bvca The voice of long-term investment

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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 all 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 Dundell

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