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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<sup>1</sup> (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.

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

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

### **Compensation arrangements**

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

### **Contractual agreements**

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

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

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

### **Disclosures**

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

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

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

### **Consultation with Investor Committees**

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

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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<sup>2</sup>. 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.***

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<sup>2</sup> CFA Institute is best known for developing and administering 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.

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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<sup>3</sup> 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.

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<sup>3</sup> The survey results can be accessed at

[http://www.cfainstitute.org/centre/news/surveys/pdf/alternative\\_investment\\_fund\\_results.pdf](http://www.cfainstitute.org/centre/news/surveys/pdf/alternative_investment_fund_results.pdf)