

Compliance for managers of closed ended funds – not merely an obligation but a tool for generating transparency and trust by investors.

Compliance for Managers of Closed Ended Funds

Private Investment Funds Practice –
Discussion Papers

With the financial crisis ultimately being a crisis of trust, the financial services market of alternative investments faces particularly severe challenges. Although the crisis creates a general hesitance towards new engagements, investors are still seeking investment opportunities, provided these meet their modified requirements. This development provides the opportunity to differentiate the market appearance of a financial product.



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This paper is addressed to the managers and sponsors of closed ended funds such as private equity, real estate and infrastructure funds. It introduces compliance not merely as a costly obligation, but as a tool for generating transparency and trust by the actual and potential investor base and thus enhancing the profitability of fund management operations as a whole.

Compliance is a term that does not naturally convey a mutual understanding of what it encompasses in a given context. We would like to use the term to describe the systems in any operation which are implemented and monitored in order to accomplish the following:

- The fund, its sponsor or manager and each of its executives and employees observe applicable mandatory laws including tax, regulatory and securities law provisions;
- Industry standards are implemented and monitored, as far as they are applicable and mandatory or as far as the leaders of an operation have chosen to abide by these standards;
- Voluntary codes of conduct or best practice rules as far as they shall apply over and above to the general industry standards or as far as they modify general rules.

We are aware that the closed ended fund industry traditionally seeks to maintain utmost confidentiality and to conduct its business as discretely as possible. As far as regulation is imposed on funds and managers, e.g. as in the case of the managers of collective investment schemes in the UK under the Financial Services and Markets Act 2000 (FSMA) or for investment companies under the Investment Company Act 1940 in the US, these compulsory regulations are often sought to be avoided – by off-shore structures in the case of the FSMA regulation or by making use of exemptions in the case of the Investment Company Act (its sections 3(c)1 and 3(c)7).

In the current environment it will become increasingly difficult to evade these. Not only because regulation will become more strict (as can be seen from the draft Directive on Alternative Investment Fund Managers published by the EU-Commission on 29 April 2009) and less fragmentary, but also because investors require more sophisticated tools for their internal risk management and reporting in order to continue investing in alternative investment vehicles.

Various industry organizations have reacted to up-coming increasing regulation by proactively introducing or elaborating on recommendations for industry standards:

- **The Walker Report:** In 2007 the British Venture Capital Association (BVCA) and a group of major private equity firms asked Sir David Walker to undertake an independent review of the adequacy of disclosure and transparency in private equity with a view to recommending a set of guidelines for conformity by the industry on a voluntary basis. The recommendations are included in the “Walker Report”. In January 2009 a first report by the Monitoring Group, established to review the implementation of the recommendations by the Walker Report, was published. So far, 32 private equity firms and 54 portfolio companies have agreed to comply with the guidelines.
- **EVCA:** The European Venture Capital Association (EVCA) has developed an elaborate set of industry professional standards covering a code of conduct, governance guidelines and reporting and valuation guidelines².

- The German Private Equity and Venture Capital Association e.V. (*Bundesverband Deutscher Kapitalbeteiligungsgesellschaften*, “**BVK**”) and the German Association of Closed Ended Funds (*Verband Geschlossene Fonds*, “**VGF**”) provide their own professional standards while the BVK is relying to a large extent on the EVCA standards and the VGF is focusing more on the requirements of public distribution on the German retail market. Both associations, however, actively promote a regulatory regime for the virtually unregulated German private equity and venture capital market³.

The common principle recommendations are:

- Being transparent
- Maintaining confidentiality
- Managing conflicts of interest
- Keeping one’s promises
- Fighting white collar crime

A first step to securing the adherence to these principles is the identification of the strengths of your investment management procedures in terms of compliance. It is important that existing capabilities and resources are applied in such a manner that available and reported information drops into place with those people within the organization of the investor that need to check the relevant boxes. Where there is room for improving existing procedures such improvements must be implemented smoothly, without causing irritation to investors, in the course of an organic process of self assessment by the fund.

A typical call for improvement arises from the principle of transparency. Being transparent requires holding all relevant information. The strengthening of one’s own capabilities to obtain information should be a constant objective of structuring a portfolio and negotiating the relevant contracts. The issues that need to be observed are: Where is the information obtained, who prepares and manages the information and who bears the associated costs? Is the right to obtain information duly incorporated and enforceable? Are conflicting confidentiality obligations and business driven sensitivities properly reflected and managed?

The principle of transparency also requires the due disclosure and management of actual or potential conflicts of interest. Disclosure requires sensitivity and the proper assessment of conflict situations. Do you know your conflicts? Sometimes business relations appear to be conflicting although they are not or vice versa. A solid legal concept is required for a consistent and reliable management of conflicts of interest. Such management is not only key to building trust with investors, but also to mitigating potential liabilities for the management of a fund.

Keeping one's promises seems to be an obvious element of a prudent management of investor relations. Technically, when do market participants and courts perceive a legitimate positive statement on a product as a binding promise that could give rise to resentment with investors or even legal claims if not kept? Various jurisdictions and markets apply different standards.

Whereas investors would traditionally rely merely on a flawless track record in terms of putting faith in the integrity of an organization and the individuals who are part of the organization, the active prevention of white collar crime by the fund will become an important factor for an investor's decision making process.

¹ *Guidelines for Disclosure and Transparency in Private Equity*, November 2007.

² For an overview on the professional standards in place please see *Private Equity and Venture Capital in the European Economy – An Industry Response to the European Parliament and the European Commission – Brussels, 25 February 2009*, Table 3 on page 247;
http://www.evca.eu/uploadedFiles/News1/News_Items/EVCA_SUBMISSION_TO_EC_AND_EP_FULLPAPER.pdf.

³ See BVK Press release of 14 January 2009:

http://www.bvkap.de/privateequity.php/cat/144/aid/425/title/BVK_stellt_falsche_Behauptungen_aus_Frontal21-Sendung_richtig; and VgF key notes on the regulation of closed ended funds of 4 February 2009: <http://www.vgf-online.de/aktuelle-themen/eckpunktepapier.html>.

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