

PRIVATE EQUITY FIRMS: MANAGING CONFLICTS OF INTEREST

The FSA has recently issued some material dealing with the management of conflicts of interest in private equity (PE) firms. FSA Principle 8 states that “A firm must manage conflict of interests fairly, both between itself and its customers and between one customer and another”. In terms of conflicts management, the FSA has an expectation that the firm looks through beyond customer relationships to those with the ultimate investors irrespective of whether they are customers of the firm or not. The FSA has long been of the view that conflicts of interest represent a significant risk both to its market confidence and consumer protection objectives. However, it has also said that the issue is generally well handled, although it does continue to pay attention to this area and the systems and controls that a firm has in place.

1. KEY POINTS

The key points for private equity firms (as well as others involved in capital markets) are as follows:

- The FSA has long been concerned about the potential risk posed to its statutory objectives by market abuse and conflicts of interest. These areas will remain central for all firms and should remain in the forefront of senior managers’ minds as a critical regulatory issue.
- The FSA expects that senior management should be fully engaged in all aspects of conflict identification and management and take a broad view of the risks posed to their business.
- There is no “one size fits all” or “off the peg” solution that a firm can use – it is expected to put in place tailored arrangements, including systems and controls, policies and procedures to manage conflicts effectively.
- The FSA views the way a firm approaches management of its conflicts of interest as a strong indicator of senior management engagement and the firm’s control environment more generally.
- The FSA has noted that, despite its recent thematic exercise having been concluded, it will continue to look at this area in its ARROW visits, and may review a firm’s arrangements against the good practice points noted in its recent Capital Markets bulletin (see link below).

Our strong recommendation to affected clients is to ensure that they revisit their policies and systems regularly, and ensure that this issue is treated with the priority that we feel the FSA will expect.

2. FSA THEMATIC REVIEW

The FSA recently published the results of its thematic review on the management of conflicts of interest within private equity firms in its Capital Markets bulletin (July 2008 - see link below).

The review looked at the individual systems and controls that firms have in place to effectively manage conflicts of interest. The review was undertaken following its June 2007 Feedback Statement 07/3 to the DP 06/6 – “Private equity: a discussion on risk and regulatory engagement”. The FSA wanted to understand the issue and how firms faced and handled it, although it has stated that it believes it is generally well handled.

The review looked at the issues facing the private equity fund and its investors, in particular:

- the extent to which the private equity business model (in its various forms) demonstrates an inherent alignment of interests with fund investors (thus reducing potential conflicts); and
- the adequacy and formalisation of firms’ approaches to conflict identification, management and mitigation, taking into account the broad diversity of size, scale and complexity of business undertaken.

2.1 Scope of the Review

The review involved questionnaires sent to around 250 firms that the FSA identified as being involved in private equity business. Firms included fund operators, managers or investment advisers – this represents a very significant proportion of the total of 300 firms involved in private equity. The response rate to the questionnaire was over 70% - non responders were followed up to understand the reasons for non-response. 20 firms were visited, including some for whom private equity was only a part of their business and where other activities represented a potential for conflicts within the same firm (for example also managing hedge funds or debt management, corporate M&A).

2.2 Potential Conflicts

The FSA has previously identified (in its 2006 Discussion Paper) many possible areas where conflicts might arise. These are:

- **Investment allocation** where conflicts can arise between investors in separate funds operated by the same fund manager on the allocation of investment opportunities, the timing for the divestment of joint holdings to the transfer of assets between funds; these issues can be dealt with by having proper governance systems or policies in place.
- **Preferential terms** where conflicts can arise where either the firm or associated parties, co-invest in private equity transactions alongside the fund on a deal by deal basis on preferential terms to those offered to the fund's third party investors - so called 'cherry picking'; this can be handled through proper and adequate investor disclosure.
- **Financial incentives** where private equity firms receive financial incentives from structuring private equity transactions (as a result of managing the fund) which are not rebated back to the fund or clearly disclosed to fund investors.

2.3 Key FSA Concerns

The FSA says its key concerns are:

- Fewer than 80% of firms surveyed have formal conflict policies and procedures and;
- Of these, only 70% are formally reviewed on a regular basis.
- Firms need to increase their use of formalised conflict management programmes, particularly covering the management of conflicts.
- Firms should make sure that co-investment agreements are covered by proper disclosure.
- Firms place too much reliance on the investment process and fund documentation to address potential conflicts of interest, with fewer than 50% of firms making use of proactive compliance monitoring measures to address conflict management. This is particularly evident within smaller firms.
- Some firms rely too much on their firm's reputation and culture as a way of influencing staff behaviour.
- Fewer than 45% of firms give formal training or refresher training, especially before directorship appointments to portfolio companies.

The FSA also says that "materially significant" improvements are required at 40% of firms visited.

3. BEST PRACTICE

The following are general areas that firms should consider when reviewing their management systems and controls:

- The most effective policies are characterised by regular compliance reviews, often developed between external advisers and business unit heads, and signed-off by a senior management committee or the board. This is particularly evident when implementing new legislation.

- Engagement with staff is a key priority – staff awareness can be heightened by the use of an annual staff declaration confirming personal responsibilities. This covers knowledge of the firm's conflict policy and PA dealing policy, as well as awareness of conflicts within the firm, adherence to the firm's code of conduct and ethical standards; the questionnaire can also declare or update outside interests such as directorships, personal holdings and gifts.
- Some firms use 'Chinese wall' communications on specific deals to remind staff of personal responsibilities and information confidentiality – this can also highlight other areas of concern such as ensuring IT security etc on sensitive deals.
- The distribution of Investment Committee and Investor Advisory Committee minutes can be used to disclose actual conflict issues to all fund investors on a deal by deal basis
- Some firms have separate and distinct committee structures to address potential conflict areas, for example: Valuations Committees to review fair valuations of illiquid securities; Allocation & Investment Committees to control the allocation of investments between funds; Remuneration Committees to review staff co-investment; and Conflict and Ethics Committees to monitor the application of conflict management within the firm.
- Regular review including a proactive approach to monitoring can include a written compliance monitoring plan, a 'live' risk map, specific ad-hoc compliance monitoring, a conflicts register and information barriers.
- The use of deal conflict check-lists at entry and exit of investments to document any apparent conflicts, methods of management and firm sign-off can be considered.
- The use of formalised business line mandates and allocation policies detailing the basis on which investment opportunities are allocated between funds, the firm and other co-investors may be adopted.

4. NEXT STEPS

Our strong recommendation to affected clients is to ensure that they revisit their policies and systems regularly, and ensure that this issue is treated with the priority that we feel the FSA will expect.

5. FURTHER INFORMATION

The FSA's recent thematic review results into the area of conflicts of interest within private equity firms may be viewed in its Capital Markets bulletin (no 3) at the following link:

http://www.fsa.gov.uk/pubs/newsletters/cm_bulletin3.pdf

The November 2006 FSA Discussion Paper (DP) DP 06/6: "Private equity: a discussion on risk and regulatory engagement" can be found at the following link:

http://www.fsa.gov.uk/Pages/Library/Policy/DP/2006/06_06.shtml

The June 2007 Feedback Paper to DP 06/6 can be found at the following link:

http://www.fsa.gov.uk/pubs/discussion/fs07_03.pdf

The British Private Equity and Venture Capital Association (BVCA) commissioned Sir David Walker to review transparency and disclosure within private equity firms and the resulting voluntary Code of Practice on a 'comply or explain' basis. The report can be found at the following link:

http://walkerworkinggroup.com/sites/10051/files/wwg_report_final.pdf

Reference: RCUK/PTG/KG

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