

# EVCA Governing Principles



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European Private Equity &  
Venture Capital  
Association



## **Corporate Governance and Professional Standards for the Private Equity and Venture Capital Industry**

Developed by the European Private Equity and Venture Capital Association

### **About EVCA**

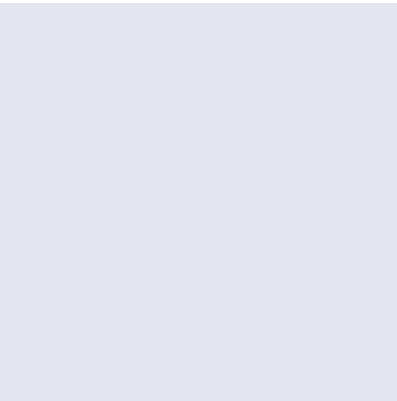
The European Private Equity and Venture Capital Association (EVCA) was established in 1983 and is based in Brussels. EVCA represents the European private equity sector and promotes the asset class both within Europe and throughout the world.

With well over 900 members in Europe, EVCA's role includes representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics.

EVCA's activities cover the whole range of private equity: venture capital (from seed and start-up to development capital), buyouts and buyins.

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# Introduction

This document is intended to provide governing principles for the establishment and management of a private equity or venture capital initiative and guidance on how those principles may apply during the life cycle of a fund. In doing so, it takes account of common market practice and corporate governance in the European private equity and venture capital industry wherever possible. EVCA expects that the document as a whole, and the examples of sound practice in particular, will be modified over time to reflect developments in the industry.

## ■ **Ω Governing principles**

The core of the document are the nine governing principles laid out on page 13. These should be considered and observed by EVCA Members and those involved in the establishment and management of private equity and venture capital funds (including those advising on and arranging investments) at all stages during their life cycle (which will usually comprise fundraising, investing, management of investments, disposal of investments, distributions to investors and liquidation of the fund).

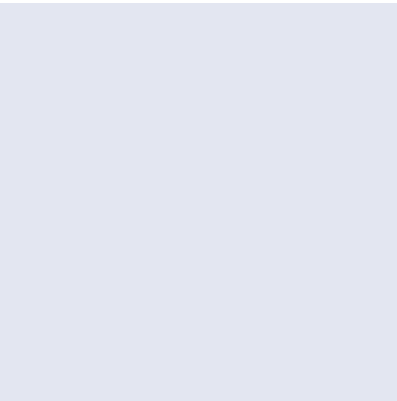
## ■ **Examples of sound practice**

Examples of the application of the Governing Principles are provided on the following pages. They illustrate how these principles may apply to certain stages of the life cycle of a fund, but are not intended to be exhaustive or prescriptive. Whilst the examples are intended to provide a useful resource for managers, it should not be assumed that 'one size fits all'. Some of the examples may be inappropriate as a result of the size, nature, jurisdiction of regulation and complexity of some managers' operations. The different investment objectives of some funds may also mean that the examples are not appropriate to all funds for which a manager is responsible.

## ■ **Limits of the document**

Local legal and regulatory requirements, and the extent to which there are fiduciary relationships and obligations, differ widely in the various European jurisdictions. The first governing principle is that these legal requirements are observed in all relevant jurisdictions. This document does not describe those requirements or provide a complete or mandatory statement of the duties of those involved in the establishment and management of private equity and venture capital funds. It is not a substitute for professional advice, which should still be obtained where appropriate.

The document does not reflect the impact of differing legal structures used for private equity and venture capital vehicles internationally. In particular, it is assumed that funds are being marketed to sophisticated investors and do not reflect the large range of legal protections for funds that are marketed to retail investors.



# Governing principles

## The governing principles

### **1 The Law**

A fund operator should make sure that the legal requirements are met in the jurisdiction of establishment of the fund and in each jurisdiction in which it operates and raises finance.

### **2 The contract**

A fund operator should make sure that the terms and conditions specified in the contracts between itself and its investors are met.

### **3 Integrity**

A fund operator should manage its business with integrity.

### **4 Skill, care and diligence**

A fund operator should manage the fund with due skill, care and diligence.

### **5 Adequacy of resources**

A fund operator should ensure an adequate level of financial and operational resources for the management of the fund.

### **6 Investors' interests**

A fund operator should pay due regard to the interests of investors in the fund taken as a group.

### **7 Transparency**

A fund operator should pay due regard to the information needs of investors in the fund, and communicate adequate information to them in a way which is clear, fair and not misleading.

### **8 Conflicts of interest**

A fund operator should seek to manage conflicts of interest fairly, both between itself and investors in the fund and between different funds and different investors and groups of investors.

### **9 Investors' assets**

A fund operator should arrange adequate protection for investors' assets, whether it holds assets on behalf of investors or arranges for a third party to do so.

# Examples

## 1 Initial considerations

There are a number of factors that initiators should consider and address during their initial planning. Doing so will help initiators to take account of the principles of skill, care and diligence and ensuring adequacy of resources.

### 1.1 Early stage planning

**Question:**

What issues should the initiators consider and address during their early stage planning?

**Explanation:**

Appropriate early stage planning of an initiative is vital to its success. It helps to focus initiators so that effort and cost are not expended inappropriately. Planning during this stage will normally outline all of the initiators' activities up to the first closing of the fund.

**Recommendation:**

The initiators' early stage planning should address the following issues:

- what the initiative's investment policy, investment objectives and investment strategy will be;
- which markets the initiative will invest in once established;
- what size of fund the initiators will need to establish to implement the investment strategy;
- what type of investors the initiators intend to try and raise the funds for the initiative from; and
- what human resources the initiators will need to put in place in order to implement the initiative and in particular who the relevant investment and industry professionals will be.

### 1.2 Investors and marketing

**Question:**

What issues regarding potential investors and marketing of the initiative should be considered at the early stages?

**Explanation:**

An efficient and well planned marketing campaign is vital in ensuring that fundraising is successful. Many jurisdictions also regulate the marketing of funds and restrict it to certain types of investors (such as institutional and professional investors) and in some jurisdictions, these restrictions may apply to early informal discussions with potential investors. Planning identifies relevant jurisdictions giving the initiators the opportunity to obtain appropriate advice.

**Recommendation:**

The initiators should clearly identify the investors and types of investor that they wish to attract to the initiative in any relevant jurisdiction. Before commencing fundraising, the initiators should establish what restrictions apply to the marketing of funds in each jurisdiction where they wish to market the initiative.



### 1.3 Structuring

**Question:**

What issues on the structure of the initiative should the initiators consider during the early stage planning?

**Explanation:**

Although the final structure of a fund is usually a result of negotiations with investors, an initial outline structure is necessary to allow the initiators to market the fund. Certain categories of target investor may have an impact on the structure of the initiative (such as US-based ERISA investors). The solutions to these issues tend to be similar in all funds and they may be addressed at the planning stage if it is intended to market the fund to such investors.

**Recommendation:**

The initiators should identify an initial outline structure for the fund, including suitable vehicle(s) for the fund and custody arrangements. Wherever possible, the initiators should take account of likely requirements of targeted investors when considering these structures (including their tax requirements). During the structuring planning, the initiators should also consider what arrangements they will make for the custody of investments held by the fund.

## 2 Fundraising

The fundraising stage (which is also often referred to as the marketing stage) is the stage at which the basis of the manager's relationship with the investors is established. It is important that the principles of integrity, transparency and skill, care and diligence are observed during this stage to ensure that an appropriate relationship is formed with the investors.

### 2.1 Initiators

**Question:**

How should responsibility during the fundraising period and prior to the establishment of the fund structure be apportioned?

**Explanation:**

During the fundraising period the manager is sometimes not yet established and the structure of the fund will not usually be finalised. However, the initiators will be involved in establishing the initiative and will undertake fundraising. The initiators will usually have certain responsibilities during fundraising, (e.g., responsibilities for complying with applicable marketing laws, responsibilities for the information provided to potential investors on the initiative and responsibilities relating to the verification of the origin of funds invested with a view to preventing money laundering).

**Recommendation:**

Tasks and responsibilities during the fundraising stage of an initiative should be clearly identified and apportioned amongst the initiators appropriately.

It should also be made clear to potential investors which responsibilities will be undertaken by the manager once it is established and what (if any) the initiators' role will be once the manager is established.

# Examples

## 2.2 Target investors

### Question:

What potential investors should the initiators target for an initiative?

### Explanation:

In many jurisdictions there are restrictions on the types of investors to whom it is permissible to promote funds. Investments in funds are usually regarded as high-risk investments and funds are usually primarily aimed at experienced investors who are considered to be fully aware of the potential risk of making an investment in a fund.

Often restrictions only permit marketing of funds to potential investors for whom they are suitable. The tests for determining suitability vary from jurisdiction to jurisdiction. In some jurisdictions, the potential investor's net worth or the minimum size of investment may be one ground for permitting marketing.

### Recommendation:

Initiators should comply with any local legal restrictions on marketing funds. Failure to comply with these requirements may mean that any agreement to invest may be unenforceable. In some jurisdictions breach of these restrictions is also a criminal offence and, in addition to being liable for damages, initiators may be subject to fines and imprisonment.

If fundraising is, as is normally the case, restricted to potential investors who can reasonably be considered to be experienced enough to properly evaluate the risk of the investment, they should be obliged to confirm in their application documentation that they are suitably experienced and that they understand and accept the risks of the investment.

Initiators should maintain a record of all persons to whom they market the initiative and a record of all information provided to them.

If for any reason less experienced investors are accepted, consideration should be given to any additional information, warnings and ongoing protections they may require.

## 2.3 Origin of funds

### Question:

Should the initiators be responsible for controlling the origin of the funds offered for investment in a fund with a view to preventing money laundering or other illicit practices?

### Explanation:

Much of the present EU and national regulation on money laundering is limited to the 'classical' financial markets which are subject to some sort of supervision through a supervisory authority. In addition, the definition of what is money laundering varies from jurisdiction to jurisdiction (e.g., in some cases it may only be illegal to launder drug and terrorism money whilst others may prohibit the laundering of proceeds of any illegal or illicit activity).

The application of anti-money-laundering legislation to the private equity and venture capital industry varies throughout Europe. In some jurisdictions there are no legal obligations imposed on the initiators or managers to carry out checks or implement procedures to prevent investors from money laundering through funds. In others (such as the UK) the manager is required not only to verify the identity of the investors, but also to conduct similar checks on co-investors, companies in which the fund invests and the directors of those companies.

**Recommendation:**

Initiators and managers should comply with the relevant local rules in any jurisdiction where they market the initiative. In addition, during fundraising, initiators should take steps to ensure that investments are not made to effect money laundering. These steps should include verifying the origin of funds offered for investment and the identity of potential investors. Investment should not be accepted where the source of the investment causes concern (e.g., where the investment originates in a FATF black-listed country) or the investor's identity cannot be verified.

Subscription documentation should also include suitable warranties from investors in the fund regarding the origin of money invested, although such warranties should not be considered to be a substitute for making appropriate enquiries. The fund documentation may include provisions that allow the manager to require investors to withdraw from the fund, if the manager reasonably believes that the investment has been made in order to undertake money laundering.

## **2.4 Investors**

**Question:**

What issues regarding investors should the initiators consider?

**Explanation:**

The quality and reliability of investors affect all those investing in a fund because it normally has drawdowns throughout its life. If one investor defaults, even when suitable sanctions are applied, other investors are likely to be disadvantaged.

Moreover, some investors may require specific opt-out or excuse clauses which will allow them not to participate in certain investments. If these issues are not addressed during fundraising, the fund may not have sufficient capital to implement the investment strategy.

**Recommendation:**

The initiators should seek to obtain a sufficient level of investment, diversification and quality of investors to reduce the risk and impact of default by any one investor. Any withdrawal of an investor should be subject to strictly defined exceptional situations.

## **2.5 Structure of the offer: terms of investment**

**Question:**

Should different investors be offered different terms?

**Explanation:**

The terms of investments in a fund will normally be the result of negotiation. Investors may be keen to get certain preferential rights or economic advantages (such as positions on investment committees, preferential co-investment rights, reduced management fees or a participation in carried interest). Trade and strategic investors will have different priorities in investing to those of financial investors.

The extent to which specific investors are granted influence over the management of the fund should be considered carefully. If such influence alters the management structure of the fund it can compromise investors' limited liability. Substantial influence on the management of a fund (in particular the decisions to invest or divest) can subject the fund to merger regulations and notification requirements with undesirable consequences for it and the investors.

# Examples

## Recommendation:

Whenever possible, the initiators of a fund should try to ensure that all investors in a fund benefit from equal treatment.

Wherever possible, preferential treatment or specific economic benefits to individual investors or investor groups should be justifiable (e.g., with reference to the large amount invested by a preferred investor or by specific experience of an investor which adds additional value to the fund).

Any preferential treatment should be made transparent to all other investors in a way that such investors at least know that certain other investors may benefit from preferential treatment. Investors should not generally participate in the day-to-day management (including the investment decision process) of the fund. Where they do so, they should be aware of the legal risks that arise from doing so in certain jurisdictions.

Where a fund is structured as multiple parallel partnerships or entities, the initiators should prevent one such entity or a single minority investor (in the context of the whole fund) being able to unduly influence the fund or block special resolutions without adequate justification.

## 2.6 Structure of the documentation

### Question:

What documentation should the initiators produce with respect to the fund and what matters should it address?

### Explanation:

Due to the ongoing negotiations until final closing of a fund, documentation tends to be continually revised to reflect all discussions with investors. However, certain core elements describe the offer and its essential characteristics.

These core elements will usually be addressed in a combination of documentation that will normally include an information memorandum (often the main 'marketing' document) and the constitutional documents of the fund.

Local laws in the jurisdictions where the initiative is marketed may set out requirements on the structure and content of the information memorandum and constitutional documents. Continuous amendment of documentation can, if not addressed appropriately, mean that not all potential investors receive the same information about the fund before they make an investment.

### Recommendation:

An information memorandum or similar fund documentation should be made available prior to first closing. Constitutional documents establishing the fund should also be produced. Appropriate information should be provided to all investors to ensure that all investors receive the same information. Between the first and the final closing this information should be updated if required and such updates should be disclosed to both existing and potential investors so that all have received the same information.

Appropriate advice should be sought on the requirements of the laws in all jurisdictions where the fund is promoted.

The fund documentation should contain full and true information presented in a manner which is clear, fair and not misleading. Appropriate steps should be taken to ensure and record the accuracy and completeness of the documentation.

Where the fund documentation requires it, any substantial changes to the documentation after first closing must be approved by the existing investors.

It is recommended that the fund documentation should address at least the following issues:

- the investment scope of the fund (e.g., target economies, target regions, etc.);
- the investment policy, investment criteria and investment period of the fund, including the applicable investment, lending and borrowing guidelines and investment restrictions (NB: These must be set out particularly clearly as, often, these important matters will not be set out in any detail in other key documents, and they are usually incorporated by cross-reference to the information memorandum);
- the provisions that the manager will make for follow-on investments;
- a description of the legal structure of the fund;
- a description of the management structure and the management team, identification of the key executives of such team and the regulation of key man events (such as departure of a key executive);
- a summary of the powers of the manager;
- conflict of interest resolution procedures;
- whether any advisory or investors' committee will be established and what its function will be (see section 7.4 below);
- how transaction and directors' fees received by the manager will be treated;
- the carried interest arrangements;
- co-investment rights and powers;
- the mechanics for drawdown of commitments;
- default mechanics in the event of investors' defaults on drawdowns (which should normally impose significant sanctions on default to reduce the risk of such default);
- the cost and fee structure (including expenses borne by the fund);
- the valuation principles that will apply;
- the reporting obligations that the manager will have to investors (see section 7.1 below);
- exit strategies;
- how distributions to investors will be made (see section 6.1 below);
- term, termination and liquidation procedures for the fund;
- any restrictions on the circumstances in which the initiators or the manager will be permitted to establish any other fund with a similar investment strategy or objective;
- the policy on co-investment with other funds managed by the manager or any of its associates;
- the circumstances in which investments may be purchased from or sold to other funds managed by the manager or its associates (see section 5.5 below);
- the pricing of interests, units, shares, etc.; and
- a summary of the risk factors that are relevant to investment in the fund, including a general warning to investors of the risks that are inherent in investing in funds, and also any particular risk factors that may adversely affect the fund's ability to carry out the investment policy or to meet any projection or forecast made.

The fund documentation (information memorandum or similar and constitutional documentation) should be prepared and made available to investors in sufficient time for them to consider it prior to closing. Appropriate subscription documentation and confirmation of a participation should also be circulated.

The initiators should take advice to establish whether the law in any jurisdiction where the documentation will be sent requires any other issues to be addressed.

# Examples

## 2.7 Presentations to investors

### Question:

What responsibilities arise with respect to marketing presentations?

### Explanation:

Presentations and information provided by the initiators which influence investors' decisions are often subject to the law of all jurisdictions where an initiative is promoted. These laws will often apply to information provided to investors, irrespective of the media by which it is communicated.

In some circumstances, presentations may be made to potential investors at an early stage and the information provided to them may influence their decision to invest, even though they have not yet received any documentation. It is important that potential investors are made aware of any changes to information provided to them at any point during the fundraising process, so that they are able to make a balanced investment decision based on correct information.

### Recommendation:

Initiators must comply with local laws which relate to the marketing of funds in all jurisdictions where the initiative is promoted and appropriate professional advice should be obtained.

Initiators should ensure that information provided to potential investors and promotional statements made to them in whatever form (e.g., in telephone calls, meetings, slide or PowerPoint presentations, letters, e-mails, websites, etc.) even at an early stage, is correct and fairly presented. Any subsequent material changes to such information should be communicated to potential investors.

## 2.8 Track records and forecasts

### Question:

What information should be provided about the track record of the management team and how far should forecasts be made?

### Explanation:

Potential investors are generally interested in the track record of the management team and the initiators may also wish to make forecasts regarding likely performance in the fund's chosen sectors, target IRR, etc. It is very easy for such material to be misread or to mislead potential investors, particularly in view of changing circumstances or if there is selective presentation of material.

### Recommendation:

Statements and forecasts set out in the information memorandum or in other documents should not be made on the basis of selective data which is unrepresentative, misleading or incomplete. The basis of all such statements and forecasts should, in any event, be fully disclosed in the fund documentation. In particular, the period to which any track record information relates should be disclosed.

Initiators should ensure that when there is any material change that affects such information prior to final closing, it is disclosed to all investors.

Track record information may be confidential (for example, to previous employers or portfolio companies) and the initiators should ensure that appropriate consent is obtained before it is used.

## 2.9 Time period for fundraising

### Question:

Is there any specific period during which fundraising must be completed?

### Explanation:

It is important that the initiators do not allow fundraising to continue indefinitely, as this can prevent the manager from implementing the fund's investment strategy whilst resources continue to be committed to marketing.

### Recommendation:

The fund documentation should specify a date when fundraising will be completed. If it does not do so, the initiators and the manager should ensure that fundraising is completed within a reasonable time after first closing of the fund. Consideration should be given to charging interest or equivalent compensatory payments to those who invest late in the fundraising cycle.

## 3 Investing

When making investments on behalf of the fund, the manager must implement the fund's investment policy with due skill, care and diligence.

### 3.1 Due diligence

#### Question:

What due diligence should be done when evaluating an investment and to what level of detail?

#### Explanation:

The due diligence process undertaken by the manager is vital. The information acquired during the process, together with the manager's own knowledge and expertise, will form the basis of any investment decision. The due diligence process will usually have a number of objectives: obtaining 'corporate' information about the investee business (such as the extent of its assets and liabilities and the likelihood of litigation against it) and also evaluating any technology, research or business opportunity that may play a part in the manager's investment decision, assessing the market for the product or service being offered and likely exit opportunities for the fund.

#### Recommendation:

A manager should seek sufficient information to allow it to properly evaluate the investment proposition being put to it and to establish the value of the investee business. This information should address all appropriate issues (which may include the financial position of the investee business, the experience and ability of its management team, the market in which the investee business operates, the potential to exploit any technology or research being developed by the investee business, possible scientific proof of any important concept, protection of important intellectual property rights, pensions liability, possible environmental liabilities, litigation risks and insurance matters).

This process should also include testing the assumptions upon which business plans are based, verifying the identity, resources and experience of managers and co-investors and objectively evaluating the risks that may arise from investing and the potential return on investment.

Any other appropriate checks (including checks on vendors) to ensure that the investment does not facilitate money laundering should be carried out.

# Examples

## 3.2 Investment decision

### Question:

How should a decision to invest be reached?

### Explanation:

Any decision to make an investment involves an appraisal of the opportunity and a balancing of the risks and rewards of the opportunity. The information to make this decision will usually have been gathered and critically appraised during the due diligence phase. The quantities of information, however, will be so great that it will be necessary to summarise them for the investment committee or other decision-making body that decides whether or not to make an investment.

Undertaking a successful due diligence exercise that confirms the validity of the underlying assumptions of a business plan will not generally be sufficient in itself. Investors look to the experience of the senior managers within a fund manager to add value to the due diligence exercise by the critical use of their business experience.

### Recommendation:

The results of the due diligence exercise and executives' recommendations should be distilled to a written investment proposal which accurately reflects the potential of the investee business. The investment proposal is an important document; not only does it provide a written record of the information considered in making an investment decision, but it can also provide a yardstick by which the success of an investment can be judged. Investment decisions should be made by suitably senior and experienced personnel. Wherever possible, the investment decision should be made by more than one person jointly (ideally by an investment committee). If the person(s) responsible for proposing an investment is involved in making the investment decision, then others should be involved in taking the decision and the proposer(s) should not have a deciding vote. Significant changes to an investment proposal may require further approval.

## 3.3 Structuring investments

### Question:

What issues should the manager consider when structuring and negotiating an investment?

### Explanation:

Investments by funds can be structured in many ways. In some cases the fund may be a passive minority investor in a business, whilst in others the fund may obtain substantial control over the investee business (for example, by appointing executives to the board of the investee business, or by having rights under shareholders' agreements). The investment strategy of the fund will be relevant in determining how investments should be structured. The fund may also need to consider its position when investing alongside others (e.g., as part of a syndicate) and whether it owes duties or obligations to others as a result. It is possible for the structure of an investment to impose liabilities and responsibilities on the fund beyond those envisaged.

### Recommendation:

The manager should structure and negotiate each investment made by the fund in such a way so as to ensure that it is in the interests of the fund. Central to the investment management process is the flow of information from the investee company and the investment agreement should always address the information which will be required from the investee and the time scales for its planning.



The manager should consider:

- appointments to the board or other decision-making bodies of the investee business;
- appointment of persons to advisory and consultative bodies of the investee business; and
- entering into shareholders agreements.

The manager should ensure that an appropriate investment agreement is concluded before making any investment.

When structuring any investment the manager should take steps to minimise any adverse tax or other consequences of any investment for the fund.

### 3.4 Possible means by which the fund may influence an investee business

#### Question:

Through what mechanism should the manager seek to ensure that the fund is able to influence an investee business?

#### Explanation:

There are a number of different ways in which the manager can ensure that the fund can influence an investee business. Which of these will be appropriate will depend on a number of factors (including the size of the fund's investment, the manager's capacity to add value to the investee business and the level of influence that the manager considers to be appropriate).

The manager may require shareholder consents to be obtained before the investee business may undertake certain courses of action (such as substantial capital expenditure or a change of business plan).

The manager may seek to appoint individuals to internal committees of the investee business (e.g., advisory committees or the remuneration and audit committee).

The manager may seek to appoint individuals to the board (or other governing body) of the investee business. However, this is not always the most effective mechanism for allowing the fund to influence the investee business, as in most jurisdictions directors are obliged to act in the best interests of the company of which they are a director. The investee business' interests may conflict with those of the fund and in such circumstances the director must act in accordance with the duties owed to the investee business.

#### Recommendation:

The manager should assess which mechanism is appropriate and ensure that the mechanisms are agreed with the investee business whilst the investment is being negotiated and set out in the investment agreement. The manager should ensure that key controls are exercised by shareholder consent rather than relying on the votes of individuals appointed as directors of the investee business, although the latter can be a valuable influence.

When considering the advantages to the fund of taking any control rights the manager should also consider possible liabilities or restrictions imposed by law on those exercising certain types of control.

# Examples

## 3.5 Investment agreements and documents

### Question:

What should be included in the investment documents?

### Explanation:

There will be a large number of documents produced during the process of making an investment, for example investment agreements, articles of association and loan agreements. The content of these will be influenced by many factors, for example tax mitigation, local legal requirements and structural considerations.

The documents will also need to take account of the commercial issues that the manager has agreed with the investee business.

These commercial terms may address the following issues:

- ownership and control of the investee business postinvestment;
- share transfers (mandatory, permitted and prohibited) and pre-empt rights;
- incentives for the management of the investee business and obligations imposed on them;
- division of managerial responsibilities following the investment;
- warranties, representations and indemnities;
- milestones and any future obligations to provide further funding;
- board and shareholder consents needed before specified actions are taken;
- agreements with lenders to the investee business;
- quality, quantity and frequency of information that is to be provided; and
- exit provisions such as tag-along or drag-along rights and/or compulsory sale provisions to resolve any deadlock regarding disposal.

It is likely that local legal advice will be required in the drafting of the various investment documents.

### Recommendation:

Managers should consider these matters when negotiating an investment and ensure that the legal investment documents reflect the commercial terms negotiated by the manager and should consider local legal advice on the appropriate manner for recording what has been agreed.

## 3.6 Manager's consent to investee business actions

### Question:

When should a manager's consent to actions of the investee business be necessary?

### Explanation:

It is common in investment agreements for certain actions of the investee business to be subject to the prior consent of the fund (e.g., the adoption of the forthcoming year's business plan, substantial capital expenditure or the transfer of the shares of a director of the investee business). These are commonly called 'investor consents'.

Where the manager has appointed individuals to the investee business's decision-making body, their consent may also be required before certain action can be undertaken, although they will often be under a duty to act in the best interests of the investee business, rather than the fund.

The availability and level of investor consents appropriate will vary depending on the size and nature of the fund's investment.

**Recommendation:**

The manager should consider requiring the investee business to obtain consent for the following:

- significant developments in the business (e.g., capital expenditure, new issues of capital, changes to the investee business's constitution);
- changes in debt structure;
- changes of control, acquisition or disposal of shares by other shareholders;
- adoption of a new business plan;
- changes to the investee business's key management or their remuneration; and
- developments in the business which will materially change the nature of the business in which the fund has invested.

Investor consents, whilst needing to be comprehensive in scope, must not be so wide-ranging as to restrict the management team's ability to run the investee business or take up excessive amounts of the manager's time.

### **3.7 Co-operation with co-investors and syndicate partners**

**Question:**

What relationship should the manager have with co-investors and other members of syndicates in which it participates?

**Explanation:**

Where an investment has been syndicated or there are co-investors, a manager may not be able to control an investment and may have to co-operate with other shareholders in order to achieve defined goals and build a consensus as to appropriate actions.

**Recommendation:**

The manager should act in the interests of the fund and any other clients investing in the relevant investment it has (where appropriate, managing any conflicts of interest that may arise between them). Wherever possible, the manager should not accept any obligations in favour of other investors, unless it would be in the fund's interests to have some agreement or understanding with those investors.

### **3.8 Co-investment and parallel investment by the manager and its executives**

**Question:**

What issues should the manager consider regarding co-investment and parallel investment by itself, its associates or its executives?

**Explanation:**

Where the fund documentation permits the manager, its associates or its executives to co-invest or make parallel investments, there is potential for the fund's interests to be prejudiced.

**Recommendation:**

Details of co-investment arrangements should be disclosed to the fund's investors. To avoid the potential of prejudice to the fund's interest, it is recommended that the fund documentation only permits co-investment or parallel investment by the manager, its associates or its executives where investment and divestment is pro-rata to the fund, in the same instruments and on the same terms. If this recommendation is not followed, it is particularly important that the operation of the co-investment arrangements should be disclosed to the investors.

# Examples

## 3.9 Co-investment and parallel investments by fund investors and other third parties

### Question:

What issues should the manager consider regarding co-investment and parallel investments by fund investors and other third parties?

### Explanation:

In some circumstances, investors in the fund or other third parties with whom the manager has some relationship may wish to invest directly in an investee business that the manager is considering investing in on behalf of the fund. Allowing such direct investment can be detrimental to the fund's interests; if the investment proves to be successful and the fund's investment was reduced to allow direct investment, the return to investors will be reduced.

### Recommendation:

The manager should determine the fund's appetite for each investment and only after that should co-investment and/or parallel investments be considered (apart from pre-arranged and disclosed co-investment arrangements or where the co-investor lends special value to the transaction). Details of co-investment arrangements should be disclosed to the fund's investors.

When a conflict of interest arises it should be resolved in accordance with the manager's conflict of interest resolution procedures.

## 3.10 Divestment planning

### Question:

How should the manager plan for the disposal of an investment?

### Explanation:

It is important to ensure that before an investment is made key investors agree a common strategy for realising the investment.

It will not always be possible to achieve the strategy, for example if the investment fails to perform and/or purchasers decline to come forward, but it is desirable to agree a strategy in advance.

### Recommendation:

The divestment process should be discussed with co-investors, other syndicate members and management of the investee business before the initial investment. The manager should seek to ensure that, on investment, it negotiates suitable mechanisms to ensure that any deadlock regarding divestment of an investment can be resolved in a manner appropriate for the fund.

## 4 Management of an investment

Good management of an investment is essential if a fund is to maximise its returns. Value in an investment can be wasted and opportunities missed if this part of the investment process is not undertaken properly. The principles of acting with due skill, care and diligence, and managing conflicts of interest effectively are particularly relevant in this context.

#### 4.1 Investment monitoring

**Question:**

How should the manager monitor the investment?

**Explanation:**

Investment agreements should ensure that the manager receives sufficient information from investee businesses to allow it to monitor and appraise the performance of the investment. This monitoring should allow the manager to confirm that the investment is progressing in accordance with the relevant business plan and should provide sufficient information to identify any failures to meet targets or milestones and to formulate remedial plans where necessary.

Information provided to a manager pursuant to an investment agreement is likely to remain the property of the investee business and the manager may not be free to disclose it or use it as it sees fit, except for the purposes of the fund's investment.

**Recommendation:**

The manager should ensure that it dedicates sufficient time and resources to monitoring of the investments of the fund.

Investment agreements should allow the manager to receive sufficient and timely information from investee businesses to monitor and appraise the investment, to confirm that the investment is progressing according to the relevant business plan, to identify any failures to meet targets and to recommend any remedial or alternative courses of action.

The manager must not disclose any information that it may receive from an investee business in a manner which may breach any duty of confidence that it may owe to the investee business but should seek to negotiate appropriate rights to disclose information to investors.

The manager should ensure that it apportions responsibility for monitoring investments appropriately. The manager should prepare regular written analyses of investments which should be reviewed by the senior management of the manager. The reviews may address performance of the investment against agreed targets and milestones (e.g., the business plan for the investment), note significant developments in the near future and since the last review, and recommend any remedial action that the manager should consider taking.

#### 4.2 Exercise of investor consents

**Question:**

What issues should the manager take into account when considering giving consents to an investee business?

**Explanation:**

Normally, an investment will be structured in such a way that certain proposals of the investee business will require consent from investors, including the fund. These consents may be shareholder consents or consents required from members of the investee business' board where the manager has appointed an executive to the board.

**Recommendation:**

The manager must ensure that when giving or withholding consent it acts in the best interests of the fund. Executives who are on the board of an investee business normally have to act in the best interests of the investee company. It may therefore be advisable to have a different executive exercising shareholder consents.

# Examples

## 4.3 Follow-on investments

### Question:

What provision should the manager make for follow-on investments?

### Explanation:

It may be necessary or desirable to make further investments into an investee business (for example, to fund future expansion plans or to re-finance a poorly performing company). The opportunity to make a follow-on investment in a successful investee business may give rise to a conflict of interest where the manager is managing more than one fund that has invested, or where the manager or its associates have invested directly in the investee business.

### Recommendation:

The fund's constitution should make provision for further investments into an investee business after a fund's investment period through provisions allowing the manager to retain an appropriate amount of funds to make appropriate follow-on investment(s) where necessary.

Decisions to make such follow-on investments should be made in the same manner as the original decision to invest and should be supported by adequate written evidence that demonstrates a clear benefit to the fund in making the further investment.

Any conflict of interest that arises out of an opportunity to make a follow-on investment should be resolved in accordance with the manager's conflict of interest resolution procedures.

## 4.4 Under-performing investments

### Question:

What steps should be taken when an investment fails to meet the targets established in its business plan?

### Explanation:

Unfortunately, not all investments will succeed, and whilst it may not be possible to save an investment made into a company with a fundamental structural problem, it may be possible to turn around a poor performance record or preserve value in an investment through:

- meeting with the management of the investee business to discuss performance and to agree methods on which turnaround can be achieved;
- increasing monitoring of the investment and meetings with management;
- agreeing remedial action;
- changing management – introducing changes in the investee business' management team; and
- negotiating with other providers of finance – agreeing to reschedule (e.g., loan or fixed payment commitments, to allow a company 'breathing room').

Managers should be aware that whilst bankruptcy laws may vary from country to country, they may impose a personal liability on a company's directors (including 'shadow' directors) if they permit that company to carry on trading in certain circumstances.

### Recommendation:

When information received as part of the monitoring process reveals that an investment is not 'performing' the manager should meet with the management of the investee business and, as necessary, other providers of finance to agree written remedial action plans and any additional information requirements.

When managing under-performing investments, the manager should ensure that sufficient resources remain committed to the monitoring and management of more successful investments. If the manager has appointed director(s) to the board, consideration should be given to having a different executive responsible for exercising the fund's rights as shareholder to reduce conflicts of interest.

## 5 Disposal of an investment

Disposal of an investment is a vital stage in the life of a fund. The outcome of the disposal process will determine the return to investors and will establish the basis on which the manager's performance will be judged (by the investors and those to whom the manager markets future initiatives).

The disposal process will also involve interaction with other parties, such as co-investors and the investee business, and can also give rise to conflicts of interest. It is important that these are appropriately managed by the manager.

### 5.1 Implementation of divestment planning

#### Question:

When should the sale of an investment take place?

#### Explanation:

Establishing the appropriate point to dispose of an investment is not simply a matter of the manager exercising its judgment to decide when value has been maximised or the extent of a loss minimised. There may be considerations other than 'paper' profits or loss that are relevant when considering disposal (e.g., interests of strategic investors in the fund, the powers of other investors and the likelihood of the disposal yielding a cash return). The manager may also have set out a divestment strategy to investors in the fund and co-investors and other syndicate members, which could impact upon when an investment can be realised.

#### Recommendation:

The manager should, as far as is possible, dispose of investments at a time and in a manner that accords with any existing divestment strategy and maximises the return to the investors.

### 5.2 Responsibility for divestment decision-making

#### Question:

Who should make the decision to realise an investment?

#### Explanation:

Any decision to realise an investment involves a comparison of the present certain value of an investment, its potential future value and the opportunities to realise that value in the future. It is important that the decision to dispose of an investment is subject to the same checks and procedures that an investment decision is subject to.

#### Recommendation:

The manager should establish a process for deciding whether and how to dispose of an investment. Wherever possible this process should mirror the process that is followed when considering an investment decision and any proposed divestment should be subject to equally rigorous checks.

# Examples

## 5.3 Warranties and indemnities

### Question:

Should warranties and indemnities be given on exit?

### Explanation:

A purchaser of an investee business may seek a range of warranties and indemnities from the fund. Negotiation over these will often be a key issue for the manager when disposing of an investment. In negotiating, the manager must consider the risks in giving such warranties and indemnities against any enhancement of return that they could bring.

When deciding whether to give a warranty or indemnity, the manager should also take into account the remaining life of the fund and the fact that in the future it may be difficult to draw down cash to meet liabilities in the event of a claim.

### Recommendation:

Managers should normally only give warranties and indemnities on a disposal where this is expected to produce an enhanced return for investors. The liability under such clauses should normally be capped in quantum and time and the manager should seek to ensure that the fund is able to meet these liabilities so long as they remain outstanding. The manager may also take out insurance that affects the fund's ability to give warranties and indemnities.

## 5.4 Should cash always be taken on realisation or can shares/earn-outs be accepted?

### Question:

Should a cash exit always be sought?

### Explanation:

A manager's obligation is to seek the best returns from an investment for the fund and the manager must consider opportunities to effect non-cash disposals in light of this. It may be that, for example, there is no cash purchaser for an investment, that a cash price is offered but at a lower valuation than a 'share for share' swap into a quoted vehicle or that the fund can participate in the future value of an investment through an earn-out.

Any decision to accept a non-cash disposal is also likely to involve additional costs. For example, there will be a cost in safeguarding and administering any quoted investments held by the fund. There are also risks of falls in the market.

Cash returned is also an important measure of performance; investors may be reluctant to accept distributions in specie and there may be restrictions upon a holder's ability to sell quoted securities, also known as 'lock-up periods'.

### Recommendation:

Managers should carefully assess any non-cash offer consideration in an exit balancing the immediate value of any cash offer, the life cycle of the fund, the need to return cash to investors, the potential future value and exit opportunities in any securities offered, and the ability to hedge against downside market risks.

## 5.5 Sales to another fund managed by the same manager

### Question:

Should one fund managed by the manager be permitted to purchase the investments of another?

### Explanation:

Whilst it might be the right time for one fund to exit (for example, because of the life cycle of a fund), there may still be future value which can be created in the investment through a secondary buyout.



There are in these circumstances clear conflict of interest issues: for example, price and whether warranties are to be given and the conditions attaching to them.

**Recommendation:**

The sales of investments between funds operated by the same manager is not recommended and could lead to legal consequences or be forbidden in some jurisdictions.

Managers should ensure that the investors in both funds and the relevant investors' committees are fully aware of the transaction.

Whenever considering such a deal a manager must be able to demonstrate that no fund has been preferred at the expense of another (for example, by arms length negotiation or obtaining an independent valuation of the investment).

## 5.6 Managing quoted investments

**Question:**

What issues should the manager consider when managing quoted investments?

**Explanation:**

There are a number of issues that affect the manager when it holds quoted investments. Dealing in such investments will often be subject to additional regulation (such as prohibitions on insider dealing and market abuse). The manager may also need to consider the impact of its dealings on the market in the investee business' securities.

In many jurisdictions it is illegal to deal in securities issued by quoted companies when in possession of unpublished price-sensitive information relating to that company's business. Where a manager has maintained a close relationship with an investee business after a flotation there are circumstances where the manager may receive such information. This may prevent the manager from selling an investment until that information is public. Market rules may also prescribe certain periods in which the investee business directors may not deal in investments. These rules may also be relevant where an employee of the manager remains a director following a flotation. The risk of the manager committing an insider dealing offence is increased where the manager maintains a presence on the investee business' board.

In many jurisdictions insider dealing is a criminal offence, punishable by imprisonment and substantial fines. Insider dealing may also allow anyone who has suffered a loss as a result of the manager's conduct to recover any loss that they have suffered from the manager.

**Recommendation:**

The manager should adopt appropriate policies on the management of quoted securities, including considering whether it is appropriate to retain a seat on the board.

The manager must ensure that it does not breach prohibitions on insider dealing and market abuse when managing quoted investments.

Where the manager retains a relationship with an investee business whose investments are quoted, the manager should ensure that it does not utilise any confidential information it acquires to determine or influence its disposal policy, unless that information is available to all of the investee business' shareholders.

# Examples

## 6 Distribution

Distributions to investors during the life of a fund and during its liquidation are an important obligation of the manager, as the returns distributed to investors are the most tangible measure of the manager's performance. The manager must ensure that it effects distributions as required by the fund's constitution at all times.

### 6.1 Distribution provisions in constitution

**Question:**

What provisions should be made for distributions from a fund to investors?

**Explanation:**

Determining the manner in which returns on the investment are provided to investors is an important issue. By addressing relevant issues, the manager will ensure that disputes do not arise as to the apportionment of profits and losses arising amongst investors.

**Recommendation:**

The fund's constitutional documents should include adequate provisions on distributions. These provisions should address at least the following issues:

- when distributions will be made of capital and of income;
- how profits and losses will be allocated and distributions made between investors (and how they will relate to carried interest);
- how distribution will affect carried interest;
- the extent of the manager's discretion to effect distributions;
- whether distributions can be made in specie;
- the extent to which distributions will take account of taxation liabilities;
- whether or not the manager is permitted to re-invest dividend and other income or otherwise; and
- how any distributions in specie will be valued (generally this should be on a conservative basis).

### 6.2 Timing of distributions

**Question:**

When should distributions be made?

**Explanation:**

Normally investors expect distributions to be made as soon as possible after a realisation. Prompt distributions improve the IRR. However, if excessive distributions are made the fund might be unable to meet its liabilities in future.

**Recommendation:**

Distributions should be made in accordance with the relevant provisions in the fund's constitutional documents.

Before making a distribution, the manager should consider the fund's current and foreseeable liabilities and assets (including liabilities for tax, escrow and clawback provisions and contingent liabilities such as those under warranties and indemnities). Distributions should not be made which risk the fund being unable to meet its liabilities in the future.

Before making a distribution in specie, any restrictions on transfer of the relevant investments should be considered.

## 7 Investor relations

Ongoing relations with investors are a vital issue for the manager to address to ensure transparency. Implementing appropriate processes will also allow the manager to operate more efficiently, by reducing the number of 'ad hoc' enquiries that the manager receives from investors. In many jurisdictions there will be obligations imposed on the manager to report to investors, although on commercial grounds many managers exceed these obligations.

### 7.1 Reporting obligations

**Question:**

What reports should the manager make to investors?

**Explanation:**

Reporting obligations are important for investors wishing to monitor the status of their investment. The nature of funds means that valuing an investment on an ongoing basis is difficult and, without information from the manager, investors cannot effectively monitor the performance of the fund.

**Recommendation:**

The EVCA Valuation and Reporting Guidelines should be followed. Wherever possible these guidelines should be followed in accordance with the Level 2 requirements set out in them. The fund's constitutional documents should contain provisions regarding the manager's obligations to provide reports to investors. These provisions should address the following issues:

- the frequency of reports to be made;
- the information to be contained in these reports;
- the manner in which the reports are to be made (e.g., in writing, by e-mail, in secure website); and
- the basis of valuation that will be used for such reports.

### 7.2 Transparency

**Question:**

What general conduct issues should the manager consider with regard to investor relations?

**Explanation:**

Relations with investors is an area where, unless it takes sufficient care, the manager can prejudice the interests of some or all investors in a fund. At the same time, in a number of circumstances a manager may be subject to confidentiality obligations to investee businesses or third parties or may be subject to restrictions relating to insider dealing or market abuse.

The manager may also have to consider the need to disclose significant issues to investors outside of established reporting obligations.

**Recommendation:**

The manager should seek transparency in its relationship with investors by ensuring that all investors receive all significant information regarding the fund in a clear and timely manner, provided that communicating such information is permitted by law. The manager should not breach confidentiality obligations binding on it but should seek to be relieved of such obligations if they prevent proper reporting to investors.

# Examples

The manager should follow the agreed procedures for disclosure of conflicts of interest to investors. Certain investors and types of investor will require different information, or information presented in a different way, to satisfy their own tax, regulatory or commercial obligations. Where practicable, the manager should comply with those requests.

Although it is not obliged to provide all information requested by one investor to other investors for whom it may not be relevant, the manager should ensure that there is parity of treatment of investors and that all investors are provided with key, relevant information regarding the fund promptly (and normally at the same time).

## 7.3 Investor relations generally

### Question:

What other arrangements should the manager make with regard to investor relations?

### Explanation:

It is of increasing importance to investors that they have a relationship with the manager on an ongoing basis throughout the lifetime of the fund.

### Recommendation:

Suitable arrangements should be made to respond to reasonable queries from investors promptly as they arise, as well as complying with the obligations in the constitutional documents on reporting and, if relevant, meetings.

## 7.4 Investors' committee

### Question:

Should an investors' committee be established?

### Explanation:

To make the process of obtaining consents from investors and giving them informal updates easier, particularly when there are many investors in a fund, it is possible to set up a representative investors' committee to liaise with the manager on behalf of all investors. It can also be a useful mechanism for the manager to obtain advice on management of conflicts of interest and agree any changes to valuation principles.

### Recommendation:

An investors' committee or advisory committee may be established to carry out certain functions, such as:

- (a) giving consent on behalf of investors if the manager or its associates or clients have conflicts of interest or duty with the fund;
- (b) receiving informal reports and providing feedback on other matters raised by the manager;
- (c) providing investors with a forum for liaising with the manager;
- (d) representing investors in relation to key man provisions; and
- (e) reviewing valuations. (NB: there is no suggestion that this committee should set, formulate or approve the valuations only that the completed valuations should be explained to this body that should be able to give its comments).

The powers of any such committee should be set out in the fund's constitutional documents. The investors' committee should not normally be able to influence the manager's investment decisions, as this can compromise investors' limited liability and may give rise to issues relating to regulation of merger control.

## 8 Winding up of a fund

The liquidation of a fund must be undertaken with care by the manager to ensure that neither the fund, the investors or the manager are exposed to unacceptable potential liabilities following liquidation.

### 8.1 Liquidation

**Question:**

What issues should the manager address on liquidation?

**Explanation:**

The liquidation of a fund will, generally, mean that the assets will be distributed to investors. This means that if claims are subsequently brought against the fund, there are unlikely to be assets available to meet those claims.

**Recommendation:**

On liquidation, the manager should make a thorough assessment of the risk of claims against the fund and should ensure suitable sums are held in escrow to meet such claims. Distributions should be made on the same basis as during the life of the fund, during the period specified by the fund documentation.

### 8.2 Fund documentation

**Question:**

What provisions should the fund documentation include on liquidation?

**Explanation:**

The manager's powers and responsibilities on liquidation will usually be set out in the fund's constitution. It is important that these provisions are clear and exhaustive to reduce the likelihood of disputes on liquidation.

**Recommendation:**

The fund's constitution should include provisions on liquidation addressing:

- the manager's power to realise the fund's investments;
- the extent of investors' liability following liquidation;
- the period in which liquidation should be effected; and
- escrow and/or clawback arrangements to cover potential future liabilities.

## 9 Management of multiple funds

A successful manager will often manage more than one fund which is active in the same market. This can give rise to conflicts of interest and make it difficult for the manager to act in the best interests of all of the funds it manages.

### 9.1 Conflicts of interest

**Question:**

What should a manager do when a conflict of interest arises between funds that it manages?

**Explanation:**

Conflicts of interest can arise relatively easily where a manager manages multiple funds. For example, one fund managed by a manager may acquire an investment being disposed by another, or opportunities for follow-on investment may arise that cannot be exploited by both funds.

# Examples

Conflicts can also arise when multiple funds hold investments in an investee business and a disposal opportunity arises. It is possible that it may not be in the best interests of all funds to dispose of the investment (e.g., where one invested on terms that mean disposal would crystallise a loss to that fund, whilst another fund would realise a profit).

**Recommendation:**

The manager should establish procedures to identify, disclose and resolve conflicts and should implement transparent procedures to resolve them. The procedures should be agreed with investors and included in the funds' constitutional documents.

## 9.2 Establishment of new funds

**Question:**

When can the manager establish further funds?

**Explanation:**

The manager could prejudice the interests of investors in an existing fund by establishing a similar fund soon after establishing the existing fund. Doing so can dilute the return to investors in the existing fund and compromise the manager's ability to implement the existing fund's investment policy.

**Recommendation:**

A manager should implement processes to prevent the establishment of further funds at inappropriate times. In general, a further fund should not be established until the existing fund is substantially invested. Specific limits are often set out in the fund document.

## 10 Manager's internal organisation

The manager has responsibility to ensure that it has adequate resources to invest, carry out post-investment management and divest investee businesses. This includes in particular human resources and financial resources.

### 10.1 Human resources

**Question:**

What responsibilities does a manager have with regard to human resources?

**Explanation:**

Employees and others engaged by the manager are a vital resource. If this resource is not adequate or is not maintained, the manager may not be able to implement the investment policy.

**Recommendation:**

The manager should, at all times, have a staff of adequate size and appropriate competence to ensure that it is able to fulfil its obligations to all funds under management. These staff should be appropriately allocated.

The manager should implement human resources management processes to administer appropriate functions (such as payment of taxation and social security contributions) and to implement any training and development policies.

The manager should implement arrangements requiring its employees to conduct themselves in an appropriate manner.

The manager should ensure that it implements appropriate succession planning arrangements to ensure that the quality of its key personnel is maintained over time.

## 10.2 Incentivisation

### Question:

How should the manager incentivise its staff?

### Explanation:

An incentivised and motivated team is vital to the success of the manager. By adopting appropriate policies to maintain a stable and motivated team, the manager is likely to improve returns to investors.

### Recommendation:

The manager should ensure suitable remuneration for its staff. The manager should ensure that carried interest and similar arrangements are structured in a balanced manner to motivate and incentivise the team and its key members throughout the life of the fund. The manager should also ensure that there are provisions that set out the extent to which leavers are permitted to participate in carried interest arrangements upon leaving the manager.

## 10.3 Financial resources

### Question:

What financial resources should the manager maintain?

### Explanation:

It is important that the manager monitors its own financial resources to ensure that they remain sufficient to allow the manager to trade and to implement the investment policies of funds under management.

### Recommendation:

The manager should maintain adequate financial resources to allow it to continue trading during the life of all funds under management.

The manager should implement internal financial reporting procedures to ensure that it monitors effectively its financial position on an ongoing basis. If the manager becomes aware that its financial resources have been seriously eroded, it should liaise with investors in funds under management to agree measures to remedy the situation.

## 10.4 Procedures and organisation

### Question:

What other procedures and organisational measures should the manager implement?

### Explanation:

Whilst the efficient operation of the manager will be ensured by adhering to general principles of good business management, there are certain issues that are specific to the private equity and venture capital industry that the manager should address.

### Recommendation:

The manager should implement procedures to address the following issues:

- personal dealing in investments by staff;
- decision-making on investment and disposal on behalf of funds;
- storage of documents and record-keeping;
- outsourcing of material functions (particularly where they may impact on the management of funds);
- prevention of money laundering;
- business continuity in the case of a disaster;
- insurance requirements to protect both the manager and the funds it manages; and
- the protection of the fund and the manager in the event of key employee departures.

# Examples

## 10.5 Segregation of fund assets

### Question:

Should the manager make particular arrangements regarding fund investments and cash under its control?

### Explanation:

In the event of the manager becoming insolvent or being the subject of legal proceedings, it is essential that assets that it holds or controls on behalf of funds are protected and cannot be used to discharge liabilities of the manager. To ensure that this is the case, fund assets must be segregated from the manager's own assets.

### Recommendation:

The manager should make appropriate arrangements to ensure that fund assets (including cash) are segregated from its own assets.

When the manager achieves this by lodging assets with an external custodian, the manager should ensure that such assets are appropriately protected by the custodian and that there is a suitable written agreement with the custodian.

## 10.6 Internal reviews and controls

### Question:

What internal reviews and controls should be established to ensure that the interests of investors are protected and the terms of the relevant agreements adhered to?

### Explanation:

Investors place a high degree of trust in a manager and when making the investment surrender control of their money for long periods with little real prospect of being able to withdraw it rapidly.

The best assurance and control mechanisms are regular information and meetings with senior management and their commitment to the investors. Formal procedural steps should however also be put in place that provide a reasonable level of assurance that the terms of the agreements and any particular laws are being adhered to.

### Recommendation:

A manager should make provision for internal review procedures which allow the board of the manager to gain a reasonable level of comfort that the terms of the agreement with any customer and any applicable legal requirements are being followed.

These procedures should be overseen by a member of staff of sufficient seniority and independence and with sufficient resources to ensure that they are undertaken effectively.

## 10.7 External assistance

### Question:

What other resources should the manager have available?

### Explanation:

Managers vary in their size and experience but no manager is likely to have all the internal resources necessary to deal with every matter for which it is responsible.

The establishment of a fund and its operation frequently involve specialist considerations in many jurisdictions.

### Recommendation:

A manager should obtain appropriate specialist advice in order to carry out its duties. Legal, tax and accountancy advice will almost always be necessary and sometimes other specialist consultants (e.g., environmental, scientific or technological) may be requested.



## 1 Definitions

In this document the following terms have the following meanings:

<b>'Fund'</b>	means a private equity or venture capital fund;
<b>'Initiative'</b>	means a proposal for investors to make an investment in a fund during the stages before the fund structure is finalised and the manager of the fund is established;
<b>'Initiators'</b>	means the manager, sponsor or other people or entities who are proposing that a fund should be set up and/or are promoting it to potential investors;
<b>'Investors'</b>	means the group of persons and/or companies investing in a fund;
<b>'Manager'</b>	has the same meaning as 'fund operator' and means the person or entity who is responsible for making the investment decisions for a fund and operating the fund on an ongoing basis once it is established. In some circumstances (e.g., in relation to the investment process), it may also mean those who advise and/or arrange deals for a fund.

## 2 List of questions addressed in 'Examples' section

- 1.1 What issues should the initiators consider and address during their early stage planning?
- 1.2 What issues regarding potential investors and marketing of the initiative should be considered at the early stages?
- 1.3 What issues on the structure of the initiative should the initiators consider during the early stage planning?
- 2.1 How should responsibility during the fundraising period and prior to the establishment of the fund structure be apportioned?
- 2.2 What potential investors should the initiators target for an initiative?
- 2.3 Should the initiators be responsible for controlling the origin of the funds offered for investment in a fund with a view to preventing money laundering or other illicit practices?
- 2.4 What issues regarding investors should the initiators consider?
- 2.5 Should different investors be offered different terms?
- 2.6 What documentation should the initiators produce with respect to the fund and what matters should it address?
- 2.7 What responsibilities arise with respect to marketing presentations?
- 2.8 What information should be provided about the track record of the management team and how far should forecasts be made?
- 2.9 Is there any specific period during which fundraising must be completed?
- 3.1 What due diligence should be done when evaluating an investment and to what level of detail?
- 3.2 How should a decision to invest be reached?
- 3.3 What issues should the manager consider when structuring and negotiating an investment?
- 3.4 Through what mechanism should the manager seek to ensure that the fund is able to influence an investee business?
- 3.5 What should be included in the investment documents?
- 3.6 When should a manager's consent to actions of the investee business be necessary?
- 3.7 What relationship should the manager have with co-investors and other members of syndicates in which it participates?

# Annex

- 3.8** What issues should the manager consider regarding coinvestment and parallel investments by itself, its associates or its executives?
- 3.9** What issues should the manager consider regarding coinvestment and parallel investments by fund investors and other third parties?
- 3.10** How should the manager plan for the disposal of an investment?
- 4.1** How should the manager monitor the investment?
- 4.2** What issues should the manager take into account when considering giving consents to an investee business?
- 4.3** What provision should the manager make for follow-on investments?
- 4.4** What steps should be taken when an investment fails to meet the targets established in its business plan?
- 5.1** When should the sale of an investment take place?
- 5.2** Who should make the decision to realise an investment?
- 5.3** Should warranties and indemnities be given on exit?
- 5.4** Should a cash exit always be sought?
- 5.5** Should one fund managed by the manager be permitted to purchase the investments of another?
- 5.6** What issues should the manager consider when managing quoted investments?
- 6.1** What provisions should be made for distributions from a fund to investors?
- 6.2** When should distributions be made?
- 7.1** What reports should the manager make to investors?
- 7.2** What general conduct issues should the manager consider with regard to investor relations?
- 7.3** What other arrangements should the manager make with regard to investor relations?
- 7.4** Should an investors' committee be established?
- 8.1** What issues should the manager address on liquidation?
- 8.2** What provisions should the fund documentation include on liquidation?
- 9.1** What should a manager do when a conflict of interest arises between funds that it manages?
- 9.2** When can the manager establish further funds?
- 10.1** What responsibilities does a manager have with regard to human resources?
- 10.2** How should the manager incentivise its staff?
- 10.3** What financial resources should the manager maintain?
- 10.4** What other procedures and organisational measures should the manager implement?
- 10.5** Should the manager make particular arrangements regarding fund investments and cash under its control?
- 10.6** What internal reviews and controls should be established to ensure that the interests of investors are protected and the terms of the relevant agreements adhered to?
- 10.7** What other resources should the manager have available?





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