Invest Europe Response to IOSCO Consultation report on

Good Practices for Consideration for Leveraged Loans and CLOs

Who we are

As recognised by IOSCO on several occasions, private finance plays a role in servicing the real economy, in particular by providing capital that public finance or banks are unable to give to businesses (for example, venture capital gives funding to start-ups that banks would have a hard time providing due to the perceived riskiness of start-up firms). Overall, private finance is an important addition to banks and public markets, and its very presence helps diversify the real economy's exposure to public market volatility.

As a segment of private finance, **private equity, which Invest Europe represents, is particularly relevant to both its investors and the employees of the firms it supports**.

The main aim of private equity funds is to help build successful businesses by making long-term – on average six years - equity investments and by actively managing these investments. As such, private equity plays an important role in delivering economic growth that creates jobs and enhances the long-term competitiveness of the markets they are active in.

As IOSCO noted, the issuance of a leveraged loans involves many different market participants. This includes certain types of private equity "sponsors". Importantly, these sponsors only constitute part of the private equity market, which only rely on the use of debt in the case of the buyout model.

Our general comments on IOSCO good practices

Overall, good practices proposed by IOSCO often follow existing market practices. These have been fine-tuned over the years and reflect the realities of a commercial arrangements between two private parties, both of which being made up of large teams with extensive experience in these deals.

Where there are divergences between market practices and the proposed good practices, we find that they often have the right objective – but the wrong method to achieve it. In these cases, the guidance could create some real concerns for commercial practices and lead to situations where deals reflect less the reality of some debt arrangements than general principles, which are not suited to the realities of these specific arrangements.

While high level practices are important to ensure borrowers and investors can find common ground, we therefore invite IOSCO to consider whether some of the more specific ones it has laid out could create challenges and not leave sufficient flexibility to experienced negotiators which share the objective of ensuring the debt can be repaid over time.

We remain at the disposal, as representatives of both fund managers and investors in their funds, to give IOSCO further indications on the specificities of these deals and the way the conflicts it has identified are met by existing market practices.

1. Origination and refinancing based on sound business premise

Measure 1 Debt repayment capacity test

Question 1

Would a consistent debt sustainability disclosure within the term sheet based on the borrowers' base case cash flow modelled projections assist investors during the negotiation and investor assessment phase? Should this debt repayment capacity test disclosure be based on 2 measures: both total committed and total funded debt?

There is no question that appropriate debt sustainability disclosure is important for investors to be aware of the debt repayment capacity. At the same time, the ability to repay debt over time is key to any private equity sponsor involved in such types of deal.

As a general point made across this paper, this does not mean that one approach will necessarily be better than another, nor that the two private parties involved in the deal may find it more appropriate to negotiate specific disclosure as opposed to another.

In fact, we argue that imposing certain models may force deals in a certain direction, that may not necessarily be beneficial to investors and sponsors/borrowers, as it does not take into consideration the specific features of specific deals and as it hinders valid commercial practices.

As can be seen in the table below, the way private equity sponsors envisage debt repayment is based on detailed analysis – but an analysis that is specific to the conditions under which the company has undertaken the debt. Testing the debt repayment over a defined number of years for example, may be appropriate for some deals, but would not be for others. What ultimately matters, from the firm's viability over the long term, is the interest cover ratio and the EBITDA ratio.

The model usually provided alongside the term sheet will indicate adequate cash generation as opposed to specific debt repayment.

The leverage is mostly a 'net' test, so we question whether there is much value in demonstrating repayment of the debt if sufficient cash can instead be demonstrated. For a bullet facility, demonstrating actual de-leveraging based on debt repayment is not a typical requirement of the loan contract.

Usually the model (in form and substance satisfactory to the original lenders/ majority lenders) is also a condition precedent to drawdown of the funding. Investors should look for

(i) reviewing the model provided closely and critically;

(ii) reviewing it in line with any financial diligence provided; and

(iii) ensuring that the model is a condition precedent and relevant representations are made in the loan agreement in respect of, and by reference to, the information contained in the model. A refreshed model should be requested on any refinancing, repricing or restructurings.

How is debt reimbursement calculated in a private equity buyout context

When a private equity fund invests in a company, the reimbursement of debt will be looked at by the lender through a series of measures whose main objective is to ensure that the debt of the company can be reimbursed over time:

1) structural ratio: this looks at the net debt over the assets of the company and/or its equity
2) EBITDA ratio: calculating the evolution of the net debt over EBITDA over time
3) interest cover ratio: looking at whether the cash EBITDA covers interest costs to be paid on a yearly basis

The third ratio is the most important from a private equity perspective – the least important of the ratios will be the structural one, which should always be met if the other two are met.

These 3 ratios are negotiated at the moment of the investment and capture the risk posed by the use of debt in a leveraged buyout context. The more stable the company is, the larger the debt service can be. If one of these ratios is not met, the bank may change the terms of their debt service.

Question 2
Should there be a further debt repayment capacity test based on permissible incremental debt and if so, should incremental cash flow generated from the incremental debt (if applicable as some incremental debt is used to pay out a dividend) also be included?

The incremental debt capacity is 'uncommitted' at the start of the deal, i.e., no lenders have agreed to provide these. Furthermore, availability and drawdown of the incremental facility may be subject to conditions. As such, it should not be seen as debt capacity readily available to the borrower for drawing.

Unless there is a clear intention on how the incremental debt will be used (so an identified target that is intended to be acquired for example), the exercise may therefore be of limited value to investors in any case if it is based on an assumed acquisition and assumed cashflow (which might end up being arbitrarily chosen numbers in any case).

It might be more useful for investors to focus on the amount of the incremental capacity approved in the documentation and any conditionality around drawings to keep a check on over-leveraging.

Question 3
To what extent should debt repayment capacity be linked to a financial covenant in a loan document and how should this be constructed? Does a debt service ratio covenant (DSCR) need to be reintroduced into loan documentation or adapted to measure debt repayment capacity test?

Linking a financial covenant to debt repayment capacity (beyond the usual leverage covenant) will have a significant (negative) impact on deals.

Absent any required amortisation which the lenders and sponsors have agreed to on a transaction, a financial covenant based on debt repayment capacity may be viewed as a back door amortisation requirement. For a business in a recessionary environment, this might compound the problems and cause an earlier cashflow issue, perhaps without allowing the company sufficient runway to improve the situation.

A debt service ratio covenant has traditionally been a useful covenant on certain transactions, in particular where the cashflow of the underlying business is cyclical. Inclusion of a DSCR can be considered on a transaction-by-transaction basis and included if this a metric deemed appropriate given nature, scale and leverage of the business.

Measure 2 Dividend Recaps

Question 4
- Should limitations be placed on the ability to effect debt-financed dividend recapitalisations e.g., based on minimum equity, total leverage, debt repayment test?

In most LLs, there is a permission from day 1 to make distributions subject to pro forma compliance with a leverage-based test. This is typically a leverage threshold which lenders are comfortable with and reflective of the fact that the business has de-leveraged substantially before distributions to shareholders is made.

However, if during the life of the LL, the business has outperformed and has improved its EBITDA and/ or debt service ability, additional debt may be incurred for a re-capitalisation (it is not uncommon that an incremental facility may be used for this purpose).

In that context, focus should rather be on capacity for incurrence of additional debt and right sizing it to the type, nature and leverage of the business upfront and possibly differential thresholds can be considered for incremental debt to be used for permitted investments versus distributions to this end.

The borrower/ sponsor must be allowed to effectively manage cash of the business and, if there is surplus cash that can be returned, then there should be appropriate flexibility to do so.

Question 5
- Should dividend recapitalisations only be permitted based on an initial origination or full debt refinancing (and not be permitted using incremental facilities in which all existing loan investors may not wish to participate)?

No.

As opposed to prohibiting some incremental facilities altogether, focus could rather be on capacity for incurrence of additional debt and right sizing it to the type, nature and leverage of the business upfront and possibly differential thresholds can be considered for incremental debt to be used for permitted investments versus distributions to this end.

Measure 3 Enterprise Values (EVs)

Question 6
Would a clearer disclosure of the arranging banks' calculation of the borrower's EV, including high level methodology (i.e., Discounted Cash Flows / Income Method, Asset Valuation, Market Based etc.) and key underlying assumptions (i.e., EBITDA adjustment and total debt) assist investors to make more informed decisions?

In theory, this could assist investors in making better decisions – but in practice there are many reasons why prescriptive guidance when it comes to EVs may not help investors.

On the point of arranging banks' calculation of the borrower's EV, we assume arranging banks might be hesitant to share their analysis (as it would open them to claims of reliance on that information, in particular if the investment does not do well).

Importantly, from a private equity perspective, private equity sponsors have fiduciary duty to their investors and would not make investments that they believe are not in their best interests. There is therefore a real alignment of interest between sponsors and investors to ensure debt can be repaid over time.

Question 7
Should EV to EBITDA multiples be highlighted in term sheets and on which basis of EBITDA i.e., proforma, adjusted, historic or forward looking?

As is the case with any commercial decision, a sponsor might invest in a business for many reasons and agree to pay a certain EV for a business based on its perceived value of that business, the industry and its prospects, its plan for that business, potential opportunities and the market pressures (as per classic demand/ supply principles).

Whilst on the face of it, a correlation between EBITDA/cashflow and EV seems obvious, their co-relation is probably non-linear and there are other reasons and factors that would build into the EV attributed to a business by a sponsor.

Insisting on EVs to be calculated on a specific basis might not in all cases yield the desired result. Understanding the rationale behind attribution of a certain EV might be more useful. Sometimes, the answer can simply be that it is the market price for doing the deal in those particular market conditions at the time.

Question 8
- Do you agree that the basis for EVs should be under-pinned by multi-year forecast cashflows and not simply based only on multiples of EBITDA comparable in other acquisitions or buyouts?

See above

2. EBITDA and loan documentation transparency

Measure 4 EBITDA complexity and opacity

Question 9

What key disclosures would assist market participants to come to a more accurate view of pro-forma EBITDA and projected leverage (e.g., what key assumptions should be disclosed in relation to pro-forma adjustments, should there be a disclosure of a more prudent pro-forma adjusted EBITDA with the exclusion of synergies and costs savings)?

While definitions have become more complex over time, investors (and their counsel) are finance (and legal) professionals who are capable of reading the documents and assessing the risk appropriately. Investors are very careful to ensure that debt cannot be provided without provisions around EBITDA add-backs being fully understood.

It is however worth pointing out that some lenders have had difficulties to comprehend the US/bond-style drafting, which may have caused concern amongst some lending institutions less familiar with these products.

Sponsor we consulted for this consultation do not however agree with the assessment that it would be "more prudent" to disclose a pro forma EBITDA number excluding synergies and cost savings. It is crucial that sponsors can have confidence that their lender(s) buy-into their valuations and overall view of the target business. In that context, a key part of this forward-looking view of a business and how positive, value-accretive changes can be made is via synergies (typically stemming from acquisitions) and cost savings.

To provide an exclusionary figure would potentially create a divide between sponsor and lender viewpoints and may inadvertently further muddy the waters in a bid to improve transparency.

Question 10

Is a 25% cap based trailing EBITDA or previous year EBITDA an appropriate cap for add-backs based on cost savings and synergies?

Sponsors generally agree that 25% is an appropriate and workable aggregate cap, although there may be occasions where it is appropriate (either by virtue of sector or deal size) for there to be no aggregate cap but for the agreed upon percentage to instead trigger a certification/verification requirement.

Agreed upon percentage thresholds will typically be run off adjusted EBITDA (tested as at the most recently completed financial quarter) or, certainly in the upper mid-market and beyond, pro forma for the synergies or cost savings in question.

Overall, it should not be the task of regulators to determine commercial negotiations between professional investors, at the risk of creating imbalances in the market.

Question 11
Is 24-months an appropriate threshold for the exclusion of add-backs based on cost savings and synergies?

As above, this is a point that should be commercially negotiated and agreed between parties on a case-by-case basis. The necessity to model into the future is required in a variety of ways when working with leveraged loans. There is therefore no reason to consider the requirement to look 24 months ahead based on reasonable assumptions as being a mandatory threshold.

This mentioned, it is now fairly standard in the upper segment of the mid-market for 24 months to be agreed as an appropriate horizon. However, deals in the mid-market (where the risk profile is slightly different) end up closer to 18 months.

Measure 5 – Transparency on covenants' limitations

Question 12
Would a disclosure of the calculation of the marketed leverage ratio assist investors in analysing borrower credit risk?

Yes, at least from our perspective.

The breakdown of marketed leverage ratio (i.e., opening leverage based-off structuring EBITDA: day-1 drawn debt) is consistently provided across the market.

Lenders and sponsors acknowledged that this detail was typically provided without any issue given its importance to credit approvals.

Question 13

Do you agree with the Measure 5 good practice, and what are the other key term-sheet disclosures that would enhance investor analysis of borrower credit risk?

We agree with the principle of Measure 5 but wish to point out that it is not as such necessary given term sheets typically contain a suitable amount of detail already.

As above, the terms of a leveraged loan agreement reflect the outcome of a commercial negotiation between finance and legal professionals. The starting point of these negotiations is, in most cases, the term sheet, and it is open to both sides to request additional information or clarification around terms.

Institutional investors have been agreeing to these terms for a number of years in order to advance their own aims in deploying capital. A regression of terms to the detriment of the sponsor/borrower is not necessarily the answer. Lenders are advised by qualified and experienced legal counsel who will be able to summarise terms relating to subordination, the ability to establish incremental debt and the ability to transfer assets out of the restricted group.

The 'Best Practice Guide for Term Sheet Completeness' co-authored by the LMA and the ELFA provides a suitable benchmark in this regard. Promoting additional standardisation of this commercial process could create more concerns than advantages.

3. Strengthening alignment of interest from loan origination to end investors

Measure 6 Transparency and fairness during underwriting and syndication

Question 14

Do you agree with the proposed good practices outlined in Measure 6 regarding circulation of a comprehensive term sheet no less than 48 hours before the bank meeting?

There is a series of reasons why such a proposal would not be in the best interest of the parties.

Given that the purpose of the bank meeting is primarily directed towards an analysis of the marketed credit and represents the main opportunity for loan investors to interact with the borrower and the relevant management team in respect of business and credit related queries, circulation of a comprehensive term sheet 48 hours prior to the bank meeting should not be a practice guidance recommendation.

From the perspective of all parties, the existing syndication procedure is already optimal in that it firstly allows investors to allocate appropriate resourcing to an assessment of the credit itself (including the related diligence workstreams). What matters to the potential lenders is the credit quality – as this is based on that factor they make their decision, the financials, business plan and model. Only if they are comfortable with the credit do potential lenders move onto an assessment of the details of the proposed terms of the debt offering (which likely involves analysis undertaken by different teams of specialists within

the investor) and on which they would comment and feedback based on their assessment of the credit.

Circulation of detailed term sheets and other related materials well in advance of the relevant meeting is also operationally burdensome on all parties and could interfere with marketing itself by drawing attention away from the credit story (i.e.: by conflicting with the purposes of the bank meeting itself). In practice we commonly see term sheets circulated shortly after bank meetings for this reason and we see no issue with this approach as the term sheet does not directly assist them in their credit assessment

Question 15

Do you agree with the proposed good practices regarding time for underwriting entities (minimum 2 weeks) and investors (minimum 5 days) to review the full loan documentation?

Guidance should take into consideration that timelines are ultimately a function of the transaction.

In most cases, the deadlines proposed generally hold true in a practical sense - but it may be the case that the relevant transaction requires speedier delivery for varying reasons (whether they be market or company specific).

In our experience, we would normally expect that underwriters have more than two weeks from commencement of process to sign off on the full and final documentation and we are not aware of any issue with respect to transaction timelines. Underwriters are commonly heavily involved in the negotiation of the term sheet and then the full loan documentation often for much longer than two weeks.

As market practice has matured, marketing term sheets have also become very detailed (and continue to become more so), providing for extensive disclosures on the most critical credit and legal points for both underwriters and investors (including detailed summaries of key economic terms, covenants, financial calculations, events of default, transfers and assignments and other deal specific drafting matters). To a large extent, investor focus has largely centred on a detailed assessment of the term sheet (as opposed to full form documentation) with any specific queries as to final forms then being more directed through underwriter channels (including through their respective advisors).

We are likewise not aware of any general issue with regards deal execution from the perspective of investors.

Question 16
What other good practices have been or could be put in place to provide transparency and fairness to investors during underwriting and syndication?

Transparency and fairness are at the very heart of a functioning underwriter and investor relationship. Investors are free to pick and choose allocations at their discretion and

guidance should certainly not hinder this, as well as all not hinder the mechanisms that the industry has put in place to ensure investors are comfortable with the information they have been given.

In the event there are issues of communication and/or perceived lack of transparency and/or fairness of dealing, these will accordingly be made well known to the wider market and be reflected in future dealings.

According to our understanding of the market, investors take an active, timely and considered approach to their investments and underwriters manage their investor relationships in a considered and thoughtful manner. Investors rely on the information provided by the borrower having the benefit of syndication pack which benefits from a wide set of representations in the full documentation which is well established and transparent process.

It is the information provided by the borrower group which is the basis of investors' credit analysis. In relation to the terms of the documentation, there is usually a highly detailed and interactive process between underwriters and investors as to its terms.

Here again the risk of producing guidance is to develop methods that are not suitable to the specificities of some exchanges and that would be counterproductive in giving investors what they wish to have the liberty to negotiate on their own terms.

Measure 7 Alignment of interest between underwriting entities and investors

Question 17

Do the considerations as set out above accurately reflect the key issues regarding alignment of interests between the underwriting banks and investors?

Yes, as they reflect what are indeed the principles that are taking into consideration by market participants, considering the existing rulebook.

Our understanding is that interests of underwriting banks and investors remain well aligned, irrespective of the movement of the loan market from "take and hold" to "originate to distribute".

Underwriting banks are highly sophisticated and well-resourced organisations with a long track record of effecting complex financing transactions in all market environments and are well compensated on a risk reward basis for underwriting and distributing debt products to investors.

Underwriters owe extensive legal and professional duties to loan investors and are very focussed on ensuring that investors have ready access to all information sufficient to undertake a thorough operational, financial and legal diligence in respect of the relevant debt offering and to take a view as to whether to participate in the relevant issue in the capacity of a long-term credit investor.

Investors are likewise active and sophisticated market participants with a key focus on issues that matter to them and are not in our experience hesitant to make their views clear (both to underwriters and to borrowers).

The loan market is a function of demand for debt and the availability of capital which means that the relative negotiating strength of the parties varies with the market against the credit back drop of each individual borrower. This can be seen in the way in terms tighten and loosen and how particular credits are received by the market. The market needs to be looked at from this perspective and its responsiveness to credit quality and market conditions considered.

Question 18

Do you agree with the measures proposed to help strengthen the alignment of interest between underwriting entities and investors?

No.

Ultimately, there will always be some degree of economic divergence between a market maker and an end buyer - but we do not feel that is it realistic for underwriting banks to bear the enhanced capital cost of risk retention mechanics in a similar vein to that observed in structured financing markets.

There is a still a firm and broad alignment of the interests of underwriters and investors and the economic alignment proposed in the consultation paper will not be capable of implementation in today's market.

There is a difference between on one hand, the lending market where investors make their credit decisions on the quality of the credit and, on the other, structured finance products where investors are often buying into a credit structure put together by the seller and with credit quality often verified by a third party (such as a credit rating agency).

If a loan cannot be sold and is left hung, underwriters are usually left facing substantial losses. This is the ultimate risk retention threat to ensure the loan offering is one which will be of sufficient credit quality and loan terms to appeal to investors.

There is also a possible unintended consequence that any risk retention would increase costs for borrowers as underwriters would seek to recover their higher capital costs of remaining a lender in the loans. The intended economic incentive could hence become a drag on the lending market and create new risks. In other words, IOSCO should be careful that introducing measures will, irrespective of how good the intentions are, potentially create new conflicts.

Question 19

What other good practices have been or could be put in place to strengthen risk management of leveraged lending activities by underwriting entities?

This is something that should be determined by those specialised in underwriter risk functions – but we understand that there is already appropriate guidance in this field.

Question 20

Do the considerations as set out above accurately reflect the key issues regarding the practice of designated counsel being chosen by the sponsor?

No.

A lawyer's duty over and above all else is to its client. Overarching professional and legal duty will be accordingly upheld regardless of whether that lawyers' original engagement arose through a proposed designation.

In the European market, the costs of the law firm acting for the arrangers and underwriters are met by the borrower which is why the borrower has always had an interest in the choice of firm. There is no reason to believe there is any conflict of interest that is not covered by existing industry mechanisms.

The prevailing view we are observing in Europe is that creditors remain comfortable with at least being presented with an opportunity to engage with certain legal firms who are familiar with the products and the operational procedures of certain market participants or alternatively suggest viable alternatives to the debtor.

Viewed through a different prism, the practice of designation is not in any way dissimilar to the "panel" approach undertaken by certain underwriters which many market participants (both on the creditor and debtor side) have since moved firmly away from, not least because of the difficulties executing complex transactions with key advisors who are not commercially or operationally on the same page.

Meanwhile, the broad categorisation of "legal designation" is at odds with commercial reality in that no lender group will accept counsel that they do not believe are acting in their interests and no borrower will insist upon the same if it means that they cannot execute the relevant transaction in a professional and expedient manner. Furthermore, individual underwriters and investors can instruct their own counsel (at their own cost) or avail themselves of their in-house counsel function which they frequently do.

4. Addressing interests of different market participants throughout the intermediation

Measure 8 Reducing restrictions on transferability of loans

Question 21

Do the considerations as set out above accurately reflect the issues surrounding transfer provisions in the LL market?

The loan market is a very sophisticated market and driven by commercial considerations and needs negotiated between the borrower and lenders as well as market practice developed over many years.

We do not consider it appropriate for there to be any regulatory intervention in this area, including interfering with the transferability of loans. Terms around transferability are determined and negotiated by the borrower for its own protection. It is not appropriate for a borrower to be compelled to publicise criteria for being on an approved list. Compelling a judgemental characterisation could increase the risk of antagonism from parties not included on the list and even theoretically increase litigation risk.

Furthermore, the legitimate due diligence of prospective additions to an approved list requires time and resource and borrowers should not be pressured to bear this burden in the name of aligning LL market liquidity to that of the HY bond market.

Question 22

Do you agree with the proposed good practice to ease restrictions on the transferability of LLs to support liquidity in the secondary market? Is there a justification for transferability to be more limited in the LL market as compared to the HY bond market?

The LL market and the HY bond market are very different and distinct markets.

It is not appropriate to assimilate the two by proposing changes to one market based on the experience in another.

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Measure 9 Managing conflicts of interest where PE sponsors also act as lenders

Question 23

Do you agree with the proposed good practice to mitigate conflicts of interest which may arise from private equity groups investing in the debt and equity of the same borrower?

Whilst the vast majority of the industry is composed of single strategy private equity firms, some of the larger multi-strategy managers indeed operate multiple business lines, often including both private equity and private credit (as well as, for example, infrastructure and real estate). These are sometimes referred to as "multi-assets" groups.

The potential conflicts of interest that can arise are well understood by these firms and significant steps are taken to identify, mitigate and manage such conflicts. For example, a private equity buyout fund and an infrastructure fund managed by the same group may both be capable of, and interested in, acquiring the same asset. Or, as discussed in the paper, a private equity fund and a private credit fund managed by the same group may be invested in the same asset.

In general, there is no overlap between private equity and private credit activities.

Firms have different models for mitigating such conflicts. As a general proposition, the private equity and private credit businesses are **distinct business lines and have distinct investment committees**, staffed by different teams of investment professionals with differing expertise, and usually housed within separate legal entities.

Some firms will not, as a matter of policy, **permit their private credit funds to lend to companies in which their private equity funds are invested**, and the firm will operate formal allocation policies to determine which business line should pursue any given opportunity.

Other firms put in place **strict information barriers between investment teams and/or decision makers**, to ensure that information is not shared inappropriately and that decisions can be taken independently having regard solely to the interests of the investors in the relevant fund. If a conflict crystallises, this will typically be referred to the limited partner advisory committees of the relevant funds to approve the proposed course of action.

No matter what happens, it is important to flag that **each fund is raised by a specific team**. This team has a fiduciary duty towards the investors of each team (credit or private equity). The track record belongs to this specific team. The team has an incentive to preserve its track record, to be able to raise future funds. Belonging to a wider structure and sharing a brand does not mean that these requirements substantially change. There are information barriers, processes and rules to manage conflicts of interest that fund investors check when investing in funds. These cases are actively addressed by these rules and processes.

It is important to note that this issue is not confined to the private finance industry; other

industry participants such as investment banks and traditional fund managers, have similar conflicts. With a few rare exceptions, the same types of potential conflict arise in traditional fund management shops and investment banks.

Specific pan-European regulatory rules on conflicts of interest for fund managers have existed for more than a decade. These rules have their origin in fiduciary duties owed by managers to investors in certain key fund management jurisdictions, which usually encapsulate a no conflict rule – i.e., fiduciaries must not place themselves in a position where their duty and their interest conflict or where there is a real possibility they may conflict.

Under the pan-EU Alternative Investment Fund Managers Directive ("**AIFMD**") (which governs EU-authorised alternative investment fund managers ("**AIFMs**"), the entities which manage the vast majority of private equity and private credit funds), AIFMs must "*take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated*".

AIFMD contains detailed rules about:

- identification of conflicts.
- maintaining and operating effective organisational and administrative arrangements.
- segregating tasks and responsibilities; and
- disclosure to investors.

Similarly, under the Markets in Financial Instruments Directive ("**MiFID**") (which governs EU-authorised portfolio managers and investment advisers, whose services may be engaged as part of private equity and credit fund structures), there are similar provisions requiring investment firms to take all appropriate steps to identify and prevent/manage conflicts of interest between themselves and their clients, or between one client and another, in the course of providing those services.

Demonstrating an ability to comply with these requirements often forms a core part of the authorisation process for new EU AIFMs/MiFID firms and the rules constitute some of the fundamental ongoing applicable requirements. These rules are enforceable by the relevant home state regulator.

Summary table

As a general, industry wide summary, conflicts of interest are managed through some or all of the following (it is not necessary to have all to have sufficient mitigation)

- **Conflicts management processes.** Firms have developed a number of internal conflicts management processes, from allocation policies (which set out a process for how the manager allocates investments between its funds) to portfolio oversight and risk management committees.
- **Information barriers and controls.**
- **Separation between private equity and private credit functions.** Portfolio management undertaken by separate teams, business lines or divisions

(sometimes housed in separate, albeit affiliated, legal entities) under delegated investment management arrangements

- **Consideration by advisory committees.** Actual or potential material conflicts of interest between the fund manager (and members of its group) and the fund/investors will typically be considered at a fund's limited partner advisory committee ("**LPAC**"[1]).
- **Disclosure in pre-contractual information.** Private placement memoranda, made available to investors before subscribing to a fund, will often contain extensive disclosures on actual or potential conflicts of interest that may arise and how they will be managed.
- **Thresholds to credit holdings**: managers that hold credit within debt consortium will take measures to ensure they do not have a percentage that would give them veto rights, when a credit fund supports a private equity deal involving the same sponsor. This conflict-of-interest mechanism ensures that the credit arm is unable to overly influence the process.

We would suggest that IOSCO guidance refers to existing rules as opposed to introducing practices that could affect the use of legitimate sponsor disenfranchisement clauses that are in the interest of both the borrower and its lenders.

Question 24
What other good practices have been or could be put in place to help manage conflicts of interest arising for the reason described here?

See above for our general comments on this subject and existing good practices.

Measure 10 Managing conflicts of interest in management of CLOs

Question 25

Have the considerations above captured the key considerations regarding potential conflicts of interest which may arise between the CLO manager and the CLO investors?

As mentioned in our response to Question 23, CLO Managers are already subject to conflicts of interest's obligations which address the points raised in addition to very well-established market practices on how to structure their business.

CLO Managers already comply with extensive regulatory requirements in order to identify, manage, disclose and mitigate/avoid any conflicts of interest, including those suggested above. Offering materials will already include extensive disclosures with respect to conflict-of-interest considerations.

[1] The LPAC is a body constituted of a select number of fund investors and is enshrined in fund limited partnership agreements. LPAC consent to waive a conflict may be required before certain transactions or arrangements can be entered into.

Most importantly, valuation methodologies may be highly sensitive, and it is not appropriate for CLO managers to be compelled to disclose these. Similar to our previous comments and general observations, the CLO market is driven by and for professional firms/clients/investors, and the market forces (in addition to the regulatory obligations described above) already enable all parties to find the right balance amongst the participants.

Question 26

Do you agree with the proposed good practices? What other good practices have been or could be put in place to help manage such conflicts of interest?

See above.

5. Disclosure of information on an ongoing basis

Measure 11 Disclosure in CLOs

Question 27

Have the above factors captured the necessary information that are important considerations to investors for their CLO investment decision and evaluation of CLO managers' performance?

Yes, these are generally the relevant factors. It is however important to leave managers and investors with sufficient flexibility in giving the information that is deemed appropriate by the latter.

Question 28
What additional good practices in disclosure can be put in place to help investors better understand and evaluate their CLO investments?

What IOSCO has proposed should be seen as sufficient in terms of disclosures.

Measure 12 Disclosure on underlying loans

Question 29

Have the above practices captured the necessary information that are important considerations for investors to evaluate the on-going financial performance of LL borrowers?

Best practices generally fit with realities of markets but may reduce the flexibility left to borrowers and sponsors to determine the terms of a deal.

It is important in that context to recall that deals are made between two professional parties – and it remains the right of investors to, where information is insufficient, to request additional details to or to simply not make the investment.

Question 30

What additional good practices in disclosure can be put in place to help investors better understand the financial position and status of LL borrowers?

What IOSCO has proposed should be seen as sufficient in terms of disclosures.

Contact

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About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

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