Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
1 Victoria Street
London
SW1H 0ET

By email: corporategovernance@beis.gov.uk

17 February 2017

Dear Sirs,

Re: BVCA response to BEIS Green Paper on Corporate Governance Reform

1. 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 industry in the UK. With a membership of over 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers.

2. We welcome the opportunity to respond to the options proposed in the Green Paper and this letter focuses on proposals aimed at strengthening the employee, customer and wider stakeholder voice, and corporate governance in large privately-held businesses. As our members primarily invest in private companies, we have not commented on options to reform executive pay in listed companies.

3. We have previously met with representatives from BEIS to discuss practice in the industry and would be delighted to meet you again to discuss this response in further detail.

4. Our response has been structured as follows:

    a. About the private equity and venture capital industry: This section sets out further background information about the private equity and venture capital ("PE/VC") industry detailing the investment model and the impact of PE/VC investment on the UK economy.
    b. Corporate governance in PE/VC and industry publications: This summarises the good corporate governance practices in place and publications developed by the industry on professional standards and responsible investment.
    c. The Walker Guidelines on disclosure and transparency in private equity: In 2007, the BVCA commissioned Sir David Walker to conduct a review of the industry. The resulting Guidelines were referenced in the Green Paper and this section provides further background on the scope and content of the Guidelines. It also covers how this voluntary regime is enforced.
    d. Response to questions in the Green Paper: Drawing on the background information provided in the preceding sections, in this section we provide our response to the options proposed aimed at strengthening the employee, customer and wider stakeholder voice, and corporate governance in large privately-held businesses.

5. In summary:

    a. We recognise that there have been examples of corporate failures where it appears that corporate governance has not worked in the way it should. As well as impacting on the reputation of UK businesses, this has led to an erosion of public trust which now needs to be restored. It is however important to remember that there are also many examples of well-run companies where there are robust and effective governance structures in place which have helped create long term value.
    b. It is therefore key that any reform in this area is both proportionate and balanced so that whilst helping prevent corporate failures, reform designed to deal with the behaviour of a minority of companies does not discourage investment in the UK and disproportionately impact on the competitiveness of UK as a place to locate and to do business.
    c. The BVCA is of the view that given (i) the close relationship between PE/VC investors and the companies in which they invest and (ii) the high standards of governance standards that are a feature of the PE/VC model, any mandatory reforms would not suitably address the concerns raised in the Green Paper. Mandatory reporting would introduce an additional layer of reporting and increase the administrative burden placed on private businesses. This comes at a time when businesses are implementing a number of reporting requirements covering the treatment of employees and suppliers.
    d. A better approach would be to focus on existing legislation and regulatory regimes that are designed to protect the stakeholders identified in the paper, such as employees, suppliers and pension fund beneficiaries.
    e. Wider promotion of non-binding guidelines or principles covering best practice in reporting and corporate governance would be a more proportionate policy response to address concerns, rather than the introduction of a code aimed at private companies that requires further reporting (even if on a comply or explain basis). Private companies in the UK already adhere to high standards of reporting and transparency. The UK has enjoyed high levels of investment due to the stability of our legal system and quality of our reporting regime. Any additional reporting or administrative burdens, with the associated additional costs, would hamper the UK's competitiveness as a destination for investment and this must be borne in mind as the UK prepares to leave the EU.

A. About the private equity and venture capital industry

The investment model

6. 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.

7. The UK is a global hub for PE/VC and our members have demonstrated their consistent ability to outperform other asset classes. On a since-inception basis, UK funds returned 13.8% (net of fees) in 2015, and the 10-year Internal Rate of Return generated 13.2% (net of fees), nearly double that of pension fund assets and the FTSE All-Share Index.[1]

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[1] BVCA Performance Measurement Survey 2015 – available here

8. 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[2].

9. Appendix 1 sets out further detail on how PE/VC funds are structured and regulated. It also explains the incentive arrangements that are in place for PE/VC fund managers. These arrangements are an important feature of the PE/VC model that ensure alignment of interests between the investors in the fund and the PE/VC manager. PE/VC funds also typically equity incentivise managers of the portfolio companies which encourages them to build businesses that are sustainable and have long-term growth prospects. By developing businesses with strong fundamentals, PE/VC managers are able to sell the company or list it with a higher value.

Investment into UK businesses and employment

10. Our members have invested over £27 billion in nearly 3,900 UK-based companies over the last five years. Private equity and venture capital funds managed in the UK currently back around 2,980 companies, employing over 900,000 people on a full-time equivalent basis ("FTEs") across the world. Of these, around 385,000 FTEs are employed in the UK and 333,000 are employed in the rest of the EU. In 2015, 34 companies experiencing trading difficulties were rescued by BVCA member firms, helping safeguard around 16,500 jobs.

11. Of the businesses invested in during 2015 in the UK, 63% were small companies, with a further 21% being medium-sized companies.

12. In 2015, London and the South East were the regions that attracted the most capital, with £2.5bn invested in London and £800m in the South East. Other regions that saw notable levels of investment include the North West at £425m and Yorkshire and the Humber, where £770m was invested.

The performance of portfolio companies under private equity ownership

13. Each year the BVCA and the Private Equity Reporting Group ("PERG") commissions EY to produce a report[3] on the performance of the largest PE-backed companies in the UK. This is based on data collected for companies subject to the Walker Guidelines on disclosure and transparency (see further detail below).

14. The EY report provides comprehensive and detailed information on the effect of private equity ownership on many measures of performance. Key findings from the 2016 report include the following:

    a. The total equity return on 64 portfolio companies that were exited by PE investors in the period 2005-15 was well in excess of the comparable public company benchmark, by a factor of 4.3. This significant outperformance is explained in equal measure by PE's strategic and operational improvement, and the net benefit of additional financial leverage.

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[2] BVCA Report on Investment Activity 2015 – available here

[3] EY Annual Report on the Performance of Portfolio Companies, IX – available here

b. Organic employment growth at the portfolio companies has been faster in the last two years, averaging c.3% per annum, consistent with economy-wide benchmarks.
c. Investment at the portfolio companies has grown by 1.6% to 7.6% per annum across a number of measures.
d. Annual growth in labour productivity in the portfolio companies at between 2.0% and 2.4% is on a par with public company and economy-wide benchmarks.
e. The portfolio companies have grown reported revenue at 5.8% per annum and profit at 4.6% per annum; organic revenue and profit growth are both 3.6% per annum.
f. The report provides details on changes to pensions schemes under PE ownership and found there have been few changes to existing company defined benefit pension schemes under PE ownership.

B. Corporate governance in PE/VC and industry publications

15. 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. This educates and supports the company with its risk management processes. Effective governance provides PE/VC firms with a strong platform to implement value-building initiatives.

16. For the PE/VC firm itself, the benefits of good governance at a portfolio company level are intrinsically linked to its own success. It protects and enhances the value of investments which is important from a reputational perspective, especially as the PE/VC firm will need to fundraise in the future to secure its own longevity. There may also be reporting requirements from the PE/VC fund's own investors and other regulatory factors to consider (e.g. anti-bribery and corruption).

17. 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.

18. Corporate governance will be reviewed by the PE/VC firm in the due diligence stage of its investment and it will implement changes soon after the acquisition of the company. The arrangements introduced will be bespoke and will depend on a number of factors. This includes the stage the company is at in its development (e.g. professionalising arrangements at a founder-owned business, preparing a company for an eventual listing on a public market, etc), whether the company operates in a regulated industry, the markets in which the company operates, the risk profile of the underlying business and products, etc. The intention is to implement a governance structure that is self-regulating with an emphasis on creating the right culture that ensures the effectiveness of the arrangements put in place.

BVCA

19. 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 handbook[4]. 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:

    a. Board composition: The PE/VC firm will typically appoint one or more of its own employees/directors/members to a portfolio company's board to monitor its investment and consent of such directors will be required on certain strategic matters. The PE/VC firms will also seek to ensure that board members have the requisite skills and experience to serve on the board and to help implement its strategic priorities. This could therefore include non-executive directors with the operational expertise and/or independence required to help balance stakeholder interests. The PE/VC firm will determine the optimum size of the board, again based on factors specific to the company.
    b. Audit and risk committees: The type and composition of committees created will be bespoke to the company to ensure there is robust internal financial control, quality assurance, risk and conflict management and transparent reporting.
    c. Remuneration: The incentive arrangements for management will be structured to ensure alignment of interests that support the long-term growth of the business, and typically a key element of this is ownership of an equity stake in the company. Management and employees will have formal employment contracts. A remuneration committee may also be in place.
    d. Policies and procedures: These will be implemented to cover areas such as fraud, bribery, corruption, health and safety, conflicts of interest and other legal requirements applicable to company, many of which could directly or indirectly impact the reputation and/or investment value for the PE/VC firm.
    e. Regular and detailed management information: Financial and non-financial key performance indicators will be developed to enable the PE/VC investor to monitor company performance and progress against strategic objectives and the business plan. This will also include monitoring of Environmental, Social and Governance ("ESG") risks and opportunities. Social factors may include those which affect employees, customers, supplies and the community and will be determined by the board of the company and the PE/VC firm. Depending on the size and nature of the business, a company may also integrate its management of social factors into a full corporate responsibility or sustainability programme and publish reports publically as part its external stakeholder engagement strategy.

20. PE/VC firms have embraced the responsible investment agenda and the focus by our industry on measuring, managing and mitigating ESG risks, as well as seizing the opportunities that good ESG governance provide, continues to grow. The BVCA has published a number of guides and case studies[5] on this area with a dedicated campaign[6] and e-learning[7].

21. A number of PE/VC firms are also signatories to the UN Principles of Responsible Investment[8]. Investors often require a manager to comply with/have reference to UNPRI even where the

[4] Invest Europe Professional Standards Handbook, November 2015 – available here
[5] BVCA Guide to Responsible Investment and Case Studies – available here
[6] BVCA Responsible Investment Campaign – available here
[7] BVCA Responsible Investment e-learning course – available here
[8] Further details are on the UN PRI homepage – available here

PE/VC firm itself is not a direct signatory. Reporting on ESG matters is also typically requested by investors as part of their reporting requirements.

22. Furthermore, PE/VC firms regulated under the Alternative Investment Fund Managers Directive are required to comply with transparency provisions in the Directive in respect of the annual reports of certain non-listed portfolio companies and the disclosure expected on acquisition of control of such companies.

C. The Walker Guidelines on disclosure and transparency in private equity

23. The Green Paper acknowledges the efforts by the BVCA in improving transparency in the private equity industry. 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. These stakeholders include government, regulators, media, employees, customers and the public more widely. This was in response to the increased scrutiny and negative publicity the private equity industry faced in 2007 from the media, trade unions and politicians, culminating in Treasury Select Committee hearings.

24. Since 2007, the industry has embraced and adopted these Guidelines with over sixty portfolio companies within scope currently providing additional disclosure in their annual reports voluntarily. Enhanced reporting by portfolio companies, and disclosures by private equity firms on their investment approach, helps to demonstrate that they are responsible owners and builders of businesses. The positive reputational impact benefits the portfolio company itself, as well as its owner, and the Guidelines support those portfolio companies with reporting ahead of a listing on a public market.

25. Appendix 2 sets out further detail on the scope and content of the Guidelines and here we comment on key attributes.

Scope of the Walker Guidelines

26. The Guidelines apply to the largest portfolio companies with a significant UK presence. The detailed definition is in appendix 2 and covers companies of significant value (measured on acquisition by the PE investor) and by reference to activities in the UK (more than 50% of revenues generated in the UK or UK employees in excess of 1,000 FTEs).

27. The acquisition value is a key threshold for determining whether a company is within the scope. The Guidelines do not cover companies that have grown organically to exceed the thresholds. The scope of companies covered is therefore narrower than if the definition had been solely based on employee numbers. This is deliberate, as the Guidelines are intended to cover large, high-profile companies in the UK and the transaction value at the point of acquisition is seen as a good indicator of this. Furthermore, a defined population with clear entry and exit points is needed as data on performance is collected for the EY report commissioned by the BVCA and PERG.

Narrative reporting requirements for portfolio companies covered by the Guidelines

28. Portfolio companies are required to publish their annual report and accounts on their websites within six months of year-end and include a number of enhanced disclosures that are normally required only of quoted companies.

29. These enhanced disclosures follow those set out in the Companies Act 2006 (and included in the strategic report in the annual report) and cover:

    a. Analysis of development and performance during the year and year-end, principal risks and uncertainties facing the company, and financial and non-financial key performance indicators.
    b. Business model and strategy, trends and factors affecting future development, performance or position, environmental matters, employee matters, social and human rights issues, and gender diversity information.
    c. Additionally, companies are required to make certain disclosures specific to the Walker Guidelines and the private equity industry:
        i. Identity of the private equity fund(s) that own the company;
        ii. details of the composition of the board; and
        iii. a financial review of its position and financial risks.

Monitoring compliance with the Guidelines and enforcement of the voluntary regime

30. The PERG is an independent body established to monitor conformity with the Guidelines and make periodic recommendations to the BVCA for changes to the Guidelines. The membership of PERG is set out below:

Nick Land	Chairman & independent member (Former Chairman of EY LLP, Financial Reporting Council board member, NED)
Baroness Drake	Independent member (Labour peer, former TUC president, pension fund trustee)
Glyn Parry	Independent member (Director of Group Financial Control at BT Group plc)
Ralf Gruss	Industry representative (Apax)

31. Each year a sample of portfolio company annual reports are reviewed for compliance with the Guidelines. The outcome of this review is published in an annual report. The level of expectation is not to simply meet a basic level of compliance. The Group encourages and reports on the standard of disclosure, benchmarking against the best-in class FTSE 350 companies. The standard of listed company reporting continues to improve every year, so portfolio companies are also expected to improve their standard of reporting.

32. The Group also monitors developments in narrative reporting and has recommended changes to the Guidelines such as the adoption of the requirements of the Strategic Report Regulations (that updated the Companies Act in 2013), and this led to further disclosure on human rights issues and gender diversity.

33. The Guidelines operate on a 'comply or explain' basis. Very few companies opt to explain non-compliance with the Guidelines and so incorporate the disclosures required in the annual report.

34. In its annual report, PERG will publicly name portfolio companies, and their owners, who do not comply with the Guidelines or provide a satisfactory explanation for non-compliance. It is the BVCA's experience that this is generally an effective approach to ensure compliance with the requirements, as firms do not want the negative publicity associated with being named in PERG's report.

35. PERG has appointed PwC as an independent advisory firm to assist it in carrying out its review of the disclosures of a sample of portfolio companies each year. A Good Practice Guide[9] is published by PwC and PERG each year to aid portfolio companies in achieving a good level of disclosure.

36. The majority of private equity firms and their portfolio companies are compliant with the Guidelines. The independent nature of PERG, which monitors compliance with the Guidelines, ensures high expectations and standards. This is reflected in the results of the 2016 report[10], where PERG publically notes that *quality* of reporting has fallen when compared against the FTSE 350 reflecting higher standards of reporting seen in this benchmark (note compliance levels still remain high)[11]. Additionally, where companies are non-compliant with the Guidelines, they have been named as such in the public report.

D. Response to questions in the Green Paper

Strengthening the employee, customer and wider stakeholder voice

7. How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons. 8. Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold? 9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

37. The Green Paper presents a number of options for strengthening the voice of other stakeholders in a company, notably employees, suppliers and pension fund beneficiaries. We agree with the recognition in the Green Paper that the relatively few instances of poor

[9] Good practice reporting by portfolio companies, March 2016 – available here
[10] PERG Ninth Report, December 2016 – available here
[11] Compliance by portfolio companies in the sample reviewed reduced slightly again last year to 88% (2015: 95%). However, only 57% of the portfolio companies reviewed achieved an overall good or excellent level of quality of disclosure, whereas 95% achieved this level in 2015.

behaviour towards stakeholders should not lead to a disproportionate policy response that applies to all companies.

38. There are a number of different potential approaches to address the concerns raised and it should be for each company to decide what the most appropriate response should be i.e. a mandatory model should not be implemented. This is because the engagement processes a company puts in place will depend on a number of factors such as the industry, market, the regulatory environment in which the company operates and the relative importance and strengths or vulnerabilities of its different stakeholders. The effectiveness of existing corporate governance arrangements in place will also be a factor. As noted in section B of this response, portfolio companies may have policies and procedures in place to monitor and respond to ESG risks and opportunities and report on these publicly through a corporate social responsibility report. If these existing processes are effective, then it negates the need for further changes to way the company engages with its stakeholders. In addition, as many companies already have effective engagement arrangements in place, the introduction of a mandatory, one size fits all engagement mechanism has potential to adversely impact both companies and their stakeholders as those arrangements might have to be replaced with less effective mechanisms in order to comply with any new legislation.

39. Our members have investments in companies in a number of different countries and some have experience of implementing similar proposals to those included in the Green Paper. Based on their experience the proposals are not a panacea for all of the perceived issues in this area and themselves give rise to their own issues. We would query the effectiveness of these given statutory duties placed on directors to act in the interests of the company and this is in line with the comments made in paragraphs 2.26 to 2.28 of the Green Paper. We would instead advocate the approach in the preceding paragraph where the company has discretion to implement the most effective process for the company. We observe that, as well as giving companies flexibility to use the mechanism that works best for them and their stakeholders, this approach is also more likely to lead to the desired cultural change that will most effectively increase public trust in this area.

40. The BVCA does not believe that section 172 of the Companies Act 2006 needs to change from the current shareholder primacy model to a pluralistic model. We note that this area was extensively reviewed in the Company Law Review in the 1990s and 2000s and the conclusion was that the shareholder primacy model should be maintained.

41. Option (iv) in the Green Paper discusses strengthening reporting requirements relating to stakeholder engagement. Any additional reporting requirements on stakeholder engagement should be voluntary given the points noted above. They should also factor in materiality when determining whether to include this information in the annual report. It should be for the company to decide what further reporting is required (if any) and where to include this. i.e. a better place might be the company's website rather than the annual report. Disclosure on a website will likely make the disclosure more accessible than if it was included in the annual report as well as being easier to update and keep current.

42. The UK is an established leader in the field of narrative reporting and this position was reinforced by the introduction of the strategic report in the annual reports of all companies that are not small. The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company) [Section 414C(1) of the Companies Act].

43. As part of the strategic report, reporting on principal risks and uncertainties and KPIs (both financial and non-financial) of the business, is already required for private companies that are not small. This would include matters relevant for wider stakeholders to the extent it relates to these areas e.g. employee retention, supply chain management and human right issues. Reporting requirements on employees are also in place for companies that employ more than 250 people.

44. The FRC prepared guidance for companies in June 2014 to assist them when drafting their annual reports and it incorporates feedback on reporting for stakeholders other than shareholders. This guidance could be promoted further along with other examples of best practice in reporting so companies refer to it when preparing their annual reports.

Corporate governance in large privately-held businesses

Option (i): Applying enhanced standards of corporate governance more widely

10. What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

11. If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

12. If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

45. The Green Paper highlights the need to have regard to other stakeholders in a company who may be affected when a company fails, such as employees, customers, pension fund beneficiaries and suppliers. Our view is that there are existing regimes in place designed to protect these stakeholders and therefore the Government's emphasis should be on strengthening those enforcement regimes if there are concerns, for example the responsibilities of the Pensions Regulator. Law and regulations are also in place to cover payment and trading practices, insolvency and employees. Attempting to increase protection of stakeholders through corporate governance is unlikely to be as effective as addressing specific concerns appropriately through direct regulation of the matter which would apply generally (as is the case for consumer protection, data protection, employment law, etc). It is also important to note that businesses will at times fail, and this would not necessarily be because of a defect in the corporate governance of the company. Any reforms should not discourage entrepreneurism and companies to set up in the UK. Furthermore, any reforms should not make it harder for businesses going through financial stress to access capital.

46. The UK Corporate Governance Code (the "Code") applies to quoted companies with a premium listing and the nature of the relationship between shareholders and listed companies is very different to that between a PE/VC-backed company and its shareholders. In section B of this response we have set out greater detail on the corporate governance arrangements that are typically put in place in PE/VC-backed companies. PE/VC investors will have rights that are different to those of shareholders in listed companies, including the right

to appoint one or more representatives to the board of the company, and this puts them a better position to protect their interests. Similarly, it is common for PE/VC investors to encourage management and employee share participation in portfolio companies to help promote alignment across these stakeholder groups in the growth and development of the portfolio company. Consequently, there is less of a need for reporting on this area.

47. The provisions included in the Code may not be applicable to or appropriate for private companies. Portfolio companies may have non-executive directors on their boards and committees to review audit and risk but this depends on the company. The Code does include requirements relating to risk management and some of these disclosures will already be incorporated into the disclosures on principal risks in the strategic report.

48. In terms of a policy response, the BVCA has a preference for principles-based guidance over a mandatory code, even if the latter operates on a comply or explain basis. Guidance offers the flexibility needed by private companies that may have differing ownership structures and corporate governance arrangements, and would not impose an undue burden on firms. Such guidance will also need to be consulted on widely before it is published. Please also see our comments in the next section on the need for a cost-benefit analysis.

49. The threshold or definition for large companies that could be covered by reforms needs to be based on broader criteria than one solely based on employee numbers - if the intention is to capture those companies in the public interest. Even a threshold of 1000 FTEs would be low in the context of many private companies, as businesses with this number of employees may have fewer resources within its corporate reporting team compared to a listed company.

Option (ii): Applying reporting standards more consistently

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

50. There are a number of different reporting obligations already placed on large private companies (as set out in the Green Paper). Any extension of these could lead to further administrative burdens and additional disproportionate expense for companies that may not have a large number of people within their finance and corporate reporting functions. The Government should therefore consider the timing of any new reporting obligations and the effectiveness of them given the points we have made above about regimes in place designed to protect other stakeholders.

51. As highlighted above, the FRC has prepared useful guidance for the preparation of the strategic report and this could be promoted more widely to assist companies. Alongside this, it is important to acknowledge that many large businesses include information on their websites relating to the history of company, an outline of its business and future plans (especially those companies with news sections), its governance structure, corporate social responsibility and employees.

52. The Walker Guidelines are enforced by the PERG as detailed in section C of this response. It is because of this oversight, the Guidelines have been effective in addressing concerns about the industry. The Guidelines were implemented for specific purpose, being to improve the reputation of the industry following significant criticism in 2007. The Guidelines are also targeted in terms of the companies covered and currently sixty companies comply with them.

The transaction value threshold is important and is in addition to the employee threshold as only the largest companies with significant operations in the UK fall within scope. We do not believe there will be any merit in extending these to a broader group of companies as it will lead to additional burdens for much smaller businesses.

53. If additional narrative reporting requirements are to be introduced, another consideration is *where* any new disclosures should be placed. The Walker Guidelines disclosures are required to go into audited financial statements. In practice there is therefore a time lag whilst the audit is taking is place. As the question refers to non-financial reporting requirements, this information could be placed on a company's website rather than the financial statements. This could help with the administrative burden and ensure more timely information.

54. Wider promotion of non-binding guidelines or principles covering best practice in reporting and corporate governance would be a more proportionate policy response. Private companies in the UK already adhere to high standards of reporting and transparency when compared to other countries in the EU. The differences are more pronounced when compared to private company reporting requirements in the US and Asia. The UK has enjoyed high levels of investment due to the stability of our legal system and quality of our reporting regime. Any additional reporting or administrative burdens would hamper the UK's competitiveness as a destination for investment and this must be borne in mind as the UK prepares to leave the EU.

55. Before implementing any changes, a thorough cost-benefit analysis is required to understand:

    a. Whether the reforms adequately address the concerns raised in the paper;
    b. The effectiveness of regulation and legislation already in place designed to protect stakeholders such as employees, pension fund beneficiaries and suppliers;
    c. Instances of good practice and voluntary regimes in place. These are usually sector-specific, such as the Walker Guidelines, and therefore more effective than more generic and broader requirements;
    d. The costs and administrative burdens associated with reforms;
    e. How any reforms will be monitored and enforced to ensure their effectiveness, and the costs associated with doing this;
    f. Any unintended consequences e.g. restricting recruitment; and
    g. The effectiveness of and potential crossover with new reporting regimes that have been or are due to be implemented such as the Modern Slavery Act and reporting on prompt payment practices.

We would be very keen to discuss the contents of this letter further with you and please contact Gurpreet Manku (gmanku@bvca.co.uk) at the BVCA to arrange a meeting.

Yours faithfully,

Amy Mahon
Chair, BVCA Legal & Accounting Committee

Appendix 1 - Explanation of a PE/VC fund structure

A PE/VC fund structured as a limited partnership is created through negotiation between investors (the “limited partners”) and the PE/VC manager (also known as the “general partner”) and their legal advisers. This results in a governing document (for example, the limited partnership agreement) that sets out the key terms of the fund. The PE/VC group owns the general partner (one of the partners in the fund) and the fund manager, which manages the fund. In some cases, the general partner and fund manager are a single legal entity. PE/VC managers are regulated by the Financial Conduct Authority in the UK and subject to various reporting and disclosure requirements 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).

Investments

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.

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.

Fund profitability

Profits are achieved by the fund only on a successful realisation of the fund's investments, which might arise on the sale of the portfolio company or following proceeds received as a result of its initial public offering on a listed market. 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.

As each of the fund’s investments are profitably realised, once any outstanding fees and expenses of the fund have been paid, investors are first repaid all the money drawn down from them in full, plus the agreed preferred return. Only then is the agreed percentage of any generated profits of the fund paid-out in carried interest to the manager and its executives.

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 constitution document. To ensure alignment with their interests, investors expect key members of the investment team at the private equity group 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 (currently, typically 8% p.a.). 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 constitutional 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).

Appendix 2 – Further detail on the Walker Guidelines

Sir David Walker's Guidelines for disclosure and transparency in private equity were first published in 2007 and were updated in July 2014 to implement the requirements of the Strategic Report under the Companies Act 2006. Below we have set out key points from the Guidelines and full details can be found on the Private Equity Reporting Group's ("PERG") website: http://privateequityreportinggroup.co.uk/

Companies within the scope the Guidelines

The Guidelines apply to the largest portfolio companies with a significant UK presence. For the purposes of the Guidelines, a portfolio company is a UK company:

a) acquired by one or more private equity firms in a public to private transaction where the market capitalisation together with the premium for acquisition of control was in excess of £210 million and more than 50% of revenues were generated in the UK or UK employees totalled in excess of 1,000 full-time equivalents; or

b) acquired by one or more private equity firms in a secondary or other non-market transaction where enterprise value at the time of the transaction was in excess of £350 million and more than 50% of revenues were generated in the UK or UK employees totalled in excess of 1,000 full-time equivalents.

Further considerations for identifying a company covered by the Guidelines are set out in a Q&A[12] and in summary do include companies owned by a private equity-like firm (including investors such as pension funds and SWFs, infrastructure and credit funds).

Corporate governance requirements

The Guidelines are focussed on disclosure, particularly at the level of the portfolio company (as well as the provision of data on performance).

There are high-level requirements that fall on the private equity firm which relate to corporate governance:

- In its own disclosures (on the website), a private equity firm must include details of its investment approach, including investment holding periods, and where possible illustrate this with case studies [Section 7 of part V of the Guidelines].

- Section 10 of part V states the following in respect of a firm's responsibility at a time of significant strategic change:

  A private equity firm should commit to ensure timely and effective communication with employees, either directly or through its portfolio company, in particular at the time of a strategic initiative or a transaction involving a portfolio company as soon as confidentiality constraints cease to be applicable. In the event that a portfolio company encounters difficulties that leave the equity with little or no value, the private equity firm

[12] Q&A on the Walker Guidelines are published on the PERG's website - available here

should be attentive not only to full discharge of its fiduciary obligation to the limited partners but also to facilitating the process of transition as far as it is practicable to do so.

Narrative reporting requirements

The Walker Guidelines require portfolio companies to include additional disclosures in their financial statements. These are limited to those included in the Strategic Report and normally applicable to quoted companies. Additionally, companies are required to make certain disclosures on their ownership structure and financial positon and risks. The Walker Guidelines do not require further disclosure on greenhouse gas emissions.

A snapshot of the reporting requirements for portfolio companies is below with a comparison to those that apply to all companies including private ones.

Guidelines–specific disclosures	
• Identity of private equity firm • Details of board composition • Statement of conformity with the Guidelines	• Financial review – position • Financial review – financial risks
Business review – these are included in the Strategic Report for UK companies and could be included in the Directors Report or another appropriate report for non-UK companies	
Applicable to all companies[13]	**Enhanced disclosures normally applicable to quoted companies that are required by the Guidelines**
• Balanced and comprehensive analysis of development and performance during the year and position at the year-end • Principal risks and uncertainties facing the company • Key performance indicators – financial • Key performance indicators – non-financial	• Strategy • Business model • Trends and factors affecting future development, performance or position • Environmental matters • Employees • Social, community and human rights issues • Gender diversity information

Publication requirements

Portfolio companies are required to publish their annual report and accounts on their websites within six months of year-end and publish a half year update within three months. This goes further than current requirements in the Companies Act 2006 where private companies are only required to file their accounts with Companies House, nine months after the year end. There is no requirement for a half year update. There is no requirement for financial statements to be on the company's website.

[13] This is applicable to all companies (including private companies) except those eligible for the small companies' exemption. Medium-sized companies are also eligible for an exemption to provide non-financial information.