CODES AND INDUSTRY STANDARDS COVERING THE BEHAVIOUR OF ALTERNATIVE INVESTORS

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As part of its work on hedge funds and private equity, the Steering Group on Corporate Governance agreed to compile a list of private sector initiatives aimed at addressing policy issues and to update it regularly.

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TABLE OF CONTENTS

THE BEHAVIOUR OF ALTERNATIVE INVESTORS: CODES AND INDUSTRY STANDARDS 3
1. Private contracting and the potential for voluntary guidelines, best practices etc. 3
2. General guidelines and principles 4
2.1 EVCA Corporate Governance Guidelines..5
2.2 Dutch code of conduct for private equity 6
2.3 UK guidelines for disclosure and transparency covering large buyouts 8
2.4 Principles and guidelines agreed by the President's Working Group about private pools of capital10
2.5 Hedge funds: The AIMA code 11
2.6 Hedge funds: Hedge Fund Working Group proposals 11
2.7 Institutional investors 12
3. Guidelines and Codes on specific issues...12
3.1 Securities lending 12
3.2 Market abuse 13
3.3 Valuation Guidelines...13
BIBLIOGRAPHY 15

Tables

Table 1. Major issues covered by private contracts and priorities..4

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THE BEHAVIOUR OF ALTERNATIVE INVESTORS: CODES AND INDUSTRY STANDARDS

At its last meeting in April 2007, the Steering Group decided to examine general policy issues raised by alternative investors at its November meeting. It was also decided that such a discussion would be informed by industry codes and standards developed through private initiatives. This Annex briefly summarises codes of behaviour etc covering the specific market environment (e.g. share lending) as well as activist hedge funds and private equity more directly. However, the bulk of the reviewed codes etc cover mainly private equity. Activist strategy is still only implemented by a small number of hedge funds (some 350 out of an estimated 6500) and with a great deal of heterogeneity in the sector, it is more difficult to detect what is regarded as appropriate in the industry compared with private equity where industry associations are more developed. This potential gap might be filled through an information exchange with the sub-sector of the industry. The Annex does not cover the broader regulatory framework such as "guidance" issued to augment takeover codes since they are more legal in nature and the emphasis here is with private initiatives. The regulatory policy issues are covered in the main paper.

This paper first discusses private contracting before considering general codes of conduct. Finally, it examines codes etc covering specific aspects of behaviour such as stock lending and valuation.

1. Private contracting and the potential for voluntary guidelines, best practices etc.

The paper discussed by the Steering Group in April, *The implications of alternative investment vehicles for corporate governance (2007)*, noted that with both private equity and activist hedge funds, the relationship between fund managers (general partners hereafter) and investors (limited partners) is specified in private contracts established within the general legal framework. In many jurisdictions, the legal construction of limited liability partnerships is the most used form of association: investors are limited partners making capital commitments and agreeing to make cash contributions to be managed by the general partners. As McCahery (2007) notes, the purpose of the contract with the limited partners is to mitigate the potential for agency problems in the reinvestment of capital and the very long nature of the contract (8-10 years). Many rules for the limited partners are default rules (e.g. lifespan, profit sharing, distribution of profits, and continuation of partnership). The default rules do not give limited partners power to remove general partners (no residual right of control) so that free contracting means that virtually all control over the investment fund is in the hands of the general partners. However, limited partners often have a right to vote on the dissolution of the limited partnership, the sale of its assets, change in the nature of its business and the admission, removal or retention of general and limited partners. In sum, limited partners have few control mechanisms so that contracts are used to establish a structure of incentives to solve the agency problem.

In establishing an incentive structure to influence the behaviour of fund managers there appear to be a number of contractual provisions that are summarised in Table 1. Of particular note is the hurdle rate which links returns to the general partners (i.e. the private equity partnership) to the performance of the fund so that *ex-ante*, general partners have fewer incentives to invest in poor deals in order to only collect a management fee. Claw-back provisions ensure that general partners don't benefit from a distribution based

on performance that might only be temporary. Provisions covering potential conflicts of interest take the place of fiduciary duty obligations usual for other investment vehicles such as mutual funds, and limit the potential for general partners to compete with their own funds. Covenants are also used frequently especially in countries with a strong legal framework.

Table 1. Major issues covered by private contracts and priorities

General partners	Limited partners
Carry Calculations	Carry calculations
Management fees	Claw-back provisions
Claw-back provisions	General partner conflict issues, including limitations of opportunities
General partner capital commitment	Key-man provisions
Limitations of liability	Management fees
Indemnification by general and limited partners	General partner capital commitment
Investment strategy, limitations and guidelines	Side letters
Fundraising period, investment period and term	Investment strategy, limitations and Guidelines
Permitted activities of general partners	Permitted activities of general partners
Limited partner approval rights	Portfolio company fee offsets

Source: McCahery (2007) and Blaydon and Wainwright (2004)

In this private contracting framework there might well be an economic incentive at some stage to economise on information costs by establishing standard contracts based on “best practice”. In a 2004 survey in the US, one study (Blaydon and Wainwright, 2004) reported an interest especially by limited partners to develop a model contract, but it is not known to what extent a template has developed spontaneously. Such an evolution has often been observed in financial markets. Industry associations or leading players have often been involved in establishing a default standard. Regulators concerned with investor protection and/or financial market stability have also on occasion sought to standardise contracts, in part through laying down some principles to be followed by an industry body through for example, reporting guidelines, code of conduct, valuation guidelines and governing principles. The examples documented below illustrate each approach.

2. General guidelines and principles

Guidelines and principles usually covering private equity have been developed in several jurisdictions. Those reviewed below do not constitute an exhaustive list at this stage and non-English language codes might have been overlooked. The assistance of the Steering Group is therefore requested.

2.1 EVCA Corporate Governance Guidelines

The European Venture Capital Association Corporate Governance Guidelines (EVCA, 2005), cover both private equity and venture capital over all stages of their investments. The starting point is that general partners recognise good corporate governance as a key element in value creation. They have in turn contributed to good corporate governance of unlisted companies by being board members as well as by demanding rigorous monitoring and reporting. The reason for developing the Guidelines stems from the acknowledgement that private equity and venture capital investments may give rise "to situations in which there is a conflict between competing interests of various parties to a business transaction or negotiation. It is the intention of these guidelines that those participants in the private equity and venture capital industry who seek to follow them will seek to manage such conflicts openly, honestly and with integrity" (EVCA, page 4).

The guidelines are based on seven underlying principles: law and regulations; integrity; partnership, the long-term view, respect for stakeholders, transparency and confidentiality. Conduct should be in accordance with applicable law and regulation and general partners are expected to act with integrity towards the investee company and its stakeholders. They should ensure that the investee company conducts its business with integrity and the business model should aim to create value by taking a long-term view of investment and therefore supporting management of the investee company in the achievement of long-term objectives and strategies. With respect to stakeholders, the principles recognises a complex situation and notes that the conduct of business will be successful in the long-term where the interests of stakeholders, including investment fund providers (i.e. limited partners), the fund manager, the board of directors, company management, employees, customers, suppliers and other stakeholders are respected, and in which conflicts of interest are managed appropriately. With respect to transparency, the investors should establish transparent communications with investee company management.

Based on the above underlying principles, the guidelines focus on three main areas, and each identified responsibility is accompanied by recommendations. The general areas are; principles of conduct as shareholder; principles of conduct as board member; and principles of conduct for management. Guideline 4.1 deals with responsibilities to other shareholders in the same or other classes of shares and to bond holders. It notes that returns for each type of investment, whether equity or debt, will frequently be variable and dependent on certain outcomes. It recommends that the negotiation of shareholder rights should be conducted openly and with clarity. "Due consideration should be given in advance to potential areas of conflict and, where conflict does arise, the resolution of the conflict should, to the extent possible, be conducted fairly. The guidelines recognise that the general partners will require frequent and detailed reporting by the investee company in order to fulfil its own duties as a shareholder and to its investors (i.e. limited partners). They recommend that the general partners should treat such corporate information with due consideration to commercial sensitivity and the needs of the investee company's other stakeholders.

Other recommendations cover board duties and are very similar to the OECD Principles. Another chapter covers the conduct of management and goes beyond the Principles in that they cover how decisions of the board are to be implemented.

The EVCA has also developed Reporting Guidelines (EVCA, 2006) to reflect the evolution of common reporting practices within the industry, setting out recommendations intended to represent the contents of reports to investors in private equity funds. The document presents two forms of guidance: requirements that must be applied to enable a fund manager to claim compliance with the guidelines and; recommendations whose adoption is left to the discretion of the fund manager and are not considered as key in nature. Unlike the potential guidelines in the UK (see below), the EVCA assumes that detailed

portfolio company information and other similar information would be kept confidential and would not be disclosed beyond the private equity firm and the investors. They recognise that Freedom of Information Acts may present a problem (e.g. as when public pension funds have to disclose to the public confidential information received from the general partners) and simply calls for fund managers and investors to make their own judgements regarding what further disclosure they might make.

There are three overall reporting principles: relevance, transparency and consistency. Transparency means that information on all relevant topics regarding the evolution of the fund's performance (a fund might have investments in several companies) should be communicated to investors in a transparent manner. Reporting should be semi-annual and the extent of external audit will be set by contractual agreement with the investors. An executive summary should include not just financial information such as internal rates of return for the fund, investments and commitments, but also any significant changes in the management company or among general partners, and any changes in portfolio or fund strategy. Material risks should also be identified together with events that have had, or might have, an impact on the future performance of the fund. Importantly for the development of standards, there should be a statement of compliance with the EVCA reporting guidelines.

There are a number of requirements for reporting about portfolio companies, including their identity and cost of investment, current fair value and interest and dividends received since inception. There should also be disclosure about percentage ownership and board representation, if any, as well as a brief analysis of significant events both over the reporting period as well as anticipated. A number of key performance indicators (e.g. EBITDA) should also be reported together with comparisons with other types of company and sector.

An important area concerns disclosures about fees and carried interest since they involve potential conflicts of interest and this information is important in assessing the incentive structure from the viewpoint of the investors. In particular, Requirement 14.1 calls for a "clear statement of related party transactions, benefits and fees, broken down into principal categories (e.g. underwriting fees, directors and monitoring fees, deal fees, broken deal fees etc). Another requirement calls for the reporting of net management fees and others specify requirements for reporting about carried interest of the general partners, both paid and accrued, together with the value of any potential claw-backs.

2.2 Dutch code of conduct for private equity

The Dutch code (Dutch Private Equity and Venture Capital Association (NVP), 2007) complements the EVCA guidelines with the stated objective to create more transparency in terms of the operating methods of the Association's member private equity firms and to encourage the professionalisation of the private equity sector. The code of conduct has been adopted for a trial period of one year and after an evaluation, it will become compulsory for all NVP members, unlike the EVCA guidelines. Infringement of the code may result in expulsion from the Association. The code of conduct covers the type of agreements that private equity firms reach with investors and with the parties involved in the participation process. The code of conduct outlines how private equity firms "… are supposed to provide clarity on their plans and objectives towards investors, management, supervisory board members and other directly involved parties, and how when conducting their business, NVP members are supposed to take into consideration the interests and responsibilities of other interested parties, in the event of a (planned) investment in a portfolio company located in the Netherlands" NVP (2007). The concern with other parties to the transaction and with the potential cooperation with management makes it very similar to the EVCA guidelines. Unlike the EVCA guidelines, the code of conduct also includes guidelines relating to transparency towards the public and the media. However, they do note that "…private equity firms are private, not public, which means the

extent and scope of the demands that can be placed upon them in terms of transparency cannot be (properly) compared with what is common on the stock exchanges".

The general principles are similar to the EVCA's. A private equity firm enters into a business relationship lasting several years with the directly involved parties (investors in the private equity firm, management, other shareholders, the supervisory body, the works council, credit providers of the portfolio companies) and there is open communication in closed circles so that all understand the relationship. A private equity firm is not automatically transparent to parties that are not involved. However, "a private equity firm is aware of its public responsibility and of the role its portfolio companies play in society".

The best practices are aimed at each of the parties involved and cover, *inter alia*:

- Investors in a private equity firm—a private equity firm will inform its investors sufficiently taking into account their specific information needs and in line with their contractual agreement. If institutional investors are subject to supervision such as some pension funds, the private equity firm will make every effort to ensure that they can comply[1].

- Management of the portfolio company—Prior to the investment, a private equity firm, together with other shareholders and members of the management (whether participating or not) of the portfolio company will draw up a plan outlining in as much detail as possible the strategic course, the financial structure, the expected duration of the participation and the task and responsibilities of the supervising party. In the case of public to private transactions, the plan cannot be made before the transaction, but will need to be done in at most six months. The extent of decision making powers of management should be carefully specified and management empowered to realise the objectives of the company, reporting to the supervisory board and the general meeting of shareholders. In many ways these best practices adapt the OECD Principles to non-listed companies.

- Other shareholders of the portfolio company—there should be a shareholders agreement specifying decision making powers. It may include the frequency and content of information disclosure, management of the portfolio company and confidentiality stipulations, as well as loan agreements. There should be reciprocal transparency between the private equity firm and other shareholders.

- The supervisors of the portfolio company-- The private equity firm should promote adequate and professional supervision of the management of the company. In the event that a supervisory board is instituted, it has the task of supervising the strategy of management and is responsible for taking into consideration the appropriate interests of all parties involved in the company. The private equity firm will ensure that its nominees to the supervisory board are able to fulfil their role adequately, are knowledgeable, and have the opportunity to operate independently of the private equity firm. The supervisory board should have full knowledge of shareholder and management agreements.

[1] In the Netherlands there is a specific requirement of the central bank: Guiding principles for the assessment of sound risk management relating to alternative investments, De Nederlandsche Bank, February, 2007.

- Credit providers and, if applicable, the works council of the portfolio company – In so far as required, other relevant parties should be informed about management arrangements and shareholder agreements.

- Public and media – A private equity company should announce which companies it has in its portfolio unless it is subject to a non-disclosure obligation. The responsibility for transparency about the portfolio company vis-à-vis the public is primarily that of the portfolio company's management. The responsibility carries greater weight according to the public role of the company. A private equity firm that is a shareholder in a large company should use its influence to ensure a certain level of transparency.

To fully understand the import of the Dutch code, it should be noted that the Netherlands is one of the European jurisdictions that emphasises the stakeholder nature of a firm creating some ambiguity as to the powers and responsibilities of a dominant shareholder. The courts have developed some general principles that do recognise a key role for shareholders, subject to restrictions such as of such as proportionality.

2.3 UK guidelines for disclosure and transparency covering large buyouts

The Walker Working Group (2007) presented its private equity Guidelines in November 2007 The Guidelines will operate on a comply or explain basis but since there are no capital markets and shareholders to promote compliance, the British Venture Capital Association (BVCA) has established a committee to monitor and report on compliance and to keep the guidelines under review. The guidelines focus on private equity involved in large buyout transactions, defined as any portfolio company that was previously a FTSE-250 listed company, or where the equity injection by the general partners exceeds 300 million pounds or where the company has more than 1000 full-time equivalent employees in the UK and an enterprise value in excess of 500 million pounds. More than 50 per cent of revenues should also be generated in the UK. The guidelines will also cover cases where a company has been acquired from another private equity fund (secondary sales) and also covers non-market transactions that appear to include purchasing a private company. Given the legal difficulty in defining both hedge funds and private equity, it is important to note the pragmatic approach followed by the Guidelines. The FSA in the UK registers all investment fund managers so that private equity is simply defined as an authorised firm that is managing or advising funds that either own or control one or more UK companies. The Guidelines are more focused than the Dutch guidelines that also cover cases where there are other important shareholders (e.g. as in growth capital transactions where the private equity firm will usually take a minority stake).

The Guidelines recommend transparency requirements for portfolio companies in between those required for listed companies and for private companies. The main ingredients of enhanced reporting should be:

- publishing an annual report and financial statements on a company website within six months of the year-end as against the 9 months currently provided in company legislation covering private companies

- the report to provide detail on the composition of the board, indicating separately executives of the company, board members who are executives of the general partner or fund and directors brought in from outside to add relevant industry or other experience

- the narrative in the statements by the Chairman or CEO and in the board's operating review to refer to the company's values and approach to its reputation, with specific reference to

employees, customers and suppliers and, as appropriate the company's role in the wider community. The business review should be substantially the same as those required for quoted companies.

- the financial revue should cover risk management objectives and policies in the light of the principal financial risks and uncertainties facing the company, including those relating to leverage, with links to appropriate detail in the footnotes to the balance sheet and cash flow section of the financial statements.

- there should be a short interim statement not more than three months after the mid-year, but no requirement is envisaged for quarterly earnings statements.

- Portfolio companies should provide data to the BVCA in support of its enlarged role in the gathering and aggregation of data and associated impact analysis.

More extensive reporting is also envisaged for the general partners themselves with heavy emphasis on soft factors such as the values that inform their approach to business. The disclosure by them should include:

- an indication of the leadership team of the management company, identifying the most senior members of the general partner team or general partner advisory group and confirmation that arrangements are in place to deal appropriately with conflicts of interest, in particular where it has a corporate advisory capability alongside its fiduciary responsibility for management of the fund or funds

- a commitment to conform to the guidelines on a comply or explain basis

- an indication of the firm's history and investment approach including investment holding periods, where possible illustrated with case studies

- a categorisation of the limited partners in their funds, indicating separately UK and overseas sources, to include pension funds, insurance companies, corporate investors, funds of funds, banks, government agencies, endowments of academic and other institutions, private individuals and others.

The Guidelines also cover the approach that should be taken by the general partners or fund in a situation in which a portfolio company encounters severe business difficulty that threatens its survival. They require that in the event that a portfolio company encounters difficulties that leave the equity with little or no value, the private equity firm should be attentive not only to full discharge of its fiduciary obligations to the limited partners but also to facilitating the process of transition for the portfolio company as far as it is practicable to do so.

While the prior consultation paper found that disclosure to limited partners had been well covered by private contracting arrangements and accepted that there was no need for intervention, the final guidelines take the opportunity to restate standards. The Guidelines call for private equity firms to follow the reporting guidelines of the EVCA (see above) covering, *inter alia*, details of management and other fees attributable to the general partners, an important form of related party transaction. In reporting, they should also value investments by using either the valuation guidelines published by the International and Private

Equity Board (IPEV) or those published by the Private Equity Industry Guidelines Group (PEIGG) or such other standardised guidelines as may be developed in the future (see below).

The Guidelines also call for funds to provide an extensive body of data on a confidential basis to a party appointed by the BVCA. Data to be collected in aggregate includes: scale of funds raised, categorisation of limited partners, leverage levels and debt structures, estimates of levels and changes in employment, aggregate performance measures of portfolio companies, estimates of fund performance, estimates of average fee payments by portfolio companies, and information about exits. The intention is to undertake an attribution analysis of the source of value increase in a privet equity transaction (e.g. what is the role of leverage).

2.4 Principles and guidelines agreed by the President's Working Group about private pools of capital

The approach of the President's Working Group on Financial Markets is to cover all private pools of capital (private equity and activist hedge funds are simply a subset) although emphasis is given to funds involving complex derivatives with difficult valuation issues and the associated systemic risks. The general approach is to ensure that the market discipline of risk taking is the rule and government regulation is the exception. There are two overarching principles:

- Private pools of capital bring significant benefits to financial markets. Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk.

- Supervisors should use their existing authority with respect to creditors, counter parties, investors and fiduciaries to foster market discipline vis-à-vis private pools of capital. Investor protection concerns can be addressed most effectively through a combination of market discipline and regulatory policies that limit direct investment in such pools to more sophisticated investors.

Attention is paid to investor protection principles, several of which are applicable to private equity and activist hedge funds and their respective investors. They address investors directly, their fiduciaries such as pension funds and mutual funds and the supervisors of the counterparties. Among the relevant principles are:

- Investors should obtain accurate and timely historical and ongoing information to enable them to make informed decisions. They should consider the private pool's manager's conflicts-of-interest and whether the manager has appropriate controls in place to manage those conflicts.

- Managers of private pools of capital should maintain and enhance information, valuation, and risk management systems that meet sound industry practices and enables them to provide accurate information to creditors, counterparties, and investors with appropriate frequency, breadth and detail.

The President's Working Group has set up two complementary private sector groups to address issues of investor protection and financial stability. One group is for hedge fund managers and the other for hedge fund investors.

2.5 Hedge funds: The AIMA code

Hedge funds are a very heterogeneous group, of which activist hedge funds are still quite a small proportion with a distinctive strategy (e.g. there might indeed be little actual hedging). Reflecting this complexity, the AIMA Guide to Sound Practices (2007a) that covers only Europe notes that given the range of investment strategies and operational issues, some or all of the practices set out in the guide may in fact be inappropriate in specific circumstances: sound practices should not be regarded as definitive or "best practices". Two articles are particularly relevant for activist hedge funds. Article 2.1.7 states that hedge fund managers should conduct themselves in a manner which a reasonable market participant would deem prudent, honest and reputable. Hedge fund managers should ensure that they understand the local law and regulations governing the EU Market Abuse Directive. Article 2.1.9 states that Hedge Fund managers should be aware that potential conflicts of interest might exist or develop from many sources, including formal or informal discussions, activities in the market and other business activities. Where they do exist or develop, the hedge fund manager should ensure it has policies and procedures in place for identifying such potential conflicts of interest. Any such potential or actual conflicts of interest should be kept under regular review by the senior management of the hedge fund and by those responsible for compliance. Hedge fund managers should also provide adequate disclosure to investors on a consistent, regular and timely basis.

2.6 Hedge funds: Hedge Fund Working Group proposals

Responding to a recommendation by the Financial Stability Forum (2002) that the private sector should take the lead in developing codes of best practice for highly leveraged institutions, the Hedge Fund Working Group was formed in the UK comprising industry participants. A discussion paper was released in November 2007 with a final paper expected in January 2008. The approach taken by the Group is UK specific since it is built around the FSA's eleven Principles for financial market regulation. The Group identifies 15 major issues that are grouped under four headings: investment policy, risk and commercial terms disclosure; valuation; risk management and; activism. Although disclosure is an important issue, for the purpose of focusing on the implications for corporate governance of portfolio companies only the fourth category is of key concern here.

With respect to active the Group identifies specific underlying concerns to include "prevention of market abuse" such as insider trading and issues relating to shareholder conduct and proposes six best practice standards and guidance:

- Hedge funds managers should ensure that they have internal compliance arrangements to identify, detect and prevent breaches of market abuse laws and regulations. Best practices include a compliance officer reporting directly to the fund governing body, an internal register where an employee believes that they have received insider information and a restricted list in these cases, and open relations with the regulator. Mangers should document where they are acting with other parties supporting the same strategy.

- Hedge fund managers should disclose to investors in the fund's offering documents whether the manager has a policy to prevent market abuse. The document also calls for clarification by the supervisory authorities about the meaning of "acting in concert", an issue taken up in this report.

- Hedge fund managers should have a proxy voting policy which allows their investors to evaluate the general approach the manager takes towards proxy voting and to determine whether this approach is consistent with their own objectives. The HFWG acknowledges that not all funds will be in a position to vote all proxies and might adopt a systematic approach, for example never

voting except in exceptional circumstances. The guideline therefore recognises the enormous variety of hedge fund strategies.

- The proxy voting policy document should be made available to investors and companies in which the funds have an investment upon request. The hedge fund manager should also document cases where the voting policy has not been followed and report to the fund governing body.

- Recognising the importance of companies knowing at times the identity of their significant shareholders, the HFWG recommends that regulators take action to introduce a regime (similar to that of the Takeover Panel in the UK applicable during takeover offer periods) requiring notification of "economic interests" in shares held via instruments such as contract for differences (CFD).

- Hedge funds following best practice will not engage in practices such as voting on borrowed stock while not being economically exposed (e.g. where they have fully hedged the economic interest but retain the voting rights).

The HFWG has thus touched on many of the issues discussed in the main report and follow the OECD Principles quite closely. The FSA (2007a) has recently proposed to change regulations covering disclosure of contract for differences.

2.7 Institutional investors

In view of the fact that both private equity and hedge funds draw heavily on institutional investors for their financing, codes and guidance for such investors might also serve to structure to some extent the market environment for alternative investment fund managers and to structure their behaviour with respect to corporate governance. One example is the ICGN Statement of Principles on Industry Shareholder Responsibilities (2007) while others focus on specific issues such as long term investing (Marathon Club, 2007). A fuller review is, however, beyond the scope of this Annex.

3. Guidelines and Codes on specific issues

3.1 Securities lending

Securities lending is used by both activist hedge funds and by private equity on occasion. There are a number of codes covering the conduct of stock lenders that could potentially impact behaviour by activist hedge funds and private equity if implemented by institutional shareholders and brokers. They include Securities Lending and Repo Committee (2004) and ICGN (2007). In addition, the International Securities Lending Association (2004) has issued additional advice. Other codes relate more to the actual operations and organisation of stock lenders and include the Australian Securities Lending Association (1997).

The Stock Borrowing and Lending Code of Guidance (2004) makes it clear that although it is technically possible for someone to borrow securities to vote, it is not regarded as good practice: "there is consensus in the market that securities should not be borrowed solely for the purpose of exercising the voting rights at, for example, an AGM or EGM (extraordinary general meeting). Lenders should also consider their corporate governance responsibilities before lending stock over a period in which an AGM or EGM is expected to be held".[2] The guidance goes on to note that it is vital that beneficial owners are

[2] This position was also supported by Paul Myners, 2005.

aware that when shares are lent, the right to vote is also transferred: "agents should make it clear to clients that voting rights are transferred". Further advice was issued by the International Securities Lending Association (2004) and endorsed by *inter alia* the London Stock Exchange. This recognises that a balance needs to be struck between the importance of voting and the benefits derived from securities lending. The advice explores how securities lending and good corporate governance can be arranged so as to minimise conflict to the overall benefit of the institutions involved, the corporations and the market. The advice notes that some 40 per cent of investors recall securities to vote and make it part of their contracts. Of those who do recall shares, 44 per cent do so to vote on contentious issues but only 20 per cent to vote on all proxies. This means that nearly 60 per cent do not recall securities to vote. However, the study notes that for the FTSE 100 the volume of share lending is only in the range of 4% of market cap, far outweighing the shares that are never voted.

The ICGN Code of Best Practices (2004) is addressed to investors, market intermediaries and public companies, and is based on three broad principles: transparency, consistency and responsibility. Transparency refers to the internal operation of the primary investor and calls for share lending to become subject to the same visibility and safeguards as any other transaction conducted on an owner's or beneficiary's behalf in a securities account. For consistency, a clear set of policies should indicate with as little ambiguity as possible when shares shall be lent and when they should be withheld from lending or recalled in order to ensure that similar situations are handled in the same way. Thus the lenders corporate governance policies are brought into line with policy to earn short term remuneration. Responsible shareholders have a duty (often a fiduciary one in the case of large institutional investors) to see that votes associated with their shareholdings are not cast in a manner contrary to their stated policies and economic interests.

In practice, the ICGN Code of Best Practices might be difficult to implement, especially in large institutions. For example, in jurisdictions with an early record date the issues to be decided may not be known well enough in advance for a recall policy to be effective. The ICGN code therefore provides more detailed guidance in several appendices while noting that best practice may be achieved by other mechanisms. While acknowledging that a lent share has in fact been legally acquired by the borrower, it suggests that the lender's Master Lending Agreement should specify that shares are not being lent for the principle purpose of voting these shares, and should provide clear guidance as to what circumstances might permit a borrower to vote borrowed shares as well as the responsibilities of any lending agents might be in those circumstances.

3.2 Market abuse

A number of industry codes of conduct cover the issue of market abuse. For example, the "Joint Statement Regarding the Communication and Use of Material Non-public Information" (2006) sets out guidance regarding the communication and use of material non-public information in connection with certain securities, credit derivatives, loan and other credit market transactions, and pledges to undertake various initiatives to inform, educate and provide additional guidance to members, non-members and other interested parties alike. A number of respondents to a recent FSA consultation cited the Joint Statement as relevant for private equity transactions (Financial Services Authority, 2007).

3.3 Valuation Guidelines

There are now a number of valuation guidelines for both private equity and hedge funds. For private equity, the EVCA and BVCA (British Venture Capital Association) standards were consolidated in 2005 into the International Private Equity and Venture Capital Guidelines and are currently adopted by 32

private equity trade associations outside of the US. In the latter, guidelines developed by the Private Equity Industry Guideline Group are used. The two sets of guidelines are substantially aligned and are widely held in both the industry and accounting profession to be representative of best practices. They are based on fair value. However, a lacuna for both hedge funds and for private equity appears to be an accepted methodology for calculating fund performance. Valuations are not so much of an issue to investors in private equity since the arrangements for carried interest are triggered only at the point of exit from a portfolio company holding, while other compensation is based on committed funds.

With respect to hedge funds, valuation appears to be more of an issue and in some cases they trigger payments to the general partners, albeit with claw-back arrangements (see *The implications of alternative investment vehicles for corporate governance, (2007)*). Guidelines include those of AIMA (2007b). Arrangements for activist hedge funds are not known but could well be different given their longer time horizon than is usual for normal hedge funds. Disclosure of the valuation methodology to investors is also stipulated.

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