

Transparency in Asset Management

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Some bills recently proposed in California and Kentucky intending to foster transparency in the private equity market were not approved or had some of their disclosure obligations attenuated. A bill in California was even amended to eliminate disclosure on related-party transactions between private equity firms and their portfolio companies¹.

Even though these episodes may be somewhat aligned with promises of the USA's new presidency to cut regulation, they are in contrast with the global trend on regulations requiring greater transparency on private equity practices. They also go against a series of enforcement actions brought by the SEC against private equity firms in the last years resulting from their failure to comply with a number of disclosure obligations.

One of the regulators' main areas of concern is how fees and expenses are handled by Private Equity advisers. The SEC, as pointed out by the US law firm Baker & McKenzie, has found cases where asset managers charge fees not fully disclosed to investors, including fees resulting from questionable advisory services provided by the asset managers, and cases where they shift costs to their portfolio companies (including salary of employees originally hired by the asset management company)². The SEC and other regulators have also become increasingly concerned about the disclosure of the asset management firms' valuation policies and conflicts of interest³.

Following such trend, in 2015 the CVM (the Brazilian SEC) enacted *Instrução* 558 regulating asset management activities in Brazil more thoroughly. The main innovations of this rule in relation to the replaced *Instrução* 306/99 are the more rigid transparency obligations for asset managers.

According to *Instrução* 558, asset managers must prepare and disclose by March 31st of each year on the CVM's and the asset managers' websites, a standard form (*Formulário de Referência*) containing information on the structure,

¹ More details at http://www.nytimes.com/2016/07/03/business/private-equity-funds-balk-at-disclosure-and-public-risk-grows.html?_r=0

² More details at <http://bakerknox.com/rv/ff00192b64a448ec5950c43cf74096407e61fbae>

³ More details at <http://www.pionline.com/article/20160809/ONLINE/160809903/private-equity-managers-must-shift-mindset-due-to-increased-transparency-demand?template=print>

practices and activities of the firm and of its controlling shareholders, subsidiaries and affiliates, as well as on how they charge for each kind of service or managed asset, and the percentage that each kind of fee (fixed fee, performance fee, entry fee, exit fee, etc.) represents in their 36-month trailing revenue.

Instrução 558 also requires that asset managers adopt and disclose codes of ethics, internal controls and risk management policies, as well as rules regarding the identification, administration and elimination of conflicts of interest that may adversely affect their asset management activities.

Some market participants criticized the rule, arguing that the disclosure obligations brought by it are overly burdensome. However, as has happened in other countries, supporters of the rule hold that the additional disclosure obligations are not just driven by what the regulators want, but also result from demands of institutional investors.

As observed by Jim Cass, senior vice president and managing director at SEI Investment Manager Services⁴, sophisticated investors are seeking more transparency on how private equity managers handle their fees and assign values to assets, as such information helps them make more insightful investment decisions. A number of renowned private equity groups have even become signatories to voluntary disclosure and transparency guidelines, such as the Guidelines for Disclosure and Transparency issued by the Bundesverband Deutscher Kapitalbeteiligungsgesellschaften (BVK), the German private equity and venture capital trade association, and the UK Private Equity Reporting Group (PERG) Guidelines for Disclosure and Transparency in Private Equity⁵.

As these movements show, furthering transparency may have become not only a matter of regulatory compliance but also a competitive edge for asset managers.

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⁴ Id.

⁵ See, for example, <https://www.carlyle.com/transparency-reporting> and <https://www.blackstone.com/transparency-disclosure>.