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PRIVATE EQUITY SECTOR ALERT



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COFI considerations for private equity funds

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COFI considerations for private equity funds

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The Conduct of Financial Institutions Bill (COFI), when enacted is set to have a significant impact on the financial services industry, including the private equity sector. This alert highlights a few of the key considerations for private equity fund managers in respect of the proposed new regulations set out in the most recent draft of COFI.

A private equity fund in South Africa is typically structured as a limited liability partnership (also known as en commandite partnership), however, in certain instances it may be structured as a company or a trust. In an en commandite partnership the general partner plays an active role and has the sole responsibility for management of the business of the partnership and its assets whereas the investors (the limited partners) play a passive role in that they simply contribute cash or assets to the partnership in exchange for a pre-agreed share of the profits of the partnership.

Private equity funds structured as limited liability partnerships typically are unregulated by in South Africa as they do not fall within the definition of a "collective investment scheme" as that term is contemplated in the Collective Investment Schemes Control Act 45 of 2002 (CISCA). Investment managers of private equity funds are, however, regulated as they are required to be registered as a financial services provider in terms of the Financial Advisory and Intermediary Services Act 37 of 2002 (FAIS). CISCA and the FAIS are proposed to be repealed and replaced by COFI.

Proposed amendments

COFI proposes to amend the Financial Sector Regulations Act 9 of 2017 (FSRA) to include "a participatory interest in an alternative investment fund" in the definition of a "financial product", and thereby seeks to regulate providers of a participatory interests in an alternative investment funds. Alternative asset classes have to date been regulated very differently to traditional financial products.

An "alternative investment fund" is proposed to be very broadly defined to mean:

"an arrangement, but excluding a collective investment scheme, constituted in any legal form, including in a company, in terms of a contract, by means of a trust or a partnership, or in terms of a statute, which:

- a) raises capital from two or more financial customers to facilitate the participation or interest in, subscription, contribution or commitment to, a fund or portfolio, with a view to investing it in accordance with a defined investment policy for the benefit of the financial customers; and*
- b) the financial customers share the risk and the benefit of investment in proportion to their participation or interest in, subscription, contribution or commitment to, the fund;"*

COFI considerations for private equity funds...continued

It is arguable that both the general partner and limited partners are recipients of a participation or interest in a private equity fund and both would be regarded as a financial customer for the purpose of the definition of “*alternative investment fund*”.

The proposed definition of “*alternative investment fund*” is drafted widely and extends to any arrangement where persons pool capital with a view to investing that capital in accordance with an agreed investment policy, including private equity funds, development finance institutions, family trusts, testamentary trusts and investment clubs.

A provider of a participatory interest in an alternative investment fund will be required to be licenced in terms of section 111(1) of the FSRA, however it is unclear at this stage exactly which entities in the private equity fund structure will be required to be licenced in terms of this provision, i.e. it is not clear whether it is the investment manager or the general partner (on behalf of the fund) that will require the licence, or both.

While the definition of “*alternative investment fund*” provides that the fund may be constituted in any legal form, COFI intends to provide that the “*management company*” of an alternative investment fund must be a company incorporated in terms of the Companies Act 71 of 2008. It is unclear whether the reference to “*management company*” in this context is intended to refer to the investment manager or the general partner, however to the extent that it is intended to refer to the latter, this may be misaligned to the current market practice because in many private equity funds the general partner is itself established as a limited liability partnership.

It is arguable that both the general partner and limited partners are recipients of a participation or interest in a private equity fund and both would be regarded as a financial customer for the purpose of the definition of “*alternative investment fund*”. Section 1 of the FSRA broadly defines “*financial customer*” to include a person to, or for, whom a financial product is offered or provided, in whatever capacity.

Key purposes of the regulation

Having regard to one of the key purposes of the regulation of investment funds and of COFI, namely the protection of financial customers, including investors, it is likely that the reference to “*financial customer*” in the definition of “*alternative investment fund*” is intended to refer to limited partners and not the general partner, however this is not entirely clear from the wording in the current draft.

Based on the current wording, which is broad enough to include the general partner as a “*financial customer*”, the definition does not cater for the typical carried interest arrangements seen in private equity funds. The definition requires that “*financial customers share the risk and the benefit of investment in proportion to their participation or interest in, subscription, contribution or commitment to, the fund*”. Typically, the general partner and limited partners do not share the benefit of investment in proportion to their interest but rather share the benefits in proportions as agreed between them.

COFI considerations for private equity funds...*continued*

COFI will also give the FSCA broad authority to prescribe conduct standards (subordinate legislation) in respect of the composition and suitability of fees or any other charges to financial customers.

The Southern African Venture Capital and Private Equity Association, the private equity industry's representative body, has made various recommendations in respect of COFI, including that the proposed definition of "alternative investment fund" exclude the general partner as a financial customer, include a sophisticated investor carve out, and stipulate that financial customers should have no day-to-day discretion or control over the fund or portfolio.

COFI will also give the FSCA broad authority to prescribe conduct standards (subordinate legislation) in respect of the composition and suitability of fees or any other charges to financial customers. This will give the FSCA authority to impose conditions which could limit the amount of fees or remuneration that a manager may receive.

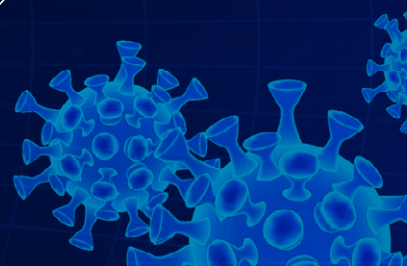
Section 33(2)(h) of COFI intends to provide that financial customers should not be subject to unreasonable fees, charges or penalties when a contract is terminated. Termination fees and payments are not uncommon in the context of the removal of the general partner or the investment manager by the limited partners in a private equity fund. This requirement of reasonableness will need to be considered in the future when negotiating such termination fees and payments.

In conclusion, it is unclear at this stage when COFI will be enacted and how and to what extent it will affect pre-existing arrangements, however it intends to bring private equity funds within its regulatory ambit in the future. We have not gone into detail in respect of the current version of COFI as it is still in draft form and will no doubt be subject to further amendments arising from public consultations and engagements with the industry.

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