Private Equity Conflicts of Interest

Final Report

TECHNICAL COMMITTEE
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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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

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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 will customarily 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.

Appendix 1

Feedback Statement on the Public Comments Received by the Technical Committee on the *Consultation Report – Private Equity Conflicts of Interest.*

Non-confidential responses were submitted by the following organisations to IOSCO consultation entitled *Consultation Report: Private Equity Conflicts of Interest*. The deadline for comments was 1 February 2010.

Association of the Luxembourg Fund Industry (ALFI)

Associazione Italiana de Private Equity e Venture Capital (AIFI)

British Venture Capital Association (BVCA)

CFA Institute (CFA)

Conseil déontologique des valeurs mobilières (CDVM)

Mr. Patrick Velay.

These responses can be viewed in Appendix 2 of this document. IOSCO is grateful for the responses and took them into consideration when preparing this final report. The rest of this section reports on the main points raised during the consultation.

Comments received

In general, responses to the consultation paper were supportive of IOSCO's work and were broadly in agreement with the risks identified in the report and the principles set out for the effective mitigation of conflicts of interest in private equity.

Identified areas of risk of conflicts of interest

The responses received generally agreed that the consultation report had appropriately identified the risks of conflict of interest that might arise in the private equity industry. One respondent indicated that whilst these were generally specific to the private equity industry some would be faced by other types of firm, whilst another indicated that some of the identified risks would be mitigated in some jurisdictions by specific legal and regulatory requirements.

Based on the responses received IOSCO has made minor amendments to its report with respect to the risks of conflict and potential mitigation techniques identified in the report. As this report is due to comment on the broad range of conflicts of interest that may be faced in private equity, irrespective of jurisdiction or the size and scope of activities of the firms concerned IOSCO considers the document appropriate in its current form.

Principles for the effective mitigation of conflicts of interest

The report set out eight principles for the effective mitigation of risk. Respondents were broadly supportive of the principles and their application.

A number of comments were received regarding the drafting of some of the principles. In particular one respondent highlighted that investors would not necessarily wish, or need, to know the substance of every discussion within the investment advisory committee but would expect to know decisions reached and if there would be dissenting views.

IOSCO also received a number of responses regarding the text providing additional detail on the application of the principles. As an example, one respondent suggested that under principle two a private equity firm could be expected to review its business, including its wider group, over time to ensure its policies and procedures remain appropriate.

One respondent, whilst agreeing that the principles were appropriate, suggested that the principles should cover not only operational measures but also contractual agreements and obligations entered into by private equity firms.

As a result of the comments received IOSCO has made a number of changes to some of the final principles for the effective mitigation of conflicts of interest and the accompanying additional information. IOSCO considers these enhance the clarity and appropriateness of the principles for use by industry participants in managing the risks of conflicts in their business.

Conclusion

In view of the comments received during the consultation the TC does not believe significant changes are merited to the original report. However, based on feedback received, a number of amendments have been made to enhance the coverage and appropriateness of the principles. IOSCO therefore considers the Private Equity Report, as contained in the remainder of this paper, to be final.

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

Italian Private Equity and Venture Capital Association

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

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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;

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- 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

Carol Dumdall

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

Centre for Financial Market Integrity

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29, January 2010

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.

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,

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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
C / Oquendo 12
28006 Madrid
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

Appendix 3 - Typical Private Equity Fund Structures in Various Jurisdictions

This Appendix aims to give the reader a view of the diversity of legal and operational structures found in the private equity industry globally to help identify how the principles may be applied in these jurisdictions.

Brazil

The most common structures for private equity and venture capital operations in Brazil are the following:

a) Fundos de Investimento em Participações – FIPs (Private Equity Funds); and

b) Fundos Mútuos de Investimentos em Empresas Emergentes – FMIEEs (Seed and Venture Capital Funds).

The private equity (FIP) and seed and venture capital (FMIEE) vehicles are structured as funds due to some characteristics of the local business environment, such as tax benefits, when compared to SPC, LLC and other types of structures, and the regulation of CVM that provides the legal framework for these funds.

Private Equity Funds – FIPs

This structure is designed for private equity investment purposes, more specifically for investments in mid and large cap companies, where the FIPs must have an active influence in the governance.

The FIPs are close-ended funds (no redemptions) and restricted to the so-called qualified investors (institutional investors, financial organizations, insurance companies, high net-worth individuals, among others).

These funds are managed by an independent manager and are registered and supervised by CVM.

Seed and Venture Capital Funds – FMIEEs

This structure is designed for the investment in seed/venture capital and small cap companies.
Like the FIP, the FMIEEs are managed by an independent manager, regulated and supervised by CVM.

These funds are also close-ended funds (no redemptions) but, unlike the FIPs, there isn´t any investor´s target public restriction (non-qualified investors are allowed). However, FMIEEs are, in fact, mostly invested by qualified investors.

It is also important to mention that both types of funds are required to submit to the CVM certain information and documents on a regular basis, including their financial statements, audited by an independent auditor registered with the CVM, as well as the composition of the portfolio.

France

The most commonly used structures for private equity funds in France are:

a) The *Fonds Commun de Placement à Risques* (*FCPR*) –some of which allow for retail investment and thus fall out of the scope of this report. FCPRs have the legal status of a specific form of French collective investment schemes (*OPCVM*);

b) *Société de Capital Risque* (SCR) which have the legal status of corporate entities.

Fonds Commun de Placement à Risques (FCPR)

The FCPR is defined in law as a joint ownership of securities (*copropriété d'instruments financiers et de dépôts*). It is not a separate legal entity and for this reason does not have the legal capacity to enter into contracts. Any contracts must be concluded by the Management Company. The minimum capital required to form an FCPR is €400,000. FCPRs are eligible to certain tax advantages. The latter accrue however exclusively to natural persons.

An FCPR is founded by two founders, the Management Company (*société de gestion de portefeuille*) and the custodian (*dépositaire*). The Management Company must have its registered office in France and must be authorised by AMF (*Autorité des Marchés Financiers*), the French financial market authority. It has sole responsibility of the management of the FCPR including all decisions to make or to sell investments of the FCPR.

Before being offered to the public, FCPRs need to be authorised by the AMF and possess as a result the status of authorised FCPRs (*FCPR agréés*).

Within the general FCPR regime, which pertains to the legal framework of French national collective investment schemes (*OPCVM*), specific rules apply to four subcategories of vehicles:

- Two types of vehicles with more specific investment strategies:
  - FCPIs (*Fonds Commun de Placement dans l'Innovation*) which specialise in investing in innovating, non-listed companies;
  - FIPs (*Fonds d'Investissement de Proximité*) which specialise in the financing of a specific region.
- Two types of FCPRs offered to qualified investors only, which are, as a result, subject to simplified investment rules and exempt of AMF authorisation requirement (they only have to register):
- FCPRs with streamlined investment rules (*FCPR allégés*), which maintain some investment constraints but are not required to comply with commitment and risk diversification ratios;

- Contractual FCPRs (*FCPR contractuels*), a category of FCPRs created by the Economic Modernization Act (*loi 2008-776*) of August 4, 2008 which, in addition, alleviates investment requirements, the latter needing to be specified on a contractual basis in funds' rules.

The Société de Capital Risque (SCR)

The SCR must take the legal form of a *société par actions* (SA), a French *société en commandite par actions* (SCA) or a French *société par actions simplifée* (SAS). It is therefore subject to the rules applicable to such companies. The SCR is managed internally by either a board of directors or by one or more managers (there is normally no independent management company).

All investors are eligible to subscribe in an SCR, including individuals. However, provided the SCR opts for a special tax treatment –and meets related requirements– it is entitled to certain tax exemptions and its unit holders may obtain certain tax benefits. In order to qualify for such tax benefits, an SCR must have as sole purpose to invest in a portfolio of investments.

Germany

The most suitable structures which are available for private equity funds in Germany are as follows:

a) the Limited Liability Company (Gesellschaft mit beschränkter Haftung (GmbH));

b) the Limited Partnership with a GmbH as the sole general partner (GmbH & Co. Kommanditgesellschaft (GmbH & Co. KG)).

In addition, the Unternehmensbeteiligungsgegesellschaft (UBG) (special investment company) has been designed specifically for the private equity sector. The UBG is a special licensed investment company for risk capital formed in accordance with the provisions of the UGB Act (Gesetz über Unternehmensbeteiligungsgesellschaften). Under current regulations it is not common to use the UGB as an investment vehicle.

The Gesellschaft mit beschränkter Haftung (GmbH)

The GmbH is a legally separate entity from its shareholders, which may be partnerships, corporations or individuals. Shareholder liability is limited to the amount of their respective subscriptions.

The GmbH & Co. Kommanditgellschaft (GmbH & Co. KG)

A limited partnership (Kommanditgellschaft (KG)) is a commercial partnership established by one or more limited partners (Kommmanditisten) and a general partner (Komplmentär). The liability of the limited partners is limited to the amount of their respective capital subscriptions.

India

Private equity in India can be structured as a Venture Capital Fund, an investment company or as a limited liability partnership. The structure of limited liability partnership has been recently introduced through the Limited Liability Partnership Act, 2008.

Venture Capital Funds are regulated by the Securities and Exchange Board of India (SEBI) and certain tax incentives have been provided to such funds which may not be available to entities which do not register as Venture Capital Funds with SEBI. The structures under which a Venture Capital Fund can be set up in India are:

a) Trust (set up under the Indian Trusts Act, 1882);

b) Company (established under the Companies Act, 1956);

c) Body Corporate (set up or established under the laws of the Central or State Legislature).

With the introduction of the Limited Liability Partnership Act, 2008, Venture Capital Funds can also be structured as LLPs.

Venture Capital Funds are required to have minimum firm commitment from investors of Rs.50 million. There is also a per investor minimum investment requirement of Rs.500,000.

The Venture Capital Fund is required to issue a placement memorandum that contains details: of the terms and conditions subject to which capital is proposed to be raised from investors (or enter into contribution or subscription agreement with the investors); and which specifies the terms and conditions subject to which capital is proposed to be raised. Contents to be included in the placement memorandum have been specified by SEBI.

Italy

The typical structure available for carrying on private equity activity in Italy is the fondo chiusu (closed end fund), although in principal other vehicles may be used.

The entities involved in the setting up of the funds are:

a) The management company (Società di Gestione del Risparmio (SGR));

b) The assets of the fund;

c) The investors;

d) The custodian bank (banca depositaria).

The Management Company - The SGR must be authorised and registered by the Bank of Italy. Under the law, the authorisation is given within 90 days from the date of filing with the Bank of Italy. Such term may be suspended or interrupted by the Bank of Italy. Before giving authorisation, the Bank of Italy consults with CONSOB.

The assets of the fund - The assets of each fund are distinct (*patrimonio separato*) from those of the SGR itself, and from those of the participants in the management company, the investors in the fund and for each the other funds managed by the same SGR. Consequently, creditors of the SGR cannot make claims against the fund; and creditors of the investors of the fund can only make claims in respect of the shares of the specific investors.

Investors – Usually private equity funds are established in the form of closed-end funds reserved to qualified investors.

Custodian bank – The custodian bank keeps custody of the investments of the fund.

Japan

Japanese private equity funds use different structures for different types of investors and investments.

Some Japanese private equity fund structures take the form of tax transparent partnerships (Japanese General Partnerships, Japanese Limited Liability Partnerships and Cayman Islands Limited Partnerships) where investment income is taxed at the members' level rather than the fund level. Some funds take the form of quasi-corporate entities (e.g. investment trusts) and corporate entities are sometimes used where it provides taxation benefits (e.g. double tax treaty benefits).

Many Japanese fund structures are based on structures used in other countries.

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.

Portugal

In Portugal, the most typical structures for private equity activity are as follows:

a) Venture Capital Companies (Sociedades de Capital de Risco or SCRs);

b) Venture Capital Funds (Fundos de Capital de Risco or FCRs); and

c) Venture Capital Investors (Investidores em Capital de Risco or ICRs).

SCR, FCR and ICR are all structures specifically regulated by Decree-Law nº 375/2007, regarding venture capital investment.

SCRs are corporate vehicles that must take the form of public limited companies (Sociedades Anónimas). The business name of an SCR must include the expression

Sociedade de Capital de Risco or *SCR,* which may not be used by other entities to avoid deception. The minimum share capital for SCRs, mandatorily represented by nominal shares, is €750,000, except if its object consists exclusively in managing Venture Capital Funds, in which case the value shall be €250,000. Additionally, minimum capital requirements for the SCR may be established by joint Ministerial Order of the Ministers of Finance and Economy and under CMVM's proposal, proportionally to the composition of the respective portfolio and of the managed SCRs.

FCRs are autonomous assets, without legal personality, but may apply to a court of law and belong to the holders of the respective investment units. FCRs are not responsible whatsoever for the debts of the unit-holders, depositaries, managing entities, marketing entities, or other FCRs. The business name of an FCR shall include the expression "Fundo de Capital de Risco" or "FCR", which may not be used by other entities to avoid deception. FCRs are closed-end funds and have a minimum subscribed capital of €1,000,000.

ICRs allow individual investors to carry out private equity activities. They are also known as *business angels*. Although acting as an individual entrepreneur, the ICR must be incorporated under the specific corporate type of a sole partner private limited liability company (Sociedade Unipessoal por Quotas), with a minimum share capital of €5,000. Only natural persons may be considered sole partners. The business name of an ICR shall also include the expression "Investidor em Capital de Risco" or "ICR".

The regulation and supervision of these three venture capital structures is made by CMVM. The set-up of a SCR, FCR or ICR structure (both legal incorporation and start of business) must be preceded of a simplified registration procedure at CMVM. Registration details are not public, although CMVM provides for a list of PE structures online.

Private equity activities in Portugal are not exclusive to SCRs, FCRs and ICRs and may be pursued through other types of corporate vehicle structures, such as public limited companies (Sociedades Anónimas) and private limited companies (Sociedades por Quotas). However, only SCRs, FCRs and ICRs benefit from a favourable specific tax treatment provided by law.

Quebec, Canada

Private equity can take a variety of forms in Quebec. The more commonly encountered structures for private equity are:

1) Private equity or venture capital funds (limited partnerships or non-redeemable investment funds) (PEF);

2) Labour-sponsored or development capital investment funds; and

3) Private pension funds.

PEFs normally raise capital from investors through prospectus exemptions or by using confidential offering memorandums. Those PEFs are not reporting issuers, therefore have very limited imposed regulatory disclosures and regulator supervision. These structures are generally aimed at investors that meet the regulatory definition of accredited investors.

PEFs can also choose to raise capital from retail investors by filing a prospectus. In those cases and in order to provide liquidity for these investors, PEFs will often register their securities on an public exchange. In those situations, PEFs are overseen by securities regulators and stock exchange supervision and consequently also subject to mandatory continuous public disclosure.

Three labour-sponsored or development capital investment funds exist in Quebec. They are created by their own individual legislation. Those structures are designed for retail investors and provide these investors with additional tax benefits not available to other private equity issuers.

Private pension funds also participate in the private equity industry. They are however limited to the capital raised from their members.

Spain

The structures available in Spain for private equity purposes are the following:

a) Public Limited Companies, or Sociedades Anónimas (SAs), and private limited companies, or Sociedades de Responsabilidad Limitada (SLs);

b) Private equity companies, or Sociedades de Capital Riesgo (SCRs);

c) Private equity funds, or Fondos de Capital Riesgo (FCRs).

Public Limited Companies (SAs) and Private Limited Companies (SLs)

SAs and SLs are limited liability companies, whose incorporation requires the grant of a public deed before a Spanish Notary Public, to be registered with the commercial registry.

Private Equity Company (SCR) and Private Equity Fund (FCR)

SCRs must take the form of an SA and have minimum share capital of €1,200,000.

FCRs lack legal personality and require a minimum capitalisation of €1,650,000 contributed in cash at their creation. FCRs must be managed by a management company (*Sociedad Gestora de Entidades de Capital Riesgo*).

The incorporation of FCRs and SCRs must be approved by the securities regulatory authority, the Comisión Nacional de Mercado Valores (CNVM). Once the authorisation is obtained, a public deed must be granted, and FCRs and SCRs must be registered with the commercial registry, and with the public registry of the CNVM.

Switzerland

With the introduction of the Federal Act on Collective Investment Schemes in the beginning of 2007 there are four different legal forms available in Switzerland for Collective Investment Schemes. All four are more or less suitable for private equity funds. But whereas the two open-ended structures (contractual form and investment company with variable capital) and one closed-ended structure (investment company with fixed capital) predominantly are used for investments in securities, derivatives, real estate etc., the second closed-ended structure, the Swiss limited partnership for collective investments, is specifically designed for investments in private equity.

A limited partnership for collective investments is a company whose sole object is collective investment. At least one member bears unlimited liability (general partner), while the other members (limited partners) are liable only up to a specified amount. Both the limited partnership and the company agreement need an authorization respectively an approval by the Swiss supervisory authority (FINMA). The general partner which must be a public limited company with its registered office in Switzerland may only be active as a general partner in one limited partnership. He may delegate investment decisions and other activities to a third party.

The limited partnership is restricted to so-called qualified investors (institutional investors, high-net-worth individuals). Therefore the density of the legal regulation is relatively low compared to collective investment schemes for retail investors. The regulation refers in particular to the minimal content of the company agreement and prospectus. As a consequence the stipulation of the company agreement remains at the discretion of the general partner. Due to this combination of high standards of investor protection, which is achieved through the authorization by the FINMA and its permanent prudential supervision and of the general partner's large discretion in managing the limited partnership, this new legal form is attractive for the general partner as well as the limited partners.

United Kingdom

The principal structures that have are used in the UK are as follows:

a) A limited partnership;

b) An investment trust company;

c) A venture capital trust.

The Limited Partnership

Currently the most common structure in the UK for private equity funds is the English Limited Partnership. The limited partnership must be registered in England under the Limited Partnerships Act 1907. For this purpose it must have a general partner with a principal place of business in England. Investors who are limited partners have their liability limited to the amount of capital in their partnership provided they do not take part in its management.

The Investment Trust

This is a company which invests in securities and whose shares are quoted on the

London Stock Exchange PLC. It also has to comply with section 842 of the Income and Corporation Taxes Act 1988 which provides, *inter alia*, that it is not permissible to distribute capital gain by way of a dividend.

The Venture Capital Trust

The venture capital trust is a variation on the investment trust structure providing tax free income and capital gains to individual investors but with restrictions on the amounts and types of company in which it can invest.

United States

The structure most commonly available for domestic private equity investment funds is a limited partnership under the laws of the state of Delaware. A Delaware limited partnership is formed upon the filing of a Certificate of Limited Partnership with the Secretary of State of the State of Delaware. A Delaware Limited Partnership is a separate legal entity which continues as such until it dissolves and winds up its affairs pursuant to the partnership agreement, which term is generally 10 years or unless otherwise dissolved pursuant to Delaware law. Limited partnerships organised in Delaware are not generally required to register with any regulatory authority if they conform to the various exemptions or exceptions commonly used in the industry; however, if the fund of a promoter of the fund maintains an office in a state other than Delaware, the fund or its promoter may be required to qualify in that state.

The management company of the fund is usually organised as a separate entity that is owned by the founders of the fund. Typically the management company serves as the management company for each fund organised by the founders, which allows the founders to centralise the management functions of the fund-family and concentrate the value of the enterprise in a single entity. Depending upon the scope of its business, the manager or co-manager may be subject to registration as an investment adviser.

Appendix 4 – Working Group Representation

Chair	Dan Waters	Director, Conduct Risk Division Financial Services Authority United Kingdom

Industry Experts

Advent International	Desmond Mitchell	EU Operations Director
APAX Partners	Monique Cohen	Partner
Brunswick	Philippe Brunswick	Partner
Capvis Equity Partners AG	Felix Rohner	Partner
EQT Partners	Bjorn Hoi Jensen	Senior Adviser
KPMG LLP	Vincent Neate	Partner EVCA Professional Standards Committee
Nomura Asset Management	Shigeki Fujitani	Senior Managing Director
Pantheon – Russell PE	Alastair Bruce	Managing Partner
Permira Advisers LLP	Christopher Crozier	Chief Risk Officer
SJ Berwin LLP	George Pinkham	Partner
The Carlyle Group	Christopher Finn	Managing Director
Travers Smith LLP	Margaret Chamberlain	Partner
BVCA		Chair, Reg. Committee
3i	Steve Hicks	Group Compliance Director

Regulators

AMF, France	Laurent Grillet-Aubert
SEBI,India	R K Nair
FSA, Japan	Shoko Ishizaki
CMVM, Portugal	Gabriela Figueiredo Dias

Spain CNMV	Lucia Conde Vidal Javier Fresno
FINMA, Switzerland	Dr Felix L Stotz
FSA, United Kingdom	David Bailey Matthew Fann Douglas Hull Adam Jacobs James Packer