Thematic Review of the Management of Conflicts of Interest within Private Equity Firms

Why are we reviewing conflict management within private equity?

The effective management of conflicts by wholesale market participants, such as private equity firms, is an important area of focus for us in seeking to achieve our statutory objectives of maintaining market confidence and investor protection.

Firms’ 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’ that can effectively address the full range of conflicts of interest that arise in firms’ businesses, so firms will have to put in place tailored arrangements, policies and procedures to manage conflicts effectively. Therefore, the way a firm approaches conflicts of interest provides a strong indicator of senior management engagement and its control environment more generally.

We have undertaken a thematic review consistent with our public commitment in our Feedback Statement (07/3) to the DP06/6: ‘Private equity: a discussion on risk and regulatory engagement’\(^1\). Namely that:

‘We note that respondents believes that conflicts of interest risks are well recognised within the industry, that many of these have been covered by previous thematic work and are generally considered to be effectively mitigated by the firm’s structures and systems, legal contracts and proactive ongoing supervision work. Having taken account of the above we nevertheless continue to perceive conflicts of interest as an area of significant risk in the industry, specifically to our objectives of market confidence, where vigilance must be maintained. This will remain an area of supervisory focus for all authorised firms involved in private equity markets. We intend to carry out further thematic analysis work in this area, within our alternative investments centre of expertise, focusing on the management of conflicts within private equity firms.’

Consequently, the review’s main objective is to help inform us and external stakeholders of current standards within the regulatory community. It also reports our findings to the wider population of private equity firms to encourage them to address areas of weakness in order to promote ‘good practice’ within the industry.

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\(^1\) www.fsa.gov.uk/pubs/discussion/fs07_03.pdf
Scope of the review

In contrast to DP06/6, which undertook a broad market-wide review of the participants and risks within the private equity industry, this thematic review’s primary aim is a more focused analysis of the key conflicts of interest which arise between private equity firms and the underlying investors in the funds that they operate, manage and provide investment advice to. Our analysis explores two key issues:

- 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’ approach to conflict identification, management and mitigation, taking into account the broad diversity of size, scale and complexity of business undertaken.

As with many sectors of the financial services industry, the private equity business model requires firms to establish relationships with various third parties – for example, the management teams of portfolio companies, banks, leveraged loan providers and legal advisers, whose interests are acknowledged by private equity firms as secondary to their own interests and those of their fund’s underlying investors. On this basis these relationships have not been the focus of this review, although we note that there may be circumstances which hold the potential for conflicts against the interests of fund investors which may deserve attention at another time. Instead, this review exclusively focuses on conflicts of interest and does not comment on other issues raised in DP06/6 or FS07/3 such as market abuse concerns in public to private transactions, market transparency and wider stakeholder disclosure. We are addressing these issues through separate and focused strands of work.

Our approach

Our review focused upon those firms supervised within our Wholesale Banks & Investment Firms Department where we identified approximately 300 firms involved in private equity business, including fund operators, managers or investment advisers. Following further analysis, we chose to send approximately 250 of those firms a questionnaire via an internet-based survey provider. The response rate was in excess of 70%.

To complete the analysis, we conducted a targeted follow-up with a number of non-respondents to understand the reasons for non-response. Analysis of this supplementary data indicates that these firms typically operate under less formal conflict management policies and procedures but offer comparable terms of investment to those firms which responded to the questionnaire.

Following detailed analysis of the questionnaire data, we chose a diverse sample of 20 firms for visits to verify and expand on our findings. These visits included firms for whom private equity was only a part of their business and where other activities represented a potential for conflicts within the same firm (e.g. also managing hedge funds or debt management, corporate M&A). There was also a split between relationship and non-relationship managed firms (we regulate the latter through our Firm Contact Centre).
Summary of key findings

We observed that size did influence the extent to which firms seek to maintain a formalised approach towards conflict management. The nature and degree of their supervisory oversight by the FSA (i.e. those managed on a relationship versus non-relationship basis) did not appear to be a significant factor. Examples of both good and poor practice were identified across the population of firms surveyed.

We note that the vast majority of firms visited operated business models with a high degree of alignment between the interests of managers and fund investors. However, a small, but significant, percentage of firms undertake certain practices which may serve to undermine that inherent level of alignment of interest, for example, by offering preferential co-investment terms to affiliated ‘cornerstone’ investors, their treatment of transaction fees and the operation of ‘deal by deal’ carried interest schemes. We acknowledge that investor disclosure of such arrangements, and more generally, appeared to be both extensive and widespread.

- Of the firms surveyed which undertake co-investment, 90% confirmed that it is made on the same terms and conditions as fund investors (allowing for differing approaches surrounding the payment of management fees and carry).
- Over 70% of firms surveyed sought to treat all fund investors equally, both in terms of investment and information disclosure. Fewer than 20% of firms reported that they used side-letter agreements which were not established on a “most favoured nation” basis. While the vast majority of these side-letter provisions were of an administrative nature, others provided meaningfully preferential access to deal co-investment opportunities, reduced fee structures (management fee, carried interest, etc), or membership of ‘investor advisory’ committees.
- Unsurprisingly, our findings suggest a greater inherent risk of conflicts occurring within broad-based firms, particularly investment banks, compared to specialist private equity firms. Broad-based firms are exposed to larger, more commercially significant conflicts and our discussions highlighted the greater challenges in managing their conflicts in a manner that fully protect external investors. Such firms have business models where private equity investment decisions, proprietary trading and corporate mandates all sit in such proximity so as to make conflicts a more pressing concern. While information may be well-contained in these firms, it is clear that other parts of the firms’ business may be involved either in support of related private equity efforts or in adversarial roles.

We note that most firms we visited were maintaining a broadly adequate approach to conflict management. However, our key concern from this review relates to the fact that fewer than 80% of firms surveyed maintain formal conflict policies and procedures, and only 70% of these policies are formally reviewed on a regular basis. This shortfall suggests a need to increase the usage of formalised conflict management programmes at firms, with our visits identifying that materially significant area(s) of improvements were required at 40% of firms visited. The most frequently identified issues related to a lack of: documentation to adequately formalise their approach to conflict management; staff training to address conflict management; ongoing review of formal conflict polices and procedures; and proactive compliance monitoring.

- In our view, firms appear to be placing a primary 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, particularly within smaller firms.
• We also observed an apparent over-reliance on the firm’s reputation and culture as a means to influence staff behaviour, with fewer than 45% of firms providing formalised conflict training or refreshers to their staff. In particular, there appeared to be limited formal training provided to staff in advance of directorship appointments to portfolio companies or, to a lesser extent, to raise awareness of the firm’s confidentiality policies and procedures.

• Based on the results of our visits, we consider that a significant number of firms should be considering formalising their approach towards the management of conflicts over and above commitments contained in prospectus documentation. In addition, firms might consider enhancing the disclosure of co-investment arrangements, especially those involving preferential terms for some investors or investor groups, including affiliated parties.

• The points highlighted above are all areas where we can enter into dialogue with firms to improve compliance standards. However, the negotiation of contractual terms with, for the most part, highly sophisticated and largely institutional investors, can itself provide a source of pressure on private equity firms to further enhance their approach towards conflict management.

Areas giving rise to potential conflict

A broad range of potential conflicts of interest were identified in DP06/6. Our findings suggest that potentially material conflicts are more likely to occur in relation to the following areas.

• Investment allocation – in the absence of clearly defined investment policies and governance, conflicts can occur between investors in separate funds operated by the same fund manager. For example, in relation to the allocation of investment opportunities, the timing for the divestment of joint holdings or the transfer of assets between funds.

• Preferential terms – in the absence of adequate investor disclosure, conflicts can occur where the firm, or affiliated parties, are permitted to co-invest in private equity transactions alongside the fund on a deal by deal basis on preferential terms (allowing over or under investment) to those offered to the fund’s third party investors, so called ‘cherry picking’.

• 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.

We found that the vast majority of firms we visited did appear to actively manage the risks associated with these conflicts to at least some extent. However, our findings indicate that most if not all firms could further bolster and formalise their conflict management procedures.

Examples of good practice

Whilst not exhaustive, highlighted below are examples of good practice identified during our firm visits.

• Firms operating the most effective conflict management policies tended to ensure that compliance reviews were undertaken on a formal basis, developed in-house with input from business heads and external advisers (particularly where implementing new legislation), and signed-off by a senior management committee or the board.

• The use of specific annual declarations for staff to confirm personal responsibilities. These could for example, cover knowledge of the firm’s conflict policy and PA dealing policy, awareness of instances of conflict within the firm, adherence to the firm’s code of conduct and ethical standards, and to declare outside interests such as, directorships, personal holdings and gifts.
• Where relevant, the use of ‘Chinese wall’ letters on specific deals to remind staff of personal responsibilities and information confidentiality.

• Proactive disclosure on a deal by deal basis of actual conflict issues to all fund investors via the distribution of Investment Committee and Investor Advisory Committee minutes.

• The use of 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.

• The use of regular and proactive monitoring mechanisms including, for example; a formalised 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.

• 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.

Further steps by firms

Private equity firms may wish to undertake a benchmarking exercise against the findings of this thematic review. This would enable them to identify any gaps between their current practice and identified good practice within the industry, implement changes where relevant and appropriate to their particular business to close those gaps, and report those changes to the FSA as part of our normal risk-assessment process. In particular, firms may wish to focus on:

• ensuring suitable training programmes are in place for new joiners with ongoing refreshers and other more formal methods to raise staff awareness of the firm’s policies and procedures, legal requirements and expectations in relation to ethics and code of conduct;

• where relevant, the development of formal policies and procedures to clarify the firm’s approach towards areas within its business which are likely to give rise to potential conflicts on a recurring basis;

• ensuring that the firm’s policies and procedures are formally and regularly reviewed in conjunction with senior management;

• where relevant, ensuring that the firm’s approach to conflict management complies with the common platform requirements under SYSC 10;

• ensuring that the firm makes appropriate use of proactive compliance measures to monitor its business on an ongoing basis; and

• ensuring that investors receive adequate conflict disclosure, particularly where the firm provides certain investors or co-investors with materially preferential terms of investment or disclosure.
Common platform requirements under MiFID

Most of the relevant firms we visited appeared to have a good grasp of the new common platform requirements under SYSC 10. With the majority of firms suggesting that the new requirements had not changed their overall approach to the issue of conflict of interest management, but had resulted in a higher degree of formalisation (and centralisation) of the firm’s policies and procedures. However, we observed very few instances where firms had fundamentally challenged their mindset or approach to conflict of interest management – rather than merely codifying their existing practice.

In addition, while not currently subject to the SYSC 10 rule requirements, most of the exempt MiFID firms we visited suggested that they ought to be able to readily comply with the proposed extension of the common platform requirements.

However, we did observe limited instances where firms may have mis-classified themselves based on their activities undertaken. This appeared to stem from the misunderstanding of how the exemption under MiFID relating to ‘operators of CIS schemes’ works in practice. The exemption does not extend to the provision of investment advice or portfolio management to a fund where the firm is not otherwise the designated fund manager.

We expect to publish the outcome of our consultation on the extension of the common platform (CP07/23) in September this year and encourage firms to examine their position regarding MiFID before then.

Next steps

Firms should expect that conflict management will remain an area of focus by our supervisory teams as part of the formal risk assessment process and ongoing interaction with private equity firms. In particular, as part of the Wholesale Small Firm’s strategy to improve compliance standards within non-relationship managed firms, we shall continue visiting private equity firms. We may consider comparing those firms against the findings of this thematic review.

For more information contact:
Matthew Fann, Wholesale Banks and Investment Firms Department
matthew.fann@fsa.gov.uk