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Managing potential conflicts of interest in investment funds

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The high level of information asymmetry between investment fund managers and their investors[1] can give rise to significant conflicts of interest which must be adequately managed. This article discusses the main conflicts of interest encountered in standard private equity, venture capital and hedge fund structures and how to mitigate or prevent them.

The idea that conflicts of interest must be adequately managed is not a novel one. However, since 2015, this concern has come to the forefront of regulatory reviews by the United States Securities and Exchange Commission (the **"SEC"**)[2] and has been an important focus in many investors' operational due diligence in Canada and the U.S.[3] The concerns arise mainly from inherent deficiencies in private equity, venture capital and hedge fund structures which entail an asymmetry of information between managers and investors and involve inherent conflicts of interest, including those resulting from the compensation of the managers in most of these funds as more fully described below.

Common conflict of interest situations

Fee structure

Compensation arrangements in investment funds can lead to numerous inherent conflicts of interest. While most private equity, venture capital and hedge funds provide for a carried interest or performance fee, it remains that a significant portion of managers' compensation comes from management fees charged to the fund. Those management fees are intended to compensate the manager for internal overhead costs incurred in its day-to-day operations and are not meant to be a source of profit. However, when a manager plays an active role in managing the assets of the funds (as is often the case with private equity and venture capital funds), those management fees typically do not cover all the overhead incurred in connection with the active management of those assets (for example, as a result of the need to hire additional staff to monitor a portfolio company). In this type of situation, the manager will often seek alternative forms of compensation by charging additional fees or expenses to the investment funds or the portfolio companies in which the funds invest. These fees can be in the form of an asset management fee or a negotiation fee charged in connection with securing a portfolio investment or for the day-to-day management of a portfolio investment. It can also be in the form of compensation paid directly to the principals of the manager acting as officers or directors of such portfolio companies. Although these types of compensation are not problematic in and of themselves, they create an inherent conflict of interest since the additional fees are an expense assumed directly or indirectly by the fund and at the same time constitute a source of revenue for the manager or its principals. As a result, and since any such fees or expenses decrease the overall asset value of the funds, it is imperative that these fees and situations be adequately disclosed to investors (the disclosure must describe not only the type or nature of the fee but also how it will be calculatedand has been an important focus in many investors' operational due diligence in Canada and the U.S.[4]). The timing of such disclosure is important; investors must be aware at the time of their commitment to the fund, that this type of fee could be charged to the fund or its portfolio investments by the manager or its affiliates or principals and has been an important focus in many investors' operational due diligence in Canada and the U.S.[5]. Disclosure made during the life of the fund (for example, when the fee is actually paid) would not be considered sufficient or adequate.

An example of the foregoing is the situation that resulted in Blackstone Management Partners (**"Blackstone"**) being forced to pay a civil monetary penalty in 2015 for failing to disclose that it was entitled to accelerate the payment of future monitoring fees charged to the portfolio companies of its funds upon termination of the monitoring agreements it had signed with those portfolio companies[6]. Blackstone effectively terminated the monitoring agreements upon the private sale or initial public offering of the portfolio companies and then accelerated the payment of the future monitoring fees in accordance with the terms of the agreements. It must be highlighted that Blackstone had disclosed to investors at the time of their investment that it could receive monitoring fees from portfolio companies held by the funds it advised and disclosed the amount of the accelerated monitoring fees during the life of the funds. However, the SEC held that Blackstone had breached the U.S. *Investment Advisers Act of 1940* by failing to disclose to the funds' limited partners prior to their capital commitment that it could accelerate future monitoring fees once the monitoring agreements ended. This decision highlights the importance of not only disclosing the potential fees and expenses to be borne by investors and the funds, but also any circumstances which might lead to an increase or decrease in their amount.

The Blackstone case clearly shows the importance of having sufficiently detailed disclosure in the private placement or offering memorandum (**"PPM"**) (or other disclosure document) provided to investors when they subscribe to the fund[7]. Such disclosure should include, for example, a statement that the principals of a venture capital fund could receive shares or fees to sit on the board of directors of start-ups in which the fund invests. Hedge fund managers should carefully disclose any side arrangement with a portfolio or sub-portfolio adviser, broker-dealer[8] or custodian (including, in particular, referral or soft dollar arrangements). Managers that use a master-feeder investment fund structure should ensure that the disclosure clearly indicates how the fees and expenses incurred for the benefit of different funds in the structure will be allocated among these funds. These are only a few examples of the types of disclosure that should be provided to investors as part of their pre-investment due diligence. In addition to such disclosure made at the time of subscription, managers should also ensure that the quarterly and annual reports provided to investors are transparent regarding the compensation compensation directly or indirectly received by the manager, its affiliates and principals. The Institutional Limited Partners Association (the **"ILPA"**) provides a template of the disclosure to be included in quarterly reports as part of its "Reporting Best Practices"[9], which managers can use to ensure an adequate level of reporting. Investment funds subject to *Regulation 81-106 respecting Investment Fund Continuous Disclosure*[10] (**"NI 81-106"**)[11] should also refer to the rules in that Regulation and in particular section 2.5 of Form 81-106F1, Contents of Annual and Interim Management Report of Fund Performance (MRFP), which states that any commission, spread or other fee paid by the investment fund to any related party[12] in connection with a portfolio transaction must be discussed under the heading "Related Party Transactions". Regardless the level of disclosure provided in the PPM or in quarterly reporting, managers should also always ensure that the funds' organizational documents explicitly authorize them to charge the fees (or other forms of compensation) that are being charged directly or indirectly to the funds. Furthermore, notwithstanding the existing disclosure requirements, the Canadian Securities Administrators also provide that registered managers should consider whether any particular benefits, compensation or remuneration practices are inconsistent with their obligations to clients[13].

Transactions involving multiple funds managed by a single manager

Another typical conflict of interest is the transfer, as part of the liquidation process of a private equity or venture capital fund, of the interest the fund held in certain portfolio companies to a follow-on fund. Such transfers occur when the manager was unable to find a successful exit for a portfolio company but considers that the investment is performing sufficiently well to justify transferring it to a follow-on fund. These situations lead to an inherent conflict of interests since the fund manager will effectively be negotiating on both sides of the table with respect to the sale of such investment between the funds as it manages both the selling fund that controls the portfolio company and the follow-on fund purchasing the investment in the portfolio company. The manager can be incentivized to benefit the selling fund to maximize its carried interest or, depending on how the selling fund has been performing, might be tempted instead to use the portfolio company as an attractive seed asset for its follow-on fund. Since the manager is negotiating with itself, investors could be concerned that the transaction will not occur at a fair market value. This can adversely impact either the investors of the selling fund or those of the follow-on fund as some limited partners of a previous fund will often invest in the follow-on fund, but typically not all of them. The favored way to manage such conflicts of interest is by stating in the funds' organizational documents that if a transaction occurs among funds managed by the fund manager, the manager will seek a formal valuation of the portfolio companies being transferred from an independent third party appraiser or will submit the pricing terms and conditions of the transaction for approval to the investors or to the fund's advisory committee. The organizational documents could also provide that the investors or the fund's advisory committee can be entitled to require an independent third party valuation if they so wish.

Funds with overlapping investment periods and investment policies create another situation in which a manager can be incentivized to favour one or more funds it manages over others. A manager finding itself in this situation will have to choose which funds will invest in a specific opportunity and in what proportion. Again, the manager could be tempted to favour certain funds over others depending on how they have been performing or according to their compensation structure. The rules set forth in the organizational documents of private equity and venture capital funds typically prohibit their managers from managing simultaneous competing[14]. funds in order to avoid such conflicts of interest, often with an exception allowing the manager to create a follow-on fund (with a similar or overlapping investment policy) once a certain percentage of the undrawn capital commitments of the previous fund have been invested (or reserved for follow-on investments and expenses). The best way for investors to protect themselves against the inherent conflict of interest arising from such a situation is to provide in the fund's organizational documents or in side letters that the manager is required to cause both funds to make parallel investments during any such period based on the amount of each fund's respective undrawn capital commitment. Contrary to private equity and venture capital fund managers, hedge fund managers typically are not prevented from managing competing funds and often simultaneously manage various funds with investment policies that overlap in certain situations (and may also manage other clients' accounts under a discretionary mandate). These managers should adopt a clear policy to determine how they will allocate investment opportunities among their funds. The policy should be sufficiently detailed to allow an investor to determine whether the terms of the policy have been met with respect to a given investment. Preferably, the policy should not simply state that the manager will allocate trades in a fair and equitable manner in light of the investment objectives and strategies of the funds and other factors. The content of the policy should be adequately described to investors in the PPM given to them when they subscribe. The PPM should also clearly describe that such a conflict of interest could arise and how the manager will deal with it.

Conclusion

While the above describes some of the more commonly encountered conflicts of interests, the diversity of such situations should not be underestimated. For example, different "related-party" transactions

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can occur during the life of a fund. Both the manager and investors have an incentive to ensure that the organizational and disclosure documents of the funds clearly define what types of transactions they will consider to be "related-party transactions" and how these transactions will be handled and reviewed by the managers and/or the advisory committee[15]. Adequate and detailed disclosure will make clear to the manager which situations fall within the scope of "relatedparty transactions" and are thus subject to the conflict of interest rules established by the manager. In its reporting template, the ILPA proposes a definition of "related party"[16] which can be used by managers and investors as a guideline to determine which situations should be covered. On the other hand, investors must understand that not all conflicts of interests are problematic and need to be addressed.

There is a certain level of misalignment between the manager's and the investors' respective interests in a fund[17] and not all of it can be managed in a cost-efficient manner; meaning that it is preferable for investors to accept that managerial actions may conflict with their best interests rather than seeking a perfect alignment of the manager's interests with their own or trying to give to the advisory committee a power of oversight over any type of misalignment. Hence, all parties involved should take a balanced approach in negotiating the conflict of interest provisions of a fund's limited partnership agreement or a side letter between the manager and an investor and pinpoint specific situations in which the advisory committee should be consulted or approve a related-party transaction.

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1. See SAHLMAN, William A. (1990). The Structure and Governance of Venture-Capital Organizations. Journal of Financial Economics, Vol 27, pp. 473-521 regarding the issue of information asymmetry in investment funds.
2. Securities and Exchange Commission speech – Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, "Conflicts, conflicts everywhere", February 26, 2015.
3. This article cites certain regulations and policy statements of the Canadian Securities Administrators(« **CSA** ») and certain cases litigated by the SEC in the United States. Although many Canadian private equity or venture capital funds and their managers are not subject to regulatory oversight by the CSA and are therefore not governed by these regulations or case law, the guidelines developed by the CSA and the extensive jurisprudence developed by the SEC could potentially support a lawsuit brought by investors in Canada against unregistered managers for breach of fiduciary duty based on the *Civil Code of Québec,* , in Québec, the organizational documents of the funds, or the securities legislation of certain provinces providing for a statutory right of rescission or damages for misrepresentations in PPMs. The standards discussed in this article should therefore be relevant and should also be used as guidance for Canadian managers not registered with a Canadian securities regulator.
4. In the case of a fee based on an amount of assets under management, for example, the disclosure should clarify how those assets are valuated
5. See Section 13.4 of the Policy Statement to Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations ("Policy Statement 31-103") which states: "Registered firms and their representatives should disclose conflicts of interest to their clients before or at the time they recommend the transaction or provide the service that gives rise to the conflict."
6. SEC, Litigation, Release No. 4219, 2015.
7. Policy Statement 31-103 states that the disclosure must "be prominent, specific, clear and meaningful to the client, and explain the conflict of interest and how it could affect the service the client is being offered".
8. See in particular the requirements set forth in *Regulation 23-102 respecting Use of Client Brokerage* Commissions and the related policy statement. Reminder: A registered manager has a "best execution" obligation, i.e. it must find the most advantageous trading execution terms reasonably available under the circumstances when selecting a broker-dealer for trades effected on behalf of the fund, as prescribed by *Regulation 23-101 respecting Trading Rules.*
9. ILPA Best Pracices. See more particularly footnotes 4 and 5 of the sample report attached to the Quarterly Reporting Standards, Version 1.1 of the ILPA (originally released in October 2011 and revised in September 2016).
10. *Regulation 81-106 respecting Investment Fund Continuous Disclosure* in Québec.
11. NI 81-106 applies to investment funds (as defined in the Securities Act (Québec)) that are reporting issuers. For more information on the definition of "investment funds" in the *Securities Act* (Québec), see our article entitled "Registration Requirements of Venture Capital and Private Equity Fund Managers in Canada: A Favourable Regulatory Framework" published in May 2014 in the *Lavery Capital* newsletter.
12. NI 81-106 refers to the Canadian Institute of Chartered Accountants Handbook with respect to the notion of "related party".

13. See Section 13.4 of Policy Statement 31-103 under the "Compensation Practices" section. See also the "Compensation-related conflicts of interest" section in the Investment Industry Regulatory Organization of Canada (IIROC) Notice 12-0108.
14. In this article, the term "competing funds" simply refers to funds that are authorized to invest in the same opportunities and can therefore be considered to be competing with each other with respect to certain types of investment opportunities.
15. The requirement to submit a related party transaction to the advisory committee is typically found in investment funds raising capital from institutional investors, not in retail-type funds
16. See the "Related Party Definition" tab of the ILPA Reporting Template (Version 1.1 published in January 2016).
17. For example, the carried interest compensation structure typically found in many funds can give the manager an incentive to make riskier or more speculative investments than what would normally be in the best interests of the fund's investors in order to generate greater compensation.