

KIRKLAND BRIEF

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Private Equity Conflicts of Interest: IOSCO Consultation

The International Organization of Securities Commissions recently published a consultation report on private equity conflicts of interest, outlining principles that industry and national regulators can use in assessing private equity firms for best practice in managing conflicts.

On November 3, 2009, the International Organization of Securities Commissions (IOSCO) published a [consultation report](#) on private equity conflicts of interest. The aim of the report is to outline principles against which both the industry and national regulators can assess private equity firms for best practice in managing conflicts. This consultation follows on from IOSCO's more general [report](#) of May 2008, which identified conflicts of interest as a significant risk emerging from the private equity industry.

IOSCO prepared its report by reference to the life cycle of a typical private equity fund managed by a multi-fund, multi-strategy firm. The report identifies the key conflicts that are likely to arise and common strategies for mitigating those conflicts. Once finalised, the report will be taken into account by national regulators when considering their approach to regulating conflicts of interest in the private equity sector.

Principles for effective mitigation of conflicts

IOSCO proposes eight Principles for Effective Mitigation of Conflicts of Interest in Private Equity. These are as follows:

- 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.
- 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.
- 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.
- 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.
- A private equity firm should favour mitigation techniques that provide the most effective mitigation and greatest level of clarity to investors.
- A private equity firm should establish and implement a clearly documented and defined process that facilitates investor consultation regarding matters relating to conflicts of interest.
- 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).
- A private equity firm should ensure that all disclosure provided to investors is clear, complete, fair and not misleading.

Conflicts and mitigation techniques

In addition to recommending headline principles for the mitigation of conflicts, the report also identifies specific conflicts that may arise during the four key stages in a fund's life cycle (fundraising, investment, management/monitoring and exit), and highlights best practices for managing those conflicts.

- *Conflicts at the fundraising stage:* These include charging placement agent fees to the fund on an undisclosed basis, and increasing fund size in order to maintain market position and/or accrue larger management fees when such large amounts of capital cannot readily be deployed. These conflicts are largely dealt with through investor negotiation, with the agreed position being set out in the fund agreement.
- *Conflicts at the investment stage:* The charging of transaction fees gives rise to a conflict of interests, which is usually mitigated by including provisions in the fund agreement setting out the basis on which such fees may be retained by the general partner. Disclosure of such fees to investors is also considered important. Additional issues arise where a firm manages more than one fund. For example, a conflict may arise where a private equity fund invests in the same portfolio company as a debt fund managed by the same firm; if the company experiences financial distress, the interests of the two funds are likely to diverge. Such conflicts should be managed by the effective use of information barriers. Conflicts may also arise in relation to the allocation of investment opportunities between funds, and the allocation of co-investment opportunities between fund investors. These conflicts are usually dealt with by disclosing to investors the basis on which such situations will be handled. In relation to GP co-investment, IOSCO reiterates that it is not acceptable to cherry-pick or to invest on more favourable terms than the fund.
- *Conflicts at the management/monitoring stage:* IOSCO recommends that fees paid by portfolio companies, such as directors' fees or monitoring fees, should be fully disclosed to investors on an ongoing basis, so as to obtain the investors' informed consent to the receipt of such fees. Firms must also ensure that investor directors manage conflicts of interest appropriately, especially where a portfolio company is in financial distress and requires additional funding. If rescue financing is obtained, conflicts may arise between existing investors who do not, or cannot, participate in the new funding round, and those investors who provide new money on a preferred basis. IOSCO notes that there are also concerns that firms may not devote sufficient time and attention to underperforming funds, which may be mitigated by the inclusion of a key executive provision in the fund agreement. In addition, conflicts may arise in relation to the enforcement of investor default provisions where the private equity firm has to balance the interests of the defaulting investor against the interests of the other investors.
- *Conflicts on exit:* Fund extensions may present a potential conflict of interest if motivated by the accrual of additional management fees, but extensions often require investor committee approval and the basis on which fees will be paid during the extension period is either set out in the fund agreement or renegotiated at the time of extension. Divestment timing may also give rise to conflicts where prior and successor funds have invested in the same portfolio company and are at different stages in their life cycles. This is primarily a disclosure and consultation issue. Finally, conflicts may arise in relation to secondary transfers where the general partner has discretion to refuse permission for the investor to transfer its fund interest. In particular, IOSCO considers that private equity firms should not seek to be involved in the negotiation of secondary transactions, to avoid conflicts relating to the valuing of investor interests in the fund.

Policies and procedures

In setting out the Principles for Effective Mitigation of Conflicts, IOSCO gives guidance on the policies and procedures to be adopted by private equity firms. The IOSCO recommendations go beyond the requirements currently imposed by most national regulators and, if adopted, are likely to require firms to devote additional time to the preparation and implementation of conflicts policies.

In particular, it is suggested that a firm's conflicts policy should be made available to prospective investors alongside other constitutional documents, such as the fund agreement, at a sufficiently early stage to allow the policy to be incorporated into the investor's decision-making process. The policy should be reviewed and updated regularly, with changes disclosed to investors.

As disclosure to, and consultation with, investors is key to managing conflicts of interests in private equity, IOSCO also makes recommendations with respect to investor committees, suggesting that they should have clearly defined terms of reference, and that their discussions should be consistently disclosed to all investors. In addition, IOSCO emphasises that all disclosures to investors must be clear, complete, fair and not misleading.

Consultation period

The consultation report is open for comment until 1 February 2010. The report will be finalised after consideration of the comments received.

Should you need additional information about the matters addressed in this *Kirkland Brief*, or would like to receive a more detailed version of this article, please contact the following Kirkland author or your regular Kirkland contact.

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