



Corporate Governance and Stewardship
Financial Reporting Council
8th Floor, 125 London Wall
London, EC2Y 5AS

By email: stewardshipcode@frc.org.uk

27 March 2019

Dear Sirs,

RE: BVCA response to the FRC's proposed revision to the UK Stewardship Code

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital ("PE/VC") industry in the UK. With a membership of over 770 firms, the BVCA represents the vast majority of all UK based PE/VC firms, as well as their professional investors and advisers. Over the past five years (2013-2017), BVCA members have invested over £32bn into nearly 2,500 UK companies. Our members currently back around 3,380 companies, employing close to 1.4 million people on a full-time equivalent basis ("FTEs") across the world. Of these, around 692,000 FTEs are employed in the UK. Of the UK companies invested in during 2017, around 83% were SMEs. Between 2013 and 2017, BVCA members rescued 91 companies experiencing trading difficulties, helping safeguard over 37,000 jobs.

We welcome the opportunity to respond to the proposed revision to the UK Stewardship Code ("the Code"). Continued engagement with our investors and effective stewardship and corporate governance frameworks in the businesses in which we invest is a vital aspect of the PE/VC investment model. PE/VC firms have developed a range of bespoke stewardship and reporting practices with their investors. These include mechanisms to align interests, reporting mandated by PE/VC fund governing documents, and industry guidance and initiatives. Strong governance is also a core aspect of the PE/VC model when investing in portfolio companies and we have previously shared our experiences with the FRC through our involvement in the development of the Wates corporate governance principles for large private companies.

The proposed revisions to the Code seek to apply them to asset classes beyond listed equity, including private equity and venture capital. Considering the stewardship practices already in place within our industry, we believe the Code is less applicable for PE/VC firms as adopting it will result in duplicative reporting requirements, albeit in a different form, with limited benefit. However, there may be some firms that opt to sign up to the Code, particularly those with multi-asset class strategies and we also welcome the opportunity to share the good stewardship practices found within our industry.

Our response has been structured as follows:

1. The private equity and venture capital model: This section sets out further background information about the private equity and venture capital ("PE/VC") investment model.
2. Stewardship and governance in PE/VC and industry publications: This summarises the good stewardship and governance practices in place and publications developed by the industry on professional standards and responsible investment.

3. Response to questions in the consultation paper: Drawing on the background information provided in the preceding sections, in this section we provide our responses to the questions found in the consultation paper. We have only provided answers to questions we believe are of particular relevance to our members.

1. The private equity and venture capital model

PE/VC firms are long-term investors, typically investing in unquoted companies (often referred to as “portfolio companies”) for around three to seven years. This is a commitment to building lasting and sustainable value in business.

1.1. How PE/VC firms structure their funds with investors

A PE/VC fund is typically structured as a limited partnership, created through detailed negotiation between investors (the “limited partners” or “LP”) and the PE/VC manager (also known as the “general partner” or “GP”) and their legal advisers. This results in a governing document (for example, the limited partnership agreement or “LPA”) that sets out the key terms of the fund. In advance of making a legally binding investment, the governing documents are heavily negotiated between PE/VC firms and their investors and professional advisers.

The PE/VC firm owns the general partner (one of the partners in the fund) and the fund manager, which manages the fund. PE/VC firms are regulated by the Financial Conduct Authority in the UK and subject to various reporting and disclosure requirements, including under the Alternative Investment Fund Managers Regulations 2013.

Investors make commitments to invest in the fund, i.e. the amount they originally agree to subscribe to the fund. The amount committed is not paid immediately on a fund’s closing but in tranches over the commitment period on an “as needed basis” (typically four to seven years).

Investors in PE/VC funds are typically institutional and sophisticated investors. This includes pension funds, university endowments, insurance companies, sovereign wealth funds, fund of funds, corporate investors and private individuals. Further detailed information on the investor base can be found in our annual survey.¹

1.2. How PE/VC firms invest

The fund invests in a number of unlisted portfolio company operating groups, typically aiming for a measure of diversification by geography, sector, etc.

In many cases, the fund will take a controlling position in the equity of the holding company (but this varies between private equity and venture capital strategies). Members of the management team of the portfolio company itself will often also have a shareholding, in order to incentivise them and align their interests to those of the fund to promote lasting and sustainable value.

Third party banks may lend to each portfolio company group. There is typically no cross-collateralisation or exposures between one portfolio company group and any of the others. Each investment is in its own silo, separated from the others.

¹ BVCA Report on Investment Activity 2017 – available [here](#)



1.3. How interests are aligned between PE/VC firms and their investors

Fund profitability

Profits are achieved by the fund only on the successful realisation of the fund's investments, which arise on the sale of the portfolio company or following proceeds received from dividends or as a result of its initial public offering on a listed market. Profits are only achieved when total distributions (investor returns) exceed total contributions (investor's drawn capital) i.e. investor cash out exceeds investor cash in. Fund profits for the purpose of paying out distributions are therefore realised and real (as opposed to being based on accounting valuations). Typically, proceeds received by a fund are distributed in a timely fashion to investors and are not held within the fund pending a fixed distribution date sometime in the future.

Carried interest

Carried interest is a fundamental element of economic incentivisation in PE/VC structures. The detailed terms of a particular fund's carried interest structure are agreed by the investors and fund managers and set out in the fund's governing document. To ensure alignment with their interests, investors expect key executives and key members of the investment team to be part of the carried interest based arrangements.

Investors must receive back from the fund in cash an amount equal to their drawn down commitments (the amounts they actually pay in to the fund at the time the distribution is being made) plus a preferred return on this amount. Only then does the carried interest vehicle start to participate in a percentage of the profits. After this preferred return has been reached, profits are allocated in accordance with a pre-determined formula agreed with investors and set out in the fund governing documents. In other words, carried interest operates on a cash to cash (realised profits only) basis. It does not pay out based on accounting valuations.

Co-investment

Co-investment by PE/VC executives is often also required by investors and to promote alignment of investor interests and those of the team, by ensuring that the investment team has "skin-in-the-game" alongside investors. This means those team members put at risk the loss of their own money through their personal investment in the fund (typically held through a co-investment vehicle).

2. Stewardship in PE/VC and industry publications

Delivering sustainable value for beneficiaries is at the heart of PE/VC investment. Regular and high quality engagement, and clear alignment between PE/VC firms and their investors is a key component of the investment model. Furthermore, PE/VC firms will need a robust track record to successfully raise capital from investors for future funds. This is reflected in various aspects of the PE/VC model, as well as industry publications.

2.1. Relationship between PE/VC firms and their investors

When seeking to raise a new fund, PE/VC firms will share with prospective investors an Information Memorandum, which sets out the key details of the fund, such as the investment policy of the fund. During this period, investors will undertake their significantly detailed due diligence of the PE/VC firms. This covers many areas including:



- information on the PE/VC firm
- investment strategy and processes
- key members of the PE/VC firm and how interests are aligned
- fund terms
- governance/risk/compliance
- environmental, social and governance (ESG) matters
- track record
- accounting/valuation/reporting
- legal/administration
- diversity and inclusion

To aid investors with their due diligence, the Institutional Limited Partners Association (“ILPA”) has developed a model due diligence questionnaire to aid investors with their due diligence.² Separately the Principles for Responsible Investment (“PRI”) has developed a due diligence questionnaire focussing to establish dialogue between investors PE/VC firms specifically on ESG matters.³ Further consideration on ESG can be found below. Even before investors have committed to a fund, engagement with PE/VC firms is personal and two-way.

For private equity funds formed as a limited partnership, the key legal document is the Limited Partnership Agreement (LPA), which sets out in detail the legally binding relations between the limited partners (the investors) and the general partner (the PE/VC manager). The partners are free to agree whatever commercial terms they choose to be in the LPA, save that a limited partner may not take part in the management of the limited partnership; if it does, it will lose its limited liability status.

The LPA sets out the rights and obligations of the partners and seeks to cover every aspect of the formation, operation and termination of the partnership, from the key commercial issues to the detailed constitutional and administrative issues. LPAs typically includes clauses on:

- Parties: Each person who is party to, and therefore bound by, the LPA is clearly identified. LPs admitted to the partnership after it is initially set up (and before it closes to new investors) are required to sign a separate deed agreeing to adhere to the terms of the LPA.
- Purpose of the Partnership: This clause binds the general partner to carry on the fund’s investment activities as outlined in the LPA and may touch on investment constraints and limits within which the general partner should operate its investment policy.
- Duration of the Partnership: This is typically for ten years with a provision for extending the life of the Partnership, typically for up to two years.
- Accounts and reports: The GP will prepare accounts for the partnership as well as separate records for each limited partner to enable each to track capital contributions, capital called and returned, income received and capital profits.
- Meeting of investors: The GP will normally convene annual general meetings of the investors, enabling investors to ask about their investments and question the manager. GPs are also typically entitled to convene an extraordinary meeting at any time, along with certain LPs.
- Advisory Board: LPAs often provide for the constitution of an LP advisory board with the purpose of representing the interests of the limited partners, as well as advising on other matters such as potential conflicts of interest for the manager and its associated companies and valuations of portfolio investments. In order to protect the limited partners’ limited

² ILPA Due Diligence Questionnaire – available [here](#)

³ PRI limited partners’ responsible investment due diligence questionnaire – available [here](#)



liability, this board will be specified to be supervisory only. These boards are usually called Limited Partner Advisory Committees (“LPACs”).

Alongside the LPAC, PE/VC firms may sign bespoke agreements with investors based on their individual needs. These bespoke agreements may include preferential economic terms, certain regulatory terms required by the investor, country-specific terms as well as numerous other terms and provisions that the investor desires, or requires, such as additional ESG reporting, prior to making an investment in the fund. Many institutional investors will themselves be required to report to their beneficiaries and so may require certain bespoke reporting.

Over the years, investor reporting guidelines have been shared with the UK and European industry in Invest Europe’s professional standards handbook⁴ to aid PE/VC firms in their reporting. These guidelines are suggested to be used alongside legal and regulatory reporting requirements. The guidelines include detail on:

- Timing and structure of investor reporting
- Fund information, including an overview of the fund, GP fees, carried interest and fund operating expenses, and relation party transactions and conflicts of interest
- Information on the underlying investment portfolio
- Investor information, including drawdown and distribution notices
- Performance measurement and reporting

The BVCA is a board member of the Cost Transparency Initiative and participated in the FCA’s Institutional Disclosure Working Group. These initiatives are seeking to standardise cost reporting for institutional investors.

Furthermore, PE/VC firms regulated under the Alternative Investment Fund Managers Directive are required to comply with transparency provisions in the Directive when control of a portfolio company is acquired. PE/VC firms are required to disclose their intentions to the regulator, the company itself and its shareholders about the future of the business and likely repercussions on employment by the company and material change in the conditions of employment. Additionally, disclosure is required on the identity of the PE/VC firm with control, the policy for preventing and managing conflicts of interests, and policy for external and internal communication relating to the company, in particular as regards employees.

As explained in the previous section, carried interest and PE/VC manager co-investment, which are both agreed in the LPA, are important features of the PE/VC model that ensures alignment of interests between investors and the PE/VC manager. This encourages managers to build businesses that are sustainable and have long-term growth interests with returns for PE/VC managers only crystallising at the same time that returns are distributed to investors.

PE/VC firms have embraced the responsible investment agenda and the focus by our industry on measuring, managing and mitigating ESG risks, including climate change, as well as seizing the opportunities that good ESG practice provide, continues to grow. The BVCA has published a number of guides, most recently a Responsible Investment Toolkit⁵, which provides practical guidance for ESG consideration at the PE/VC firm level and at the different stages of an investment into a portfolio company, as well as case studies illustrating responsible investment in practice. A dedicated e-learning

⁴ Invest Europe Professional Standards Handbook, April 2018 – available [here](#)

⁵ BVCA Responsible Investment Toolkit – available [here](#)



on Responsible Investment has also been developed for PE/VC practitioners.⁶ Additionally the BVCA also annually presents Responsible Investment Awards to recognise outstanding ESG practices within the industry.⁷

A number of PE/VC firms are also signatories to the Principles of Responsible Investment⁸. Investors often require a manager to comply with/have reference to PRI even where the PE/VC firm itself is not a direct signatory. As noted before, investors may perform specific due diligence on ESG matters when evaluating a prospective PE/VC firm and regular reporting on ESG matters is also typically requested by investors.

The increased focus on responsible investment in part has been driven by investors and consideration of ESG is now expected by most investors. Institutional investors are typically invested into a number of different PE/VC funds alongside other investors. As a result, best practice expectations in stewardship will be shared between investors and so expectations across the industry will continue to rise. PE/VC firms that do not keep up with investor expectations will find future fundraising difficult.

2.2. Relationship between PE/VC firms and their portfolio companies

PE/VC firms seek to introduce and strengthen existing corporate governance arrangements that are in place in the portfolio companies in which they invest. This allows them to effectively monitor and manage their investments from a strategic perspective, and to implement value-building initiatives.

PE/VC firms also specify certain additional rights in the portfolio company's constitutional documents and agree contractual rights in the shareholders agreement it enters into with the management (who, as mentioned above are typically incentivised by equity ownership programmes) and other shareholders of the portfolio company, such as (i) requiring certain strategic and significant operational matters to be subject to prior investor/shareholder consent and (ii) the ability to make board appointments. The type of investor consents will vary depending on the size and nature of the investment and will also address potential conflicts of interest. This is a key difference to the rights of shareholders in listed companies as PE/VC investors are in a position to protect their interest.

Over the years, examples of good practice in corporate governance have been shared with the UK and European industry in Invest Europe's professional standards handbook⁹. Importantly this is not a prescriptive set of guidelines as the arrangements put in place will depend on a wide variety of factors specific to the company. The types of governance arrangements implemented include: board composition; audit and risk committees; remuneration; policies and procedures; and regular and detailed management information.

2.3. Sir David Walker's Guidelines on disclosure and transparency in private equity

PE firms that invest in the largest portfolio companies in the UK are also expected to comply with the Walker Guidelines on disclosure and transparency in private equity. In 2007, the BVCA commissioned Sir David Walker to establish guidelines that provide a framework for the private equity industry to enhance stakeholders' understanding of our activities and address concerns about a lack of transparency in the industry. Since 2007, the industry has embraced and adopted these voluntary Guidelines with over fifty portfolio companies within scope currently, owned by more than 20 PE

⁶ BVCA Responsible Investment e-learning course – available – available [here](#)

⁷ Past winners of the BVCA Responsible Investment awards can be found [here](#)

⁸ Further details are on the UN PRI homepage – available [here](#)

⁹ Invest Europe Professional Standards Handbook, April 2018 – available [here](#)



firms. Enhanced reporting by portfolio companies, and disclosures by private equity firms helps to demonstrate that they are responsible owners and builders of businesses.

The PE firms, including some of the largest firms in operating in the UK (both domestic and non-domestic) firms are also required to produce certain disclosures on their public website. Many of these disclosures are now normally found on websites of PE firm, even if they are not in scope of the Guidelines. Required disclosures include:

- A description of where the FCA-authorized entity fits in the PE firms structure
- An indication of the firm's investment history, approach and investment holding periods
- A commitment to comply with the Walker Guidelines on a comply or explain basis
- Identifying the senior leadership of the UK element of the firm
- Confirmation that arrangements are in place to deal appropriately with conflicts of interest
- A description of UK portfolio companies in the PE firms portfolio
- A categorisation of limited partners in the PE firm's funds, by geography and type of investor

An independent body, the Private Equity Reporting Group ("PERG"), monitors conformity with the Guidelines and periodically makes recommendations to the BVCA for changes to the Guidelines. The majority of PE firms and their portfolio companies are compliant with the Guidelines. Having an independent body that monitors compliance with the Guidelines ensures high expectations and standards.

3. Response to questions in the consultation paper

Q9. The draft 2019 Code incorporates stewardship beyond listed equity. Should the Provisions and Guidance be further expanded to better reflect other asset classes? If so, please indicate how?

Considering the range of bespoke stewardship and governance practices already in place within the PE/VC industry, which we have outlined above, we believe the Code is less applicable for PE/VC firms, as there is limited benefit in producing duplicative disclosures. PE/VC firms already apply the relevant Principles per the Code, which we have summarised below. There may be some firms that opt to sign-up to the Code, particularly firms with multi-asset class strategies.

Purpose, Objectives and Governance

PE/VC firms are effective stewards and responsible owners and an integral part of the financial system, thus well-functioning sustainable financial markets are of the utmost importance for the success of the industry. The majority of PE/VC firms operating in the UK are members of the BVCA. The BVCA's governance structure means that members are actively involved with our work. We engage closely with other participants in the financial markets, policymakers and regulators to build a sustainable financial system. This is reflected in the industry initiative to increase transparency through the Walker Guidelines, the BVCA's involvement in the development of the Wates Principles, and previously supporting FRC's project on culture. The BVCA is also a board member of the Cost Transparency Initiative (the successor to the FCA's Institutional Disclosure Working Group) and the Joint Money Laundering Steering Group (which promotes good practice when complying with AML regulation).

The investment purpose and strategy of a PE/VC firm are set at the outset when they begin to fundraise and is clearly outlined in fundraising documents. Considering the long-term commitment to PE/VC funds, investors need to have a clear understanding of the investment purpose/strategy when determining asset allocations. This is explicitly agreed as part of governing fund documents by PE/VC



firms and the investors. Additionally, most PE/VC firms will explain their investment strategy on their public website. This is also a requirement of the Walker Guidelines. Some firms provide case study examples on their websites to illustrate investment beliefs in practice.

Alignment of values and culture with PE/VC firms are an important consideration for investors that are committing to invest in a fund for around a decade. Understanding the values and culture of a PE/VC firm begin will often begin well in advance of formal fundraising and this relationship will only continue to develop as PE/VC firms regularly engage with investors throughout the life of the fund. Alongside performance, values and culture will be a factor as to whether an investor will commit to a future fund.

Generally, stewardship in PE/VC firms is broadly the same across their respective funds. Smaller first-time firms may only have one fund, but more established and larger funds will have a number of funds. Where funds managed by the same PE/VC firms have different investment strategies (e.g. different geographical focus or both a buyout and growth capital fund), this will be made explicit to investors as part of the fundraising process and governing documents of the fund. More often than not, the different investment strategies of funds managed by a PE/VC firm will also be described on the firm's website.

The role of the executives is an essential component of effective stewardship in PE/VC firms. Firms seek to attract and retain the best talent to carry out their activities with the track record of the firm and its executives an important factor for LPs in committing to a fund. Firms also invest significant time and expense in training new executives, who are expected to be involved in investment activities from early-on to build up experience and knowledge. Increasingly firms are training executives on matters such as ESG consideration throughout the deal-cycle, which can be a selling-point when it comes to fundraising. As discussed above, incentives of PE/VC executives are closely aligned with investors through the carried interest mechanism as well as the expectation to co-invest alongside the investors. Additionally, key man provisions are always found in the fund governing documents to ensure that senior executives are committed for the life of the PE/VC fund.

Alignment of interest between PE/VC firms and investors through carried interest and co-investment also reduces the risk of conflicts of interest. Potential conflicts of interest will be discussed with investors at LPACs, which may provide advice to the PE/VC firm. Firms regulated under AIFMD are required to disclose the policy for preventing and managing conflicts of interest and information on safeguards. Additionally, PE firms complying with the Walker Guidelines are required to disclose they have policies in place to manage conflicts of interest.

Investment Approach

PE/VC firms are legally required to invest in a manner that is consistent with fund governing documents. As noted above, this is heavily discussed with investors as part of the fund raising process and investors will undertake detailed due diligence to understand the investment process of the PE/VC firm. PE/VC firms themselves will undertake due diligence when assessing an investment and alignment with the investment mandate of the fund as agreed with investors will be ensured. PE/VC firms will usually be required to report back to investors on overall investment decisions, as part of their formal quarterly reporting as well as at LPAC and ordinary meetings.

ESG specifically is now an important aspect of the investment approach. Investors increasingly expect PE/VC firms to have clear policies on ESG and will often ask specific questions on ESG as part of their due diligence of PE/VC firms. Consideration of material ESG factors, including climate change, is increasingly embedded into the investment approach by PE/VC firms, when acquiring, managing and exiting from an investment. PE/VC firms are typically expected to report back to investors on specific



ESG performance and KPIs, alongside other financial and non-financial reporting, with some investors requiring additional ESG reporting from firms.

Active Monitoring

Active monitoring is an important aspect of the PE/VC model. PE firms will typically take a controlling interest in portfolio companies, thus will naturally closely monitor issues that may impact the value of their investment and swiftly address these. This is similar for VC firms, who will typically not take a controlling stake, but will have significant influence through additional rights attached to their shares such as board seats and certain veto rights. VCs will also actively monitor for issues and work closely with entrepreneurs to address concerns. The degree of involvement by PE/VC firms will depend on how well portfolio companies perform against expectations, which is a reflection of the level of monitoring conducted by PE/VC firms.

As part of the due diligence process, firms will identify key priorities, which will often be included in the company's 100 day plan as areas to focus on, in order to mitigate risks identified and as potential areas of value creation. This increasingly includes ESG considerations. As part of the reporting back to PE/VC firms, KPIs may be set for portfolio companies. This in turn will be consolidated and reported onto investors in the PE/VC funds, typically on a quarterly basis.

Constructive Engagement and Clear Communication

PE/VC industry inherently practice 'collaborative engagement'. As explained in the previous section, firms will be closely involved with their portfolio companies; it is a key part of the investment model to work directly with management to support the growth of their companies in a sustainable manner over the long-term. PE/VC firms would be expected to collaborate with other investors (where relevant), including debt holders in the company, as it is mutually beneficial to do so.

As explained previously, there are a number of ways that PE/VC firms clearly communicate to investors on a regular basis:

- Reporting on a quarterly basis to investors
- LPAC meetings with investors
- Ordinary and, where required, extraordinary meetings

Exercise Rights and Responsibilities

The very nature of the PE/VC model means that firms will exercise their rights and responsibilities as owners in order to support the growth of portfolio companies for the benefit of their investors. The degree to which PE/VC firms will get involved will vary, but as outlined above there will be regular monitoring of performance (monthly reporting and at board meetings) and where required, intervention by the PE/VC firm will occur whether in a control situation or working alongside investors in a VC investment.

Q14. Should there be a mechanism for investors to escalate concerns about an investee company in confidence? What might the benefits be?

PE/VC firms have significant influence to address any concerns about an investee company. The introduction of a mechanism to escalate concerns about an investee company does not make sense in a PE/VC investment, where the owners are in a position to quickly and efficiently make changes to address any concerns. This may differ in other asset classes where investors have limited ability to affect change due to a lack of control or limited influence over the investee company.



We would be happy to discuss the contents of this response with you; please contact Gurpreet Manku (gmanku@bvca.co.uk).

Yours faithfully,

A handwritten signature in blue ink, appearing to read 'Amy Mahon', is written over a light grey rectangular background.

Amy Mahon
Chair, BVCA Legal and Accounting Committee