



The Regulation of the Private Equity Fund in South Africa

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ABSTRACT

This study examined the challenges confronting private equity funds. These funds face governance challenges, including a lack of transparency and disclosure to investors.

Investor protection in leading jurisdictions ranges from voluntary self-regulation, to minimal regulatory measures and an exhaustive regulatory approach. These approaches have, however, proven limited with regard to both application and their effectiveness in promoting investor protection, and market efficiency.

Two methods have been identified to address governance challenges. The legal tools include facilitating transparency, the disclosure of information and the promotion of investor protection. These tools include:

- 1) A negotiated structural approach, with side letters that provide individual investors with information and the establishment of an advisory board with limited control over the fund's operations; and
- 2) A co-regulatory approach, which combines contractual, self-regulation, and financial regulations to address governance challenges efficiently and effectively.

Both methods have potential to address the governance challenges and increased investor concerns that have arisen as a result of the manner in which private equity funds operate. The approach suggested by this study is based on an understanding of private equity as an asset class. The approach is effective and efficient. It encourages and promotes investor protection, while at the same time promoting the South African private equity industry as a flexible and lucrative market.

There has been limited critical legal assessment of governance mechanisms in the context of private equity. This study thus contributes to the body of knowledge on the legal assessment of private equity funds.

TABLE OF CONTENTS

	Page No
DECLARATION.....	i
PLAGIARISM DECLARATION.....	ii
ACKNOWLEDGEMENTS.....	iii
ABSTRACT.....	iv
CHAPTER ONE.....	1
1. INTRODUCTION.....	1
1.1 Background.....	1
1.2 Problem Statement.....	2
1.3 The Structure of the Dissertation.....	6
CHAPTER TWO.....	8
2. THE NATURE OF PRIVATE EQUITY.....	8
2.1 Introduction.....	8
2.2 Private Equity Defined.....	8
2.3 The Supply of Capital and Institutional Investors.....	9
2.4 Types of Investment Strategies.....	10
2.5 Implementation Models.....	11
2.6 Private Equity Investment Fund Vehicles.....	11
2.7 The Internal Arrangements.....	13
2.8 Fund Manager as the Financial Intermediary.....	14
2.9 Issues and Concerns.....	15
(a) Investor Protection.....	15
(b) Overregulation or Inappropriate Regulation of the Industry.....	17
CHAPTER THREE.....	18
3. THE REGULATION OF PRIVATE EQUITY FUNDS IN SOUTH AFRICA.....	18

3.1 Introduction	18
3.2 Forms of Private Equity Funds in South Africa.....	20
(a) The Limited Liability Partnership.....	20
(b) The Bewind Trust.....	23
(c) The Structure of a Private Equity Investment.....	24
(i) Fiduciary Duties.....	25
(ii) Contracts.....	25
3.3 The General Regulatory Framework.....	27
3.4 Regulations which Support the Growth of the Industry.....	32
(a) Pension Funds.....	32
(b) Public Investment Corporation.....	34
3.5 Regulations Proposed to Deal with the Issues and Concerns.....	34
(a) Treating Customers Fairly.....	34
(b) The National Treasury Policy Document.....	35
(c) Private Equity Scandal's Influence on the Proposed Regulations.....	37
(i) The Fidentia Asset Management Scandal.....	37
(ii) The Tri-Linear Asset Management Scandal.....	38
(iii) Influence on the Proposed Regulations.....	39
3.6 Conclusion.....	40
CHAPTER FOUR.....	42
4. UNITED KINGDOM AND THE UNITED STATES OF AMERICA'S REGULATION OF PRIVATE EQUITY FUNDS.....	42
4.1 Introduction.....	42
4.2 Private Equity Funds in the United Kingdom.....	43
(a) Forms of Private Equity Funds	43
(b) The General Regulatory Framework.....	45
4.3 Private Equity Funds in the United States of America.....	50

(a) Forms of Private Equity Funds.....	51
(b) The General Regulatory Framework.....	55
4.4 Conclusion.....	63
CHAPTER FIVE.....	66
5. THE VOLUNTARY SELF-REGULATION AND REGULATORY APPROACH.....	66
5.1 Introduction	66
(a) Voluntary Self-Regulation Approach.....	68
(b) The Regulatory Approach.....	70
CHAPTER SIX.....	72
6. APPLICATION AND EVALUATION OF APPROACH.....	72
6.1 Introduction.....	72
(a) Monitoring Risk Mitigation Strategy.....	73
(i) Structural Approach – Private Monitoring Solutions.....	74
(ii) Co-Regulatory Approach.....	77
CHAPTER SEVEN.....	79
7. CONCLUSION.....	79
BIBLIOGRAPHY.....	83

CHAPTER ONE

1. INTRODUCTION

1.1 Background

While the United Kingdom (UK) and the United States of America (USA) have applied a regulatory approach to the private equity fund (fund),¹ funds in the Republic of South Africa (South Africa) are not subject to specific regulations or legislation and no government body is responsible for regulatory oversight of such funds. This is problematic because their performance cannot be adequately assessed by investors. Non-regulation creates concerns relating to transparency and disclosure, resulting in inadequate investor protection.

There have been instances where fund managers have exploited the lack of regulatory oversight. These scandals illustrate how a lack of regulation leads to serious problems of non-transparency and non-disclosure in the management of a fund, deficits in investor confidence, and serious threats to economic growth and stability. The Fidentia Asset Management scandal (Fidentia scandal) in South Africa is a good example. Fidentia asset managers used institutional investors' funds for purposes other than what they were mandated for.² As a result of lack of adequate disclosure and transparency, investors suffered significant losses. A similar scenario played out in the Tri-linear Asset Management scandal (Tri-linear scandal).³ Such scandals could reduce investor confidence, resulting in a reduced appetite for investment in private equity.

The Bernard L. Madoff Investment Securities LLC scandal (Bernie Madoff scandal) in the USA is another example of the problems exposed by the Fidentia and Tri-linear scandals.⁴ As with Fidentia, there was a lack of adequate transparency and disclosure, which resulted in the perfect conditions to conduct a Ponzi scheme.⁵ The problem was not uncovered by the regulatory bodies. Instead, Bernie Madoff, the

¹ Paul Dickson *The Asset Management Review* 3 ed (2014).

² *Brown and Others v Financial Service Board and Others* (679/2007) [2013] ZAWCHC 142; *S v Brown* 2015 (1) SACR 211 (SCA).

³ *Kawie v Master of The High Court of SA 2012 JDR 1190* (WCC) (unreported); *Infra* note 283

⁴ *United States v. Bernard L. Madoff*, 09 Cr. 213 (DC).

⁵ *Ibid.*

fund manager, notified the authorities after the fact.⁶ The Madoff scandal revealed loopholes in the regulatory environment not just for hedge funds, but for private equity funds as well.

1.2 Problem Statement

The problem addressed by this study is best demonstrated by an example. A fund is formed as a result of an agreement between the fund manager and institutional investors. Internal arrangements are regulated by a contract. In terms of the contract, the fund manager controls the affairs and conducts the business of the fund. Because the fund is a legal investment ‘vehicle’ such as a partnership or a *bewind* trust, certain regulations and legislation do not apply. For example, if the ‘vehicle’ were structured as a company, the South African Companies Act⁷ (the Companies Act) would apply. However, the fund will be regulated by the common law and other relevant statutes. As will be shown, this form of regulation may not provide adequate safeguards. In terms of disclosure and transparency, the fund manager is not obliged to account to investors and may conduct the affairs of the fund as he/she sees fit. This may jeopardise investors and impact negatively on the economy, especially when the investor is an institutional investor such as the Mineworkers’ Provident Fund (MPF); or university endowment fund among others. The concerns arising from this example are discussed below.

One of the concerns is the lack of oversight of funds in South Africa. For example, a fund does not have to be registered with a government agency. However, the Financial Advisory and Intermediary Services (FAIS) Act⁸ requires fund managers to register as financial services providers. Fund managers may also register as members of the South African Venture Capitalist and Private Equity Association (SAVCA), a voluntary association.⁹ However, they are not obliged to do so. While this voluntary association regulates the affairs of funds, concerns have been raised that voluntary regulation might not be effective.¹⁰

⁶ Amir Efrati et al December 2008 ‘Top Broker Accused of \$50 Billion Fraud’ *The Wall Street Journal* 12 December 2008, available at <http://www.wsj.com/articles/SB122903010173099377>, accessed on 10 November 2014.

⁷ Act No. 71 of 2008.

⁸ Act No. 37 of 2002.

⁹ South African Venture Capital and Private Equity Association (SAVCA), available at <http://www.savca.co.za/membership/become-a-savca-member/>, accessed on 12 February 2015.

¹⁰ Julia Black ‘Critical Reflections on Regulation’ (2002) 27 *Australia Journal of Legal Philosophy* 2.

As revealed by the example above, another concern is the structure set up to manage the private equity fund. A fund is formed either through a limited partnership or a *bewind* trust.¹¹ These structures evade certain regulations which serve to protect the economy and the investor. The specific concerns in this regard include a lack of transparency and disclosure of information to investors.

Investors depend on the fund manager to provide information.¹² However, even when information is disclosed, there is little that investors can do with it. Investor control is usually minimal.¹³ Furthermore, investors may not be able to exit the fund, and in the event that they are able to do so, they face a host of further problems.¹⁴ Some critics also argue that the lack of transparency enables many funds to take advantage of their status as limited partnerships or *bewind* trusts to pay top managers exorbitant fees with little fear of being found out.¹⁵ Therefore being private in this sense has costs.¹⁶ Subject to limited controls, the fund manager can do whatever they want with little threat of investor retaliation.

There is also a tendency to inflate the reputation of the fund manager. It is submitted that, from a theoretical perspective, knowledge of an investment manager's reputation is less useful than knowledge of investments made by the fund through ensuring greater transparency. Bernie Madoff and Fidentia Asset Management are perfect examples. It is submitted that had these funds been more transparent and ensured adequate disclosure, these scandals could have been averted. However, to quote Warren Buffett, 'You only find out who is swimming naked when

¹¹ South African Venture Capital and Private Equity Association 'Three Decades: An account of the rise and establishment of South African Private Equity'. February 2015, available at <http://www.savca.co.za/wp-content/uploads/2015/02/Three-Decades-Magazine-2015.pdf> accessed on 20 February 2015.

¹² Jennifer Payne 'Private Equity and its Regulation in Europe' (2011) *University of Oxford Legal Research Paper Series* 1.

¹³ Joseph McCahery 'Private Equity Regulation: A Comparative Analysis' (2010) *Journal of Management and Governance* 197.

¹⁴ Douglas Cumming & Sofia Johan 'Regulatory Harmonization and the Development of Private Equity Markets' (2007) 31 *Journal of Banking and Finance* 3218.

¹⁵ The Economist 'Barbarians in the Dock' 3 March 2007, available at <http://www.economist.com/node/8776229>, accessed on 10 November 2014.

¹⁶ Andrew Metrick & Ayako Yasuda 'The Economics of Private Equity Funds' (2010) *The Review of Financial Studies* 2303.

the tide goes out'.¹⁷ In other words, one only becomes aware of the true state of affairs when it has already occurred.

Those that believe that the concerns raised are unjustified argue that the investor is skilled and should thus be able to address such issues.¹⁸ This study therefore assesses the issues and concerns raised regarding funds in order to determine whether or not the regulation of such funds in South Africa is effective and efficient.

This study aims to contribute to our understanding of the regulation of funds in South Africa and the manner in which it differs from other jurisdictions. It provides a general overview of this industry in the country and explores whether the concerns raised; such as a lack of transparency and disclosure are justified, as well as possible solutions to these issues.

The study does not seek to address the regulation of the private equity industry as a whole, but rather the regulation of the private equity investment fund and investor protection. Addressing the regulation of the industry as a whole would require an examination of Exchange Control and Income Tax regulations, among other issues, that is beyond the scope of this study. Rather, the study focuses on the regulation of the private equity investment fund and promoting transparency and disclosure to investors.

In sum, this study examines how the industry and investors in funds can improve investor protection and the governance structures of the funds in which they invest. The approaches adopted in the jurisdictions of the UK and the USA are considered and discussed. These are leading global economies. Furthermore, in light of the global financial crisis (GFC), the measures they adopted are pertinent to this study.

There are various approaches to the regulation of funds. An examination of the regulation of this industry in the USA and UK shows that regulators have either adopted mandatory legislation, which is characterised as a meek regulatory approach, or the onerous maximalist approach. The industry has also applied voluntary

¹⁷ Berkshire Hathaway Inc. 2001 Annual Report to Shareholders 'Warren E. Buffet: Letter to the Shareholders of Berkshire Hathaway Inc.' available at <http://www.berkshirehathaway.com/2001ar/2001ar.pdf> , accessed 10 January 2015.

¹⁸ Black op cit (n10) 2.

regulations which are overseen by industry associations.¹⁹ These approaches are discussed as well as the implementation and evaluation of possible solutions, in the form of structural private monitoring solutions, and the co-regulatory approach.

In regulating the private equity industry, it is vital that South Africa not simply follow other jurisdictions and cross the proverbial Rubicon.²⁰ Simply following other jurisdictions is to cross the Rubicon which runs between, on the one hand, regulating funds appropriately and on the other, inappropriately regulating funds. The inappropriate regulation of funds may deter investors and negatively impact economic growth. There are other options. A balance needs to be maintained between a fund manager's ability to engage with the market, achieve investment objectives, and adequately disclose the pursuit of such objectives. To quote Wilbur Ross, 'Banking and investments are the most heavily regulated industry in the world. Regulations don't solve things. Supervision solves things.'²¹

The predicament the private equity industry faces includes identifying appropriate solutions to promote transparency and disclosure and decrease the risk level without affecting the flexibility of an industry that has thrived on limited intrusion in contractual relations.²² It is submitted that during the era when private equity prospered, contractual relations were sufficient to address the issues among the parties.²³ However, legislators will intervene when malfeasance emerges and the economy is affected.

This study assesses whether the South African legal environment should follow other jurisdictions which have called for the regulation of funds, or whether the current milieu in which private equity operates should be maintained, with minor adjustments to allay prevailing concerns.

¹⁹ Douglas Cumming *The Oxford Handbook of Private Equity* (2012) 156.

²⁰ The idiom 'Crossing the Rubicon' (*Aleata Iacta Est* – The Die is Cast) means to pass a point of no return and refers to Julius Caesar's army crossing of the Rubicon River in 49 BC.

²¹ 'The Financial Crisis: The Frontline Interviews', *Frontline*, available at <http://www.pbs.org/wgbh/pages/frontline/oral-history/financial-crisis/tags/regulatory-failures/> accessed on 16 November 2014.

²² Black op cit (n10) 2.

²³ Payne op cit (n12) 1.

1.3 The Structure of the Dissertation

Chapter two presents an overview of the private equity industry. It discusses the background of private equity, distinguishing it from other funds, as well as identifying the issues confronting this industry. These include governance challenges in the context of corporate governance, focusing on the distinctions between companies and partnerships and trusts.

Chapter three assesses and discusses the regulation of funds in South Africa. The fund manager's role as the agent of the fund and the consequence of governance failures are discussed. The need for regulation is assessed and certain regulatory developments are highlighted.

Recent regulatory responses in the UK and USA are considered and assessed in Chapter four and their success and applicability in the South African setting are examined.

Chapter five examines the adequacy of voluntary self-regulation and financial regulation to address the concerns raised in relation to funds. Private actors' effectiveness in ensuring the effective function of private equity is examined.

Chapter six focuses on possible solutions to the issues relating to the regulation of funds, which include side letters and the establishment of an advisory committee as well as the co-regulatory approach to address governance challenges.

South Africa's legal framework encompasses a wide range of laws, regulations, administrative rules, and self-disciplinary guidelines. Globally, investors have recognised that one of the risks of investing in funds in South Africa is the possibility of the authorities changing their rules, or the manner in which they are applied.²⁴ Such concerns were amplified when the Minister of Finance, Nhlanhla Nene recently exercised his authority under the Collective Investment Schemes Control Act²⁵ (CISCA) to pronounce hedge funds collective investment schemes from 1 April 2015 (Government Notice 141 of 2015).²⁶ Sensitivity to changes in government policy in South Africa is critical to investors. Private equity rules and regulations could be an

²⁴ SAVCA Three Decades op cit (n11) 22.

²⁵ No. 45 of 2002.

²⁶ National Treasury on Regulation of Hedge Funds in South Africa 2015, available at <http://www.gov.za/speeches/regulation-hedge-funds-south-africa-2015-6-mar-2015-0000>, accessed on 15 March 2015.

impediment to the growth and the development of this industry. This study therefore examines possible solutions, taking into account South Africa's unique context, as well as the practical implementation of such solutions.

Chapter seven presents the conclusion.

CHAPTER TWO

2. THE NATURE OF PRIVATE EQUITY

2.1 Introduction

Private equity is the least understood of the asset classes.²⁷ This has serious consequences such as the overregulation or inappropriate regulation of the industry. Misconceptions are rife, such as the description of private equity as a ‘locust’ or ‘vulture’, especially with regard to its place in our legal system and whether it ought to be regulated.²⁸ This chapter presents an overview of private equity, the manner in which funds undertake investments, and concerns relating to this industry.

2.2 Private Equity Defined

Private equity is an asset class which consists of debt and equity capital in operating companies that are not publically traded on the stock exchange.²⁹ Private equity consists of investors and funds that directly invest in private companies or conduct buyouts of public companies that delist from an exchange.³⁰ In the UK and in Africa, the term ‘venture capital’ and ‘private equity’ are used interchangeably. In the USA, ‘venture capital’ refers to investment in early stage and expanding companies.³¹ To avoid any misunderstanding, the term private equity is used as a broad term that encompasses all types of private equity investment in private and public companies. Each type corresponds to specific profiles of companies and uses different financial structures.

Private equity has existed since the beginning of commercial activity.³² Centuries ago, Phoenician merchants and European traders paid a fifth of their proceeds to their ship captains in return for making dangerous voyages to ‘The New World and the Far East’, setting the model for the structure used in private equity throughout the world today.³³

²⁷ D Cumming *Private Equity Fund Types Risks and Returns and Regulation* (2010) at 437.

²⁸ The Economist ‘Private equity in Germany: Friendly locusts-A swarm of foreign investors visits the Finanzplatz’ *The Economist* 23 February 2006, available at <http://www.economist.com/node/5557472>, accessed on 27 December 2014.

²⁹ Steven Kaplan & Per Strömberg ‘Leveraged Buyouts and Private Equity’ (2009) 23 *Journal of Economic Perspectives* 121.

³⁰ Cumming op cit (n14) 3.

³¹ Cumming op cit (n14) 1.

³² SAVCA Three Decades op cit (n11) at 3.

³³ *Ibid.*

It can be argued that the first private equity asset management in South Africa was the Dutch East India Company, established at the Cape of Good Hope in 1652 and funded by investors in Holland.

Today, investors pay fund managers in return for ‘dangerous voyages’ into the private equity market.³⁴ Private equity has grown and become a large scale industry.³⁵ Venture capital firms were formed after World War II, including 3i in the UK; and J.H. Whitney and Company and American Research and Development in the USA.³⁶ These firms are still in existence.

2.3 The Supply of Capital and Institutional Investors

A variety of different investors supply capital to the private equity fund.³⁷ On the supply side the fund³⁸ is a ‘vehicle’ formed to pool the funds of different investors, such as university endowments (e.g., the University of South Africa, and the University of Cape Town), pension funds (e.g., the Government Employees Pension Fund), insurance companies (e.g., Sanlam), and wealthy individuals (e.g., Mark Shuttleworth and Mitt Romney). This is not a closed list.

The capital is invested in a range of different assets by professional fund managers.³⁹ Institutional investors participate in these pool investment vehicles in order to spread risk and provide investors with access to markets with capital growth potential. The investment patterns of institutional investors fit the private equity business model and its long term approach.⁴⁰ Institutional investors have begun to assign greater percentages of their funds to private equities.⁴¹ The industry has

³⁴ *Supra* 32.

³⁵ Robert J Samuelson ‘The Private Equity Boom’ *The Washington Post* 15 March 2007, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/03/14/AR2007031402177.html> accessed on 11 January 2015.

³⁶ F Barber, & M Goold ‘The Strategic Secret of Private Equity’ (2007) *Harvard Business Review* 53.

³⁷ Richard Brealey et al *Principles of Corporate Finance* 10 ed (2011) 4.

³⁸ Harry Cendrowski et al *Private Equity: History, Governance and operations* (2008) 29.

³⁹ Bob Zider ‘How Venture Capital Works’ (1998) *Harvard Business Review* 131.

⁴⁰ M Wright ‘The Economic Impact of Private Equity: What we know and What we would like to know’ (2009) 11 *Venture Capital* at 1-21.

⁴¹ SAVCA/ KPMG Private Equity Industry Survey covering the 2013 calendar year. June 2014. Available at: <http://www.savca.co.za/wp-content/uploads/2013/08/KPMG-SAVCA-Private-Equity-Industry-Survey-2015-final-upload.pdf> Accessed on: June 2015.

developed skills⁴² and confidence has grown in this asset class because private equities include asset classes that have the potential for high revenue.⁴³

2.4 Types of Investment Strategies

Private equity funds subscribe to two types of investment strategies, venture capital and buyout funds.⁴⁴

Venture capital funds have become a source of funding for high growth industries in the expansion and start-up phase.⁴⁵ Buyout funds buy a corporation from a seller; this is referred to as an institutional buy out.⁴⁶ If the target corporation's resources are used as security to raise additional debt to finance the purchase, this is referred to as a leveraged buyout. Private equity funds may also acquire the company listed shares on the Securities Exchange; this is known as a public-to-private buyout.⁴⁷

The objective of these private equity investments is to seek maximum capital value at some exit point. Unlike in the public listed environment, private equity has a complex risk profile, due to the fact that it is 'exit driven'.⁴⁸ 'Exit driven' in this sense means that funds seek to sell their interests as soon as they acquire control of an asset and are able to make a profit. Due to this high risk profile, effective investor protection is important.

⁴² Steven N Kaplan & Antoinette Schoar 'Private Equity Performance: Returns, Persistence, and Capital flows' (2005) 60 *Journal of Finance* 1791.

⁴³ L Delevingne 'Private Investors Pile into Africa' *Consumer News and Business Channel* 17 March 2015, available at <http://www.cnbc.com/2015/03/17/private-equity-investors-pile-into-africa.html> accessed on 21 March 2015.

⁴⁴ Douglas Cumming & Sofia Johan *Venture Capital and Private Equity Contracting: an International Perspective* (2009) 51.

⁴⁵ Cumming op cit (n19) 10.

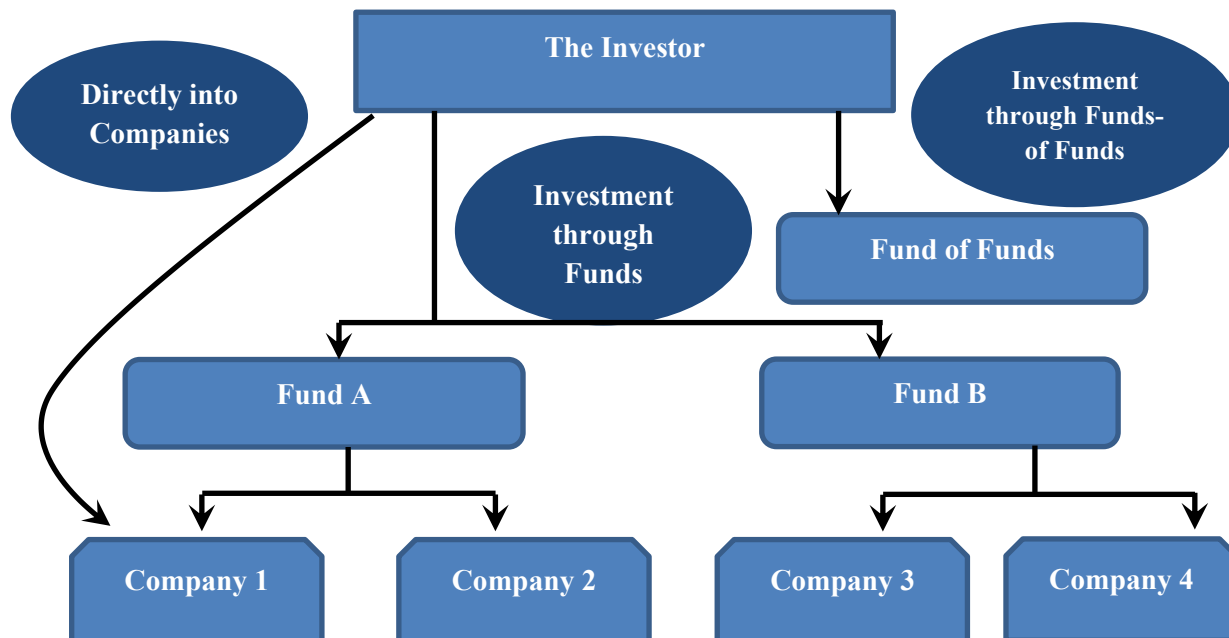
⁴⁶ M Wright, S Thompson & K Robbie 'Venture Capital and Management-led Buyouts: A European Perspective' (1992) 7 *Journal of Business Venturing*.

⁴⁷ *Ibid.*

⁴⁸ Petri Mäntysaari *The Law of Corporate Finance: General Principles and EU Law* (2010) Volume 1 at 343.

2.5 Implementation Models

The diagram below illustrates the implementation models of an institutional investor.



Private Equity Investment Structures Model⁴⁹

There are three main implementation models of an investor:

- 1) Into private companies directly, sourced from the investor's process and own network, or through funds;⁵⁰
- 2) Advisors and Fund-of-Funds choose funds for the investor and manage the investment; and
- 3) Funds, managed by asset management firms committed to determining, investing, handling and realising company investments.⁵¹

2.6 Private Equity Investment Fund Vehicles

The form of the fund 'vehicle' is driven by two factors: tax transparency, and the limited liability of the investors.⁵² A vehicle in the form of a company satisfies the latter but not the former requirement.⁵³

⁴⁹ Cumming op cit (n27) 14.

⁵⁰ Nielsen Meisner 'Institutional Investors and Private Equity' (2008) 12 *Review of Finance* 185.

⁵¹ Cumming op cit (n27) 9.

⁵² James Spindler, 'How Private is Private Equity and at What Cost?' (2009) 76 *University of Chicago Law Review* 311.

In South Africa, two vehicles are typically employed: limited partnerships (*en commandite*); and *bewind* trusts.⁵⁴ The governance mechanisms relied on by investors includes the internal arrangements of the vehicle, and the common law. In contrast with other jurisdictions, no specific legislation applies to these ‘vehicles’ in South Africa. These ‘vehicles’ are discussed further in Chapter three.

Limited partnerships, limited liability companies and the offshore company are frequently used in the UK as private investment vehicles.⁵⁵ Each investment fund is structured to address the unique characteristics of the investment vehicle. These include the regulatory position of the asset fund manager, and the tax treatment of the participants and the investments.⁵⁶ Private equity funds’ governance structures stem from the choice of the legal vehicle, as well as the nature, demographics, and the number of the participants in the fund.⁵⁷ Although other investment vehicles exist, limited partnerships have become the investment vehicles of choice in the UK for reasons which include tax, and regulatory deficiencies.⁵⁸ However, following the European Union Alternative Investment Fund Managers Directive (AIFMD) and its regulations, an analysis of the regulations is necessary to ensure that a tax efficient vehicle does not inadvertently lead to issues relating to marketing and regulatory permission.⁵⁹

Funds in the USA are commonly structured as limited partnerships (LP) or limited liability companies (LLC).⁶⁰ Both are usually under the Delaware law. Funds can also be established outside the USA, such as in the Cayman Islands, to achieve tax efficiency for non-US or tax exempt investors.⁶¹

These investment ‘vehicles’ are discussed further in Chapter four.

⁵³ G Fraser- Sampson *Private Equity as an Asset Class* (2007); Eli Talmor & Florin Vasvari *International Private Equity* (2011) 11; Geoff Yates & Mike Hinchliffe *A Practical Guide to Private Equity Transactions* (2010) 1.

⁵⁴ SAVCA Three Decades op cit (n11).

⁵⁵ Kay Muller ‘Investing in Private Partnerships: The Role of Monitoring and Reporting’ (2007) *Entrepreneurial and Financial Studies* 11.

⁵⁶ Dickson op cit (n1) 466.

⁵⁷ Timothy Spangler ‘Overcoming the Governance Challenge in Private Investment Funds through the Enrolment of Private Monitoring Solutions’ (2009) *London School of Economics* at 27.

⁵⁸ *Ibid* at 28.

⁵⁹ Timothy Spangler *The Law of Private Investment Funds* 2 ed (2012) at 196.

⁶⁰ A Schneeman. *The Law of Corporations* 5 ed (2010) at 52 – 113.

⁶¹ Dickson op cit (n1) 506.

2.7 Internal Arrangements

The internal arrangements of the fund are regulated by the trust deed where a *bebind* trust is used as the investment vehicle, and contract,⁶² where the investment vehicle is a LP or a Memorandum of Association and Articles of Association where an LLC or an offshore company is used.⁶³ The agreement between the institutional investors and the asset management firm (private equity firm) includes contractual terms that define the guidelines governing the running of the fund.⁶⁴ Terms and conditions include:⁶⁵

1. Limitations on investment choices, which include the length of the investment, and equity investment;⁶⁶
2. Limitations on financial arrangements, such as leverage, and reinvestment of capital after it is realised;
3. The investment mandate;⁶⁷
4. Financial accounting; and⁶⁸
5. Investor protection and rights, which include the ability to remove the fund manager; accounting, reporting and valuations requirements; and investor representation on advisory committee.

Contractual terms and covenants have been presented as an ideal structure to alleviate principal-agent conflicts in the investment model of private equity.⁶⁹ In practice however, it is possible that they actually increase conflicts of interest, thus calling for more effective regulation.⁷⁰

⁶² Daniel Schmidt & Mark Wahrenburg 'Contractual relations between European VC funds and investors: The impact of bargaining power and reputation on contractual design' (2003) *CFS Working Paper* No. 2003/15, 2003 at 1.

⁶³ Yates & Hinchcliffe op cit (n53) 47.

⁶⁴ Paul A Gompers & Josh Lerner 'The use of covenants: An empirical analysis of venture capital partnership agreements' (1996) *Journal of Law and Economics* 463; Metrick op cit (n16) 2303.

⁶⁵ Kate Litvak 'Venture Capital Limited Partnership Agreements: Understanding compensation arrangements' (2009) *University of Chicago Law Review* at 161-218.

⁶⁶ Cumming op cit (n27) 15.

⁶⁷ Gompers & Lerner op cit (n64) 2303.

⁶⁸ Cumming & Johan op cit (n44) 51.

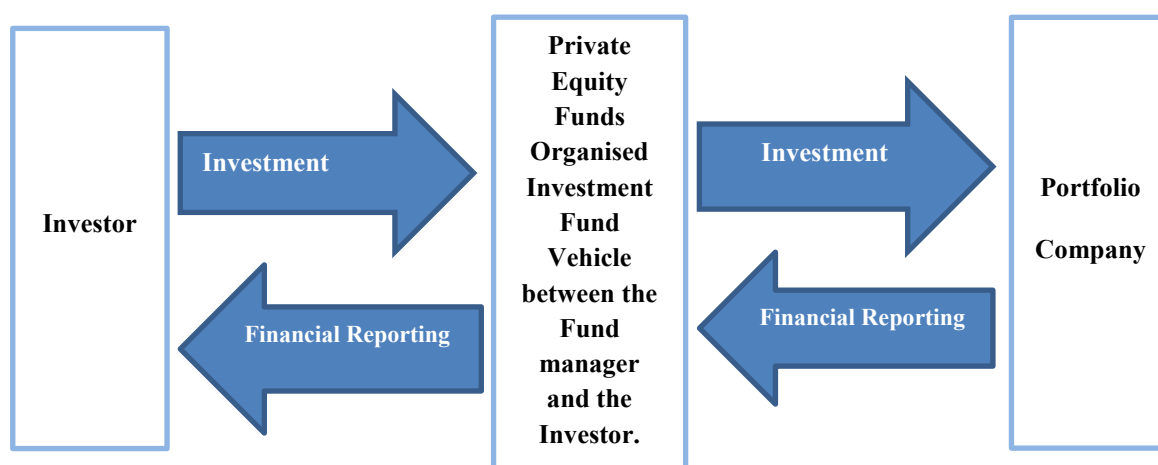
⁶⁹ Gompers & Lerner op cit (n64) 463.

⁷⁰ Cumming and Johan op cit (n44) 27.

2.8 Fund Manager as the Financial Intermediary

While reducing but not eradicating the information asymmetries and agency costs associated with the portfolio company, the fund manager's position as the financial intermediary creates informational asymmetries and agency costs in funds.⁷¹

Informational asymmetry refers to circumstances where relevant information is not known to all parties involved.⁷² Participants do not have access to the information required for sound decision-making.⁷³ Agency costs refer to conflicts between the principal (investor) and their agent (fund manager), which emerge from the separation of ownership and control.⁷⁴ One of the solutions for informational asymmetries and agency costs is disclosure of performance and transparency from the portfolio company, to the private equity firm, and from the private equity firm to the investor.⁷⁵ The diagram below illustrates the fund manager as the financial intermediary and the disclosure of information discussed above.



Information/Investment flows in a Private Equity Setting⁷⁶

While the disclosure from the portfolio company to the private equity firm is made in compliance with company law, the performance disclosure to the investor is hampered by two complications. On the one hand, valuation requires sufficient information on the performance of the fund, whereas on the other, even if such

⁷¹ Cumming op cit (n27) 335-336.

⁷² A Sufi 'Information Asymmetry and Financing Arrangements: Evidence from Syndicated Loans' (2007) 62 *Journal of Finance* 629.

⁷³ LYutao, A Saunders & P Shao 'Did Regulation Fair Disclosure Affect Credit Markets?' (2015) *Journal of Banking & Finance* 54.

⁷⁴ A Berle & G Means *The Modern Corporation and Private Property* (1932).

⁷⁵ Cumming op cit (n27) 13.

⁷⁶ *Ibid* 72.

information is obtainable, private equity firms choose to disclose information tactically.⁷⁷ As noted, funds have unfettered freedom to run the fund, enabling the fund manager to exercise his/her judgement untouched by regulation.⁷⁸ Inadequate transparency and disclosure obligations impose substantial constraints on the relationship between the fund and investors.

2.9 Issues and Concerns

(a) Investor Protection

The concern regarding investor protection arises from the collectivised nature of investment funds.⁷⁹ South African, UK and USA law provide for investor protection in different ways,⁸⁰ including criminal law provisions; substantive rights and obligations under civil law; voluntary systems of regulation; and statutory systems of regulation.⁸¹ Although statutory regulation exists, due to the nature of funds, it falls outside the oversight of the Financial Services Board (FSB) in South Africa.

As a result of the ‘unregulated nature’ of the private equity fund, investor protection concerns are addressed at a late stage of negotiations after issues such as the economic arrangements between the parties and the investment objectives of the fund have been resolved.⁸² The question therefore is to what extent are the legal remedies outside the statutory regulation regime sufficient to address the ‘governance challenge’.⁸³ Participants rely on the governance mechanisms of the legal ‘vehicles’ used as funds, supplemented by any additional contractual agreements between the parties, for oversight of the fund manager.⁸⁴ The investor protection provided by transparency and disclosure are regulated by the terms of the agreement.⁸⁵

⁷⁷ Cumming op cit (n19) 16.

⁷⁸ David Rosenberg ‘Venture Capital Limited Partnerships: A Study in Freedom of Contract’ (2002) 363 *Colum Bus L Rev* 398.

⁷⁹ A Fung et al *Full Disclosure: The Perils and Promise of Transparency* (2007) 14.

⁸⁰ Spangler op cit (n59) 1.

⁸¹ Robert Clark ‘The Soundness of Financial Intermediaries’ (1976) 86 *Yale Law Journal* 26.

⁸² Douglas Cumming & Uwe Walz ‘Private Equity Returns and Disclosure around the World’ (2004) *Journal of International Business Studies* 727.

⁸³ Spangler op cit (n59) 20.

⁸⁴ Cumming op cit (n27) 375.

⁸⁵ Gompers & Lerner op cit (n64) 463.

Hedge funds,⁸⁶ as opposed to private equity funds (funds) in South Africa are now regulated by the Cisca.⁸⁷ Hedge funds are short-term investors, which pursue profit from short-term speculative investments.⁸⁸ This study focuses on private equity funds, where the only investor protection provided is at the level of the private equity firm.⁸⁹

Evidence shows that the level of investor protection has important economic consequences for the market.⁹⁰ La Porter et al assert that the higher the investor protection provided, the more developed the financial markets and the greater the economy's growth.⁹¹ The problem this study addresses is how to improve investor protection and governance structures in funds by providing adequate transparency and disclosure.⁹² Niamh Moloney notes the appeal of 'investor protection',⁹³ which has been the dominant regulatory objective in developed and emerging markets. However, the question remains as to whether the regulators are justified in intervening.

Investor protection is necessary where there has been a market failure, primarily related to information asymmetries and agency costs.⁹⁴ Investor risks stem from incentive misalignment in the principal/agent relationship which characterises the investor/intermediary relationship in private equity.⁹⁵ As noted, investors have insufficient ability to negotiate for protection in agreements and to evaluate financial intermediaries. There is thus a need to address information asymmetries. This also calls for the protection of the individual's independence and promotes minimal intervention by regulators. Moloney also notes that paternalism is associated with investor protection.

⁸⁶ Steen Thomsen 'Should Private Equity be Regulated?' (2015) 10 *European Business Organization Law Review Cambridge University Press* 97.

⁸⁷ The National Treasury on Regulation of Hedge Funds op cit (n26).

⁸⁸ David Stowell *An Introduction to Investment Banks, Hedge Funds, and Private Equity* (2010) 543.

⁸⁹ In this instance the protection which is provided is the Companies Act 71 of 2008, Financial Advisory and Intermediary Services Act 37 of 2002 and other legislation which may be specifically applicable to the fund manager and not the fund.

⁹⁰ Rafael La Porta et al 'Investor Protection: Origins, Consequences and Reform' (1999) *National Bureau of Economic Research Working Paper No. 7428*; Rafael La Porta et al 'Investor Protection and Corporate Governance' (2000) 58 *Journal of Financial Economics* 3; Rafael La Porta et al, 'Investor Protection and Corporate Valuation' (2002) 57 *Journal of Finance* 1147.

⁹¹ R La Porta et al 2000 op cit (n90) 3.

⁹² A Fung op cit (n79) 30.

⁹³ Niamh Moloney *How to Protect Investors: Lessons from the EU and the UK* (2010) 45.

⁹⁴ Spangler op cit (n59) 289.

⁹⁵ Spangler op cit (n59) 20.

Moloney asserts:

‘[p]aternalism is the interference of a state or an individual with another person, against their will, and defended or motivated by a claim that the person interfered with will be better off or protected from harm. It is less concerned with information and more associated with intervention for the individual’s [investor] own good.’⁹⁶

Benjamin states that this more defensive approach to investor protection leads to heavier interference in the investor/investment firm relationship, and in the delivery and design of investment products.⁹⁷ Private equity returns are influenced by strong investor protection laws in a jurisdiction, providing investors with the capability to contract with certainty.⁹⁸ Due to the structure of funds, disclosure of information offers benefits to investors in regulating dubious activities by fund managers.⁹⁹

(b) Overregulation or Inappropriate Regulation of the Industry

The key concern is to promote the fund’s transparency and disclosure to the investors, without imposing onerous obligations on the fund managers and the private equity industry. Overregulation or inappropriate regulation of the industry would be detrimental to its continued growth.¹⁰⁰ Therefore, adequate investor protection in the form of transparency and disclosure is required without crossing the proverbial Rubicon. A balance is needed. The question is, considering the current milieu in which private equity is conducted, does the industry have the regulatory balance between promoting growth and investor protection?

The following chapters examine how the industry and investors in funds can improve transparency and disclosure and the governance structures of the funds in which they invest. The question of whether South Africa should follow other jurisdictions which have called for the regulation of funds is addressed. An alternative approach, that is, whether the country should maintain the current milieu in which private equity operates, with minor changes to allay current concerns, is also examined. The following chapter discusses and analyses the regulation of private equity funds in South Africa.

⁹⁶ Moloney op cit (n93) 45.

⁹⁷ Joanna Benjamin *Financial Law* (2007) 18.

⁹⁸ R La Porta et al (2002) op cit (n90) 1147.

⁹⁹ Cumming op cit (n27) 359.

¹⁰⁰ D Oakley ‘Billy the Kid is not a Good Role Model for Regulators’ *Financial Times* 20 October 2013 available at <http://www.ft.com/intl/cms/s/0/bb609ea8-371c-11e3-9603-00144feab7de.html> accessed on 10 May 2015.

CHAPTER THREE

3. THE REGULATION OF PRIVATE EQUITY FUNDS IN SOUTH AFRICA

3.1 Introduction

The global community regards South Africa as a profitable market for private equity investments.¹⁰¹ The 2015 KPMG and South African Venture Capital and Private Equity Association Industry Performance Survey for 2014 notes that a substantial part of funds are obtained from within and outside South Africa.¹⁰² These private equity investors' long term commitments contribute to Foreign Direct Investment in South Africa and the rest of Africa.¹⁰³ The survey highlights the role of private equity in Broad Based Black Economic Empowerment (BB-BEE).¹⁰⁴ Private equity investments facilitate BB-BEE shareholdings, and many transactions have a BB-BEE element to their structuring.¹⁰⁵ The survey noted a substantial increase in private equity investments in 2014, with a growth in the number of deals, overall value and the average size of the deal.¹⁰⁶

As a profitable asset class, the private equity industry is an important sector within the financial services industry.¹⁰⁷ Thus, as a contributor to the South African economy,¹⁰⁸ regulation of this industry should not inhibit private equity investment.

South Africa has a sophisticated private equity industry, with different funds at all stages,¹⁰⁹ although it is small in comparison with those of the UK and the USA.¹¹⁰

International forces have shaped the South African private equity industry.¹¹¹ Whilst the country's private equity industry emerged from the GFC of 2007-2008 in

¹⁰¹ World Bank Group. Doing Business in South Africa, available at: <http://www.doingbusiness.org/data/exploreconomies/south-africa>, accessed on 10 March 2015.

¹⁰² SAVCA/KPMG Survey op cit (n41) 4-5.

¹⁰³ *Ibid.*

¹⁰⁴ *Id* at 6.

¹⁰⁵ The Codes of Good Practice for Broad Based Black Economic Empowerment.

¹⁰⁶ SAVCA/KPMG Survey op cit (n41) 5.

¹⁰⁷ A Banerjee 'Private Equity in Developing Nations' (2008) 9 *Journal of Asset Management* 158.

¹⁰⁸ The Economic Impact of Venture Capital and Private Equity in South Africa 2013 Study, available at <http://www.savca.co.za/wp-content/uploads/2014/04/SAVCA-DBSA-Economic-Impact-Study-2013.pdf> accessed on 10 February 2015.

¹⁰⁹ SAVCA/KPMG Survey op cit (n41) 10.

¹¹⁰ SAVCA/KPMG Survey op cit (n41) 28.

¹¹¹ Steven N Kaplan 'The Future of Private Equity' 21 *Journal of Applied Corporate Finance* (2009) 8; Cumming op cit (n27) 419.

better shape than other jurisdictions,¹¹² the crisis accelerated financial regulation of this industry and reduced interest in private equity.¹¹³ Regulation is partly the result of misunderstanding private equity as an asset class. Nonetheless, the private equity industry in South Africa has continued to grow.¹¹⁴ The reasons are diverse and are beyond the scope of this dissertation. This would be a useful topic for further research. In short however, the growth of South African private equity investments resulted from substantial institutional support and the commitment of funds to this sector. BB-BEE legislation,¹¹⁵ as well as pension fund legislation,¹¹⁶ provided the institutional support for private equity and the allocation of funds to private equity investments.¹¹⁷

The Companies Act sets out requirements that seek to promote the transparency and disclosure of the portfolio company and the private equity private equity firm to the regulator.¹¹⁸ The establishment of private equity firms in South Africa is governed by the new Companies Act.¹¹⁹ For example, as part of the Fidentia Group, Fidentia Asset Management (Pty) Ltd had to comply with the regulations of the Companies Act with regard to transparency and disclosure.¹²⁰ It also had to adhere to the regulations of the FAIS Act in order to operate as a Financial Services Provider (FSP).¹²¹ However, funds that are managed by asset managers offer transparency and disclosure to different degrees, depending on the form of the ‘vehicle’ used by private equity investors, the common law, and contractual arrangements.¹²² Therefore, investor protection can be limited.

¹¹² SouthAfrica.Info, How the World rates South Africa, available at <http://www.southafrica.info/business/economy/global surveys.htm#.VXm55TCqqko> Accessed on: 10 March 2015; Cumming op cit (n27) 420.

¹¹³ SAVCA Three Decades op cit (n11) 1.

¹¹⁴ SAVCA/KPMG Survey op cit (n41) 7.

¹¹⁵ Broad Based Black Economic Empowerment Act No. 53 of 2003.

¹¹⁶ Pension Funds Act No. 24 of 1956.

¹¹⁷ Roderick L Kennedy et al (2014) ‘Private Equity in South Africa: Market and Regulatory Overview’ Practical Law. Multi-Jurisdictional Guide 2014/2015. Available at:

<http://uk.practicallaw.com/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf&blobkey=id&blobtable=MungoBlobs&blobwhere=1247992685894&ssbinary=true> Accessed on 20 January 2015.

¹¹⁸ Part C of the Companies Act No. 71 of 2008; Section 23 – 34

¹¹⁹ Farouk Cassim et al *Contemporary Company Law* (2011) 66.

¹²⁰ Part C of the Companies Act No. 71 of 2008. Section 23 – 34.

¹²¹ Section 8 of the FAIS Act op cit (n8).

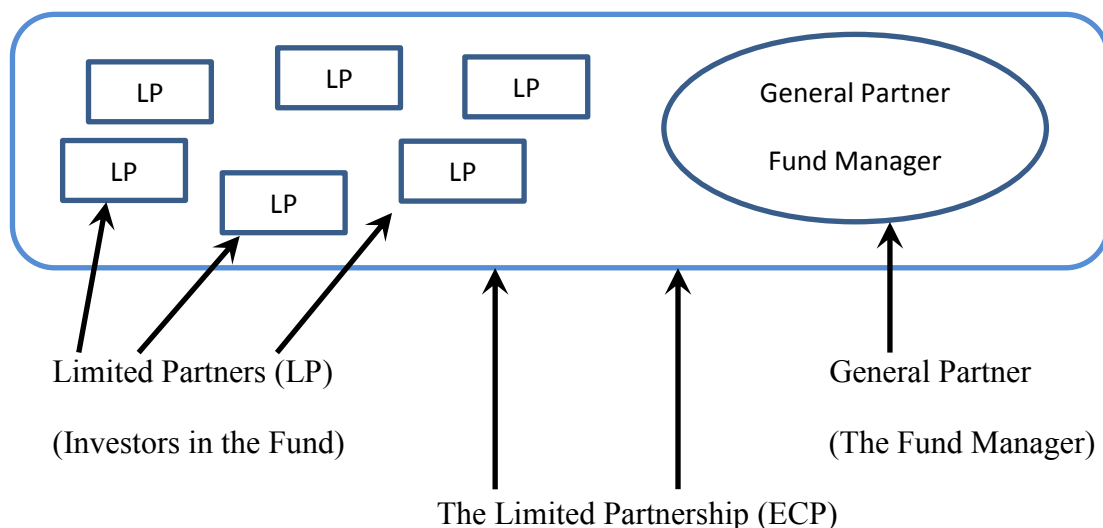
¹²² Rafael La Porta et al ‘Law and Finance’ (1998) 106 *Journal of Political Economy* 1113.

3.2 Forms of Private Equity Funds in South Africa

The ‘vehicle’ often used by private equity firms in South Africa is the *en commandite* partnership (ECP), or a *bewind* trust. Private equity firms use the ECP or the *bewind* trust for two reasons:¹²³ tax issues, and transparency and disclosure obligations. While the Companies Act contains provisions on transparency and disclosure, funds are subject to the common law and the agreement between the fund manager and investors.

(a) Limited Liability Partnership

The most common investment vehicle is the limited liability partnership.¹²⁴ In South Africa it is known as the ECP, a type of common law partnership.¹²⁵ Similar to the limited partnerships found in other jurisdictions,¹²⁶ the ECP does not have a separate legal personality. It has two categories of partners: partners with limited liability which is usually a private equity fund's investors or limited partners; and partners with unlimited liability as regards third parties known as the general partner which is the fund manager. A general partner (GP) is responsible for overall transactions; the GP has unlimited liability and has a number of *en commandite* or limited partners. The identity of the *en commandite* partner is not disclosed and they thus carry limited liability restricted to their capital contribution amount.¹²⁷ The diagram below illustrates a fund structured as a limited partnership.¹²⁸



¹²³ SAVCA Three Decades op cit (n11) 39.

¹²⁴ SAVCA/KPMG Survey op cit (n41).

¹²⁵ SAVCA Three Decades op cit (n11) 39.

¹²⁶ R C Williams *Concise Corporate and Partnership Law* 2 ed (1997).

¹²⁷ *Ibid* at 4.

¹²⁸ Cumming op cit (n27) 370.

The LP contributes a fixed amount on condition that the investor receives a certain share of the profit, if any. In the event of a loss, the investor is liable to their co-partners to the extent of the fixed amount of agreed capital contribution only.¹²⁹

An ECP is established by contract,¹³⁰ and its internal nature or functioning is regulated by such.¹³¹ The contract between the parties reflects the intention to establish an ECP and identifies the general or disclosed partner.¹³² There are no registration requirements for establishing the ECP, and no legislation regulates such partnerships.¹³³ Instead, they are governed by the common law.¹³⁴ Together with contractual obligations, the GP owes fiduciary duties to the partnership as they stand in a fiduciary relationship.¹³⁵

The partners have wide discretion to arrange their affairs in the partnership in accordance with their commercial intentions, provided that the partnership adheres to the requirements of an ECP and subject to the general requirements for enforceable contracts. This includes the requirement that the terms of the agreement should be sufficiently certain and lawful.¹³⁶ The terms of the partnership agreement are not publicly available. Transparency and disclosure requirements are contained in the contract, and in most instances, fund managers do not set out such terms in the agreement.

The fact that the identities of the LPs are not disclosed has a number of effects.¹³⁷ They are not presented as partners and accordingly, individuals dealing with the partnership do not form that mistaken impression. The LP is only liable to their co-partners and not for partnership debts to creditors. They therefore enjoy the benefits of limited liability.¹³⁸ The LP may not participate in the partnership business although the LP is entitled to advise the managing partner and may also enjoy limited consent rights. They also cannot claim reimbursement of their

¹²⁹ Williams op cit (n126) 22.

¹³⁰ *Ibid* at 4.

¹³¹ *Smith v Oertal* (1864) 5 S 16 28; *De Villiers v Smith* 1930 CPD 219 221.

¹³² J J Henning 'Partnership' *The Law of South Africa (LAWSA)* vol 19 Para 260.

¹³³ South Africa has a Companies Act, but no Partnership Act.

¹³⁴ Williams op cit (n126) 4.

¹³⁵ *Ibid* at 5.

¹³⁶ *Eaton & Louw v Arcade Properties (Pty) Ltd* 1961 (4) SA 233 (T)

¹³⁷ Williams op cit (n126) 41.

¹³⁸ *S Butcher & Sons v Baranov Bros* (1905) 26 NLR 589; *Eaton & Louw v Arcade Properties (Pty) Ltd* 1961 4 SA 233 (T).

contributions or payment of their share of the partnership profits in competition with the partnership's creditors.¹³⁹

The GP of the ECP has unlimited liability to the partnership's creditors in circumstances where the partnership's resources are not sufficient to settle debts.¹⁴⁰ The ECP is usually terminated upon agreement between all the partners or in accordance with the partnership agreement, which may, for example, provide that the GP may terminate the partnership on notice to the other partners.¹⁴¹

The principles for ensuring that an LP's liability remains limited are simple. Unfortunately, South Africa has no list of acceptable LP activities. Therefore most investors adopt a conformist approach to fund involvement.¹⁴² If LPs participate in the partnership business, they will lose their limited liability status.¹⁴³

The question of disclosure of the identity of LPs, and specifically, the effect of such disclosure on the liability of the partners in an ECP is not clear. Early case law and textbook writers seem to feel that it is important that the identity of LPs is not disclosed to third parties.¹⁴⁴ However, *Mmabatho Food Corporation (Pty) Ltd v Fourie en Andere*¹⁴⁵ is the authority for the proposition that the non-disclosure of LPs is not the issue. The key issue is that an LP enjoys protection against the claims of the partnership's creditors to the extent that he/she has not created, or permitted to be created, a mistaken impression on the part of outsiders that they can rely on his/her credit as an ordinary partner in the partnership.¹⁴⁶ If LPs participate in decisions on the partnership's investment, they will be partaking in the business of the partnership and may thus lose their limited liability status.

There are two ways to avoid this. The LP may sit on an advisory committee to the partnership. In this way the LP does not participate actively in investment/divestment decisions, and does not take part in the everyday management

¹³⁹ Williams op cit (n126) 41.

¹⁴⁰ *Supra* 149.

¹⁴¹ Williams op cit (n126) 48.

¹⁴² D Lingelbach et al 'The rise and fall of South African venture capital: A Co-production Perspective' 2008 Paper presented at International Council for Small Business World Conference, Halifax, Canada, available at <http://ssrn.com/abstract=1459175> accessed on 16 March 2015.

¹⁴³ Williams op cit (n126) 41.

¹⁴⁴ *Ibid.*

¹⁴⁵ 1985 1 SA 318 (T).

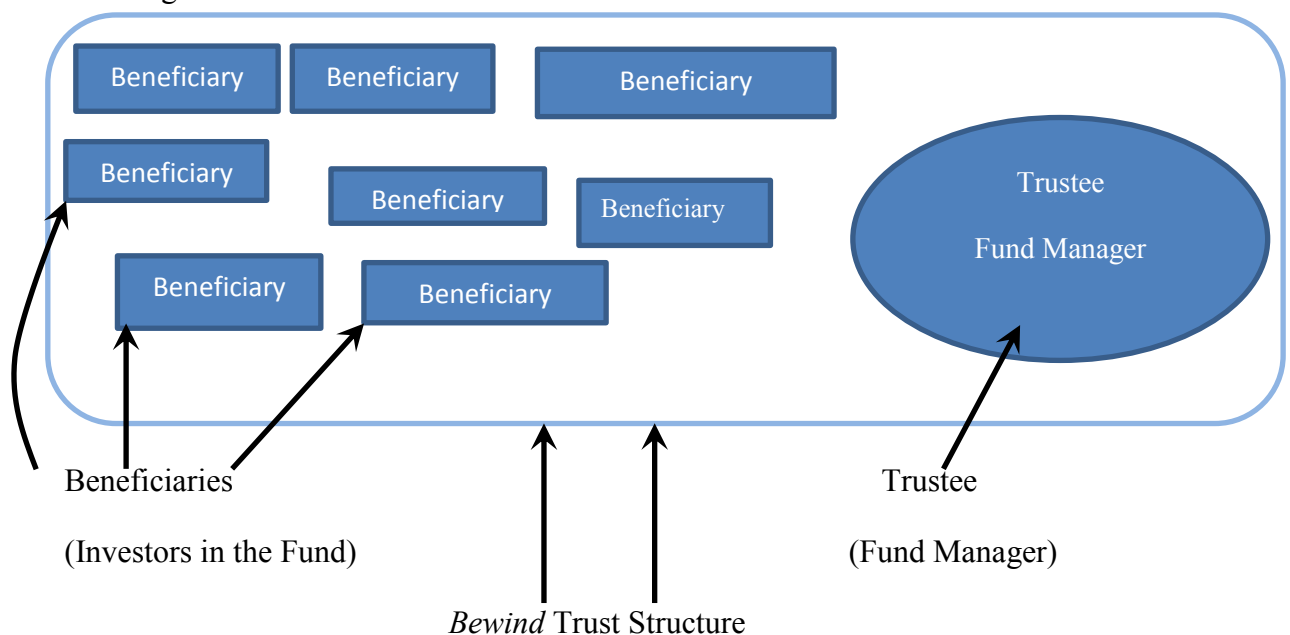
¹⁴⁶ 1985 (1) SA p321.

of the partnership.¹⁴⁷ The LP may also sit on the advisory committee of the investment firm and make recommendations to the fund. The use of advisory committees is, however, limited in South Africa. This issue is discussed in more detail in Chapter 6.

(b) *Bewind Trusts*

The *bewind* trust is another structure that is used to establish a fund. *Bewind* trusts have become very popular in South Africa as private equity investment vehicles.

The diagram below illustrates a fund structured as a *bewind* trust.¹⁴⁸



It is established by way of a written trust deed.¹⁴⁹ This applies to all trusts. A *bewind* trust differs from other forms of trusts under South African law like the ordinary trust.¹⁵⁰ In a normal trust, the beneficiaries do not own the assets of the trust; the trustee holds and administers these assets.¹⁵¹ In the *bewind* trust,¹⁵² the trustees do not own, but merely administer the assets of the trust that are owned in undivided shares by the beneficiaries of the trust.¹⁵³ The trust assets does not form part of the trustee estate,¹⁵⁴ except insofar as the trustee is a beneficiary.¹⁵⁵ As noted

¹⁴⁷ *Ibid* at 322.

¹⁴⁸ Cumming op cit (n27) 441.

¹⁴⁹ Farouk Cassim et al *The Law of Business Structures* (2013) 8.

¹⁵⁰ François du Bois et al *Wille's Principles of South African Law* 9 ed (2007)710.

¹⁵¹ M J De Waal et al, *Trusts Law of South Africa* vol 31 Paragraph 531.

¹⁵² Section 12 of the Trust Property Control Act, 1988 (the Trust Property Control Act).

¹⁵³ M J De Waal et al *Honore's South African Law of Trusts* 5 ed (2007); M J De Waal et al op cit (n151) Para 531.

¹⁵⁴ Section 12 of the Trust Property Control Act No. 57 of 1988 (the Trust Property Control Act).

¹⁵⁵ Section 20 of the Trust Property Control Act.

above, the trust deed may not provide for transparency and the disclosure of the fund arrangements to the other beneficiaries of the *bewind* trust.

Similar to partnerships, apart from the particular issues which are subject to the statutes dealing with *inter alia*, insolvency, licensing and criminal proceedings and the rules of court regulating civil litigation, *bewind* trusts in South Africa are governed by the common law. The fund manager as trustee owes the trust the fiduciary duties of care and skill, and the avoidance of conflicts of interest, among others.¹⁵⁶ Along with the fiduciary duties, the contract attempts to address any issues and concerns.

(c) The Structure of a Private Equity Investment

An institutional investor's ability to assess and monitor the investment fund manager's decision-making process is very important to the investor. With regard to funds, the investor/fund manager relationship is complicated due to the imposition of the intermediary investment vehicle. Consequently, the monitoring of the investment fund manager is intertwined with the governance mechanisms of the investment fund.¹⁵⁷ The fiduciary duties and contractual agreements entered into attempt to deal with any issues and concerns.

The fund manager's contractual role informs the range of fiduciary duties owed by the fund manager to the investment fund.¹⁵⁸ The legal duties owed by a fund manager to an investor in a fund are set out in the investment agreement entered into as part of the establishment of the fund and the investment vehicle.¹⁵⁹

As noted, while the private equity firm is a company, and therefore regulated by the Companies Act and the FAIS Act as an FSP, funds structured as an ECP or a *bewind* trust are not subject to regulations and there is no government body that applies regulatory oversight. It is questioned whether reliance on the common law and contractual agreements will provide sufficient protection.

¹⁵⁶ *Re Smith and Fawcett Ltd* [1942] Ch 304.

¹⁵⁷ Spangler op cit (n59) 7.

¹⁵⁸ These could include action against negligence; misrepresentation; and breach of contract.

¹⁵⁹ Christa Bond 'Conflicts of Interests in the Financial Services and Markets' (2006) *Journal of International Banking Law and Regulation* 678.

(i) Fiduciary duties

There is trust involved in the relationship between a fund manager and the investor; this means that the fund manager will be deemed to be the investor's fiduciary.¹⁶⁰ This results in a duty of loyalty.¹⁶¹ In addition to claims of negligence and breach of contract, such duty could be the basis for a claim by the investor. A definition of the fiduciary relationship which is appropriate in the private equity investment funds setting is provided by the Law Commission:

'[b]roadly speaking a fiduciary relationship is one in which a person undertakes to act on behalf of another, often as an intermediary with a discretionary power that affects the interests of the other who depends on the fiduciary for information and advice.'¹⁶²

The effectiveness of fiduciary duties can be limited by contractual means.

Contractual approaches include using agreements to modify the fiduciary duties. This is done either by means of exclusion clauses or disclosure and consent. The terms of the contract therefore play an important role in defining the fiduciary relationship.

The fiduciary duties of the fund manager to the fund and the investors are an effective means of recourse for clients in ensuring that the investment manager offers professional services in compliance with recognised standards.¹⁶³ The common law fiduciary duties of the fund manager differ from the provisions of the Companies Act, in that the duties are owed directly to the investors, as the fund manager stands in a fiduciary position to the investors. However the effectiveness of the fiduciary duties varies depending on the contractual agreements.

(ii) Contracts

With regard to the organisation of the fund, in the South African context, the investment vehicle housing the fund would typically appoint the fund manager or adviser in terms of a written mandate to manage the everyday affairs of the fund and

¹⁶⁰ Williams op cit (n126) at 41.

¹⁶¹ *Bristol & West Building Society v Mothew* [1998] Ch 1 at 18, Millet LJ provides a definition of a fiduciary that is clear in the asset management context. 'A fiduciary is someone who has undertaken to act for or on behalf of another person in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty, the principal is entitled to the single minded loyalty of his fiduciary'. *Phillips v Fieldstone (Africa) (Pty) Ltd* 2004 (3) SA 465 (SCA) '(w)here one man [stood] to another in a position of confidence involving a duty to protect the interests of that other, he [was] not allowed to make a secret profit at the other's expense or place himself in a position where his interests conflict with his duty'. (Paragraph [30] of Heher JA's C judgment at 478H - I/J.) *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168 at 180 applied.

¹⁶² The Law Commission, *Fiduciary Duties and Regulatory Rules*, Report No 236, December 1995, para 1.3.

¹⁶³ Spangler op cit (n57) 68.

to identify and execute investments and disinvestments.¹⁶⁴ Funds involve many contractual arrangements between the fund vehicle and the fund manager. Where the fund vehicle is a limited partnership or a *bewind* trust, the limited partnership agreement or trust deed will also be a contract negotiated between the parties. A frequent claim against a fund manager is for breach of an implied or express term in the investment management agreement. The fund manager often faces liability in both contract as well as breach of a fiduciary duty.¹⁶⁵

Although practice varies, the fund manager or adviser would not always have direct contractual obligations to specific investors, save if created by way of a side letter and would in many cases only owe contractual obligations to the *bewind* trust or partnership housing the fund.¹⁶⁶ A side letter or side agreement is a collective agreement that is not part of the primary agreement which the parties to the contract use to reach agreement on issues not covered by the agreement. It is applied to clarify issues in the agreement, or to modify the agreement permanently or temporarily.¹⁶⁷ Side letters are regarded as an effective tool to regulate the internal nature of agreements in private equity, and the industry has seen an increase in their use.¹⁶⁸ Side letters are discussed further in chapter six.

Although it is standard practice for the attorneys advising on the establishment of the fund to issue an opinion confirming that the applicable agreements have been duly authorised and are lawful, valid and enforceable, such opinion is often given to the fund rather than to investors.¹⁶⁹ This could adversely impact transparency and disclosure.

The matters typically addressed in the applicable trust deed or partnership agreement have become standardised. Investors in a South African fund could expect contractual provisions dealing with a number of terms.¹⁷⁰

¹⁶⁴ Cumming op cit (n19) 15.

¹⁶⁵ *Supra* 161.

¹⁶⁶ Cumming op cit (n19)15.

¹⁶⁷ D Jones 'Side Letters: The Times They Are a-Changing- A few observations on side letters, the process of negotiating a fund-raise and related regulatory developments. 2014, available at <http://www.pegcc.org/newsroom/newsletters/side-letters-the-times-they-are-a-changin/#sthash.1WS7QfsF.dpuf> accessed on 10 March 2015.

¹⁶⁸ *Ibid.*

¹⁶⁹ The Attorneys Act 53 of 1979, in terms of Section 83(8) lays down that it is an offence for anyone except a practicing attorney, notary or conveyancer to draw up the relevant agreement; D Cumming op cit note 53 at 343.

¹⁷⁰ Cumming op cit (n27) 335.

Due to the standardised nature of the contractual provisions, terms with regard to transparency and disclosure to the investors are not adequately given effect to.¹⁷¹ This puts the funds of the investor at risk and could ultimately be to the detriment of investments. Without adequate disclosure to the investor, the investor may be unable to determine whether the funds are being applied as mandated. As a result of agency costs and information asymmetries, investors would only receive such information after the fact, after the tide has gone out, to quote Warren Buffet.¹⁷² Adequate disclosure and transparency to the investors may limit information asymmetries and agency costs, and ensure the fund is complying with the mandate and representing the true value to investors.

As noted above, in contrast with private equity funds, hedge funds are now regulated in terms of the CISCA.¹⁷³ The amendments to the CISCA are likely to lead to improved investor confidence and have the potential to enhance growth in the industry. While the transparency and disclosure requirements are commendable, it is submitted that South Africa should avoid crossing the Rubicon, by overregulating or inappropriately regulating the private equity industry as this would deter investment. Financial regulations' potential to address such issues and concerns is further discussed in Chapters six and seven.

Given the concerns regarding non-disclosure and non-transparency and the need for investor protection, an overview of the South African regulatory framework and the main regulatory bodies is presented. This chapter also discusses the specific rules governing a private equity investment. Furthermore, the discussion will consider the impact of overregulation and inappropriate regulation of the industry.

3.3 The General Regulatory Framework

The general private equity regulatory framework in South Africa consists of relevant legislation, the formal bodies and industry associations.

¹⁷¹ A Hudec 'Negotiating Private Equity Terms: The Shifting balance of Power' *FARRIS* (2009) available at [http://www.farris.com/images/uploads/ALH_-_Negotiating_Private_Equity_Fund_Terms_in_2010_\(2\).pdf](http://www.farris.com/images/uploads/ALH_-_Negotiating_Private_Equity_Fund_Terms_in_2010_(2).pdf) accessed on 17 June 2015.

¹⁷² Warren Buffet op cit (n17).

¹⁷³ It is important to note however, that when it comes to transparency and disclosure of the fund to investors, the hedge fund manager is obliged to comply with fiduciary duties and is expected to comply with the initial and on-going disclosure requirements specified in terms of Section 3 and Section 100 of the CISCA.

While a fund is not required to register with a government agency, fund managers are required to register as financial services providers (FSP) under the FAIS Act.¹⁷⁴

The provision of financial intermediary services or advice to investors in South Africa is subject to regulations in terms of the FAIS Act. The licences issued in terms of the Act include:

- a) category I licences which are assigned to FSPs providing non-discretionary intermediary advice or services;
- b) category II licences assigned to FSPs who provide discretionary fund management;
- c) category IIA licences assigned to FSPs who manage funds on a discretionary basis; and
- d) category III licences assigned to administrative FSPs who aggregate client funds or securities.

Such licence holders are bound by the principles and rules set out in the applicable codes of conduct established by the FSB. The FAIS Act regulates the provision of certain financial advisory and intermediary services to investors. It enforces a duty on FSPs to provide financial services fairly; reliably, with due care, diligence and skill, in investors' interests and in a way that promotes the integrity of the financial services industry.¹⁷⁵ The FAIS Act provides for detailed regulation of actual and possible conflicts of interest between financial intermediaries and advisers licensed under the Act. It includes the requirement that such persons must implement and adopt a conflict of interest management policy.¹⁷⁶

The FAIS Act seeks to deal with transparency and disclosure by requiring information at the level of the fund manager.¹⁷⁷ It does not provide such transparency and disclosure to investors in the private equity fund. An example is the private equity firm's disclosure. A miscreant fund manager's conduct only becomes apparent when the fund manager is called on to disclose information in compliance with the

¹⁷⁴ Section 8 of the FAIS Act op cit (n8).

¹⁷⁵ Board Notice 80 of 8 August 2003: The General Code of Conduct for Authorised Financial Services Providers and Representatives, Paragraph 2.

¹⁷⁶ Paragraph 3 and 3A of the General Code of Conduct for Authorised Financial Services Providers and Representatives, BN80 of 2003 (as amended), available at https://www.fsb.co.za/Departments/fais/legislation/BoardNotice_ByYear/BN58of2010.pdf accessed on 16 January 2015.

¹⁷⁷ Chapter V of the Act, Section 17 – 19.

Act. Even then, such disclosure occurs long after the investor's funds are used. It is also noted, that the delictual and contractual liability of the asset manager is contingent on the emergence of fraud or misrepresentation by the fund manager. This liability is based on the common law and the FAIS Act. The transparency and disclosure of the fund manager occurs after the fact; on-going transparency to investors would limit miscreant conduct.

The regulatory bodies include both formal and voluntary industry associations. These are the Financial Advisory and Intermediary Services *Ombud*, the FSB, and the SAVCA.

The Office of the *Ombud* for Financial Services Providers ('FAIS *Ombud*') was established by the FAIS Act.¹⁷⁸ The role of the FAIS *Ombud* is to resolve disputes between FSPs and their investors.

The FAIS *Ombud* deals with various determinations under its authority. It has the authority to deal with violations of the Act by fund managers. Fund managers who fail to comply with transparency and disclosure to the regulator are dealt with by the *Ombud*. Complaints by the public of a lack of compliance with the fund manager's investment mandate, such as non-disclosure, are also dealt with by the *Ombud*. However, the *Ombud* is limited in addressing issues and concerns.

The main body responsible for administering applicable legislation is the FSB which is established as a statutory body by the Financial Services Board Act (FSB Act).¹⁷⁹ It controls the undertakings of non-banking financial services¹⁸⁰ and acts in a consultative capacity to the Finance Minister.¹⁸¹

The Executive Officer (EO) of the FSB has wide powers, which include the cancellation of authorisation to provide financial services. The EO has official authority to undertake investigation with criminal sanctions. It can apply to court for a mandamus, interdict or curatorship where required. The regulatory powers of the EO take effect where the authorised FSP conduct appears to have been in breach of the law, or if it is unsure if the FSP is fit and proper to provide services.

¹⁷⁸ Financial Services Board, available at <http://www.fsb.co.za/Pages/Home.aspx>, accessed on 12 January 2015.

¹⁷⁹ Act No. 97 of 1990.

¹⁸⁰ Section 3 of the FSB Act.

¹⁸¹ Section 2 of the FSB Act.

As noted above, private equity firms are also subject to regulations imposed by voluntary self-regulated associations if they are members.¹⁸² Private associations establish voluntary rules that private equity firms have to abide by if they wish to retain their membership.¹⁸³ Private equity firms are encouraged to become members as this promotes access to investors.

The SAVCA is a self-regulatory association that many private equity firms are members of.¹⁸⁴ It describes itself as a voluntary private regulator and a representative of institutions that act in the capital and financial markets.¹⁸⁵ As a regulator, the SAVCA plays different roles as ‘watchdog’, and ‘representative’ of the industry.¹⁸⁶ It promotes transparency and disclosure, produces statistical surveys of capital markets, and educates the public on investment decisions.¹⁸⁷

It is submitted that investors need to be able to trust the funds in which they invest. This trust has been replaced with suspicion and mistrust with the uncovering of private equity wrongdoing. The legislation as well as suggestions on corporate governance are being and have been amended to protect investors and prevent corporate malfeasance and failure. Formal bodies and industry associations such as FAIS *Ombud*, the FSB, and the SAVCA are attempting to deal with the issues and the concerns which have been raised.

With regard to FAIS Board Determinations, the FAIS *Ombud* has jurisdiction to hear complaints.¹⁸⁸ The FAIS *Ombud* deals with various determinations under its authority.

Section 28 of the FAIS Act provides that where a matter has not yet been settled or a recommendation in Section 27 (5) such as conciliation is not accepted, the *Ombud* must make a final determination of the complaint. The FAIS *Ombud* has attempted to promote its objectives and ensure compliance with the Act by

¹⁸² SAVCA Membership op cit (n9).

¹⁸³ South African Private Equity and Venture Capital Association. Code of Conduct. Available at: <http://www.savca.co.za/about-us/code-of-conduct/> Accessed on 12 February 2015.

¹⁸⁴ SAVCA Three Decades op cit (n11) 1.

¹⁸⁵ SAVCA op cit (n9).

¹⁸⁶ SAVCA Code of Conduct op cit (n183).

¹⁸⁷ SAVCA Three Decades op cit (n11) 1.

¹⁸⁸ Daleen Millard ‘Bespoke Justice? On Financial Ombudsmen, Rules, and Principles’ (2011) *De Jure* 44 232 – 258 available at <http://www.dejure.up.ac.za/index.php/volumes/44-vol-2-2011/articles/millard-d> accessed on 17 May 2015.

permitting complaints to be brought, and providing determinations.¹⁸⁹ In some instances the FAIS *Ombud* has referred the matter to the South African Police Service (SAPS) for further investigation where there has been criminal activity.¹⁹⁰

In the matter between *Sunker v Shevgem Investments*;¹⁹¹ and *Blessie v Shevgem Investments*;¹⁹² the *Ombud* for FSPs was called upon to make determinations in terms of Section 28 of the FAIS Act. The *Ombud* upheld both complaints that there had been inadequate compliance with the Act, and inadequate disclosure. In these matters, the asset manager failed to comply with the investment mandate by not providing disclosure and transparency to the investors. The authority of the *Ombud* is, however, limited in that its jurisdiction to hear matters is limited and even where the office has jurisdiction the return of the funds invested is not always guaranteed.

The FSB is responsible for regulating market conduct and administering applicable legislation to ensure that the markets function efficiently. The EO has wide regulatory powers, and has applied these in order to protect financial markets. These include the termination of authorisation to provide financial services as well as investigative powers with criminal sanctions; the EO may apply to the court for various actions such as winding up institutions or placing them or curatorship, among others. The FSB has displayed its power in dealing with corporate scandals caused by a lack of adequate disclosure and transparency of a fund.¹⁹³

While the FSB's ability to regulate market conduct is commendable, it is clear that it fails to adequately deal with all issues and concerns. Transparency and disclosure to the investor is limited, in that the fund manager has no direct obligations to investors, save if negotiated by contract. As seen in the Fidentia scandal, the ability and powers of the FSB are limited in that it does not deal with issues and concerns directly. In this scandal, investors suffered damage due to the conduct of the private equity firm. The firm acted contrary to its mandate, and due to inadequate disclosure and transparency, the malfeasance emerged at a late stage. The Tri-linear scandal revealed further weaknesses in the FSB's ability to address such

¹⁸⁹ N Melville 'Has Ombudsmania Reached South Africa? The Burgeoning Role of Ombudsmen in Commercial Dispute Resolution' (2010) *SA Merc LJ* 50.

¹⁹⁰ Personal Finance: Police Probe Investment Firms, available at <http://www.iol.co.za/business/personal-finance/police-probe-investment-firms-1.1686076#.VageB66qqko>, accessed on 12 February 2015.

¹⁹¹ *Sunker v Shevgem Investments and another* FAIS: 00606/09 KZN (01) 2012.

¹⁹² *Blessie v Shevgem Investments and another* FAIS: 02202/09-10/KZN/1.

¹⁹³ *Supra* 2.

concerns. Even after being suspended as FSPs, the investment managers continued trading, resulting in further losses to investors. As the matter proceeds to trial it will reveal other weaknesses in the context of funds, and this may influence regulators' approach to the private equity asset class.

With regard to the SAVCA, its ability to deal with issues and concerns is also limited. While it promotes disclosure and the transparency of funds, because membership is voluntary, the voluntary regulations only extend to asset managers who are members. Those who are not members may simply avoid applying transparency and disclosure. Furthermore, the SAVCA Code is not legally binding. However, membership of the SAVCA influences the ability of the private equity firm to attract investors. This is clearly indicated by the Pension Funds Act,¹⁹⁴ and its 'Conditions' which promote membership of the SAVCA. Members of SAVCA are able to attract pension funds seeking to invest. In this manner this Act promotes compliance with the SAVCA. Another example is the Public Investment Corporation (PIC), which applies the Code for Responsible Investing in South Africa (CRISA). CRISA recognises the objects of the SAVCA; therefore, members of the SAVCA are able to attract PIC investors.

The adequacy of financial regulation and voluntary self-regulation is discussed and assessed further in Chapter 5.

3.4 Regulations which Support the Growth of the Industry

With regard to the growth and regulation of private equity investments, the regulatory developments worth noting are the position with respect to pension fund investors, and the PIC.

(a) Pension Funds

In terms of the regulatory framework, the Registrar of Pension Funds issued conditions for investment in funds known as 'The Conditions' in March 2012.¹⁹⁵ 'The Conditions' stipulate requirements in order for a fund to qualify for investment by a pension fund. Although the applicable requirements do not bind funds, pension funds are substantial investors and therefore funds have a strong incentive to comply with 'The Conditions'.

¹⁹⁴ Act No. 24 of 1956.

¹⁹⁵ Conditions for Investment in Private Equity Funds; Approval in terms of Section 5(2) (e) of the Pension Funds Act, 15 March 2012.

The most significant requirements contained in ‘The Conditions’ are the following:

- 1) the fund auditors must verify the assets of the fund on a biannual basis,¹⁹⁶ and the fund must produce audited financial statements conforming with international financial reporting standards within 120 days of the end of its financial year;¹⁹⁷
- 2) fund managers must be members of the SAVCA,¹⁹⁸ and are required to be authorised as discretionary FSPs under the FAIS Act, a category of licence that many fund managers did not hold before ‘The Conditions’ were published;¹⁹⁹
- 3) the pension fund must consider a list of prescribed due diligence matters before investing in a private equity fund, including the fee structure of the fund and its risk and compliance policies and procedures;²⁰⁰
- 4) permissible local private equity structures are limited to ECPs, *bewind* trusts and companies;²⁰¹ and
- 5) the fund must have policies and procedures to determine the value of the funds’ assets, in compliance with the International Private Equity Valuation Guidelines,²⁰² and any valuations must be certified annually by a third party.²⁰³

‘The Conditions’ have affected funds in that they have given legal binding effect to the SAVCA Code. Pension funds require that the contractual terms comply with the checklist of due diligence matters prescribed by the Registrar.²⁰⁴ ‘The Conditions’ seek to promote transparency and disclosure to pension fund investors.²⁰⁵ However, this does not apply to other investors such as insurance companies, wealthy individuals, and university endowments.

¹⁹⁶ Condition 6.

¹⁹⁷ Condition 9(1).

¹⁹⁸ Condition 2(2) .

¹⁹⁹ Condition 3.

²⁰⁰ Condition 7.

²⁰¹ Condition 2(1).

²⁰² Private Equity and Venture Capital Valuation Guidelines. 2012, available at <http://www.privateequityvaluation.com/valuation-guidelines/4588034291> accessed on 1February 2015.

²⁰³ Condition 8.

²⁰⁴ SAVCA Three Decades op cit (n11) 52.

²⁰⁵ Condition 2(2).

(b) Public Investment Corporation

The PIC is regulated by the Public Investment Corporation Act No. 23 of 2004. Wholly-owned by the government of South African, the PIC is obliged to comply with the governance and financial management provisions of the South African Public Finance Management Act 29 of 2009.²⁰⁶ The PIC is a strategic supporter of the CRISA.²⁰⁷ CRISA promotes transparency and investors should consider a collective approach to promote acceptance and application of its codes and standards and other principles applicable to investors.²⁰⁸ Although these requirements are not binding on funds, the PIC is a significant investor and funds therefore have a strong incentive to comply with CRISA. In applying CRISA, the PIC promotes transparency of funds, which are likely to comply in order to attract investment.

These regulatory developments are characterised as the co-regulatory approach, which combines contractual regulation, voluntary self-regulation, and financial regulation. The co-regulatory approach is discussed further in Chapters six and seven.

3.5 Regulations Proposed to Deal with the Issues and Concerns Raised

(a) Treating Customers Fairly

The FSB is developing a Treating Customers Fairly (TCF) Policy Programme to regulate the market conduct of financial services firms.²⁰⁹ The programme aims to ensure that fair treatment of investors /customers is rooted within the firms' culture.

Although the programme has not yet been finalised, industry surveys shows that many investment firms are evaluating their practices against the applicable outcomes-based principles.²¹⁰ The FSB's visions for the TCF programme are that investors' financial services requirements are met by a viable industry.²¹¹ This

²⁰⁶ Public Investment Corporation Integrated Annual Report, available at <http://www.pic.gov.za/wp-content/uploads/2012/04/PIC-Annual-Report-2014-PART-1.pdf> accessed on 17 April 2015 at 3.

²⁰⁷ *Ibid* 10.

²⁰⁸ The Code for Responsible Investing in South Africa (CRISA) 2011, available at: <http://www.atlanticam.com/pdf/responsible-investing/crisa.pdf> accessed on: 13 November 2014.

²⁰⁹ FSB: Treating Customers Fairly: The Roadmap (31 March 2011), available at <https://www.fsb.co.za/feedback/Documents/Treating%20Customers%20Fairly%20-%20The%20Roadmap%202011.pdf> accessed on 15 January 2015.

²¹⁰ TCF Implementation Update and Baseline Study Feedback Report. December 2013 available at <https://www.fsb.co.za/feedback/Documents/TCF%20Baseline%20Study%20Feedback%20Report.pdf> accessed on 15 January 2015.

²¹¹ The Roadmap op cit (n209) 6.

embraces the transitional TCF outcomes which include enhanced transparency and discipline, appropriate products and services, and improved customer confidence.

The private equity industry is relatively new in South Africa, and further understanding of how it operates is required. Due to the nature of financial services the concerns of prejudicial treatment surface much later. Increasing the risk of consumer exploitation, these issues are deepened by the poor level of financial knowledge among investors in South Africa.²¹²

As noted, the South African regulation of the financial sector includes numerous methods directed at protecting investors.²¹³ However, a harmonised investor protection regulatory framework applied across the sector that is tailor-made to address the explicit risks to the sector has been lacking. This is indicative in the scandals and miscreant behaviour on the part of fund managers witnessed in the private equity sector.²¹⁴ It was against this background that the FSB published the TCF Discussion Document. The Document specified that TCF would be implemented as part of the regulatory framework and highlighted real examples of the prospective application of the TCF approach.²¹⁵

The FSB will make regulatory amendments to legislation, including the FAIS Act to implement the policy document, and apply the TCF policy.²¹⁶ Although the FAIS Act has features of the TCF Policy in its regulations, including limited disclosure requirements, the Policy is anticipated to be more extensive.²¹⁷

(b) The National Treasury Policy Document

The National Treasury published a policy document entitled ‘A Safer Financial Sector to Serve South Africa Better’ (NT Policy Document) on 23 February 2011.²¹⁸ Proposals to strengthen the regulation of this sector were set out in the Document.²¹⁹

²¹² The Roadmap op cit (n209) 6

²¹³ SAVCA Three Decades op cit (n11) 24.

²¹⁴ The Fidentia Scandal and the Tri-linear Scandal, as well as various FAIS Ombuds Board determinations.

²¹⁵ *Supra* 210.

²¹⁶ This Roadmap confirms the FSB’s commitment to the TCF programme by setting out its approach to implementation.

²¹⁷ The TCF Policy will be implemented across the financial sector, and further amendments to retirement funds, insurance and collective investment schemes legislation may therefore be required.

²¹⁸ National Treasury: A Safer Financial Sector to Serve South Africa Better, available at <http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf> accessed on 16 January 2015.

²¹⁹ The Roadmap op cit (n209) 9.

Market conduct and investor protection are the important policy priorities for financial sector regulation. They have been acknowledged in the NT Policy Document.²²⁰ It also notes the significance of market conduct in ensuring financially sound regulation. The Financial Sector Regulation Bill proposes a new market conduct regulator.²²¹ Market conduct wrongdoings contributed to systemic risks during the recent GFC.²²² It was only ‘after the tide had gone out’ that the wrongdoings emerged.

The TCF notes the South African movement towards a ‘twin peaks’ financial model of regulation given the importance of strengthening practical and market conduct regulation.²²³ One regulator, the South African Reserve Bank,²²⁴ will have the duty of prudential regulation of the sector, and the FSB,²²⁵ will have the duty of market conduct regulation.²²⁶ The ‘twin peaks’ model is a will mean tougher market conduct regulation at the FSB as opposed to the general ‘hands-off’ approach currently applied.²²⁷

The NT Policy Document describes the TCF Programme as ‘an important step in strengthening market conduct objectives in the financial sector’.²²⁸ Therefore, the FSB has been given a clear directive by National Treasury to present the TCF programme as a significant tool to drive investor protection through strengthened market conduct regulation.²²⁹

In terms of the current regulatory milieu, the FSB and the FAIS *Ombud* do provide safeguards, but they offer protection after the fact, after the prohibited conduct has been engaged in or has allegedly been engaged in. Continued

²²⁰ *Supra* 218.

²²¹ The Financial Sector Regulation Bill, The Republic of South Africa, available at <http://www.treasury.gov.za/twinpeaks/20131211%20-%20Item%201%20Financial%20Sector%20Regulation%20Bill.pdf> accessed on January 2015.

²²² NT Policy Document op cit (n218) 13,40.

²²³ The Roadmap op cit (n209) 9.

²²⁴ NT Policy Document op cit (n218) 31.

²²⁵ G Jones ‘Revised financial regulation bill clarifies ‘twin peaks’’. *BD LIVE*, available at <http://www.bdlive.co.za/business/financial/2014/12/17/revised-financial-regulation-bill-clarifies-twin-peaks> accessed on 10 January 2015.

²²⁶ ‘Implementing a twin peaks model of financial regulation in South Africa’, published 1 February 2013 for public comment by the Financial Regulatory Reform Steering Committee.

²²⁷ NT Policy Document op cit (n218) 42.

²²⁸ *Id* 46.

²²⁹ Media Statement: Twin Peaks: Second Draft of Financial Sector Regulation Bill and Draft Market Conduct Policy Framework discussion document, available at, http://www.treasury.gov.za/comm_media/press/2014/2014121201%20-%20Media%20release%20FSR%20Bill%20and%20MCP.pdf, accessed on 1 January 2015.

transparency and disclosure may provide the FSB with improved ability to perform its functions. Until such time as the TCF Programme is implemented, and the objectives of the NT Policy document are given effect, concerns remain regarding investor protection. However, the question remains whether the adoption of such regulations will result in the overregulation or inappropriate regulation of the industry, crossing the proverbial Rubicon. The effect of onerous regulations is discussed further in Chapters 5 and 6.

(c) Private Equity Scandal's Influence on the Proposed Regulations

The proposed regulations contained in the FSB's TCF Programme and the NT Policy Document aim to ensure investor protection through strengthened market conduct regulation. The regulations seek to address the information asymmetries and agency costs associated with the financial sector. Recent private equity scandals highlighted the specific risks caused by a lack of transparency and disclosure.

(i) The Fidentia Asset Management Scandal

The Fidentia Group was under the control of Mr. J. Arthur Brown. Fidentia Asset Management (FAM) was the group's main business.²³⁰ Analysis of the Fidentia case and others has shown that without proper management, as well as observance of good corporate governance, stakeholders' risk exposure can be amplified.²³¹

Based on reports by the provisional curators and FSB inspectors, the Fidentia Group was placed under final curatorship,²³² as it could not account for R680 million of the almost R2 billion under FAM's management.

The private equity firm used an ECP as the investment vehicle. Partnership agreements were entered into between FAM and its investors. The FSB inspectors found that investors' funds were used to cover expenses of the business, and private

²³⁰ L Wessels (2007) 'Fidentia curatorship: What are the odds?' *FSB Bulletin*, first quarter 2007, available at <https://www.fsb.co.za/Departments/communications/Documents/2007%20FSB%20Bulletin%20First%20Quarter.pdf> accessed on 16 June 2015.

²³¹ B Cameron (2007) 'Millions missing in Fidentia scandal' *Mail and Guardian* 2 February 2007, available at <http://mg.co.za/article/2007-02-02-millions-missing-at-fidentia> accessed on 20 June 2015.

²³² FSB Curator Report, August 2013, available at <https://www.fsb.co.za/CuratorshipReports/Fidentia%20Curators%20Report%20of%2030%20August%202013.pdf> accessed on 20 June 2015; *Financial Services Board, press release, 2007. Financial Services Board, 27 March*, available at <http://www.journalism.co.za/wp-content/uploads/fid%20-%20fsbi.pdf> accessed on 23 May 2015.

equity investments for the Fidentia Group.²³³ The investments held by FAM on behalf of investors were concealed.²³⁴

The legal requirements that a company must comply with before operating as a FSP are an obstacle to entry. This obstacle was lower at the time Fidentia entered the industry. There was no real differentiation amongst FSPs.²³⁵

FAM failed to fulfil any of its duties as required. It also failed to submit audited financial statements (AFS) as required for the year ending February 2005.²³⁶ By using clients' money to pay for business expenses, FAM did not act in good faith.²³⁷ The assets under the administration of FAM were 'artificially disguised to misrepresent the nature of the investments' (FSB, 2007:13).²³⁸ FAM and its staff did not act honestly or fairly,²³⁹ in the interests of its clients or in accordance with the integrity of the financial services industry.²⁴⁰

The conduct of the fund's affairs was regulated by the agreement, and fiduciary duties, and not the legislation. In this way, FAM avoided further disclosure and transparency to the detriment of investors.

(ii) *Tri-linear Asset Management Scandal*

The Tri-linear Asset Management (Tri-linear) Scandal presents another example of corporate scandals in the private equity industry.²⁴¹ The FSB used its power to revoke the licences of Tri-linear, which is at the centre of the disappearance of more than R100 million in trade union members' savings and pension funds. Tri-linear engaged with investors, specifically the South Africa Clothing and Textile Workers Union (SACTWU) using a trust, the Tri-linear Empowerment Trust (TET).²⁴² Due to

²³³ *Supra* (n2).

²³⁴ Pieter Steenkamp Fidentia: A Strategic and Corporate Governance Analysis. (Unpublished MBA Thesis, University of Stellenbosch, 2007).

²³⁵ *Supra* at page 28.

²³⁶ Wessels op cit (n230).

²³⁷ J Cameron 'Fidentia interrogations begin' *Moneyweb* 4 June 2007, available at <http://www.moneyweb.co.za/archive/fidentia-interrogations-begin/> accessed on 20 May 2015.

²³⁸ Wessels op cit (n233).

²³⁹ *Ibid.*

²⁴⁰ FSB Curator Report op cit (n232).

²⁴¹ The alarm bells ought to have been taken heed of when in 2006 the PIC instituted action against Tri-linear for the recovery of R10, 4 million in fees that it claimed Tri-linear had taken unlawfully; S Gunnion 'PIC sues investment firm for 'appropriated' R10 million' *Business Day* November 2006, available at <http://www.nfvzone.com/news/2006/11/12/2069475.htm> accessed on 10 March 2015.

²⁴² Tri-linear was created as an investment vehicle for Western Cape based union interest groups.

inadequate disclosure between the fund and the asset management firm, this resulted in a loss of the funds' money.²⁴³

The fund manager failed to disclose the investments, and had applied the funds in an inappropriate manner, contravening the Pension Funds Act.²⁴⁴ Fraud charges have been laid against the Tri-linear fund managers, and the trial continues.²⁴⁵

Tri-linear managed five SACTWU provident funds. The FSB suspended the firm from November 2007 to May 2008 due to its failure to provide financial statements. However, during this period, Tri-linear continued to invest clients' funds, ignoring the suspension. After the suspension was raised, a whistle-blower reported Tri-linear's activities. The FSB only responded seven months later.²⁴⁶ The inspectors found that the five pension funds had placed R314 million with Tri-linear, of which R66 million was sent to Canyon Springs, which later used R27 million to invest in three unlisted companies. The inspector's report which was handed to the FSB was only acted on in 2011. The FSB withdrew Tri-linear's license as an asset manager. However, the time taken to act on the allegations and report back resulted in Tri-linear making further investments, which resulted in further losses to investors.²⁴⁷

As noted above, the Tri-linear asset managers are currently involved in court proceedings. Criminal as well as civil charges have been instituted.

(iii) Possible Influence on the Proposed Regulations.

The fund scandals have had a profound effect on the financial services sector. As noted above, regulators anticipate that the TCF Policy and the NT Policy Document will serve as tools for the holistic regulation of the industry and promote investor protection.²⁴⁸ The purpose of the proposed regulations is to limit the corporate malpractices investors have been exposed to as well as the risks inherent in the industry.

²⁴³ *Supra* (n3).

²⁴⁴ N Brand-Jonker 'Pension Fund Investment Contravenes Act', *Fin24* March 2011, available at <http://www.fin24.com/Companies/Financial-Services/Pension-fund-investment-contravenes-Act-20110327> accessed on 24 February 2015.

²⁴⁵ *Supra* (n3).

²⁴⁶ D Gleason 'Financial Services Board no help when pensions lost' *BD Live* June 2013, available at <http://www.bdlive.co.za/opinion/columnists/2013/06/11/financial-services-board-no-help-when-pensions-lost> accessed on 12 March 2015.

²⁴⁷ P Ndzabela 'Why Tri-linear Bulkied on Pinnacle' *MoneyWeb* 7 January 2011, available at <http://www.moneyweb.co.za/archive/why-Tri-linear-bulkied-on-pinnacle/> accessed on 16 March 2015.

²⁴⁸ South African Government. 2013. Implementing a twin peaks model of financial regulation in South Africa. available at: <http://www.gov.za/documents/implementing-twin-peaks-model-financial-regulation-south-africa> Accessed on 10 May 2015.

The regulators seek to promote laws that are complete, harmonised and integrated with a focus on outcomes and contract terms and costs.²⁴⁹ Through the use of new consolidated market conduct laws, and not simply fiduciary duties and contract, the regulators seek to achieve their objectives. It should be noted, however, that that new onerous regulations are open to criticism. The limitations of the regulations are discussed further in Chapter 5.

3.6 Conclusion

This chapter has illustrated that the South African private equity industry has experienced growth, and it is poised to grow further in the future. Key to the growth of the industry has been changes in its regulation and South Africa's regulatory policies that allow pension funds and the PIC to invest directly in private equity funds.

The main regulators of the private equity industry in South Africa are the FAIS *Ombud*, the FSB, and the self-regulatory SAVCA. This chapter has shown that South Africa adopted a 'hands off' approach to the regulation of funds, as opposed to hedge funds which are now regulated in terms of the Cisca. This approach is evident in the FAIS and FSB's minimal registration requirements and the reluctance to scrutinise private equity activities, until that activity deals with capital markets and only where there has been or appears to be unlawful activities. However, the implementation of the TCF Programme and the NT Policy document will have a profound effect on the market.

This chapter has shown that the funds' structure, through the use of an ECP or a *bewind* trust has encouraged private equity investments. However, there has been a lack of transparency and disclosure requirements for private equity investment vehicles, save for pension funds investing in funds, and the PIC promoting CRISA. This has led to agency costs and information asymmetries. Improved transparency and disclosure to investors could promote continued growth and address the concerns raised in respect of this industry.²⁵⁰

²⁴⁹ KPMG (2015) Market Conduct Regulatory Framework in South Africa, available at: <http://www.kpmg.com/za/en/issuesandinsights/articlespublications/financial-services/pages/market-conduct.aspx> accessed on: 10 May 2015.

²⁵⁰ Kaplan op cit (n111) 8.

Regulations on the management of private equity investment are limited to the requirement to disclose information relating to the firm's financial position as a company in compliance with the Companies Act,²⁵¹ and in compliance with the FAIS Act as an FSP. This is a commendable requirement, as it promotes a high standard of accounting. However, transparency and disclosure obligations of the fund to investors are limited, and their only means of protection is the common law and negotiated contractual terms.²⁵² This could affect investor confidence.²⁵³ The TCF Policy and NT Policy Document seek to promote future growth by providing a holistic framework for adequate investor protection. Nonetheless, it is possible that the implementation of the TCF Policy and NT Policy Document could inhibit economic growth by overregulating or implementing inappropriate regulation of financial institutions.

The UK and the USA have specific regulations in place to regulate the private equity industry. These frameworks are reviewed in the following chapter.

²⁵¹ Part C of the Companies Act No. 71 of 2008, Section 23 - 34.

²⁵² Hudec op cit (n171) 46.

²⁵³ La Porta et al (2000) op cit (n90) 17.

CHAPTER FOUR

4. THE UNITED KINGDOM AND UNITED STATES OF AMERICA'S REGULATION OF PRIVATE EQUITY FUNDS

4.1 Introduction

The UK and the USA jurisdictions represent the leading economies in developed markets.²⁵⁴ Assessing these jurisdictions will provide insight into the application of financial regulation and voluntary self-regulation in promoting corporate governance in the form of transparency and disclosure. As noted in Chapter 3, concerns raised with regard to the private equity industry call for an investigation of this industry's growth, its key regulators and existing regulations, and a critical assessment of the regulatory policies.

In the UK and USA, funds are subject to specifically tailored regulation,²⁵⁵ and the overall financial services regulatory regime. Regulation in both jurisdictions is based on the acknowledgement that collectivised investment,²⁵⁶ management relationships and intermediary vehicles increase the risk of malfeasance and fraud.²⁵⁷ Similar to the approach applied in South Africa, investment firms in the UK and the USA are bound to comply with the company and securities legislation.²⁵⁸ In the UK, the UK Corporate Governance Code (Combined Code) seeks to promote investor protection and sound corporate governance by traditional companies while the corresponding legislation in the USA is the Public Company Accounting Reform and the Investor Protections Act of 2002, commonly known as the Sarbanes-Oxley Act. Investor protection and corporate governance in funds have not been addressed. There has been limited critical legal assessment of governance structures in these funds; instead, the focus has been on the manner in which private equity affects portfolio listed companies.²⁵⁹ Compared to the vast body of research on disclosure

²⁵⁴ *Infra* (n256) 219.

²⁵⁵ Metrick op cit (n16) 2303; Steven Hurdle 'Blow to Public Investing: Reforming the System of Private Equity Fund Disclosures' (2006) 53 *University of California Los Angeles Law Review* 239; Barbara George et al 'The End of an Era of Limited Oversight' (2013) *Florida Journal of International Law* 210.

²⁵⁶ James H Kocis et al *Inside Private Equity: The Professional Investors Handbook* (2009).

²⁵⁷ George et al op cit (n255) 210.

²⁵⁸ Cumming & Johan op cit (n44) 214.

²⁵⁹ Ronald W Masulis & Randall S Thomas. 'Does Private Equity Create Wealth?' The Effects of Private Equity and Derivatives on Corporate Governance' (2009)76 *University of Chicago Law Review* 219.

and transparency in capital markets, funds' reporting and information obligations to their investors have been neglected by scholars.

This chapter discusses recent investor interest in the growing area of private equity, and examines the regulatory framework and the main regulatory bodies in the UK and the USA. It also discusses the specific rules that govern private equity investment.

4.2 Private Equity Funds in the UK

In response to the GFC,²⁶⁰ the financial services industry in the UK has undergone a number of changes.²⁶¹ The main change has been a move to a new system of financial services regulation. The 'twin peaks' system subjects insurers and banks to supervision by the Prudential Regulation Authority (PRA) for prudential matters, and asset managers are supervised by the Financial Conduct Authority (FCA) for market conduct issues. The private equity industry has witnessed a shift from exclusive attention to the safety of individual financial institutions, to an emphasis on the health and stability of the financial system holistically.²⁶² The recent reforms in the UK also include the passing of the European Union (EU) Alternative Investment Fund Managers Directive (AIFMD) into law. The AIFMD applies to the UK by virtue of its membership of the EU. The AIFMD includes variations to the marketing of certain investment schemes and the forms of investment vehicles which exist in the UK.

(a) Form of Private Equity Funds

Each investment fund is structured to address the unique characteristics of the investment vehicle.²⁶³

A private equity fund's governance structures are determined by the choice of the legal vehicle, as well as the nature, demographics, and the number of the

²⁶⁰ Houman Shadab 'Coming Together After the Crisis: Global Convergence on Private Equity and Hedge Funds' (2009) *North-Western Journal of International Business Law* 614.

²⁶¹ Dickson op cit (n1) 466.

²⁶² D Gregory 'Private Equity and Financial Stability' (2013), available at <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130104.pdf> accessed on 10 June 2015 (A distressed corporate sector can have an adverse effect on the health of the financial system).

²⁶³ They include the tax treatment of the participants and the investments, and the regulatory status of the fund manager; Dickson op cit (n1) 466.

participants in the fund.²⁶⁴ Limited partnerships (LPs) have become the chosen investment vehicles for various reasons which include tax, and regulatory deficiencies.²⁶⁵ However, following the recent reforms, an analysis of the regulations is necessary to ensure that the tax efficient vehicle does not inadvertently lead to issues relating to marketing and regulatory permission.²⁶⁶

As oppose to South Africa, LPs in the UK are formed under the Partnership Act 1890 (1890 Act).²⁶⁷ They are registered under the Limited Partnership Act 1907 (1907 Act). In terms of Section 4 of the 1907 Act, a LP is defined as having one or more limited partners (LP's) whose liability is limited to the contributed capital amount, and one or more general partners (GP), who are liable for all the obligations and debts of the partnership,²⁶⁸ provided they are not involved in management.²⁶⁹

Governance arrangements for LPs are flexible. The 1907 Act sets out limited rules with regard to the division of the GP and LPs' responsibilities, other than the prohibition of LP's being involved in the partnership's management. The LP is governed by the general law on partnerships. With regard to fiduciary duties, a partner owes co-partners fiduciary duties, and a duty is placed on the partner to be truthful in their relations with third parties, irrespective of whether or not the transaction is of a partnership nature.²⁷⁰ Section 28 of the 1890 Act provides that a partner must offer co-partners a true account and the fund information about the affairs of the partnership. Furthermore, in terms of Sections 29-30 of the 1890 Act, there is a duty not to compete with the partnership and make secret profit.

As noted by Spangler, even prior to the 1890 Act, the courts acknowledged that the fiduciary relationship is of central importance in the partnership:

‘[i]f fiduciary relationship means anything I cannot conceive a stronger case of fiduciary relation than that which exists between partners [in partnerships and limited partnerships]. Their mutual confidence is the lifeblood of the concern. It is because they trust one another that they are partners in the first instance; it is because they continue to trust each other that the business goes on.’²⁷¹

²⁶⁴ Spangler op cit (n57) 72.

²⁶⁵ *Ibid.*

²⁶⁶ Spangler op cit (n59) 196.

²⁶⁷ While the 1890 Act focuses on general partnerships, the 1907 Act provides for modifications in the case of limited partnerships.

²⁶⁸ Section 4(2) of the 1907 Act provides this by stating that the limited partners ‘...shall not be liable for the debts and obligations of the firm beyond the amount so contributed’.

²⁶⁹ Section 6(1) of the 1907 Act.

²⁷⁰ *Carmichel v Evans* [1904] 1 Ch 486.

²⁷¹ *Helmore v Smith* [1885] 35 Ch D 436 at 444 per *Bacon VC*.

However, it is submitted that the investor may not be able to assert their fiduciary duties in the partnership agreement, and may only discuss the disclosure and transparency terms after the agreement has been entered into.

Whilst a partnership can be entered into without it being in writing, a limited partnership agreement must be in writing, due to the need for registration.²⁷² The investment fund is formed by a written agreement which sets out the rules and arrangements of the LP. It also sets out the relationship between the investors and the investment managers.

An LP is a form of a business organisation, and a form of contract.²⁷³ As a business organisation, shareholders of a corporation exercise more control than the limited partners in an LP.²⁷⁴ As stated by Rosenberg, limited partners are analogous to ‘disguised creditors’.²⁷⁵ There is an imbalance of power, which is derived from the nature of the LP itself. As a form of contract, the participants in the fund have the freedom to establish the contractual terms they feel are important without being bound to follow company law. Rosenberg asserts that this has meant that partnership agreements have become susceptible to power dynamics, and the agreements have reduced the duties owed by the GP to the LPs.²⁷⁶ It is noted that this arrangement is not mandated by the law, as well as the scope of the terms negotiated by the parties which can give effect to the duties. This also applies to the ECP in South Africa.

(b) The General Regulatory Framework

The general private equity regulatory framework in the UK consists of the relevant legislation, formal bodies and industry associations.

The Financial Services and Markets Act 2000 (FSMA) is the legislation for the regulation of asset management in the UK, as well as various other mechanisms contained in the FSMA.²⁷⁷

The FSMA regulates financial and investment services in the UK.²⁷⁸ It does so through the concept of ‘regulated activities’ that are carried out by individuals with

²⁷² In terms of the 1907 Act, LPs are required to be registered with the Registrar of Companies, who acts as the Registrar of Limited Partnerships.

²⁷³ Rosenberg op cit (n78) 374.

²⁷⁴ Stowell op cit (n88) 1493.

²⁷⁵ Rosenberg op cit (n78) 374.

²⁷⁶ *Id* at 384.

²⁷⁷ Dickson op cit (n1) 466.

authorisation, or who are otherwise able to obtain release from the authorisation requirement.²⁷⁹ The Financial Services Markets Act 2000 Regulated Activities Order 2001 (the Regulated Activities Order),²⁸⁰ set out the regulated activities which are carried out by corporate entities in association with the identified investments listed in the Regulated Activities Order.²⁸¹

The list of specified activities includes:

- 1) Arranging investment deals;
- 2) Managing investments;
- 3) Undertaking investments as a principal or agent;
- 4) Managing and handling an alternative investment fund (AIF);
- 5) Winding up, establishing, or operating a CIS;
- 6) Managing collective investment in transferable securities (UCITS),²⁸² and
- 7) Investments advice.²⁸³

Fund managers and certain investment funds also require FCA authorisation. In the UK in terms of Section 23 of the FSMA, it is a criminal offence for an individual who has not been authorised or exempted to undertake any regulated activity. Section 21 of the FSMA prohibits a person who is not authorised from engaging in investment activity during the course of business.²⁸⁴

The FSMA regulates the asset management firm as oppose to the fund. Transparency and disclosure is to the regulator, not the investors in the fund. The Act does not impose specific obligations on the authorised firm to afford information to its investors. However, the AIFMD has changed the manner in which funds are regulated; this is discussed below.

The FCA is the formal regulator of all authorised asset management firms in the UK. Most investment vehicles and investment managers who require authorisation are regulated solely by this body. The FSMA confers a variety of

²⁷⁸ A wide range of financial products is specified as investments, including shares, deposits, units in collective investment schemes (CISs), bonds, government securities and contracts of insurance.

²⁷⁹ Section 19 of the FSMA.

²⁸⁰ SI 2001/544.

²⁸¹ Section 22 of the FSMA.

²⁸² Activities (d) and (f) were introduced by the Alternative Investment Fund Managers Regulations 2013.

²⁸³ Dickson op cit (n1) 466.

²⁸⁴ Section 21(2) and 21 (5) of the FSMA. The Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 (SI 2001/1355) (as amended).

regulatory authorities and functions on the FCA. The FCA has extensive rule and code-making powers.²⁸⁵ The FCA has the ability issue rules that it considers necessary and beneficial. The FCA Handbook consolidates the rules and guidelines applicable to FCA authorised firms. It includes requirements for the regulatory guidelines, conduct of business, high level standards and comprehensive expert sourcebooks which apply to a range of activities and asset management vehicles.²⁸⁶ The contents of the FCA Handbook are influenced by EU legislation, for example, the AIFMD.²⁸⁷ The FCA uses a number of supervisory tools to oversee the asset management industry. These include ‘thematic reviews’,²⁸⁸ which involve investigations into current or emerging risks relating to a specific issue or product.

The British Private Equity and Venture Capital Association (BVCA) is the industry association and public policy promoter for venture capital and private equity in the UK.²⁸⁹ It has served as an authoritative voice in negotiating for and speaking on behalf of the UK industry to a range of stakeholders.²⁹⁰ Similar to SAVCA, the BVCA describes itself as a voluntary private regulator as well as a representative of institutions that act in the capital and financial markets. The BVCA promotes the services of its members to investors, as well as providing research, training and networking opportunities. It also issues guidelines which its members are obliged to comply with when dealing with investors.²⁹¹

As noted above, private equity firms are subject to the regulations imposed by self-regulated associations if they are members of such associations. Private associations establish voluntary rules that private equity firms have to abide by if they wish to retain their membership. Firms have an incentive to join these associations as this promotes access to investors.

With regard to the ability of the ability to address the issues and concerns, the FCA has significant authority to regulate the financial market and fund managers.

²⁸⁵ George op cit (n255) 210.

²⁸⁶ The FCA Handbook is available at <https://fshandbook.info/FS/html/FCA> accessed on 1 June 2015.

²⁸⁷ George op cit (n255) 210.

²⁸⁸ Dickson notes that the recent thematic reviews include TR13/10 Outsourcing in the asset management industry; TR14/7 Clarity of fund charges; and TR 14/01 Transition management.

²⁸⁹ The BVCA, available at

<http://www.bvca.co.uk/ResearchPublications/Publications/BVCAGuides/PubliclyAvailableGuides.aspx> accessed on 10 May 2015.

²⁹⁰ *Ibid.*

²⁹¹ BVCA Membership, available at: <http://www.bvca.co.uk/Membership/WhyJointheBVCA.aspx> accessed on 10 May 2015

The FCA's ability to investigate and apply its powers to ensure a healthy financial system is commendable. These powers have now been given greater latitude in light of the effect of the AIFMD in the UK.

While the BVCA promotes disclosure and transparency on the part of the private equity fund, its ability to deal with issues and concerns is limited. Membership is voluntary and funds that are not members may simply avoid applying transparency and disclosure.

As a result of recent developments, investment funds operating as LPs will now also be Alternative Investment Funds (AIFs) for the purposes of the AIFMD. The AIFMD is an EU Directive which applies in the UK. Whether acting as a general partner or a third party manager, the fund manager will require FCA authorisation to manage an AIF. Following the application of the AIFMD, the industry has observed a number of changes for asset managers who fall within the regime's scope.²⁹² The AIFMD seeks to harmonise the regulatory requirements for investors and managers of AIFs in the EU.²⁹³ Its main aim is to re-establish trust in EU fiscal markets,²⁹⁴ by providing strong investor protection. The application of the AIFMD in the UK by means of the Alternative Investment Fund Managers Regulations 2013 (AIFM Regulations) has created an additional regulatory category for investment funds.

AIFs are broadly defined,²⁹⁵ as a result funds and other investment vehicles are AIFs and their administration and management fall within the AIFMD.²⁹⁶

²⁹² Tom C Hodge 'The Alternative Investment Fund Managers Directive: The European Union gives Private Equity Fund Managers the 'Social Market Economy' Treatment' (2014) 18 *North Carolina Banking Institute* 321

²⁹³ *Ibid.*

²⁹⁴ Restoring Investor Confidence in European Capital Markets Final Report of the European Investors'. Working Group Organized by European Capital Markets Institute (ECMI) in partnership with CFA Institute Centre for Financial Market Integrity March 2010 (Second edition) , available at http://www.feelingeurope.eu/Pages/european_investors_working_group_report.pdf accessed on 13 March 2015.

²⁹⁵ An AIF is a collective investment undertaking that raises capital from a number of investors, with a view to investing it in accordance with the defined investment policy for the benefit of those investors and that is not an Undertaking For The Collective Investment Of Transferable Securities (UCITS) Scheme.

²⁹⁶ Deloitte. Responding to the New Reality. Alternative Investment Fund Managers Directive Survey (July 2012), available at: <http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-aifmd-survey-responding-new-reality.pdf> Accessed on 13 May 2015

Through the AIFM Regulations, the AIFMD requirements have been combined with the UK regulatory regime as well as changes to the FCA rules and guidelines.²⁹⁷ They include the introduction of the Investment Funds Sourcebook (FUND).²⁹⁸ The AIFMD Level 2 Regulation,²⁹⁹ contains comprehensive requirements, including transparency and operating conditions, leverage, and calculation of assets under management.³⁰⁰

With regard to authorisation, the AIFM must be approved under Part 4A of the FSMA to manage an AIF in the EU.³⁰¹ The AIFM must comply with a number of requirements.³⁰² AIFMs in the UK that are authorised under Part 4A are subject to the full requirements of the AIFMD,³⁰³ in the FUND and AIFM Regulations.³⁰⁴

With regard to transparency and disclosure, the AIFMD obliges AIFMs to make information available to investors and the FCA.³⁰⁵ An AIFM must divulge the information specified in FUND 3.2 for each AIF it markets or manages. It is required to do so prior to the investment and periodically thereafter. For example, it is required to divulge the AIF's risks and risk management, all the fees which are borne indirectly and directly by investors, and the AIFM's investment strategy. The AIFMD is driven by the supposition that greater disclosure of information is better than less disclosure.³⁰⁶ In terms of FUND 3.3, an annual report must be made available to investors and the AIFM must report regularly to the FCA on the matters

²⁹⁷ EVCA, the AIFMD Essentials, Brussels, (December, 2010), available at http://www.evca.eu/uploadedFiles/Home/Public_And_Regulatory_Affairs/AIFM_Directive/EVCA_AIFMD_Essentials.pdf accessed on 10 April 2015.

²⁹⁸ The FCA has been clear that where there is a conflict between the AIFMD and the FCA Handbook, the requirements of the AIFMD will prevail; FCA, CP13/9, Implementation of the Alternative Investment Fund Managers Directive, March 2013, available at <https://www.fca.org.uk/static/documents/policy-statements/ps13-05.pdf> accessed on 10 March 2015.

²⁹⁹ Regulation 231/2013.

³⁰⁰ Julia Khort 'Protection of Private Equity in the EU' (2014) *Uppsala Faculty of Law Working Paper*.

³⁰¹ Dickson UK op cit (n1) 466.

³⁰² George op cit (n255) 210.

³⁰³ Dickson UK op cit (n1) 466.

³⁰⁴ *Ibid.*

³⁰⁵ Reporting obligations under Articles 3(3) (d) and 24(1), (2) and (4) of the AIFMD.

³⁰⁶ Troy A Parades 'Blinded by the Light: Information Overload and its Consequences for Securities Regulation' (2003) 81 *Wash. U. L. Q.* 417.

set out in the FUND 3.4.³⁰⁷ It is submitted that under the new regime, funds have to provide additional information to their investors.³⁰⁸

The AIFMD is not without its critics. The adequacy of the financial regulations has been questioned, although they do represent a step in the right direction with regard to investor protection. The AIFMD addresses the issues and concerns surrounding funds as AIFMs are obliged to make information available to investors and the FCA. Under the new regime, funds have to provide additional information to their investors.

Although the transparency and disclosure obligations are commendable, the AIFMD imposes onerous duties on asset managers. This may result in the proverbial crossing of the Rubicon. The adequacy of the voluntary self-regulatory approach and financial regulation is further discussed and assessed in Chapter five.

4.3 Private Equity Funds in the USA

On-going economic crises have impacted USA's financial markets.³⁰⁹ Congressional concern and increased media attention have led to panicked efforts to pass remedial legislation.³¹⁰ Tillman critiques these measures as follows:

‘.[I]n seeking out to put out the flames of panic and financial instability [resulting from the GFC], such regulations have, at times, been mismatched to the problems they were intended to address. Perhaps due to the sophistication of the regulated entities, legislators feel as if the rules must reach widely enough to encompass efforts to circumvent the law.’³¹¹

Tillman is of the view that US legislators have regulated far beyond the pre-crisis situation, rather than adjusting the legislation to address the issues of limited transparency and disclosure in the private equity industry.³¹² The question regulators ought to ask is: how do they legislate and provide investor protection without inappropriately regulating the industry? Inappropriate regulation restricts investment

³⁰⁷ Including the main instruments it is trading, its risk profile, and details on the level of the leverage employed if the AIF employs leverage on a regular basis.

³⁰⁸ Spangler op cit (n59) 91; Regulation 38 AIFM Regulations.

³⁰⁹ Cumming op cit (n19)156.

³¹⁰ Joseph A Tillman ‘Beyond the Crisis: Dodd-Frank and Private Equity’ (2012) *New York University Journal of International Law and Politics* 1602; Roberta Romano ‘The Sarbanes-Oxley Act and the Making of Quack Corporate Governance’(2005) 114 *YALE L.J.* 1521.

³¹¹ *Ibid* 1602.

³¹² *Id* at 1604.

activity and result in investors being pushed to other jurisdictions in search of greater returns.³¹³

The private equity industry has been described as being too private in that limited disclosure of the funds' activities is provided to investors.³¹⁴ Following the 1929 financial crash the USA Congress enacted various pieces of legislation to protect investors. They include the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisors Act of 1940.³¹⁵ By mandating open disclosure for most securities and funds, these Acts protect investors from potential abuse. As one commentator famously stated, 'sunshine is the best disinfectant'.³¹⁶

The USA Securities and Exchange Commission (SEC) aims to protect investors, simplify capital realisation, and preserve fair, orderly, and efficient markets.³¹⁷ For the purposes of raising funds in the financial markets, securities regulations create disclosure obligations as well as rights of action and penalties for any abuse of the disclosure commitments.³¹⁸ However, these regulations can be easily circumvented due to the nature of private equity. This is done either by obtaining exemption from the regulations, or by structuring the fund in such a manner that the regulations are not applicable.³¹⁹ This has also been the case in South Africa, and the UK.

(a) Forms of Private Equity Funds

Limited partnerships (LPs), limited liability companies (LLCs), and offshore companies are used frequently in the USA.³²⁰ Each investment fund is structured to address the unique characteristics of the investment vehicle.³²¹

The most common vehicle for funds in the USA is the Delaware LP, which grants limited liability to investors who are LPs. The fund manager acts as the GP,

³¹³ *Supra* 311.

³¹⁴ Privacy in the private equity industry is informational.

³¹⁵ Hurdle op cit (n255) 239.

³¹⁶ Amitai Etzioni 'Is Transparency the Best Disinfectant?' (2010) *Journal of Political Philosophy* 1; Louis Brandeis *Other People's Money and How Bankers Use it* (1914).

³¹⁷ Dickson op cit (n1) 506.

³¹⁸ Henry Ordower 'The Regulation of Private Equity, Hedge Funds, and State Funds' (2014) 3 *The American Journal of Comparative Law* 265.

³¹⁹ Dickson op cit (n1) 506.

³²⁰ Schneeman op cit (n60) 53.

³²¹ Ordower op cit (n318) 265.

and has unlimited liability for the LP's obligations. The statute governing the LP in the USA is the Delaware Revised Uniform Limited Partnership Act (DRULPA).³²²

Similar to the position in SA and the UK, a Delaware LP consists of one or more GPs, and the LPs. Under the DRULPA, a GP has unlimited liability for a partnership's debts and obligations towards third parties, other than the partnership itself and the LPs.

The partnership agreement sets out the liabilities and duties of the partners, as well as to other parties. The duties include fiduciary duties,³²³ as discussed and evaluated in previous chapters. A partnership agreement may therefore restrict the fiduciary duties or expand the fiduciary duties that the partners may owe.³²⁴

The courts in Delaware hold that GPs owe legal and fiduciary duties to the partnership.³²⁵ These are similar to those owed by a director of a Delaware corporation to the LPs. The fiduciary duty of fair dealing by a GP to LPs is no less than that owed by a director to a shareholder.³²⁶ The arrangement of the structure does not lessen the duty of fair dealing by those in control of the investments.³²⁷

The key features of the DRULPA include the following: Under the Law of Delaware, a substantive connection with the state of Delaware is not required to form a LP in Delaware. Similar to the position in SA and the UK, the disclosure of the identity of the LPs in Delaware is not required. However, in contrast to the position in SA and the UK, the DRULPA sets out a so called 'safe harbour' list of activities, that will not result in the LPs losing their limited liability. Under the Delaware law, the exercise of certain rights and powers by the LPs will not constitute involvement in the control of the partnership business. Being involved in the control of the partnership results in the forfeiture of the LP's limited liability. Sections 17-303 of the DRULPA³²⁸ set out a list of activities which will not remove the limited liability

³²² Delaware Revised Uniform Limited Partnership Act, available at <http://delcode.delaware.gov/title6/c015/> accessed on 19 June 2015.

³²³ Section 403 of the DRULPA defines the fiduciary duty owed by a general partner as 'the duty of loyalty and the duty of care'; Section 404 sets out the content of these rights.

³²⁴ Spangler op cit (n57) 134.

³²⁵ *Boxer v Husky Oil Co.* 429 A 2d 995 (Del Ch 1981).

³²⁶ Schneeman op cit (n60) 53.

³²⁷ *Ibid* 325.

³²⁸ It includes: calling, requesting, attending, or participating in a meeting of the partners or the LPs; serving on a committee of the LP, the LPs, or the partners; and taking any action, or causing or refraining from taking any action concerning the matters set forth in the partnership agreement, and others.

of the LPs. Therefore, the Delaware LP agreement can be drafted in a manner that offers LPs more protection.³²⁹ This is especially significant in regard to the governance of the partnership. LPs are able to serve on an advisory committee, without fear of losing their limited liability.³³⁰ For instance, the LP agreement could limit the GP's power to take any action by requiring the LPs' prior consent.

In the UK and SA, these governance control mechanisms could be indirectly incorporated into the structure of the fund, using mechanisms such as setting up a LPs' 'advisory committee'. The LPs participate without acting in the capacity of control. However, it is submitted that only a few investors are in a position to negotiate such rights at the level of the GP. The other investors would have to depend on the South African common law, or the Limited Partnership Act 1907 in the UK to address governance concerns.

A Delaware limited liability company (LLC) may be used instead of a LP.³³¹ The LLC is less popular. There are two primary drawbacks to using an LLC, especially for funds that invest outside of the USA or which have non-US investors. These are that LLCs are not recognised as tax transparent in some jurisdictions; and that, in some jurisdictions, investors and LLCs may have difficulty in accessing the benefits of tax treaties.³³²

The Delaware Limited Liability Company Act states that controlling members and managers of a LLC owe duties of loyalty and care to the LLC as well as its members.³³³ In terms of a recent amendment, parties to an LLC are permitted to increase, eliminate, or curb fiduciary duties in the agreements. This is however subject to the implicit terms of fair dealing and good faith. This amendment was driven by the Delaware Supreme Court's decision in *Gatz Properties, LLC v. Auriga Capital Corp*, November 2012.³³⁴ Transparency and disclosure terms are left to the parties to negotiate.

The Cayman Islands is the most common offshore jurisdiction for a fund with a large investment directive. Funds in the Cayman Islands provide a comparable level

³²⁹ Johan op cit (n44) 93.

³³⁰ Schneeman op cit (n60) 53.

³³¹ Delaware Limited Liability Company Act.

³³² Schneeman op cit (n60) 113.

³³³ *Ibid.*

³³⁴ 40 A.3d 839 (Del. Ch. 2012).

of limited liability to investors as that provided for by the Delaware vehicle (LP or LLC).

Funds established offshore are structured as limited companies that issues shares.³³⁵ The affairs of the offshore company are governed by the board of directors, who owe fiduciary duties to the fund and its investors. This is pursuant to the common law and the company law of the specific offshore jurisdiction.³³⁶ Cayman Islands company law is primarily codified in the Companies Law (2013 Revision), and the Securities and Investment Business Law (2011 Revision).³³⁷ Other than compliance with administrative obligations and requirements, the Cayman Island's company law is silent on the duties of directors. The common law governs the duties and obligations of companies incorporated under the Cayman Islands laws. It draws on cases in the Cayman Islands, English common law and other cases.³³⁸

The director's duties imposed by the Cayman Islands jurisdiction, range from detailed statutory rules to the common law. The board of directors is responsible for ensuring that the fund complies with investment limitations and its objectives.³³⁹ The frequency of reporting by the fund manager and regular meetings of the board are important for the board to determine whether the investments are undertaken in accordance with the mandate, thus protecting investors.

Investors depend on the fund manager to provide information. This is the key governance challenge. As stated by Spangler, although Cayman Islands law is founded on English common law, the Companies Law 1998 of the Cayman Islands is not the same as the UK Combined Code or the USA Sarbanes-Oxley Act. The Cayman Islands has not followed the corporate governance movements in the UK and the USA. Instead, it relies on a fund's regulatory mechanisms, which in this case would be the fiduciary duties of the company, in terms of the common law. This is one of the limitations of structuring a fund as an offshore company; investors rely on the contractual terms of the fund. In this instance it would be the Memorandum of

³³⁵ Spangler op cit (n59) 165.

³³⁶ Christopher Bickley *Bermuda, British Virgin Islands and Cayman Islands Company Law* 4 ed (2013).

³³⁷ *Ibid.*

³³⁸ *Re Smith and Fawcett Ltd*, [1942] Ch 304. A director is a fiduciary and is responsible for the success of the company's business; *Item Software (UK) Limited v Kouroush Fasshihi*, [2004] EWCA Civ 1244 at 41. *Argentine Holdings (Cayman) Limited v Buenos Aires Hotel Corporation SA*, [1997] CILR 90.

³³⁹ Spangler op cit (n59) 165.

Association (MOA) and the Articles of Association (AOA) of the offshore company. Imposing contractual disclosure and transparency obligations on the fund manager in the MOA and the AOA would deal with this issue. However, this has a limited effect.

(b) The General Regulatory Framework

The general private equity regulatory framework in the USA consists of relevant legislation, formal bodies and industry associations. The regulatory bodies in the USA include formal bodies such as the SEC and informal self-regulatory bodies such as the Private Equity Growth Capital Council (PEGCC). Recent regulatory developments include the Dodd-Frank Wall Street Reform and the Consumer Protection Act (Dodd-Frank Act).³⁴⁰

In the private equity industry, the federal laws of importance are the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Federal securities legislation which regulates asset management firms does not mandate disclosure by investment funds.

The aim of the Securities Act of 1933 (Securities Act), is to ensure adequate information disclosure to investors when offers are made to the public. Exemptions apply to the registration requirements in terms of this Act. They are available to certain sales and offers that either occur in the secondary market or are a private placement. Funds in the USA avoid the registering requirements by applying the exemptions of Section 4(2) of the Securities Act.

Where a matter does not involve a public offering in terms of Section 77 (2), one may apply for an exception. Private equity firms are able to take advantage of the exemption as their interests are generally offered to large pension funds and institutional investors, in order to take advantage of further exemptions in the Investment Company Act of 1940. Should the sale of the interests fail to qualify for an exemption, the SEC has now provided safe harbour rules, known as Regulation D. An ‘investment company’ is defined in terms of the Investment Company Act of 1940 (Investment Company Act) as ‘any issuer of a security, which is or holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in

³⁴⁰ Pub.L. 111–203, H.R. 4173.

securities'.³⁴¹ The Investment Company Act was enacted to address issues that affect public interests and the interests of investors adversely. Preceding the Dodd-Frank Act, the US Congress allowed for exemptions where the exclusion of companies from the provisions of the Act would not harm investors or the public interest.

Prior to the Dodd-Frank Act, a private equity firm that was able to apply for exemption from the provisions of the Investment Company Act, was not subject to the Act's disclosure and reporting requirements. In terms of the Act, investment companies are required to file a registration statement with the SEC containing its policies on underwriting other companies' securities, lending and borrowing, issuing senior securities, investing in industries of a particular nature, buying and selling commodities and real estate, and portfolio turnover.³⁴² In terms of Section 80a-44(a), unless the SEC determines that limiting disclosure protects investors, or does not harm the public interest, the registration documents are available for public viewing. In terms of Section 80a-29(e) of the Investment Company Act, investment companies must provide semi-annual reports to shareholders. The Dodd-Frank Act amendments are discussed below.

The Investment Advisers Act of 1940 (Advisers Act) imposes duties and obligations on investment advisers. An 'investment adviser' is defined as any person who for compensation participates in the business of advising others as to the value of securities, or the advisability of investing in, selling, or purchasing securities.³⁴³ By advising its portfolio companies, and in recruiting limited partners, the private equity firm acts in this capacity.

Unless it qualifies for an exemption, the investment adviser must register under the Act. Prior to the Dodd-Frank Act, similar to the Securities Act and the Investment Company Act, a private equity firm was able to obtain exemption. The most commonly used exemption was known as 'the fewer than fifteen clients' exemption.³⁴⁴ Hurdle submitted that most private equity firms had a limited number of funds to invest in, and due to the scarcity of these funds, a single private equity

³⁴¹ Section 202 (a) (12).

³⁴² Section 80a-8 (b)(1).

³⁴³ Section 80b-2(a)(11).

³⁴⁴ Section 80b-3(b)(3); The Act provided for exemption from registration '...if during the course of the previous 12 months, an investment advisor has had less than fifteen clients and neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Act'.

firm often had less than 15 active funds in a year.³⁴⁵ The result was that most private equity firms qualified for such exemption in the USA.

Similar to the Investment Company Act, there are many benefits of being exempted from the definition of ‘investment adviser’ in terms of the Advisers Act. Private equity firms did not have to register under the Act. They thus did not have to disclose financial statements or the basis for the compensation of the adviser. They also did not have to keep records as defined by Section (a) (37) of the Securities Exchange Act of 1934. The public did not have access to such information, as would have been the case if the fund was required to disclose it.³⁴⁶

The regulation of private equity firms is achieved by means of the application of the securities legislation in the USA. As submitted above, sunshine is the best disinfectant for corporate malfeasance.³⁴⁷ However, because private equity firms were able to obtain exemption in terms of the aforementioned securities legislation in the USA, the issues and concerns were not dealt with. Firms were able to maintain secrecy, and avoid making reports and disclosure. The Dodd-Frank Act abolished exemptions, and private equity firms are now regulated by the regulatory bodies. However, private equity firms are still not obliged to make disclosures to investors in the fund. The regulatory developments and the application of the Dodd-Frank Act are further discussed below.

The formal regulatory body in the USA is the SEC and the informal industry association is the PEGCC. The SEC regulates investment advisers and managers mainly under the Advisers Act, and the Rules adopted under that statute.³⁴⁸ In response to the GFC, the US Congress adopted the Dodd-Frank Amendments to the financial regulatory regime.³⁴⁹ These changes are discussed below.

In response to increased fraud and misconduct in hedge funds, the SEC adopted the Anti-fraud Rule 206 (4)-8.³⁵⁰ The Rule forbids advisers to investment companies and other investment vehicles from defrauding investors, and making misleading statements to them. The execution of the Rule by the SEC is through civil

³⁴⁵ Hurdle op cit (n255) 250.

³⁴⁶ Section 80b-10(a).

³⁴⁷ Etzioni op cit (n316) 1.

³⁴⁸ J Broaded ‘A Survey of Regulations Applicable to Investment Advisers’ (2009) 12 *Duquesne Business Law Journal* 27.

³⁴⁹ Dickson op cit (n1) 506.

³⁵⁰ *Ibid.*

and administrative action against advisers under Section 206(4) of the Advisers Act. There is no private course of action against an adviser.³⁵¹ It is important to note that all advisers to an investment fund are covered by the said Rule. It is designed to protect investors in investment funds and establishments that are excluded from the Advisers Act's definition of an 'investment company' under Section 3(a) by reason of either Section 3(c)(1) or 3(c) (7) of the 1940 Act.³⁵² The Rule does not differentiate among the types of pooled investments.

Advisers are prohibited from creating any materially misleading or false reports to investors in the fund in terms of Rule 206(4)-8(a)(1). It is irrespective of whether the fund is offering, redeeming, or selling securities. Participants in the fund have direct avenues for recourse against fund managers for malfeasance or misconduct on an 'after the fact' basis, after the tide has gone out.³⁵³ The SEC Rules and Regulations establish a behavioural standard for fund managers, similar to the position in the UK.³⁵⁴ However, the SEC does not go as far as to mandate governance or structural parameters for funds.

The private equity industry association and public policy advocate for the industry is the PEGCC.³⁵⁵ The PEGCC works with all branches of government, and institutions to foster a better understanding of how entrepreneurship and private equity influences the US economy. It enables private equity firms and entrepreneurs to be active in the policy development process. Similar to the SAVCA, and the BVCA, the PEGCC describes itself as a voluntary private regulator and as a representative of establishments that are active in capital and financial markets.

The PEGCC's professional development programmes aim to improve knowledge and encourage information sharing on best practices, research, and strategy.³⁵⁶ As the voice of the US private equity community, the PEGCC empowers its members by advocating for policies that inspire innovation and reward long-term

³⁵¹ Dickson op cit (n1) 506.

³⁵² *Id* at 507.

³⁵³ Warren Buffet op cit (n17).

³⁵⁴ S Willmer & A Katz. 'Big private equity firms in 'secret fees' scandal' Biznews.com January 2015, available at <http://www.biznews.com/global-investing/2015/01/01/big-private-equity-firms-secret-fees-scandal/> accessed on 1 May 2015.

³⁵⁵ Private Equity and Growth Capital Council, available at <http://www.pegcc.org/about/> accessed on 10 May 2015.

³⁵⁶ *Ibid*.

investment. Members must comply with certain requirements, including a professional approach before and after an investment is made.³⁵⁷

The Institutional Limited Partners Association (ILPA) Guidelines are also considered by members of the PEGCC. The ILPA aims to promote advancement in private equity practice by refining the GP and LPs relationship. It has published a set of private equity principles that encourage sound governance, transparency, and alignment between fund managers and investors' interests.

As noted above, private equity firms are subject to voluntary regulations imposed by self-regulated entities if they are members of certain associations. Firms are encouraged to become members as this promotes access to investors.

With regard to the effectiveness of addressing the issues and concerns in relation to funds, the regulatory regime provides participants in the fund with avenues for direct recourse against fund managers for malfeasance or misconduct on an 'after the fact' basis, after the tide has gone out.³⁵⁸

In response to complaints by investors, the cases taken up by the SEC have involved charges under the Securities Act, the Exchange Act, and the Advisers Act. The SEC's focus has been on protecting investors and addressing aspects of funds which have raised investor protection concerns. The SEC's enforcement efforts have revealed that there is a pattern of fund managers engaging in fraudulent activities, to the detriment of investors. In some cases, this involved fund managers misrepresenting their fund's performance.³⁵⁹ Other cases involved outright fraud and theft.³⁶⁰ A theme that runs across the cases is manipulated valuations and false reporting.

While the SEC's efforts to address misconduct are commendable, it has its limitations. There are limitations to 'rule-making' through enforcement.³⁶¹

³⁵⁷ *Supra* 355.

³⁵⁸ Warren Buffet op cit (n17).

³⁵⁹ In *SEC v Coadum Advisors, Inc.*, the SEC filed complaints against two individuals who controlled a group of six fund vehicles. In connection with a securities offering, the companies raised \$30 million from 150 investors by misrepresenting how the money would be invested. They also misrepresented the supposedly earned profits, made \$3 million in loans to themselves and disbursed \$5 million to related parties. Litigation Release No. 20475 (4 March 2008). The defendants were ultimately found guilty. Litigation Release No. 21406 (3 February 2010).

³⁶⁰ In *SEC v Northshore Asset Management* Litigation Release No. 20632 (1 July 2008).

³⁶¹ Douglas Cumming & Sofia Johan 'Is it the law or the lawyers?' *Investment Fund Covenants across Countries* (2006) 12 *European Financial Management* 535.

Enforcement provides protection after the fact, and in some instances, miscreant fund managers may not be in a position to pay back misused funds to investors. It is submitted that increased transparency and disclosure to investors would serve a greater purpose and ensure adequate investor protection. Exposing malfeasance ‘before the tide has gone out’ as opposed to ‘after the tide has gone out’ would offer increased protection to investors.

Similar to the SAVCA and BVCA, the PEGCC’s ability to address the issues and concerns relating to the private equity industry is also limited. Because membership is voluntary, its reach extends only to asset managers who are members. Those who are not members may simply avoid applying the PEGCC’s standards. However, and again similar to the SAVCA and the BVCA, membership of the PEGCC enables asset fund management firms to attract investors.

With regard to regulatory developments in the USA, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transformed the traditional ‘hands off approach’ to private equity.³⁶² Prior to the Act’s enactment, fund managers used exemptions to evade registration, record keeping, and reporting requirements of the Advisers Act.³⁶³ Despite the intentions of the regulators and Congress, the practical effect of the exemptions by the time Bernie Madoff was imprisoned were that a management company could escape the domain of the SEC,³⁶⁴ by gaining exemption.

The US Congress responded to concerns over investor protection³⁶⁵ by passing the Dodd-Frank Act that abolished exemptions for asset management firms, thus addressing the unregulated nature of the private investment industry. This led to a rise in the number of advisers registered with the SEC. In February 2010, the Director of the Division of Investment Management of the SEC, Andrew J. Donohue stated:

³⁶² Dodd-Frank was based on the premise that the financial crisis was the result of deregulation.

³⁶³ Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than \$150 Million in Assets Under Management, and Foreign Private Advisers, Securities and Exchange Commission, Investment Advisers Act Release No. 3222 (June 22, 2011); Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 Section 408.

³⁶⁴ I B Knauer, W R Emans & S T Matthew ‘Private Equity and the SEC: A Brave New World of Scrutiny and Compliance’, 2014, available at <http://www.pepperlaw.com/publications/private-equity-and-the-sec-a-brave-new-world-of-scrutiny-and-compliance-2014-05-21/> accessed on 19 June 2015.

³⁶⁵ Hurdle op cit (n255) 239.

‘[t]he USA securities laws have not kept pace with the growth and the market significance of the hedge funds and the private equity funds, and as a result the Commission [SEC] has very limited oversight authority over these vehicles... Consequently, advisers [fund managers] of private equity funds can ‘opt out’ of Commission oversight. This represents a significant regulatory gap in need of closing.’³⁶⁶

For Donohue, requiring the managers of these funds to register with the SEC would provide the essential ability to oversee the industry and protect investors in these funds.³⁶⁷ As stated by Spangler,³⁶⁸ this would be accomplished by means of fund managers providing the SEC with complete and reliable information about the investment funds’ operations, and their impact on the country’s securities markets, while allowing the funds to maintain flexibility with regard to investment strategies.

The Dodd-Frank Act thus brought fund managers under the direct regulation of the national financial regulator. Spangler noted further that in light of the amount of assets managed by fund managers, exemption from regulation and oversight by the SEC had become an anomaly,³⁶⁹ especially when compared with the approaches adopted by other industrialised countries.³⁷⁰

The promulgation of the Dodd-Frank Act means that domestic and foreign fund managers who were previously exempt from registration under the Advisers Act are now subject to SEC registration.³⁷¹ Domestic investment advisers in the USA holding \$100 million or more of assets under management have to register with the SEC.³⁷² However, if private investment funds are managed by advisers,³⁷³ that are not considered to be a ‘venture capital fund’, the threshold is raised to \$150 million or more in assets.³⁷⁴ Where these thresholds are exceeded, advisers must register under the Advisers Act. The latter threshold will capture unregistered advisers to

³⁶⁶ A J Donohue ‘Regulating Hedge Funds and Other Private Investment Pools; Speech to 3rd Annual Symposium on the Regulation of Investment Funds’, February 19, 2010, available at <https://www.sec.gov/news/speech/2010/spch021910ajd.htm> accessed on 1 April 2015.

³⁶⁷ *Ibid.*

³⁶⁸ Spangler op cit (n59) 80.

³⁶⁹ Spangler op cit (n59) 81.

³⁷⁰ *Ibid* at 83.

³⁷¹ Dickson op cit (n1) 506.

³⁷² George op cit (n255) 210.

³⁷³ ‘Private Funds’ are defined as entities that would be an ‘investment company’ under the Investment Company Act of 1940, as amended, but for the exceptions set out in the Sections 3(c)(1) and 3(c)(7) of the aforementioned Act.

³⁷⁴ Dickson op cit (n1) 506.

hedge funds and private equity which profited from the exemptions³⁷⁵ that were eliminated by the Dodd-Frank Act.

The Dodd-Frank Act and the AIFMD impose similar requirements on fund managers' activities.³⁷⁶ However, the AIFMD goes further, and is harsher in its directive than the Dodd-Frank Act. The AIFMD applies the 'maximalist' approach.³⁷⁷

The reporting requirements for advisers have been modified by the Dodd-Frank Act. Additional record keeping and reporting commitments are imposed on registered advisers as well as advisers previously exempt from registration. The SEC has the power to issue rules requiring unregistered advisers to maintain and deliver the information the SEC requires, in the interests of the public and for the investors' protection. However, the SEC does not define the requirements these reports and records must meet.³⁷⁸

While the Dodd-Frank Act is a welcome new direction in regulating the US financial services sector, the compliance requirements imposed on fund managers are limited, and do not address the concerns and issues discussed earlier.³⁷⁹ The Act simply builds on the securities legislation implemented prior to its enactment and makes it applicable to unregistered investment advisers.³⁸⁰ No direct transparency and disclosure obligations to investors are imposed.

The Dodd-Frank Act's ultimate effectiveness is unclear. While the SEC is central to the US approach,³⁸¹ since the GFC and the increase in its responsibilities under the Dodd-Frank Act, issues such as its lack of resources have come to the

³⁷⁵ For example, the benefit of 14 or fewer clients exemption.

³⁷⁶ Impact of the Dodd-Frank Act on Private Equity Funds, Hedge Funds and Their Investment Advisers, Private Equity Newsletter, 16 September 2010, available at <http://www.davispolk.com> accessed on 16 April 2015.

³⁷⁷ Unlike the Dodd-Frank Act, the AIFMD also contains rules of capital requirements, independent valuation provides and depositories and the possibility of regulators imposing limits on the private equity fund's leverage.

³⁷⁸ D Oakley op cit (n100).

³⁷⁹ A Greenough et al 'Reigning in Private Equity' (2010) 29 *International Financial Law Review* 49.

³⁸⁰ Stephen L Ritchie & Stephen Drewitt *The Private Equity Review* 4 ed (2015) 472.

³⁸¹ Edward F Greene 'Dodd-Frank: A Lesson in Decision Avoidance' (2010) 6 *Capital Markets Law Journal* 29, 59.

fore.³⁸² Observers in the US have maintained that the Act has failed to improve the regulatory regime in the country.³⁸³

The modifications brought about by the Act increased the SEC's duties, but the governance of funds ultimately remains outside its scope.³⁸⁴ Investors themselves will need to take decisive steps to address the issues and concerns relating to the governance structure of these funds. As one commentator has observed:

‘[t]here has been a growing consensus that there should be more regulation of hedge funds and private equity funds, although there is a substantial difference between the USA and the European Union (EU) [UK] as to what the scope and the content of that regulation should be. The Dodd-Frank Act takes the ‘minimalist’ approach.’³⁸⁵

As noted by Spangler, by applying the EU AIFMD, the UK has adopted an onerous, ‘maximalist’ approach to regulation.³⁸⁶

4.4 Conclusion

This chapter examined how the UK and the USA, as leaders in the private equity industry, have sought to address the issues and concerns relating to the private equity industry by regulating this sector.

The UK has applied the twin peaks model, and has sought to regulate the financial services industry in a holistic manner. Also, prior to the application of the EU AIFMD, the regulation of the fund was based on a general ‘hands off’ approach.³⁸⁷ The implementation of the AIFMD introduced a new approach to private equity in the UK. By means of the AIFM, the AIFMD now regulates disclosure to investors in funds and the regulator. As a commentator noted, the AIFMD adopts a ‘maximalist’ approach.³⁸⁸ This chapter has indicated that while the AIFMD is a welcome change, it places onerous burdens on investment managers in alternative investment funds. This may lead to a focus on conformance as opposed to performance of the investment fund objectives.

In the USA, prior to the Dodd-Frank Act, investment fund managers were able to obtain exemptions; this shrouded the private equity industry in secrecy. The Act

³⁸² Dickson op cit (n1)506.

³⁸³ Martin E Lybecker ‘Enhanced Corporate Governance for Mutual Funds: A Flawed Concept that Deserves Serious Reconsideration’ (2005) *83 Washington University Law Quarterly* 1045.

³⁸⁴ Khort op cit (n300) 1.

³⁸⁵ Greene op cit (n381) 64.

³⁸⁶ Spangler op cit (n57) 84.

³⁸⁷ Barber et al op cit (n36) 53.

³⁸⁸ Spangler op cit (n57) 84.

mandated the SEC to regulate fund managers. The Dodd-Frank Act is a welcome and commendable regulatory development in the USA. However, while it regulates specific private equity investment managers, and calls for disclosure of information to the SEC, it does not address all the issues and concerns. The SEC's ability to protect investors is limited. The promulgation of the Dodd-Frank Act resulted in an increase in the number of advisers registered and the SEC now requires more resources in order to apply its powers and assess investment adviser reports.

Investment advisers are now obliged to report to the SEC and keep proper records. However, the Dodd-Frank Act does not provide for direct transparency and disclosure to investors. This is left to the investor to pursue by means of governance mechanisms. As noted, the legal mechanisms of the investment vehicle are largely inadequate in addressing the issues and concerns relating to the private equity industry. As a commentator observed, the Dodd-Frank Act has adopted a 'minimalist' approach.

Compared with the approach adopted in South Africa, the methods adopted in the UK and the USA, are instructive and commendable. However, they fail to adequately address the identified issues and concerns. On the one hand, the UK has adopted an onerous 'maximalist' approach, whereby securities regulations now inappropriately regulate the private equity industry. On the other hand, the USA has adopted a meek, 'minimalist' approach, in that the regulations place onerous duties on the SEC and fail to address the specific issues and concerns identified in relation to funds.

For South Africa to achieve its objective of becoming a lucrative market for private equity investment, it will need to find a balance between the onerous and meek approaches adopted by the UK and the USA, respectively. The approach adopted should address the issues and concerns raised in relation to the private equity industry; ensuring effective investor protection is imperative for the continued growth of this sector.³⁸⁹ South Africa will need to strike a balance and avoid crossing the Rubicon by inappropriately regulating the private equity industry.

³⁸⁹ La Porta (2002) op cit (n90) 1147.

The following chapters discuss the adequacy of the voluntary self-regulation of industry associations and financial regulation in addressing the issues and concerns raised in relation to funds. This is followed by an evaluation of possible solutions.

CHAPTER FIVE

5. THE VOLUNTARY SELF-REGULATION AND REGULATORY APPROACH

5.1 Introduction

The private equity industry has witnessed a growth in self-regulatory initiatives and formal financial regulations.³⁹⁰ As noted by private equity industry associations, these developments have been motivated by the need to avoid top-down regulation by regulators. While regulators have sought to regulate this industry, the changes adopted have been incomplete and at times inappropriate. The regulations are embodied in the AIFMD in the UK and the Dodd-Frank Act in the USA.³⁹¹

There are a range of possible regulatory choices, including industry self-regulation and intervention by regulators. As one commentator notes

‘[t]he industry self-regulation [by industry associations] and the governmental intervention [paternalism] are being considered in order to lower the level of risk and to redress the balance between investors and the private equity firms...’³⁹²

As noted in previous chapters, funds previously avoided regulators and legislators’ scrutiny.³⁹³ However, increasing concern regarding investor protection and potential costs to investors resulted in regulators stepping up their regulation of funds and their asset managers without necessarily understanding the private equity asset class. This resulted in inadequate and inappropriate regulation. Flexibility and innovation are hallmarks of successful private equity investments. Effective regulation calls for an approach which not only ensures investor protection, but promotes innovation. Thus, the regulatory approach needs to be both effective, and appropriate.

A private equity fund’s internal arrangements are structured by the contract which brought it into existence.³⁹⁴ The contractual flexibility of the investment fund enables investors and fund managers to enter into specific schemes and contractual terms that support their interests and reduce agency costs.³⁹⁵ The contractual basis for funds was adequate in addressing agency costs at the time when private equity was

³⁹⁰ Thomsen op cit (n86) 97.

³⁹¹ As discussed in Chapter four.

³⁹² Cumming op cit (n27) 359.

³⁹³ This arguably contributed to its success in attracting investors; D Cumming (2005) ‘Capital Structure in Venture Finance’ (2005) *Journal of Corporate Finance* 550-585.

³⁹⁴ Josh Lerner & Antoinette Schoar ‘Does Legal Enforcement affect Financial Transactions? The Contractual Channel in Private Equity’ (2005) 120 *Quarterly Journal of Economic* 223-246.

³⁹⁵ Cumming op cit (n27) at 1.

popular and successful. However, when transparency and disclosure to investors is limited, the risks of fraud and malfeasance may increase, resulting in a decrease in investor confidence.³⁹⁶ Legislators have thus intervened in order to promote investor protection.³⁹⁷

The question is whether the current regulatory regime in South Africa that is characterised by limited regulatory intervention is well-matched to address the issues and concerns relating to the private equity industry. As one commentator noted, the level of regulatory intervention will increase where there has been a high profile failure in the market. Fraud and conflicts result in losses to investors.³⁹⁸ The Fidentia and Tri-linear scandals are clear examples.³⁹⁹

McCahery and Vermuelen note that the private equity industry faces the difficult task of finding well-suited solutions, which increase the level of disclosure and transparency, and reduce the risks that investors are exposed to. This needs to be achieved without undermining the benefits and flexibility of the private equity model that has thrived on restricted interference in contractual dealings.⁴⁰⁰

As noted by Cumming, in evaluating whether a regulatory reaction is required, it is imperative to identify the best system and to establish whether the existing framework is appropriate to address the issues and concerns relating to fund investments.⁴⁰¹

From a South African perspective, funds are exposed to risks, which include decreased investor confidence resulting from inadequate disclosure and transparency. In determining the type of reaction required, the choice is between voluntary self-regulation, and other regulatory policies.⁴⁰² This chapter evaluates and analyses the effectiveness of voluntary self-regulation and imposed regulation.

(a) Voluntary Self-Regulation

Voluntary self-regulation refers to the principles and industry codes and guidelines tailored specifically to funds by industry associations. Industry codes and guidelines

³⁹⁶ Mariya Stefanova et al *Private Equity Accounting, Investor Reporting, and Beyond* (2015).

³⁹⁷ Thomsen op cit (n86) 97.

³⁹⁸ Cumming op cit (n27) 361.

³⁹⁹ *Supra* Chapter three.

⁴⁰⁰ D Oakley op cit (n100).

⁴⁰¹ Cumming op cit (n37) 366.

⁴⁰² *Ibid.*

assist investment firms and investors in the fund to address the issues and uncertainties associated with such funds. The question is whether these guidelines improve the contractual governance of funds. The guidelines and standards address the current issues facing these funds that remain outside of regulatory regime, such as disclosure and transparency.

An example of an industry code is the SAVCA Code of Conduct.⁴⁰³ This Code was planned in consultation with professionals in the industry. The SAVCA Code provides a set of voluntary processes that centre on the funds' investment decisions, and the contractual circumstances which cover investments.

The recommendations supplement other guidelines and standards that aim to improve transparency. The SAVCA Code sets standards for record keeping, in order to ensure that the records accurately describe the services provided. According to the Code, fund agreements should detail agreed investment objectives and investment powers.⁴⁰⁴ A comparable set of guidelines was produced in the UK by Sir David Walker's working group for the BVCA on disclosure and transparency in the private equity industry.⁴⁰⁵

The Walker Guidelines are a voluntary set of rules applied on a 'comply or explain' basis. They require increased disclosure by private equity firms and portfolio companies. Similar to the SAVCA Code, the transparency requirements include filing an annual report and financial statements on the company website within four months of the end of the financial year.⁴⁰⁶ This serves as a way to communicate their trade and the governance organisation of their firm.

The Walker Guidelines did not envisage the need for statutory provisions on disclosure and transparency in the UK.⁴⁰⁷ The Walker Group expected that the principles, the BVCA's active role and monitoring and reviewing the funds would offer the necessary enticement for private equity firms to fulfil the guidelines. However, the Walker Guidelines were not given legislative effect when the UK adopted the 'twin peaks' model, and the EU AIFMD came into effect (see Chapter four).

⁴⁰³ SAVCA Code of Conduct op cit (n198).

⁴⁰⁴ *Ibid.*

⁴⁰⁵ McCahery op cit (n13) 197.

⁴⁰⁶ Thomsen op cit (n86) 97.

⁴⁰⁷ Cumming op cit (n27) 382.

It is submitted, that the self-regulatory mechanisms of the SAVCA can play an important part in responding to calls for increased disclosure and transparency in relation to equity fund's capital structure and management practices.⁴⁰⁸ The advantage of the SAVCA approach as opposed to the legislative approach is the flexibility it offers and the fund's ability to adapt to the regulations.⁴⁰⁹ Cost is another advantage. An increase in legislative regulation increases the cost of undertaking private equity investments which is passed on to the investor. The SAVCA voluntary regulations avoid these disadvantages.⁴¹⁰ They also enable the FSB to focus on its objectives, as opposed to applying onerous requirements.⁴¹¹

The principles of the SAVCA Code have an advantage over mandatory regulations. As a commentator noted:

'... [w]e need flexibility in practice... to have 'one size fits all' is not possible, and legislation on governance takes the focus off enterprise. This in turn impacts the ultimate social and economic responsibility of a company, which is performance, not conformance.'⁴¹²

The private equity firm will be adversely affected if inadequate or inappropriate legislation is adopted.⁴¹³ The firm's performance as an agent of a fund will be affected by the focus on conforming to regulations. Principles are more effective than rules and regulations.

One of the criticisms levelled at the Guidelines and the Codes, is that they are not legally binding.⁴¹⁴ However, effective private monitoring solutions and co-regulation would provide a mechanism for legal enforceability which the Codes lack on their own. This is further discussed in Chapter six.

Another concern is that, as noted above, the Guidelines and Codes offer an aggrieved investor limited courses of action. Furthermore, private monitoring solutions are a means to promote governance, and not an end in itself. It is submitted

⁴⁰⁸ SAVCA Three Decades op cit (n11).

⁴⁰⁹ Khort op cit (n300) 27.

⁴¹⁰ C Doidge et al 'Why do Foreign Firms Leave U.S. Equity Markets?' (2010) 65 *Journal of Finance*. 1507, 1508.

⁴¹¹ Ruan Jooste 'Regulation: The Red Tape Noose' *Financial Mail* 23 July 2015, available at <http://www.financialmail.co.za/coverstory/2015/07/23/regulation-red-tape-noose> accessed on 24 July 2015.

⁴¹² Mervyn King 'Governance is King', available at <http://www.ifac.org/system/files/downloads/1.3-king-governance-is-king-final.pdf> accessed on 10 October 2014.

⁴¹³ Thomsen op cit (n86) 97.

⁴¹⁴ Cumming op cit (n27) 359.

that they lack ‘normative content.’⁴¹⁵ Nonetheless, it is submitted that private monitoring solutions and co-regulation, together with the Guidelines and the Code, could provide a legal framework and the normative content which would address governance challenges and investor protection. At the same time, they would ensure the flexibility of private actors in reacting to changes in market practice.

(b) Regulatory Approach

With the increase in regulation, it is submitted that national regulators have been given extensive responsibilities to achieve the objectives and priorities set by their governments.⁴¹⁶ The regulation of funds is limited to indirect regulation, by regulating the fund manager.⁴¹⁷ However, the approach adopted in the UK applies directly to the fund, by virtue of the AIFMD.

The recent changes introduced by the AIFMD in the UK and the Dodd-Frank Act in the USA were discussed in Chapter four. However, many important issues and concerns with regard to the governance of funds have not been addressed by the top-down regulatory regime, or when addressed, have offered inappropriate solutions. Funds have either been inappropriately regulated or not regulated at all. The limits of financial regulation were demonstrated by the examples of the UK and the USA. The AIFMD and the Dodd-Frank Act offer lessons to South Africa. The net effect of the regulations varies.⁴¹⁸ On the one hand, the cost of doing business has increased. This raises the risk of investors moving to other jurisdictions that are less regulated.⁴¹⁹ On the other hand, a regulatory gap can reduce the appeal of these jurisdictions.⁴²⁰ With regard to legislative regulations, it is submitted that the inflexible nature of mandatory legal rules prevents private equity firms from making innovative investment decisions which are a key characteristic of the industry.⁴²¹

The AIFMD and the Dodd- Frank Act also imposed onerous duties on formal bodies like the FCA and the SEC, respectively.⁴²² While the regulations have

⁴¹⁵ Spangler op cit (n57) 164.

⁴¹⁶ Hodge op cit (n292) 321.

⁴¹⁷ Thomsen op cit (n86) 106.

⁴¹⁸ The costs of overregulation include higher costs for firms and investors; and a loss of competitiveness of financial centers, leading to migration of firms from overregulated to less regulated markets.

⁴¹⁹ Cumming op cit (n27) 359.

⁴²⁰ Doidge op cit (n410) 1507.

⁴²¹ R La Porta (2002) et al op cit (n90) 1147; Cumming op cit (n361) 535.

⁴²² Greenough op cit (n379) 49.

increased their duties and objectives, regulators' ability to deal with the issues and concerns are limited. This was clearly indicated by the SEC's calls for more assistance from the United States Congress in applying the Dodd-Frank Act.⁴²³

With regard to the AIFMD, increased regulation has moved to a point where the regulators have regulated the industry inappropriately. Firstly, the AIFMD places a duty on the fund manager to divulge information to investors, but the information provided is limited in its usefulness. Increasing the amount of information disclosed will not always promote knowledgeable investment decisions. As noted by Paredas,⁴²⁴ overburdening investors with information can have the opposite effect. Furthermore, onerous disclosure requirements push investments to less regulated jurisdictions. In terms of the AIFMD, the fund manager is subjected to onerous disclosure requirements in terms of investment strategies. A balance is required. It is submitted that the AIFMD crosses the Rubicon by regulating private equity inappropriately.

The analysis of the legislative protection of investors in funds has shown that current efforts have either adopted the meek, 'minimalist' approach, which is inadequate or limited, or the onerous, 'maximalist' approach, inappropriately regulating the industry. It is submitted, that as long as regulators fail to address the governance challenge of investor protection directly and appropriately, private monitoring solutions and co-regulation strategies are alternative approaches which the industry and regulators should consider.

⁴²³ B Karparti 'Enforcement Priorities in the Alternative Space' Speech before the Regulatory Compliance Association, New York, N.Y. 18 December 2012, available at <http://www.sec.gov/News/Speech/Detail/Speech/1365171492012> accessed on 6 January 2015.

⁴²⁴ Paredas op cit (n306) 117.

CHAPTER SIX

6. APPLICATION AND EVALUATION OF APPROACH

6.1 Introduction

Commentators have emphasized that risk in private equity investments is increased by asymmetric information and agency problems.⁴²⁵ These problems affect the relationship and interaction between the investors and the fund manager. Specific contractual provisions and governance strategies are required to address these problems.⁴²⁶

The problems arise from the agent's (private equity firm) lack of ability and opportunistic behaviour that act against the interests of the investor.⁴²⁷ Zambelli notes that in the absence of appropriate control mechanisms, agency problems and information asymmetry may lead to 'adverse selection' (the problem of hidden information), as well as a moral hazard (the problem of hidden action).⁴²⁸ Zambelli asserts that the moral hazard problem is driven by the divergence of interests between the principal and the agent.⁴²⁹ To mitigate these problems,⁴³⁰ appropriate mechanisms need to be adopted to enable the fund manager to perform in the fund's best interests, and deter him/her from opportunistic behaviour. The economic literature and empirical evidence (e.g., Gompers 1995; Kaplan and Stromberg 2004; Cumming 2012) have shown that investors in funds have developed various strategies to mitigate the underlying risk and agency problems.⁴³¹

As noted in chapter four, increased interest in private equity transactions has sparked debate on whether investment advisers and funds should be subject to greater information disclosure and registration. The USA and the UK illustrate two

⁴²⁵ I.e. information problems and conflict of interests.

⁴²⁶ D Cumming op cit (n19) 158.

⁴²⁷ S Zambelli 'Private Equity Governance and Financing Decisions' in D Cumming (ed) *The Oxford Handbook of Private Equity* 158.

⁴²⁸ The adverse selection problem arises before the financing is provided by the investor and refers to misrepresentation by the fund manager to induce the investor to invest. The 'moral hazard' arises during the conduct of the mandate of the asset manager, and refers to the possibility of the fund manager using opportunistic behaviour against the interests of investors; Zambelli op cit (n454) 158.

⁴²⁹ Zambelli op cit (n427) 158.

⁴³⁰ *Ibid.*

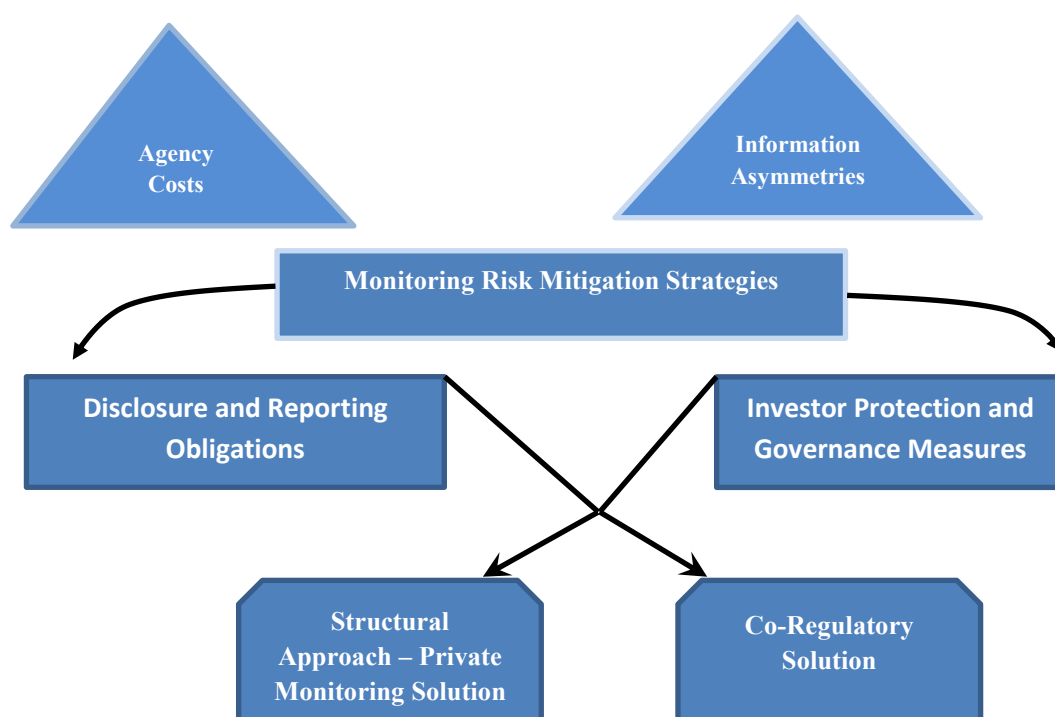
⁴³¹ Which include screening, monitoring, syndication stage financing, contracting and financing mechanisms; Paul A Gompers 'Optimal Investment, Monitoring, and the Staging of Venture Capital' (1995) *Journal of Finance* 1461-1489; Douglas Cumming 'Agency Costs, Institutions, Learning, and Taxation in Venture Capital Contracting' (2005) *Journal of Business Venturing* 573-622; Steven N Kaplan & Per Stromberg 'Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analysis' (2004) 59 *Journal of Finance* 2177-2210.

opposing approaches, and offer lessons for the future regulation of the industry in South Africa. It is imperative for the South African regulatory environment to find a balance between the meek, ‘minimalist’ and the onerous, ‘maximalist’ approach.

(a) Monitoring Risk Mitigation Strategy

Two monitoring strategies are used to address the limited disclosure and transparency of funds; these involve investors and transactions.⁴³² The strategies are: the disclosure and reporting requirements of the fund manager and the private equity fund; and investor protection and governance measures.

The diagram below illustrates the Monitoring Risk Mitigation Strategy.



Risk mitigation mechanism based on Zambelli.⁴³³

The disclosure of financial information and operations of the private equity fund, including the valuation of investments, is an effective tool to prevent misconduct on the part of investment managers.⁴³⁴ The disclosure of information during the course of investments as opposed to after the fact enables investors in the funds to make informed investment decisions. It is, however, submitted that the mere receipt of information will not eliminate fraud, negligence and malfeasance. More is

⁴³² Cumming (n27) 359.

⁴³³ Zambelli op cit (n427) 159.

⁴³⁴ *Id* 158.

required if investors are to exercise their rights. Monitoring therefore requires the ability to access information as well as the ability to process it so that the correct conclusions can be reached.⁴³⁵

The growth of the private equity industry calls for the institution of innovative regulatory measures. This chapter evaluates possible solutions to the issues and concerns relating to this industry. Monitoring strategies include private monitoring solutions, and co-regulation solutions (co-regulatory).

(i) Structural Approaches – Private Monitoring Solutions

One of the monitoring strategies that are applied to mitigate potential risks is the application of structural approaches to the private equity fund. In order to address governance concerns, an agreement can be reached between investors and the fund manager on fund documentation.⁴³⁶ This can be achieved by the use of side letters between a single fund investor and the fund manager, and/or an advisory committee.⁴³⁷ Both solutions could enhance disclosure and transparency.

A side letter is a written agreement between the investor and a fund or between the investor and the fund manager.⁴³⁸ The side letter supplements the private equity fund's offering documents, *bebind* trust deed, partnership agreement, and subscription documents. It offers individual investors better preferential terms than those offered to other fund investors.⁴³⁹ Therefore, the effect of entering into a side letter agreement is to customise the commercial and legal relationship with a single investor without affecting the relationships with other investors in the fund.

A side letter with the private equity fund, or the manager of the fund, is one way to address the governance challenge in funds⁴⁴⁰ to promote investor protection.

⁴³⁵ Sussana K Ripkhem 'The Dangers and Drawbacks of the Disclosure Antidote: Towards a More Substantive Approach to Securities Regulation' (2006) 58 *Baylor Law Review* 139.

⁴³⁶ N Bloom & J Van Reenen 'Do Private Equity Owned Firms have Better Management Practices?' (2009) *Centre for Economic Performance* London School of Economics and Political Science, London, UK. Available at <http://cep.lse.ac.uk/pubs/download/occasional/op024.pdf> accessed on 16 April 2015.

⁴³⁷ Spangler op cit (n57) 116.

⁴³⁸ *Id* 115.

⁴³⁹ R Blackstein & M B Dzulynsky 'The Use of Side Letters to Limited Partnership Agreements', available at <http://www.gowlings.com/KnowledgeCentre/article.asp?pubID=2460> accessed on 10 July 2015.

⁴⁴⁰ L Yasho & R Kopel 'From Side Show to Centre Stage: The (Sometimes Overstated) Perils of Side Letters' *Bloomberg L.P* (2006) available at <https://www.yumpu.com/en/document/view/11664462/from-side-show-to-center-stage-the-sometimes-baker-botts-llp> accessed on 10 July 2015.

Specific amendments are made to the documentation of the fund to address the concerns of an individual investor. In side letter agreements, investors seek special terms and conditions to govern their investments. Such agreements accommodate the legal and regulatory needs of the specific investor.⁴⁴¹ The most common terms are requests for additional information.⁴⁴² These could include details about the decision-making process with regard to investments, modified reporting requirements, and details about the underlying investments undertaken by the fund.⁴⁴³ A single investor in a fund is capable of connecting bilaterally to the fund manager and/or the private equity fund; these contractual mechanisms address the governance challenge.⁴⁴⁴

Fund investors may be in a position to negotiate a term in the side letter that entitles the investor to nominate a representative to serve on the funds' advisory committee.⁴⁴⁵ As noted in Chapter three, participating in the advisory committee would provide access to information on the manner in which a fund manager is fulfilling his/her duties.⁴⁴⁶ An advisory committee can be composed of investor representatives, and senior personnel from the investment fund. The advisory committee's functions include resolving conflicts of interest and an approval mechanism for investments that would otherwise be outside the scope of the fund.⁴⁴⁷ With regard to partnership funds, steps should be taken to safeguard that involvement in the advisory committee is not considered to be participation in the partnership.⁴⁴⁸ This would result in the investor losing their limited liability.⁴⁴⁹

With regard to the advisory committee, as noted, individual parties who engage in management activities could risk losing their limited liability. A commentator observed that:

[t]he legal default rule of limited liability of investors [in limited partnership] also reinforces the separation of ownership and management and again creates the potential for agent misconduct. The implications of the liability rules reaffirm the notion that the general partner controls the operation of the business and is personally liable for partnership debts. The limited partner's protection from liability

⁴⁴¹ The use of side-letters has become common in funds.

⁴⁴² Ice Miller Legal Counsel. 2013, available at <http://www.icemiller.com/ice-on-fire-insights/publications/the-use-of-side-letter-agreements-in-private-equit/> accessed on 10 July 2015.

⁴⁴³ Bloom et al op cit (n436).

⁴⁴⁴ Spangler op cit (n59) 115

⁴⁴⁵ *Ibid.*

⁴⁴⁶ *Id* 116.

⁴⁴⁷ Saule T Omarova 'Rethinking the Future of Self-Regulation in the Financial Industry' (2010) 35 *Brooklyn Journal International Law* 665, at 686.

⁴⁴⁸ *Supra* 156.

⁴⁴⁹ Williams op cit (n126) 141.

has been traditionally tied to the idea that they avoid excessive intervention in managerial decision making. When private equity investors participate in management, they create a small chance that they too may be exposed to potential liability under the control rule and other legal principles that tie liability to conduct.⁴⁵⁰

Unlike the USA DRULPA,⁴⁵¹ the UK 1907 Act and South African partnership common law do not provide a list of activities the LPs may engage in without losing their limited liability. The UK 1907 Act provides LPs with little guidance as to what constitutes ‘management’ activity. With regard to advisory committees, considering the effect of taking part in ‘management’, LPs have been cautious and have remained on the side lines. It would thus be helpful to draw up a list of activities LPs that may engage without fear of losing their limited liability.

While side letters offer a meaningful way to address the governance challenge, they do display weaknesses that need to be taken into account. The value of a side letter may be limited where investors are unable to assess the information provided to them.⁴⁵² Since private equity is a complex asset class, institutional investors require skills to analyse the information provided.⁴⁵³ Another criticism is that investors are not treated equally, which would be of concern to regulators. Side letters undermine the equal treatment of investors, yet investors assume that the treatment would be on a *pari passu* basis. This could be the source of the FSB’s concern over the use of side letters.⁴⁵⁴

Therefore, there can be practical limits to the use of side letters in private equity, due to the issues that arise in their negotiation and implementation.⁴⁵⁵ Furthermore, entering into a side letter is the first step in an on-going process of monitoring and oversight.⁴⁵⁶ Such monitoring and oversight rests on the investors who entered into the side letter. It is submitted that, regardless of the criticisms, side letters offer positive benefits. An effective side letter offers investors improved governance of the fund, to the extent of their participation in the fund. However,

⁴⁵⁰ Lee Harris ‘A Critical Theory of Private Equity’ (2010) 35 *Delaware Journal of Corporate Law* 259 14.

⁴⁵¹ As noted in Chapters three and four.

⁴⁵² Ripkkem op cit (n435) 139.

⁴⁵³ *Ibid.*

⁴⁵⁴ Conditions for investment in Hedge Funds – Financial Services Board, available at <https://www.fsb.co.za/Departments/retirementFund/Documents/Draft%20Notice%20Hedge%20Fund%20Investments%2030%2010%202013.pdf> accessed on 15 July 2015.

⁴⁵⁵ Harry McVea ‘Hedge Fund Regulation, Market Discipline, and the Hedge Fund Working Group’ (2008) *Capital Markets Law Journal* 63.

⁴⁵⁶ Yasho op cit (n440).

side letters are a possible solution for only one or a few fund investors. It is submitted that alternative approaches that address the governance challenges confronting all investors in a fund are preferable to an approach which serves one interest over others. Such an approach would require an analysis of governance mechanisms within and outside the fund vehicle.

(ii) Co-Regulatory Approach

As noted in previous chapters, there are several approaches to the regulation of private equity, including contractual regulation, voluntary self-regulation, legislative regulation, and co-regulation.⁴⁵⁷ The individual application of each of the methods has limitations. Each of these methods has been applied individually to address disclosure and the transparency of the fund to investors.

As noted in previous chapters, membership of self-regulatory organisations is voluntary. It is submitted that the law can enforce compliance with the private equity standards developed by self-regulatory associations. By setting minimum requirements for information disclosure, the law protects small institutional and indirect private equity investors. An approach which combines the methods of regulation is referred to as co-regulatory approach.⁴⁵⁸ A number of studies have identified co-regulation as the best method to regulate funds.⁴⁵⁹

There are many advantages of co-regulation, including legal certainty and the predictability of legislation, together with the flexibility offered by self-regulation.⁴⁶⁰ Co-regulation offers the possibility of compliant engagement which involves private equity firms selecting from a selection of mechanisms to manage a particular issue.⁴⁶¹ Firms adopt co-regulation in order to attract investors and enhance their reputation.

In South Africa, pension funds and the PIC are examples of this approach. In terms of the Pension Funds Act,⁴⁶² pension funds are required to apply ‘The Conditions’ when investing in private equity. ‘The Conditions’ require the pension fund to comply with the SAVCA, which promotes disclosure and investor protection.

⁴⁵⁷ Cumming op cit (n27) 359.

⁴⁵⁸ *Ibid.*

⁴⁵⁹ Cumming op cit (n14) 3218.

⁴⁶⁰ Cumming op cit (n27) 359.

⁴⁶¹ *Ibid.*

⁴⁶² *Supra* 116.

In terms of the PIC, they apply the CRISA. The CRISA calls for investment in funds with adequate governance mechanisms, and requires disclosure to investors. The SAVCA Code and the CRISA are examples of the manner in which investments are undertaken, and illustrate co-regulation's place in the regulatory milieu. The co-regulatory approach adequately addresses the issues and concerns relating to the private equity industry and promotes disclosure and the transparency of the fund. Adopting this approach would offer investors a mechanism to enforce industry associations' codes and guidelines in their agreements with fund managers.

As opposed to the approach adopted by the UK, and the USA, South Africa should reconsider its approach to private equity regulation. Co-regulation is the most efficient approach. It includes contractual terms protection, voluntary self-regulation, and legislative enforcement of the standards developed by self-regulatory associations as well as disclosure requirements which are in the best interests of all indirect and institutional private equity investors. Co-regulation offers effective investor protection, and promotes the flexibility of private equity structures. It is thus an appropriate approach that offers solutions to the issues and concerns relating to the private equity industry.

CHAPTER SEVEN

7. CONCLUSION

The study sought to address the issues and concerns relating to the private equity fund and contribute to our understanding of private equity as an asset class.

Private equity funds have operated with limited or no transparency and disclosure. Thus, the study's primary objective was to suggest an approach that would protect investors and efficiently and effectively regulate the private equity fund.

Due to inadequate investor protection, fund managers have been able to disregard their duties and engage in misconduct.⁴⁶³ This has resulted in a loss to investors, which has reduced investor confidence.⁴⁶⁴ The issues and concerns raised illustrate the governance challenge with regard to funds.⁴⁶⁵ While there is a rich body of literature on transparency and disclosure on the part of companies and capital markets, there is a paucity of research on reporting and information disclosure by private equity funds.

The growth of private equity and the various fund scandals, highlight the need to address governance challenges in this sector.⁴⁶⁶ All the while the market was experiencing gains, and functioning efficiently, the contractual arrangements and governance mechanisms of investment vehicles were adequate to address these issues and concerns. However, misconduct on the part of fund managers was revealed 'when the tide had gone out'.⁴⁶⁷ South African regulators have thus sought to place the private equity industry in the regulatory spotlight.

The jurisdictions analysed have sought to address concerns about investor protection either through the meek, 'minimalist' regulatory approach, or the onerous, 'maximalist' regulatory approach.⁴⁶⁸ It is submitted that there is a need to avoid over-regulation or inappropriate regulation of the industry. This requires an understanding of this asset class.

⁴⁶³ The Fidentia, and the Tri-linear scandals, among others.

⁴⁶⁴ Cumming op cit (n27) 336.

⁴⁶⁵ LYutao et al op cit (n73) 54.

⁴⁶⁶ Banerjee op cit (n107) 158.

⁴⁶⁷ Warren E. Buffet op cit (n17).

⁴⁶⁸ Greenough et al op cit (n379) 49.

In light of the regulatory approaches applied by the UK and the USA, it is submitted that incomplete and inappropriate regulations have been adopted by the regulators. On the one hand, a healthy, stable and lucrative market requires efficient investor protection; while on the other, the market requires an approach which does not deter investment.

It is submitted that the South African private equity industry faces a tough task in adopting a regulatory approach which is able to promote transparency and disclosure, and reduce the risks that investors are exposed to. The approaches applied in the UK and USA, are opposite sides of the private equity regulatory coin. A balance is required between voluntary self-regulation measures, meek regulatory measures and onerous regulations.

This study found that voluntary self-regulatory measures and the meek regulatory approach fail to address the specific governance challenge concerning transparency and disclosure by the fund to investors. The self-regulatory measures lack legally binding provisions, while the meek regulatory approach regulates the investment firm as opposed to the fund directly.

It is further submitted that the adoption of an onerous regulatory approach has imposed onerous requirements on funds, limiting their flexibility to engage innovatively in transactions. Such regulations fail to ensure investor protection, due to a misunderstanding of private equity as an asset class. The regulatory approach applies a one-size-fits-all model that may result in limited success in ensuring investor protection and promoting investment in the economy. With the regulatory approach, fund managers become too focused on conforming as opposed to the performance of the fund, which limits investment returns.⁴⁶⁹ This approach fails to promote innovation in the private equity asset management industry, which is a key characteristic of this industry.

Monitoring strategies have been documented which address the issues and concerns relating to funds, which involve investors and transactions. These strategies include the disclosure and reporting requirements, and investor protection and

⁴⁶⁹ J McCafferty 'Time for Sensible Thinking on Easing Disclosure Overload' *Compliance Weekly*, March 2013, available at <https://www.complianceweek.com/blogs/boards-governance/time-for-sensible-thinking-on-easing-disclosure-overload> accessed on 10 June 2015.

governance measures.⁴⁷⁰ Monitoring strategies to address the governance challenge include private actor measures such as the use of side letters and advisory committees, as well as co-regulation.⁴⁷¹

It is submitted that the use of side letters and advisory committees addresses individual concerns and issues. Side letters promotes disclosure and the transparency of the fund to individual investors. An advisory committee addresses these concerns as it is privy to investment decisions. However, these solutions have limitations in holistically addressing the issues and concerns relating to the private equity industry. They have the potential to cause further problems such as the potential loss of the limited liability of a LP when an investor serves on an advisory committee. Therefore, co-regulation is the best option to effectively and holistically address investor protection in the private equity industry.

Co-regulation addresses the concerns and issues relating to funds. The co-regulatory approach provides the balance between the meek approach and the onerous, ‘maximalist’ approach to private equity regulation. Co-regulatory solutions present an ability to regulate the private equity industry appropriately and effectively, contributing to its efficiency. The approach includes contractual terms protection, voluntary self-regulation, and the legislative enforcement of the standards developed by self-regulatory organisations.

The South African regulatory milieu currently applies a general ‘hands-off’ approach to fund regulation; they are regulated indirectly, at the level of the fund manager. This is similar to the meek regulatory approach.

The analysis of the diverse approaches to the regulation of the private equity industry revealed that there is limited investor protection. As opposed to the approach applied in the UK via the AIFMD, and the USA via the Dodd-Frank Act, and in light of the TCF Policy Document and National Treasury policy document, South Africa should assess and re-evaluate its approach to private equity fund regulation. This study concludes that the most efficient approach is co-regulation that avoids the one-size-fits-all model. As noted, it imposes minimum disclosure requirements which are in the interests of all indirect and institutional private equity investors.

⁴⁷⁰ Cumming op cit (n27) 359.

⁴⁷¹ *Ibid.*

As illustrated earlier, a balance is required; it is submitted that the new South African regulatory approach should avoid inappropriate regulation of the private equity industry. Co-regulation is the ideal approach as it promotes flexibility, and allows asset management firms to focus on performance as opposed to conformance.

Co-regulation offers a balance in addressing the issues and concerns in this industry; it advances investor protection, and promotes the South African private equity industry as a lucrative market.

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