuant to general or specific legal or regulatory provisions, or simply result from common practice or general doctrine. The working group agreed that the conflicts of interest identified by the report would be those which are common across private equity structures, taking a multi-fund, multi-strategy private equity firm as a reference point (see Generic Industry Structure below).

The aim of this report is to outline principles against which both the industry and regulators can assess the quality of mitigation of conflicts of interest by private equity firms. Generally, these principles reflect a level of common approach and a practical guide currently acknowledged by regulators and industry practitioners. Moreover, implementation of the principles may vary from jurisdiction to jurisdiction, depending on local conditions, requirements and circumstances.

# Chapter 3 - Overview of Private Equity Market

## Introduction

Private equity is, as the name suggests, equity raised by companies privately rather than through public fundraising. The private equity industry encompasses a wide range of firms which raise capital into funds with a diverse range of potential investment strategies. The sector is primarily focused on matching medium to long-term capital with companies which require funding to develop and grow to maximise potential shareholder returns. Equity capital is typically raised in a fund structure from a variety of sources including pension funds, institutional investors and sophisticated, high net worth individuals. Many of the specific duties owed by a fund manager to the fund's investors will be largely shaped by fund documents that are the subject of negotiation between the fund and its investors. Depending on the jurisdiction, obligations other than those arising from the fund documents may exist, such as common law of fiduciary duties that may arise. Traditionally any debt element within the proposed capital structure of a portfolio company is provided by banks and is often partially or fully redistributed to other banks and institutional debt market participants. Private equity firms can typically be differentiated from other private investors which take controlling stakes in firms, such as individual large investors or family firms, as they typically raise capital on a regular basis in sequential fund raisings rather than on an *ad hoc*/as needs basis for individual deals and deploy that capital in multiple companies with common investment objectives.

Within its geographical and industry sector areas of expertise, a private equity firm's investment strategies are defined based on the stage of development and capital requirements of the portfolio companies in which it intends to invest its fund(s). Commonly, these investment strategies are defined as early stage/venture capital, growth capital and late stage/leveraged buyouts, although increasingly private equity firms are looking to raise funds specializing in infrastructure, distressed debt and private investment in public equity. The firm's investment strategies and the expertise of the firm's investment professionals will be a major factor in determining the optimal size of its funds, the enterprise value of its portfolio companies, and the nature of its investment. For example, generally early stage/venture capital funds focus on providing equity seed capital to young or emerging companies via the acquisition of a minority interest, making them significantly different from a leveraged buyout fund which seeks to acquire a controlling equity stake in a mature company. The exact nature of a private equity firm's structure and operating model will depend on a number of factors and the typical operating model may vary from country to country. A more detailed overview of the potential structures is included in Appendix 3.

The establishment of a fund by a private equity firm allows the pooling of capital by a number of investors to purchase equity or equity related securities in typically privately owned companies. As such, individual investors in a fund own a percentage of the fund as a pooled investment vehicle, e.g. shares, units or limited partnership interests. The majority of private equity investors are institutional and sophisticated market participants, although retail exposure to private equity can occur through specific structures which pool retail funds.

## Size of Industry

The private equity industry is present in a large number of global markets, particularly the

more advanced capital markets. Given the level of detailed knowledge of local laws and regulations that is required to operate successfully, competent private equity firms tend to focus on areas in which they are established and have developed a high level of expertise. The investor capital private equity firms raise for their funds has become increasingly globally mobile over recent years as private equity investors have sought growth opportunities in less mature and established markets.

An International Financial Services London (IFSL) report in August 2009[3] estimated that $189bn of private equity was invested in 2008, representing a drop of 40% from their figure for 2007. The level of investment activity within private equity fell sharply in response to the global financial crisis, reversing the strong growth seen in previous years. In particular, the share of total investments attributed to buyouts fell markedly from 89% in 2007 to 41% in 2008 with total numbers of buyouts falling 70% and 80% in Europe and the US respectively. Despite the fall in investment, fund raising remained relatively robust with an 8% fall on the 2007 figure down to $450bn, although indications are that the rate of decline in fund raising has been accelerating. The total amount of funds under management was in the region of $2.5tn, a 15% increase on 2007, partly due to a strong start to fund raising and partly due to firms choosing not to exit deals in an adverse economic climate.

North America has by far the largest private equity market; according to the IFSL report, with the region accounting for 26% of global private equity investments and 64% of funds raised in 2008. Europe's share of investments was 40% of global investment activity and funds raised accounted for 25% of the global figure. Since 2000 there has been a rise in the importance of the Asia-Pacific region and emerging markets as investment destinations, particularly China, Singapore, South Korea and India. The Asia-Pacific region now accounts for 9% of funds raised, but 29% of global private equity investment occurs in this region. The major change since 2007 has been a shift of investments away from the North American market towards Europe and the Asia-Pacific region (North America saw an 8% fall in share of investment, with Europe and Asia-Pacific regions gaining 6% and 2% respectively from 2007).

**Generic Industry Structure**

As identified above, the exact nature of a private equity firm structure can vary widely, and the actual structure of the private equity funds established by these firms can be highly complex. Some countries will have common structures across the full breadth of private equity business whilst in others fund structures will vary with circumstance. However, in the interest of clarity when describing, later in this report, potential conflicts that might occur it is necessary to outline some common characteristics and defining terminology for private equity firms and funds. Therefore the following description uses a multi-fund, multi-strategy private equity firm as a point of reference.

**Fund structures**

Private equity funds are generally formed as limited partnerships or a legally similar structure, which varies from country to country. A summary of the typical structures found

[3] *Private Equity 2009* International Financial Services London, August 2009 available at http://www.ifsl.org.uk/upload/PrivateEquity2009.pdf

within a number of countries can be found in Appendix 3. The partnership is formed of the investors as limited partners and a private equity firm as a general partner. A private equity firm may have a number of active funds at any time, each formed as a separate legal entity with separate general partners. The private equity firm and/or its staff will typically also invest their own capital alongside the fund's (this can generally be around 2-5% of the total committed capital of the fund, although in larger funds this amount can be higher).

**Fund life cycle**

Private equity funds are typically close-ended and are raised to have a life span of ten years. Most funds will be raised with the possibility to extend the fund life, typically with investor agreement, by up to three 1-year extensions. Subject to mutual agreement, such provisions could in theory lead to an almost infinite extension of the fund, although this would be significantly detrimental to the reputation of the fund manager. The life span of the fund is, along with a number of other key features of the fund, formalised in a contractual agreement (such as a limited partnership agreement (LPA)) made between the general partner and fund investors prior to the final commitment to invest. Investors often enter into side letter arrangements with the fund manager providing for certain additional terms and conditions such as enhanced reporting, or terms addressing tax or regulatory conditions uniquely applicable to an investor. In many cases, investors are covered by the same contractual agreement, generally benefiting from the terms negotiated by other investors in their side letters (the *most favoured nation* principle). In this sense, smaller investors in private equity funds sometimes benefit from the sophistication and bargaining power of larger investors, although in many instances an investor's *most favoured nation* rights are limited to terms of those investors with an equal or smaller commitment. Committed investor capital is not drawn down or invested by the fund manager at the point of agreement to invest, but rather is available to be drawn down by the fund manager throughout the course of the life of the fund as investment opportunities become available.

Private equity fund managers follow a strategy of investment and asset disposal that reflect the life span of the fund. Given the common ten year life of a fund, a typical fund cycle will involve an initial period of investment of around five years in which the fund manager identifies suitable investment opportunities that it expects to generate an appropriate return from investment within the remaining fund life span. As the capital committed is invested, the fund manager will increasingly focus on transforming and disposing of investments before the fund reaches its expiration. Where a fund manager is able to exit an investment before the end of the fund life cycle return they may do so if they perceive this will maximise overall value for investors. This means that the actual amount of time that the fund holds an investment in a company is generally well below ten years and is more often around three to five years.

Given the length of time it can take to raise a new fund and the fact that funds are often fully drawn down before the maximum life span, it is not uncommon for private equity firms to begin raising subsequent funds at intervals of around five years. Firms with a number of concurrent funds will often seek to raise funds more regularly. Firms will seek to raise new funds from a variety of sources although the most important of these tends to be investors in previous or currently active funds.

In assessing an investment opportunity a firm will consider the likely exit strategies. There are a number of avenues available for exiting investments with common routes including a

public sale of shares in connection with a portfolio company's initial public offering (IPO), a trade sale to a company which is interested in acquiring the investee company to complement their existing operations, a sale to the firm's management team, repayment of preference shares or a secondary sale to another private equity fund. The choice of exit will depend on a number of factors and can be a highly complex decision. Factors that may be considered include whether the fund wishes to make a partial or complete exit, the remaining growth potential of the portfolio company, the relative costs involved in completing the different possible exit strategies and feasibility, including an assessment of current market conditions.

**Investor Commitment**

Once investors have entered into the contractual agreement they are obliged to remain committed to providing the agreed capital throughout the life of the fund, although typically the fund manager is permitted to call capital to make new investments only during the investment period. Following the investment period, capital calls are usually allowed for the purpose of funding expenses, management fees, follow-on investments and repayment of permitted indebtedness. As the fund matures the amount of capital committed that remains outstanding will diminish as it is drawn down by the fund manager to make investments and pay expenses and returned to the investor following asset sales. Given that investor commitments remain binding throughout the life of the fund and given the typical length of investment in portfolio companies prior to returning funds to the investor, private equity investments are considered highly illiquid.

**Investment Decision Process**

Once the private equity firm has identified a potential investment they will typically make an investment proposal to an investment committee, formed from senior staff at the private equity firm. The committee will determine whether or not the investment should be pursued and set parameters for bidding for the company. The committee will reach its decision based on the consideration of a wide range of factors, particularly compatibility with the fund's investment strategy and the potential for medium to long-term growth within the remaining life span of the fund.

Before the final completion of an investment, due diligence <u>will customarily</u> have been conducted on the transaction by both internal staff and external consultants/advisers.

**Fees**

As a simplistic overview of typical fee structures, once investors have committed to a fund they will pay a management fee, typically an annual percentage (1-2%). During the investment period, the fee is generally calculated as a percentage of total commitments to the fund. Following the investment period, the fee is generally calculated as a percentage of *invested capital* (i.e. capital invested in assets which have not been sold). The fee is paid at intervals, usually quarterly. The private equity firm in its capacity as general partner will also typically be able to earn *carried interest*, which is a percentage (circa 20%) of the profits of the fund above a certain level of pre-agreed cash return (*hurdle rate*).

## Chapter 4 - Identified Areas of Risk and Methods of Mitigation for Conflicts of Interest within Private Equity

The following chapter provides an outline of the key conflict of interest risks that were considered to be both particular to private equity business and within the scope of this working group. The identified risks have been set out in order of the life cycle of a typical private equity fund rather than in any particular order of priority.

For the purposes of this report the life cycle of a typical private equity fund has been split into four stages. These stages are:

- Fund Raising Stage;
- Investment Stage;
- Management Stage; and
- Exit Stage.

**Characteristics of good practice in the private equity industry**

Measures to mitigate the occurrence of such potential conflicts of interest have been outlined for each risk identified. The working group identified four key mitigating factors which typically may serve to minimise the occurrence of conflicts of interest between the private equity firm and its fund investors, these are:

- Compensation arrangements:

  The majority of private equity firms (and their staff) only accrue performance related remuneration on realised profits and only after fund investors have received a full return on their investment plus a *cost of money* hurdle, having taken into account all fund costs and fees.

- Contractual agreements:

  Private equity funds are created following contractual negotiation and renegotiation between the private equity firm and its prospective fund investors on an individual basis. Such funds are established under a negotiated contractual agreement which will stipulate the material terms and conditions of the fund, often including, among other terms: the fund's structure; its investment strategy; the allocation of fees and costs; allocation of investment opportunities; any firm co-investment arrangements; the allocation and distribution of profits; the content and frequency of investor reporting; key-man and devotion of time provisions; and mechanisms for conflict and dispute resolution. Private equity funds are sometimes established subject to a *most favoured nation* clause which may provide less influential investors with the ability to benefit from more favourable terms negotiated by larger investors, thereby providing consistency among all investors, although in many instances an investor's *most favoured nation* rights are limited to terms of those investors with an equal or smaller commitment.

- Disclosure:

  As part of the process of establishing the fund, investors actively negotiate the terms and frequency of information disclosure to be made by the private equity firm on behalf of the fund. As a practical matter, larger investors often demand and enjoy better access to fund managers than the access enjoyed by smaller investors, even among highly sophisticated institutional investors. Some fund managers implement policies to address the potential conflict raised by disclosure disparity such as a prohibition on disclosure regarding current fund holdings.

  While clearly driven by local requirement and individual investor appetite, within developed private equity markets the provision and content of core investor reporting requirements has already been established.[4] Investor reporting centres around the production of regular fund valuation reports and transaction reporting (quarterly/semi-annually/annually) which provide investors, to varying degrees, with details of all new investment/divestment activity, a breakdown of both fund expenses/income and profit/loss, and a review of the performance of individual portfolio assets as well as annual investor meetings.[5] Disclosure to all investors should be clear, fair and not misleading.

- Consultation with investor committees:

  As part of regular fund reporting, it remains common practice for private equity firms to provide fund investors with details of any circumstances which have given rise to either perceived or actual conflicts of interest. However, funds operating within more developed private equity markets are typically established subject to a contractual requirement for each fund to maintain an investor advisory committee, comprising a small sample of fund investors (who are often the largest investors in the fund). The committee's main function is to review the firm's approach towards resolving all material fund related conflicts of interest (providing a forum for conflict management rather than investment decision making), in advance of the firm undertaking any particular proposed course of action.

Whilst the above categories are the major types of mitigation in place to address conflicts of interest they do not represent all possible methods for doing so. Other methods that may mitigate conflicts of interest include the establishment, where appropriate, of robust and effective information barriers between potentially conflicted business units.

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4 Industry participants have indicated that there is an established and generally good flow of information between private equity fund managers and fund investors. However, it is recognised that transparency and the adequacy of wider stakeholder disclosure by private equity firms is currently a topic of public debate.

5 Within developed markets the existence of industry standards detailing good practice for information disclosure between general partners and fund investors is already common place. However, residual concerns do still exist regarding the adequacy of such disclosure, particularly within less developed markets.

## A. Fund Raising Stage

### A.1 Investment advisors

In the course of establishing and operating a fund, private equity firms regularly employ the services of third-party advisors. For example, this may occur during the fund raising process where a private equity firm instructs an external placement agent to market the fund to a wider range of institutional investors. However, any intention the private equity firm may have to recover or attribute costs associated with the appointment of a placement agent to the fund on an undisclosed basis would present a material conflict of interest with its fund investors. Another area for concern relates to the provision of investment advice regarding the merits of investing in a particular fund(s), where the advisor may have failed to disclose to potential investors that it is incentivised by or affiliated to the private equity firm raising the fund.

*Mitigating factors:* Where third-party advisory fees are to be borne by the fund, the basis and/or amount of any such cost would normally be agreed in advance with fund investors via the limited partnership agreement, with the clear expectation that investors will receive appropriate disclosure of all actual costs as they are incurred. Fees associated with the engagement of a placement agent are often borne by the private equity firm (either directly, or paid by the fund with a corresponding offset against the management fee). In some cases, the fund splits such fees with investors and/or bears 100% of the burden over a specified threshold. We further note the need for potential investors to receive up front disclosure of the basis under which placement agents are being remunerated by fund managers.

### A.2 Size of fund – impact on return to limited partners

The final size of the fund is typically determined and agreed during the fund raising process by means of contractual negotiation between the private equity firm and prospective fund investors. There are many factors which contribute towards assessing the optimum size of the fund, such as market conditions, investor appetite, the fund's proposed investment strategy, target transaction size and the availability of leverage etc. However, there remains a potential conflict of interest between the private equity firm's desire to maintain its market position by raising funds of an increasingly larger size, set against the investors' need to ensure that whatever capital is raised can be effectively deployed towards suitably attractive investment opportunities within the fund's proposed investment period.

This conflict may manifest itself because of the way that the fund manager's annual fee is calculated. It is usual practice for the manager to receive an annual fund management fee during the fund's investment period calculated by reference to a percentage (e.g. 1-2%) of the total amount of investor committed capital, chargeable once the fund has reached its first closing. A larger fund has the potential, depending on the circumstances, to serve the interests of the manager without a corresponding increase in the attractiveness of the fund to the investors. Management fees are typically paid during the investment period of the fund, but may continue throughout the life of the fund. Although it is common for management fees to *step down* after the investment period, it is possible in significantly larger funds that the management fee may serve to undermine the proper incentive provided by performance related remuneration, for example, carried interest. This is the case where the amount raised is more than can be sensibly invested.

*Mitigating factors:* One method employed by private equity firms to demonstrate an alignment of interest, and relied upon by investors, is for the fund to be raised subject to the condition that the private equity firm and/or its staff commit to co-invest a set percentage on a parallel basis alongside the fund, based on the total amount of investor committed capital. A private equity firm's desire to protect its reputation and to maintain a good relationship with its investors to facilitate future fund raising is noted as a significant motivating factor.

However, the main mitigant against this potential conflict is the fact that the fund-raising process is subject to contractually binding negotiations between the manager and the investors, where investors are able to negotiate a *hard cap* limit to ensure that a maximum size is not exceeded at the *final closing* of the fund. As part of this process, investors will also seek to negotiate both the level and balance of management fees (where investors seek to challenge the creation of so-called *lifestyle* funds) against performance related payments to be received by the manager. In addition, in many cases, investors negotiate for lower management fee percentages on committed capital in excess of a certain size.

## B. Investment Stage

### B.1 Transaction fees – alignment of interests

Private equity firms may seek to charge the underlying portfolio company(ies) fees for work undertaken as part of completing a fund transaction. Such fees include, but are not limited to, underwriting fees and arrangement fees. While not directly chargeable to the fund, the receipt of such fees by the private equity firm has a negative financial affect on the investee company and, therefore, detracts from the economics of the fund's investment. The terms governing the nature and basis under which transaction-based fees become payable to the firm are generally agreed in advance with investors when the fund is established. However, it is recognised that the quantum of such fees cannot be readily known in advance as the resulting transactions have yet to be completed.

*Mitigating factors:* The ability of fund investors to negotiate the contractual terms under which the private equity firm can charge and retain such transaction-based fees is viewed as being an effective mitigant. This can be further strengthened where investors require the private equity firm to provide disclosure of all actual transaction fees received as part of ongoing fund performance reporting. In addition, it is recognised that investors often have the ability to negotiate to varying degrees with the fund manager to either off-set all, or part of, any transaction fees received against the management fee. However, it is recognized that this mitigant may not be as effective for investors, such as small investors, who may have limited ability to influence fund terms.

### B.2 Conflicting Investment Strategies

Within the private equity industry, multi-strategy firms which have either overlapping or fundamentally competing investment strategies are relatively common. Typically, this can occur where the firm operates a private equity fund alongside a credit/debt fund. In such circumstances, it is recognised that investment opportunities may present themselves which lead to multiple pools of capital operated by the same firm being invested in the same target company, potentially doing so at different levels within the capital structure. This is best illustrated where a private equity fund invests in the equity of a company alongside a credit fund which invests in that company's debt. To the extent that the investee company's

performance remains positive, the private equity firm's ability to act in the interests of both sets of fund investors remains well aligned. However, that alignment of interests may be undermined where the investee company experiences financial distress and the interests of investors in different parts of the capital structure diverge.

*Mitigating factors:* This risk reinforces the need for those private equity firms managing funds with potentially conflicting investment strategies to maintain well-defined fund investment mandates/strategies, with a clear delineation of the investment decision-making process. To the extent possible, it remains common practice for such controls to be detailed within fund documentation, such as the limited partnership agreement. On this basis, the establishment of robust and effective information barriers between potentially conflicting or competing business units is viewed as being an important mitigant. Where such conflicts arise, the main mitigant is the firm's ability to provide, and the investor expectation to receive, advance disclosure of the firm's proposed handling of the transaction, via the relevant fund investor advisory committees.

### B.3 Investment Allocation

Under the typical private equity business model, private equity firms are subject to a requirement which prevents them from raising/investing a new fund with the same or similar strategy until the preceding fund has invested a predetermined amount of its committed capital (typically between 75% – 90%). This protects the interests of investors in the preceding fund, while still providing the firm with access to sufficient capital to complete pipeline investment opportunities during the fund raising process. However, this approach creates a situation where for a period of time the private equity firm may have discretion over how to allocate investment opportunities between the two funds until such time as the preceding fund is fully invested. Similarly, conflicts of interest may also occur where a fund operates two or more funds with overlapping investment strategies. The most widespread method of addressing this potential area of conflict is for the private equity firm to give priority towards allocating all suitable investment opportunities to the preceding fund. However, through negotiation with investors, other fund terms may stipulate that investment opportunities are to be allocated between the relevant funds on a *pro rata* basis, or provide the flexibility to allocate larger investments in their entirety to the successor fund to avoid issues associated with joint ownership. Levels of exposure within funds (by geography, sector, currency, etc.) can also influence this decision making process.

Another potential area for conflicts of interest to occur is where follow-on or rescue financing is required for a portfolio company, which is being provided by another fund operated by the same private equity firm. This will usually occur where the fund has exhausted its investment capital or is reaching the end of its life. In such transactions, key issues to address for the fund manager include:

(i) establishing the price at which the equity is being provided; and

(ii) ensuring that the assets of the new fund are not being used merely to *prop up* the preceding fund at the expense of other, preferable investment opportunities.

It is common in such circumstances for the private equity firm to seek a valuation from an independent third party (or a valuation point by reference to what an independent third party is prepared to pay).

*Mitigating factors:* The strategy and investment criteria of a fund are the subject of contractual negotiation between the fund manager and investors when the fund is being established, which will take into account the extent to which the manager currently has, or may raise in the future, funds with overlapping investment strategies. Where such funds have been raised, it is common practice for the private equity firm to provide advance disclosure to both sets of investors, via their respective investor advisory committees, of all proposed transactions to be undertaken by its funds which could give rise to the potential for perceived or actual conflicts of interest to occur. In instances where a private equity firm has a practice of giving priority towards allocating all suitable investment opportunities to a preceding fund, such practice should be disclosed to prospective investors in the new fund before they invest in the new fund. In addition, the fund agreement may contain an express limitation on the number of investments which can be made by more than one fund managed by the fund manager.

It is noted that where mitigating the risk of conflict associated with follow-on or rescue financing, firms must place primary reliance upon making adequate investor disclosure (via the respective fund investor advisory committees) particularly with respect to investors in the succeeding fund, ahead of the initial round of financing and ahead of every additional round of financing thereafter.

### B.4 Co-investment by General Partners

Co-investment by the private equity firm (or its affiliates) alongside the fund is seen as a positive and motivating factor in aligning the interests of the firm/its staff with fund investors. However, conflicts of interest can occur if the private equity firm is permitted to invest on a deal-by-deal basis and/or on different terms to those offered to fund investors. For example, where the amount of capital being invested is altered based on the merits of a particular transaction (so called *cherry picking*), or where the manager or its affiliates are offered preferential terms of investment, such as sweet equity or loan finance.

*Mitigating factors:* Typically, private equity fund contractual terms will stipulate the basis under which the fund manager and/or its staff are required to co-invest alongside the fund. Generally, such terms will require a 2-5% *pro rata* participation by the firm which must invest in all deals *pari passu* with fund investors. It is noted that the use of preferential co-investment terms by private equity firms has been, to a large extent, eliminated in developed private equity markets, but may still represent an issue in emerging markets with a developing private equity presence.

### B.5 Deal Co-investment by Fund Investors

To enable the fund to participate in larger transactions (which otherwise would be too large for the fund or would breach its investment diversification limits), the private equity firm may offer fund investors the opportunity to co-invest directly alongside the fund on a particular deal. There are positive aspects of such arrangements, as they enable the general partner to retain investment control by avoiding the need to undertake joint deals with other private equity firms, and they provide the investors with an opportunity to increase their investment usually without having to pay a management fee and at a reduced or no carried interest on the additional exposure. While all limited partners should be informed if co-investment can occur and will therefore have an expectation to be notified when such

opportunities arise, if they have indicated an interest in being involved in such opportunities, Private equity firms will generally seek to identify investor appetite to commit to such co-investments when the fund is being established. Although the nature of these opportunities is such that resulting availability cannot be readily known in advance.

The practicalities of completing private equity transactions mean that only those investors with the ability to commit quickly are likely to be offered specific co-investment opportunities, which private equity firms argue protects the overall interests of the fund's investors. However, while understandable this approach does present the risk that certain investors will be favoured by the private equity firm and given more access to these investment opportunities, at the expense of other investors who may be equally as willing and capable. Where limited partners are charged management fees on such co-investment opportunities it creates a potential conflict for the general partner, given the potential incentive to source co-investment deals as a means of fee generation.

*Mitigating factors:* To ensure that all investors are equally aware of the discretionary nature of co-investment invitations, to the extent possible, it is common practice for the private equity firm to notify investors that co-investment opportunities will be offered to suitable investors at the firm's total discretion, if and when they are identified. As part of ongoing investor reporting, the basis under which certain investors have undertaken deal co-investment should be disclosed to all of the other fund investors, consistent with legal and regulatory requirements and duties of confidentiality. It is sometimes the case that private equity firms waive management fees with respect to co-invested monies.

## C. Management Stage

### C.1 Other Fees derived by Fund Manager

Once a transaction has been completed, the manager may continue to receive other fees from the investee company on an ongoing basis, such as director's fees, monitoring fees and consultancy fees. However, any fees derived directly or indirectly as a result of the fund manager's relationship with the investee company may not be transparent and, therefore, create a potential conflict of interest with the manager's obligation to its fund investors. In this regard, it is noted that as a matter of general fiduciary law (although this requirement may differ by jurisdiction) the fund manager is required to adequately disclose to its fund investors the nature of any fees it may receive so as to obtain their informed consent to the receipt of such fees.

*Mitigating factors:* Investors may be able to protect their interests by agreeing in advance the extent to which the manager is permitted to retain fees derived from its relationship with investee companies. Effective mitigation may be achieved by ensuring that the fee structure is clearly set out in the fund's contractual documentation; where any applicable fees paid to the manager are, to a lesser or greater extent, offset against the fund management fees and verified by a third party, and in instances where actual fees are being charged, detailed disclosure is provided to fund investors on an ongoing basis.

### C.2 Fees derived by Manager Affiliates

On a similar basis to the risk of conflict presented by a fund manager receiving fees from an investee company, the manager may seek to appoint an affiliated party to provide chargeable

services to the fund and/or an investee company which are not awarded to that affiliate on a competitive arms-length basis.

*Mitigating factors:* To protect their interests, investors may be able to negotiate contractual limitations on the nature of any services to be provided to the fund and its investee companies which the fund manager may seek to award to affiliated parties, and to ensure that any related fees are verified by a third party and clearly disclosed to investors as part of ongoing fund reporting. The use of a tendering process also may act as an effective mitigant, where the disclosure of third-party bidding for mandates is made available to fund investors.

### C.3 Shareholder-Directorship Appointments to Portfolio Companies

It is common practice within the industry for a private equity firm (on behalf of the fund) to require that a member of its staff is appointed to the board of the investee company to monitor performance and effect business improvements. This dual role creates an ongoing obligation for the appointed individual to consider the needs of both parties independently, and to ensure that any information received from either party is not shared inappropriately. While it is generally considered that the interests of the firm, its fund investors and the portfolio companies are well aligned, that alignment may break down in instances where, for example, the investee company may be seeking additional funding as a result of extreme financial distress. However, in such circumstances it is common for the private equity firm to instruct another member of its staff (or independent party) to monitor the investee company on behalf of the fund, leaving its board representative free to fulfil those duties owed to the investee company. This issue is already addressed under company law which often clarifies the requirement that as a director of the investee company such individuals have a primary responsibility to the company.

In addition, where an investee company is exited via an IPO, it is common for the private equity firm to retain a board seat on the newly listed portfolio company for as long as the fund retains a significant stake. However, this creates a situation where that individual, in their capacity as a board member of the investee company, is restricted in the information they are permitted to disclose to the private equity firm. It also creates a situation which restricts the private equity firm's ability to divest the fund of its remaining investment in the listed company.

*Mitigating factors:* The primary mitigant is the fact that the board member owes a duty to the portfolio company. Private equity firms can further enforce this by ensuring that all staff (and external parties) appointed as a director of a portfolio company are formally made aware of their legal responsibilities, with the use of disclosure clauses detailing how information gained by directors of investee companies can be disclosed to other members of the private equity firm.

To enable the fund to trade out of its shares in the listed company without being restricted by the receipt of inside information, the firm may seek to sell down the fund's stake with a view to resigning its appointment to the board. Although in practice the exit strategy of such an investment will be weighed against the importance for the private equity firm to demonstrate an ongoing commitment to existing shareholders of the portfolio company.

## C.4 Allocation of Management Resources by Private Equity Firms

There is a perception that private equity firms may seek to reduce or completely divert staffing resources away from monitoring portfolio companies owned by a poorly performing fund in favour of other better performing funds, particularly where that fund has no chance of delivering carried interest for the private equity firm or its staff.

*Mitigating factors:* The main mitigant against such practice is the establishment of defined clauses which seek to protect investors' interests, such as; the *no fault divorce* clause, where investors can effectively stop the private equity firm's investment mandate without having to demonstrate cause; and the *key-person* clause, where the private equity firm is required to ensure that certain individuals remain focused towards managing a particular fund(s). In this regard, the initial fund documentation such as the private placement memorandum provides investors with a high level of transparency regarding the firm's available resources. In addition, the private equity firm's desire to protect its reputation and to maintain a good relationship with its investors to promote future fund raising is noted as a significantly motivating factor to continue to allocate resources to poorly performing funds.

## C.5 Enforcement of Default Remedies

Most fund agreements provide for remedies in the event an investor defaults and fails to meet a required capital call. These remedies can include a forfeiture of a significant portion of the defaulting investor's interest in the fund (25-75%). However, in some cases the enforcement of remedies is at the discretion of the fund manager. In such a case there is a potential conflict if the fund manager is in a position where it has to balance the best interest of the non-defaulting investors and its ongoing relationship with the defaulting investor(s). However, given that the investor has defaulted in many cases there may well be no ongoing relationship.

*Mitigating factors:* To protect their interests, investors are able to negotiate in advance the terms upon which the default remedies should be applied. Investors can seek to require investors to be placed into default and that certain remedies are applied in the event the default is not cured within some period of time. In addition, investors can negotiate to require prompt disclosure from the fund manager to the investor advisory committee regarding investor defaults and the remedies being applied.

## C.6 Rescue Financing

As a result of the recent financial crisis, many portfolio companies are requiring additional capital to fund their operations and/or refinance indebtedness. Accordingly, many private equity funds lack sufficient un-drawn capital commitments and reserves to fully fund the business plans of these portfolio companies. In order to secure additional funds, some fund managers are seeking additional commitments from existing or third party investors on preferred terms senior to existing investors. Those investors who do not participate can face significant dilution of their investment. These rescue financings present significant conflicts as they may skew the alignment of incentives between those investors which were invited to participate in such offerings against the interests of those investors which were not presented with the same investment opportunity.

*Mitigating factors:* The main mitigant against such practice is for investors to specifically

negotiate super-majority approvals for such rescue financings, to require that any rescue financing be first offered pro rata to existing fund investors.

## D. Exit Stage

### D.1 Extension of Fund Life

As noted earlier, most private equity funds are established contractually with a life span of ten years, typically with scope to invoke extension periods consisting of up to three 1-year extensions, subject to investor approval. The extension periods are intended to be used to provide the fund manager with additional time to divest the fund of any remaining assets, otherwise it would be faced with either potentially selling assets at a reduced price or distributing the fund's remaining assets *in specie* (which investors generally view as undesirable). However, the application of such extension periods may present a potential conflict of interest if used by the fund manager for its own benefit, for example, where motivated by the accrual of additional management fees.

*Mitigating factors*: Investors are often able to negotiate to provide that some or all of the term extensions will be subject to investor advisory committee approval. The terms under which management fees are paid to the fund manager during the fund extension period are agreed with the investors when the fund is being established. In addition, the enactment of one or more of the extension periods by the manager would normally trigger a fee renegotiation with the fund's investor advisory committee. In such circumstances, it is not uncommon for investors to stipulate that the manager is not entitled to charge additional management fees.

### D.2 Generation of Market Value Fees

It appears to be un-common practice within developed markets for funds to be established on the basis that the manager will receive any fees based on the current market value of the fund or its underlying investments. This is particularly true of the traditional limited partnership model. Nevertheless it is acknowledged that funds may be established with such market value based fees. In certain circumstances, generating marked-to-market data may be necessary, for example by private equity fund of funds, to enable the manager to show case fund performance ahead of forthcoming fund raisings. However, conflicts of interest can occur where the fund manager is incentivised to overstate fund valuations, for example, with a view to receiving a larger management fee or presenting past performance to potential investors.

*Mitigating factors:* Accepted market practice is for the fund manager to receive its management fees during the fund's investment period based on the total value of committed capital at the final close of the fund (in accordance with recognised industry valuation principles and guidelines, such as the International Private Equity and Venture Capital Valuation Guidelines). After the fund's investment period management fees are calculated based on the total amount of still invested drawn down capital, held at cost (or where appropriate, written down asset value). Whether invested capital should be written down is also subject to the recognised valuation standards.

The most effective mitigants against the risks associated with market value fees is for the investors to contractually agree in advance the basis under which the fund manager will be remunerated, and to ensure that the manager provides detailed disclosure of all such fees on

an ongoing basis, which should be verified by an independent third party. It may also be advisable to establish and disclose valuation policies and procedures. It is noted that the use of external fund auditors is established industry practice. Moreover, investors often negotiate and approve (either directly or through the investor advisory committee) the fund's valuation methodology.

### D.3 Divestment Timing of Assets held by Multiple Funds

The basis under which the fund manager determines the most appropriate timing to exit a portfolio investment can create a conflict of interest, particularly where that investment is jointly owned by two or more funds operated by the same manager. Despite the recognition that joint holdings are likely to be owned by funds that are at different stages of their life cycle, it is generally considered preferable for the manager to enter into such transactions on the basis that it will divest all funds of their investments simultaneously. The timing for divestment will normally be determined by reference to the fund which made the original investment or that has reached the end of its life first. However, this approach may still present the fund manager with a conflict of interest in terms of deciding between divesting an investment at the end of one fund's life, set against the potential for a younger fund to benefit from receiving greater returns if the investment is held for a longer period.

*Mitigating factors:* There are a number of potentially effective mitigants that a fund manager and its investors may employ to manage the risk of conflict, including contractual provisions requiring the disclosure of exit criteria in fund agreements (e.g., non *pro-rata* divestitures to be approved by the investor advisory committee), the disclosure of proposed exit rationale to the funds' respective investor advisory committees, disclosure to investors of actual divestments via ongoing fund performance reporting, and the ability of the fund manager to extend the fund's life beyond its original term to maximise investment returns. In the event of a transaction between funds under the same management, a validation by the investor advisory committee of the approach used to establish the price may be an effective mitigant.

### D.4 Retention of Minority Stakes by a Fund

There may be instances where a fund manager will arrange to sell the majority of a fund's investment in an investee company to a third party, but given its perceived growth potential, will seek to retain a minority stake in the investee company for investment by one of its other funds. This is more likely to occur in venture capital investments where the fund may not be of a sufficient size to enable it to finance the portfolio company's follow-on investment needs. For example, such situations can occur in *down rounds* where the portfolio company is in financial trouble and in *up rounds* where further capital is required for continued growth and expansion. Given that the fund manager is, in effect, on both sides of the transaction (representing the interests of two sets of fund investors), this creates the potential for conflicts of interest to arise in respect of the pricing of the transaction. A similar conflict exists where a fund manager seeks the sale of an asset between the funds it manages.

*Mitigating factors:* Given the obvious potential risk for conflicts to occur in such transactions, it is common practice for the fund manager to refer its proposed handling to the relevant investor advisory committees in advance of the deal proceeding. It is further noted that general partners observing good industry practice will generally establish and disclose to investors, at the time when the fund is being established, their divestment strategy in the event of an IPO disposal. However, the main mitigating factor is the third party's own

commercial incentive to purchase the investee company at an attractive price.

### D.5 Sales of Fund Interests

Throughout a fund's life there may be occasions where investors seek to sell their interests in the fund in the secondary market. Generally the fund's contractual agreement will contain a standard clause that requires any transfer of ownership to a third party to be signed-off by the fund manager, in some cases at the manager's sole discretion, often with the proviso that such approvals should not be unreasonably withheld. However, this approach can present a potential conflict of interest where it may be in the investor's best interests to sell its investment to a party which the fund manager may deem to be an unsuitable buyer, for example, a competing private equity firm. It is noted that the potential for conflicts to occur is exacerbated where the general partner and/or the private equity firm is active in the secondary market for limited partner fund investments.

*Mitigating factors:* The potential for this conflict to arise is partially mitigated through investor disclosure; the standard terms of a fund's contractual agreement typically state that the investment in the fund is an illiquid asset and that the manager will be able to restrict any secondary sales deemed to be inappropriate, at its own discretion. To avoid conflicts relating to the valuing of investor interests in the fund, the manager should not seek to be involved in the negotiation of any such transaction.

## Chapter 5 - Principles for the Effective Mitigation of Conflicts of Interest in Private Equity Firms

These principles were developed using a multi-fund, multi-strategy private equity firm as a reference point. 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.

Listed below, in bold italics, are the principles for mitigation of conflicts of interest in private equity firms. Each principle is followed by explanatory text and should be read in conjunction with the preceding sections of this document.

1. ***A private equity firm should 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.***

A private equity firm's clients are the funds it manages (whether the fund is a single legal person or a group of investors acting together). Whilst the private equity business model creates the need for the fund manager to establish contractual relationships with a range of connected and un-affiliated parties, its primary duty is to its fund client(s). Examples of connected and affiliated parties include cornerstone investors, portfolio companies, and finance providers, affiliated companies, principals of the private equity firm and employees of the private equity firm. Some of these relationships have the potential to give rise to conflicts of interest with those obligations owed by the fund manager to its fund(s) and external investors.

It is important for a private equity firm to structure its business in such a way that it can effectively manage all relevant conflicts of interest and the firm should seek to place primary importance upon those obligations owed to the fund(s). A private equity firm should seek to manage conflicts in a way that is in the best interests of its fund(s) and therefore the overall best interests of fund investors.

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.***

These policies and procedures should clearly set out the firm’s governance over the process of policy development and the roles and responsibilities of parties involved in implementing the policies and procedures. The policies and procedures should also be consistent with any legislation and regulation applicable in any of the jurisdictions in which the firm operates, and they should be applied consistently across the range of businesses, funds and locations that the firm operates.

The policies and procedures should be drafted so as to be appropriate for the size, scale and structure of the private equity firm and should cover the entire lifecycle of a firm’s relationship with its investors. Firms should conduct holistic reviews of their business, including a consideration of activities and structure of the wider group over time to ensure that their policies and procedures remain appropriate. Issues which should be considered/addressed within the policies and procedures include:

a) the specific processes through which conflicts will be identified;

b) the tools a firm will use to mitigate conflicts (e.g., disclosure, use of investor representation/consultation); and

c) the process through which identified conflicts will be disclosed to investors.

***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.***

The policies and procedures should be established and documented prior to the inception of a fund by a private equity firm. They should be made available, alongside other constitutional documents relating to a fund (such as a Limited Partnership Agreement), at an appropriately early stage of negotiation with prospective investors, to allow them to be incorporated into the investor's decision making process. The purpose, and significance, of the policies and procedures should be clearly highlighted to investors who should also be afforded a mechanism with which to offer feedback.

Furthermore, as the policies and procedures will be subject to periodic review and potential update, as updated versions become finalised they should be available to all investors on an equal basis. The policies and procedures should include clear guidelines regarding the process through which any changes will be communicated.

***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.***

The environment in which private equity firms operate is subject to continual change, as is the scale and scope of a firm's business. This may result in a firm's policies and procedures becoming inappropriate or ineffective to address new and/or existing conflicts. It is therefore important that a firm establishes a clearly defined approach to reviewing its policies and procedures to ensure they remain fit for purpose. The review should typically be conducted at pre-defined intervals, or when change to the business model or environment demands. The responsibility for areas including: the timetable of review; the responsibility for conducting the process; and its overall governance and oversight should be clearly defined within the policies and procedures, and therefore available to investors.

The periodic review of the policies and procedures should also include analysis as to the appropriateness of their application. This may take the form of, for example, a Compliance Monitoring Plan or internal audit. The review should focus on whether the procedures have been implemented effectively and are being observed both in terms of the letter, and spirit, of the policies.

Where review of the policies and procedures, or their application, highlight deficiencies then appropriate action should be taken, in a timely manner, to address the relevant issues. Where a materially substantive update is required to the policies and procedures, the change, its purpose and rationale should be made available to all investors in a timely manner and in accordance with Principle 3.

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

As has been discussed in previous sections of this document, appropriate mitigation of potential conflicts of interest that can occur between a private equity firm and its investors can take many forms. Mitigants can include addressing the conflict via: legally binding documentation; disclosure to investors; delegation of certain tasks to independent third parties (such as auditors); open competition for certain services; and reallocation of responsibilities with a firm. A firm should ensure it is organised to reduce or eliminate conflicts of interest by implementing, where appropriate, segregation between conflicting operational activities or business units, for example by the use of effective information barriers.

Where a range of mitigation techniques are available to a private equity firm then the firm should choose the most appropriate mitigant. In considering the appropriateness of different mitigants a firm may consider relevant cost benefit factors including: the specific conflict in question; its potential impact on investors; the size and scale of the private equity firm; its business model; and its relationship with the investors who may be affected.

If a variety of mitigation techniques are available, with approximately equivalent costs and benefits to investors, then a firm should aim to provide disclosure about the action taken that provides the greatest level of clarity to investors, taking into account any preferences expressed. Mitigation techniques should also provide the greatest potential for recourse, including contractual recourse, in the case of investor detriment. This should help provide investors with the greatest confidence that the conflict in question has been effectively mitigated. However, in effecting such a mitigation strategy the firm should seek to ensure that it continues to operate in accordance with the other principles contained within this document.

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.***

Many potential conflicts of interest can be effectively dealt with through discussion and collaboration with the investors who may be detrimentally impacted if the conflict were to crystallise. To facilitate this process, a firm should establish a clearly defined process for engaging in investor consultation. This process should be appropriate for the size and scale of the firm's activities and the range of investors in its funds. A regularly used method for facilitating investor consultation has been through the use of investor advisory committees. Where such a structure is used, clearly defined and documented Terms of Reference should be established to cover points including: selection and appointment of committee members (in agreeing the composition of the committee consideration should be given to the relevant expertise and availability of potential members); the range of issues on which the committee should be consulted; the method and timeliness within which consultation will occur; and the nature of opinion given by the committee. However, it is recognised that firms operating smaller and less complex business models may be able to establish equally effective investor consultation mechanisms which place reliance upon other forms of communication, i.e. electronic or paper based media.

7. ***A private equity firm should disclose the outcome of discussions from 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).***

It is recognised that all investors are likely to have an interest in opinion given through the investor consultation process. It is therefore important that the process is transparent to all relevant investors. The outcome of discussions, including the substance of any opinion in opposition to the final outcome of the discussion, should therefore be consistently disclosed to all relevant investors as soon as is appropriate. Often this will be through regular investor reporting mechanisms that the private equity firm has put in place and agreed with its investors.

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

The use of disclosure has been highlighted as an important method of mitigating conflicts of interest that occur during the course of private equity business. It is recognised that the method and substance of individual disclosures will vary according to the exact requirements of the item being disclosed and the nature of the relationship between the private equity firm and its investors. In all cases, it is imperative in maintaining stakeholder confidence, that a private equity firm does everything possible to ensure that disclosures are clear, complete, fair and not misleading.

Firms should consider the most appropriate form of disclosure incorporating upfront and ongoing disclosures to investors.