bvca The voice of long-term investment

Dear Sirs,

EU Corporate Governance Consultation Response

General introduction:

The British Private Equity and Venture Capital Association (BVCA) welcomes the opportunity to comment on the European Commission's Green Paper 'The EU corporate governance framework', published on 5 April 2011.

The BVCA is the industry body for the UK private equity and venture capital industry. With a membership of over 450 firms, the BVCA represents the vast majority of all UK based private equity firms and their advisers. This submission has been prepared by the BVCA's Legal & Technical Committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry.

In general, our members manage or advise investment funds which invest principally into private companies, across all sizes and stages of development, and in many different countries (European and elsewhere). Our response is therefore predominantly concerned with corporate governance in unlisted companies. However, our members do also invest in listed companies from time to time, sometimes undertake public to private transactions and some of our members are themselves listed companies. Therefore, in places our comments relate to corporate governance in the listed sector. We have only answered questions where we believe that a UK private equity or venture capital investor has a particular interest.

Our members seek to create lasting value in the companies in which they have an interest. This is at the heart of the investment strategy of private equity and venture capital investors. That means that effective corporate governance is crucial to them. In almost all cases, when a private equity or venture capital investor invests in an unlisted company, it will agree an "investment" or "shareholders" agreement with the other shareholders, and will negotiate specific provisions to be inserted into the company's constitution (in the UK, the Articles of Association), to address shareholder issues in relation to corporate governance. This process allows the governance provisions to be "tailor made" for a company, which is preferable to mandatory rules which may or may not be appropriate in the given circumstances.

As the European Commission is well aware, unlisted companies vary dramatically in size, and their ownership can range from a single shareholder to many hundreds. However, in most cases there will be a sufficiently small number of shareholders for them to exert real influence over the governance of the company (and, as mentioned above, often with the assistance of shareholder agreements that are negotiated to fit the particular circumstances), and they will be able to design governance structures which are proportionate and appropriate for the company concerned and monitor these closely. Frameworks which are developed to protect institutional shareholders with large, listed companies in mind (where "agency costs" arising from the separation of ownership and control, and widely dispersed ownership, can create real governance issues) should not be compulsorily applied to unlisted companies, where they may be not only unnecessary but could create additional burdens and costs for business that will hamper growth and innovation.

It is, of course, vital that the duties and the roles of directors are clearly spelt out both in the laws of the country of incorporation and in the articles of association or by-laws of each company, so that all companies understand how the board must behave. The law should require that they discharge their duties in a way that promotes the success of the company.

However, we believe that this is a matter for national laws (and in the UK the law was reviewed and restated in this area only a few years ago). Our view is that the European Commission should focus on encouraging key principles of corporate governance that can be used and adapted by member states to take account of national legal frameworks. We do not believe that an EU Directive is required, **and in the case of unlisted companies we do not believe that any EU action is needed.**

We also think that it is important that the law, and any corporate governance principles, continue to respect the current position that shareholders (in their capacity as shareholders) are accountable to those whose capital they are investing (in the case of our members, generally the capital comes from pension funds, insurance companies and other institutional investors) – and therefore as shareholders they do not owe duties to the company in which they have invested. That would create a conflict of interest which in our view would be impossible to reconcile. Of course, when investors appoint directors to the board of an investee company (as our members frequently do), those investee company directors are subject to the same duties as the other board members (ie they owe duties to the company concerned and not to the shareholder(s) that has appointed them). In such circumstances any conflicts are manageable and, in the UK and other Member States, governed by strict legal frameworks.

Specific questions:

1) **Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.**

   No, we do not believe that this is necessary. We believe that the European Commission should develop broad principles that can be adapted by member states and subsequently reflected in their national legal frameworks and then applied on a comply or explain basis. Any principles or rules should also be broad or flexible enough to accommodate specific codes for particular types of company (such as for listed investment companies) or companies with a small number of shareholders.

2) **Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?**

   No, we do not believe that this is necessary. We believe that it would be preferable for the Commission to focus on promoting the development and adoption of voluntary codes (such as the ecoDa Corporate Governance Guidance and Principles for Unlisted Companies in Europe ("ecoDa Guidance") and the BVCA guide to responsible investment). This gives practical guidance that can be adapted by companies and their shareholders depending on their size, stage of development, shareholder base and other needs. As mentioned above, shareholders can agree specific governance provisions with a company, and require appropriate provisions to be applied as a condition of their investment. We believe that frameworks which are developed with large, listed companies in mind would be not only unnecessary if applied to unlisted companies but could create additional burdens and costs for business that will hamper growth and innovation.

3) **Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?**

   As a matter of principle we generally support such a separation as a matter of good practice, but we believe that this should be a matter for national company law and national comply or explain codes.

Many listed investment companies are externally managed and will not have a CEO or other executive directors.

In the unlisted sector, particularly, there are many companies where (mainly for size reasons) separation would not be appropriate or practical and is a matter that can be agreed on a case by case basis.

4) Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?

The private equity and venture capital industry supports the principle that diversity in boards can improve the quality of decision making (providing the board is not so "diverse" that it becomes dysfunctional), and also that companies should be clear about the skills that they are seeking when recruiting directors. Guidance on these issues can certainly be helpful (and we believe that it should be through national codes). However it is important that any such guidance is not prescriptive because that may inhibit the selection of the most appropriate candidate and ultimately prove be counter-productive. Ultimately the right blend of skills is a matter for the boards of directors to determine in conjunction with their stakeholders.

We would further note that national laws may in certain circumstances require some of the directors to be physically located in the domicile of the company, and this requirement is likely to have a bearing on the availability of suitably qualified resource.

In the unlisted sector particularly, the needs of a board will vary considerably from company to company, and can be discussed and agreed with shareholders directly.

5) Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?

Yes, on a comply or explain basis and provided there is no obligation to have such a policy or to disclose the detail of such policies that do exist.

6) Should listed companies be required to ensure a better gender balance on boards? If so, how?

We support a better gender balance on boards in both the listed and the unlisted sector.

We believe that listed companies should be required to say whether they have a policy on board gender diversity, and, if so, to report against it. This could be part of their general obligation to disclose diversity policies.

We are not in favour of mandatory quotas for companies, which we believe can be counter-productive.

7) Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?

No, we do not think that this is necessary or desirable. UK law and the law of other member states prescribe the legal duties of directors. We believe that it is for the company and the director to determine whether the needs of the company, and the time commitment required by the director in order to fulfil his or her statutory and contractual obligations, allow other appointments to be accepted and, if so, how many. This will vary considerably from company to company and director to director, depending on the expected role of the director concerned (which will often be specified by the company in a letter of

appointment), his skill and experience, the competency of the director concerned and the time taken by the other commitments, which may also vary depending on the nature of those commitments (which may themselves be an executive position, a non-executive directorship or a role in a not-for profit organisation or governmental body).

We would also point out that wide experience (provided that it does not give rise to irresolvable conflicts of interest) is likely to be helpful to a company, and it could be contrary to the European Commission's objective to improve the quality of decision making in boards if directors holding a number of other appointments could not be recruited by a company in need of the skills that such a director had to offer.

8) Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?

We would generally support this principle in the listed sector, although it may not be cost effective for a smaller listed company or necessary for certain types of company and an internal evaluation may suffice. We believe that a recommendation, applied by member states on a comply or explain basis, would be appropriate in the listed sector. It is important, however, that any evaluation is not published, because that is not likely to encourage people to be frank.

We do not believe that this is necessary in the unlisted sector, because shareholders will be in a position to decide for themselves whether they are satisfied with the board and, if necessary, require an external evaluation.

9) Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?

In the UK, listed companies must provide a full remuneration report to shareholders on an annual basis. In unlisted companies, however, such disclosure would not be necessary since the shareholders are very likely to be closer to management, and/or have rights under the shareholders agreement to review and approve specific remuneration awards where they believe that is desirable.

10) Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?

See answer to 9) above. We are not in favour of a mandatory vote, rather than an advisory vote, for listed companies and do not think it is necessary or desirable for unlisted companies to be subject to such requirements.

11) Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?

Yes, we agree that the board is responsible for the company's "risk appetite" and this is (correctly) covered by directors' legal duties to the company. In the UK, company law requires directors to have regard to wider societal risks in discharging their duty to the company, where those risks are relevant to the company's own prospects of success.

While there may be a case for disclosure of such matters to shareholders in listed companies, we do not believe that is necessary in unlisted companies, where the relationship between the board and the

shareholders will be closer and the information flows (including an overview of risk) will be greater and prescribed by bespoke shareholders' agreements. Formal requirements for disclosure in these circumstances are likely to add a significant burden on unlisted companies for no (or at best minimal) additional benefit.

12) Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?

It is the responsibility of all members of a Board to use reasonable endeavours to ensure that risk management procedures are in place and operating effectively and in line with a company's established risk policy. It is not possible for any one director, and especially not for a non-executive director, to ensure that these procedures exist and are followed. We believe that existing fiduciary duties are sufficient in this regard.

13) Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.

The liquidity requirements to be imposed by Solvency II (and other forthcoming regulation of institutional investors, including pension funds) could act to encourage short-termism, as they make investment in illiquid assets more onerous. Some investors are reducing their allocations to private equity and other illiquid assets as a result of this, and this is to the detriment of fund-raising activity. This will have a negative knock-on effect on funding growth companies. While appropriate capital requirements are necessary, it is important that the real risks of investment are not overstated, and that the negative implications on investment in growth companies across the EU are well understood by policy makers.

14) Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?

We have no comment on incentives and performance evaluation of institutional asset managers.

However, we would note that, in the context of private equity, venture capital, and some asset managers in the infrastructure and property sectors, incentive structures are largely dependent on a cash paid return to the investors. In such circumstances, the performance is clear and cannot be manipulated, and we believe incentives are appropriately aligned, and we do not feel there is a need for the EU to take measures in respect of these sectors.

15) Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?

We assume that this question relates principally to institutional asset managers and their investments in listed investee companies.

In the context of private equity and venture capital fund managers who manage investments into unlisted companies, there is significant monitoring of these matters (including the extent to which asset managers engage with investee companies), and these matters are fully described and explained before an investment is made and are the subject of considerable ongoing compliance. Many are also now covered by the Alternative Investment Fund Managers Directive. We do not believe that any additional EU laws are needed in this sector.

16) Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?

We assume that this question relates to wholesale asset managers and universal banking firms.

We do not believe that conflicts of interest of the types described in this question arise in the private equity and venture capital sector. To the extent that there are conflicts of interest, there are regulatory and contractual frameworks in place which stipulate how they should be dealt with. We note, in the context of private equity, that the AIFM Directive mandates that AIFs "take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated".

17) What would be the best way for the EU to facilitate shareholder cooperation?

There is no issue with shareholder co-operation in the private equity and venture capital sector, because the investment strategy and philosophy are founded on principles of active ownership and engagement. There is, therefore, no need for any EU action in this regard in the context of private equity or venture capital, or indeed for unlisted companies generally.

18) Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest, and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?

We express no view on this question.

19) Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?

We express no view on this question.

20) Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).

There is no need for such a mechanism in privately held companies where owners and changes of ownership would be noted in the companies share register, and are generally known to the company and the other shareholders. Indeed, as noted above, private equity and venture capital investors typically negotiate bespoke corporate governance arrangements.

We have seen the response of LPEQ Listed Private Equity on this point and we agree with them that greater transparency in the listed sector would be beneficial.

21) Do you think that minority shareholders need additional rights to represent their interest effectively in companies with controlling or dominant shareholders?

No, because we believe that this is already dealt with appropriately in the UK by national company law, and shareholders in unlisted companies will negotiate bespoke protections as a condition of their investment.

22) Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?

This is not a problem in the private equity and venture capital context because shareholders agreements, company constitutions and national law already provide adequate protection.

In the case of listed companies, Listing Rules or similar provisions may provide protection in addition to that applying under national company law. We think that any additional protection should be a matter for national law, having regard to the particular characteristics of companies in that jurisdiction.

23) Are there measures to be taken, and if so, which ones, to promote at EU level employee share ownership?

Tax rates, exemptions and incentives are critical to employee share ownership, but we believe that this is a matter for national governments rather than EU-level action.

24) Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?

In our view, unlisted companies should not be required by law to apply corporate governance codes but should be able to do so on a voluntary basis. To the extent that corporate governance codes may apply to unlisted companies, we think that it is for shareholders to determine what level of explanation is sufficient.

***25)* Do you agree that monitoring bodies should be authorized to check the informative quality of the explanations of in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?**

We believe that this question relates to listed companies and we express no view on it.

The BVCA would of course be willing to discuss further this submission and looks forward to receiving and commenting on any further proposals which the Commission makes.

Yours faithfully
Simon Witney

Chairman – BVCA Legal and Technical Committee