

# EVCA Corporate Governance Guidelines

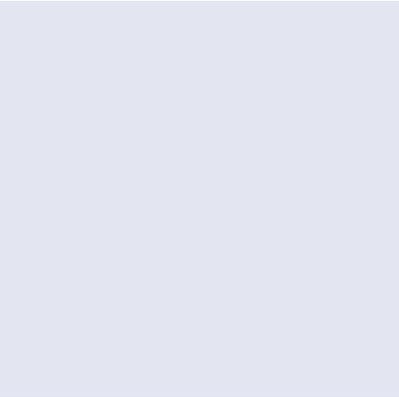
Guidelines and good practice in the management of privately held companies  
in the private equity and venture capital industry



June 2005



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

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### **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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# Foreword

## 1 Foreword

Private equity and venture capital backed companies have high standards of governance because general partners demand rigorous monitoring and reporting, and sit on company boards. Indeed, the private equity and venture capital industry has been instrumental in developing corporate governance standards in unlisted companies over the past two decades and has been hugely successful in promoting the concept that good corporate governance is a key element in value creation.

To help further enhance awareness the industry's leading role in this field, EVCA set out to produce common guidelines and good practice in the management of privately held companies in the private equity and venture capital industry. The initiative was warmly welcomed by European and International policy makers, particularly given the increased focus on corporate governance issues.

The guidelines were discussed and written over a 12-month period by the EVCA Corporate Governance Working Group, which consisted of industry practitioners, advisors and other stakeholders with both European and broader International perspectives. During the drafting process, the Working Group also took the time to respond to the European Commission's consultation exercises further to their action plan to modernise European Union corporate governance and company law.

The principles set out in these guidelines are intended to be multi-jurisdictional and be applied to all stages of the private equity and venture capital business cycle, while recognising the specific activities that take place will vary in different circumstances.

EVCA would like to thank the members of the Working Group for their enthusiasm, insights and hard work in producing these guidelines.

We would also like to thank all EVCA members who took the time to respond to and contribute to the consultation exercise, as well as the OECD and the European Commission.

These guidelines will contribute to the further professionalisation of the private equity and venture capital industry and we warmly commend them to EVCA members and the wider industry.

Javier Echarri,  
*EVCA Secretary General*

# Introduction

## 2 Introduction

*“Corporate governance is one key element in improving economic efficiency and growth as well as enhancing investor confidence. Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”* OECD Principles of Corporate Governance, 2004.

Many sources of guidance exist on the principles of good governance and its application in business. So why does the European Private Equity and Venture Capital Association (EVCA) think it is necessary to produce these guidelines? These guidelines have been developed to highlight the unique position of the Private Equity and Venture Capital Investor.

Successful investment requires well-informed decision making at all levels and by all parties. At its core, good governance creates the environment for the attitudes, mechanisms and behaviours that allow this well-informed decision making to take place. Failures of governance lead to bad decisions and business failures. Where individuals can be relied upon to act with integrity a proliferation of guidance and the imposition of regulation is unnecessary. These guidelines aim to help members of the EVCA decide what acting with integrity means in the industry.

Private equity investing as represented by the EVCA membership is characterised by a number of features. The Private Equity and Venture Capital Investor brings deep industry focus and understanding to the particular business and its investments are characterised by a great deal of shareholder involvement in the strategy and direction of the investee company. The Private Equity and Venture Capital Investor takes a long term view of value creation and is seeking, as much as possible, the alignment of stakeholder interests in order to maximize value.

The private equity and venture capital industry has been instrumental in developing corporate governance standards in unlisted companies over the past two decades and the industry has been hugely successful in promoting the concept that good corporate governance is a key element in value creation. These guidelines gather together good practice existing within the industry to provide help and assistance to those working in the industry and those coming into contact with the industry for the first time.

In particular these guidelines should help the management of companies with private equity and venture capital backing understand better the approach taken by their Investors and the demands the relationship will put upon them.

The guidelines are drafted so as to be applicable to as wide a range of situations and circumstances as possible. No particular operational jurisdiction is envisaged and therefore references to shareholders, the board and management should be taken as functional titles rather than particular legal structures.

It is important to recognise that the private equity and venture capital industry encompasses a broad range of investment situations from seed and development capital to large leveraged buyouts. These principles set out in these guidelines are intended to be applied to all such investment situations while recognising that the specific activities that take place will differ in different circumstances.

# Introduction

Private equity and venture capital investment follows a cycle of purchase, holding and then divestment. These principles set out in these guidelines are intended to be applied to all stages of the cycle while recognising that the specific activities that take place will differ in different circumstances.

Private equity and venture capital investment also may give rise to situations in which there is a conflict between the competing interests of various parties to a business, transaction or negotiation. It is the intention of these guidelines that those participants in the private equity and venture capital industry who seek to follow them will seek to manage such conflicts openly, honestly and with integrity.

Section 3 of this document sets out certain principles which underlie good governance in the private equity and venture capital industry. Section 4 focuses on the conduct expected of an owner of shares, of whatever proportion, in a private company. Section 5 relates to the conduct of private equity and venture capital members of the boards of private companies. Section 6 deals with responsibilities within the private company for management.

**Each of sections 4 to 6 presents examples of current good practice and these examples should be thought of as illustrative rather than exhaustive.**

# Good governance

## 3 Principles of good governance for private equity and venture capital investing

The following underlying principles drive these guidelines. There may be instances when principles are in conflict with each other. In such circumstances the Private Equity and Venture Capital Investor will above all seek to act within the law and with integrity.

### 3.1 Law and regulations

The conduct of business should always be in accordance with applicable laws and regulations of the jurisdictions in which the business takes place including, but not exclusively, fiscal legislation, competition legislation, consumer and data protection legislation and anti-money laundering measures.

### 3.2 Integrity

The Private Equity and Venture Capital Investor will act with integrity towards the investee company and its stakeholders and will seek to ensure that the investee company conducts its business with integrity.

### 3.3 Partnership

The Private Equity and Venture Capital Investor offers an investment solution that establishes a relationship in partnership with the investee company that is defined by negotiated, mutually agreed rights and responsibilities for all parties. This relationship between partners takes into account that the Private Equity and Venture Capital Investor actively contributes to the success of the investee company.

### 3.4 The long term view

The business model of the Private Equity and Venture Capital Investor aims to create value by taking a long term view of investment and supporting management of the investee company in the achievement of long term objectives and strategies.

### 3.5 Respect for stakeholders

The conduct of business will be successful in the long term where the interests of stakeholders, including investment fund providers (i.e. limited partners), the fund manager, the board of directors, company management, employees, customers, suppliers and other stakeholders are respected and in which conflicts of interest are managed appropriately.

### 3.6 Transparency

Success for a Private Equity and Venture Capital Investor depends upon clear disclosure and timely communication of relevant and material information to facilitate high quality decision-making. The Private Equity and Venture Capital Investor will seek to establish transparent communication with investee company management.

### 3.7 Confidentiality

The Private Equity and Venture Capital Investor will treat investee company information as confidential and will not make use of that information in a way that is detrimental to the investee company.

# Principles of conduct

## 4 Principles of conduct as shareholder

As a shareholder in the business of the investee company the Private Equity and Venture Capital Investor has responsibilities and should exercise those responsibilities proactively.

### 4.1 Responsibilities to other shareholders in the same or other classes of shares and to bondholders

#### Question:

How should the Private Equity and Venture Capital Investor conduct themselves in relation to other investors in the business?

#### Explanation:

It is common practice in the industry for different classes of individuals to acquire different types of instruments according to their position in the deal, the nature and level of the risk they are taking and the nature of the value they are bringing to the investment.

The returns for each type of investment whether equity or debt will frequently be variable dependant upon certain outcomes. It is therefore possible that conflicts may arise between different classes of securities if expectations are unclear or based on erroneous assumptions or if performance is not as intended at the outset.

#### Recommendation:

The negotiation of shareholder rights should be conducted openly and with clarity. Due consideration should be given in advance to potential areas of conflict and where conflict does arise the resolution of that conflict should, to the extent possible, be conducted fairly.

### 4.2 Responsibilities in relation to strategy

#### Question:

To what extent is the Private Equity and Venture Capital Investor responsible for the definition and execution of corporate strategy?

#### Explanation:

At investment the Private Equity and Venture Capital Investor is normally supporting a specific strategy, business plan and management team. Frequently, through the negotiating process leading up to investment the Private Equity and Venture Capital Investor will have had significant input in determining corporate strategy. Over a period of time, the business strategy may need to be refined and amended.

#### Recommendation:

The Private Equity and Venture Capital Investor should participate actively as shareholder in setting the initial strategy. The responsibility for execution of strategy sits with the board and executive management of the investee company. The Private Equity and Venture Capital Investor as shareholder should ensure that it is informed of, and takes an interest in, progress towards achievement of the strategy and should, where appropriate, be available to advise and assist where strategy needs to be refined and amended.

Further, the Private Equity and Venture Capital Investor should ensure that the investee company understands the importance of having the right tools and mechanisms in place for responsible, efficient and appropriate decision-making.

The degree of activism of Private Equity and Venture Capital Investors will vary according to the nature and structure of investments made and the investor should therefore ensure adequate involvement relative to the circumstances of a particular investment.

### 4.3 Responsibilities in relation to performance information

#### Question:

What are the Private Equity and Venture Capital Investor's responsibilities in relation to performance information?

#### Explanation:

Most jurisdictions have legislative obligations in relation to information to be provided to shareholders. However it is common practice for Private Equity and Venture Capital Investors to require more frequent and detailed information than required by legislation. In particular, the Private Equity and Venture Capital Investor may require more frequent and detailed information from the investee company in order to fulfil its obligations as fund manager to its own investors.

#### Recommendation:

The Private Equity and Venture Capital Investor should agree its non-legislative information requirements with management taking into account its own reporting obligations, its ability to perform its responsibilities as shareholder and the efficient and effective use of resources within the investee company.

The Private Equity and Venture Capital Investor should treat corporate information which it obtains with due consideration to commercial sensitivity and the needs of the investee company's other stakeholders.

### 4.4 Responsibilities in relation to the board

#### Question:

How should the Private Equity and Venture Capital Investor act in relation to the board?

#### Explanation:

The Private Equity and Venture Capital Investor will frequently appoint one or more members to the board of the investee company. There are different models commonly used by the industry including the appointment of one or more single directors who are members/employees of the Private Equity and Venture Capital Investor, the appointment of an independent non-executive chairman, the appointment of an independent non-executive board member and many other variations.

#### Recommendation:

The Private Equity and Venture Capital Investor should ensure that the board is structured and appointments are made in the best interests of the investee company.

The relationship between the board and the management of the investee company should be clear and supported by appropriate documentation of roles and responsibilities.

The Private Equity and Venture Capital Investor should ensure that appointees to the board be individuals of appropriate authority, skill and experience who can provide value and insight to the investee company.

The Private Equity and Venture Capital Investor should ensure that its appointee(s) fully understand their responsibilities both to the Private Equity and Venture Capital Investor and as an individual member of the board.

The Private Equity and Venture Capital Investor should encourage its board appointees to seek appropriate support and training to enable them to carry out their duties as board members to the best of their abilities.

The Private Equity and Venture Capital Investor should ensure that its board appointees do not have conflicts of interest with their role as members of the board.

# Principles of conduct

## 4.5 Responsibilities in relation to other stakeholders

### Question:

To what extent does the Private Equity and Venture Capital Investor have responsibilities in relation to other stakeholders?

### Explanation:

The nature of private equity and venture capital investments is such that there are frequently different classes of securities with different rights and obligations attached to them.

Additionally all private equity and venture capital investments will have other stakeholders including, but not restricted to, employees, customers, suppliers and the wider community.

### Recommendation:

The Private Equity and Venture Capital Investor should act openly, honestly and with integrity, balancing the interests of the company, the needs of effective decision making and the needs of other stakeholders.

# Principles of conduct

## 5 Principles of conduct as board member

The Private Equity and Venture Capital Investor will usually appoint one or more representatives to the board of the investee company. These individuals have responsibilities both towards the Private Equity and Venture Capital Investor who has arranged their appointment, and the investee company as a company director. They may be employees of the Private Equity and Venture Capital Investor or independent individuals with specific and appropriate industry knowledge and insight.

Additionally the investee company will have other board members whose position results from their responsibilities as managers of the business or who are representatives of other investors or are independent members of the board.

These principles apply to the whole board.

### 5.1 The board share a collective responsibility to ensure that the business strategy is set and kept under continuous review.

#### Question:

What are the key components of strategy that are the responsibility of the board?

#### Explanation:

Strategy consists of a number of core components. First and foremost is the development of sources of current and future revenue. Also important are the efficient and effective delivery of products and services, the development of competitive future products and services, and the effective use of available resources, including financial resources.

#### Recommendation:

All members of the board should seek to understand and support the business strategy and should challenge that strategy in the context of their individual understanding of market and product and service developments.

### 5.2 The board shares a collective responsibility for the identification and assessment of risk.

#### Question:

What is the board's role in relation to the identification and assessment of risk?

#### Explanation:

A key element of business strategy execution is the identification and assessment of risk, including the decisions as to what levels of risk are acceptable and how to manage the business accordingly.

#### Recommendation:

All members of the board should participate in risk identification and assessment.

### 5.3 The board shares a collective responsibility for the management of risk

#### Question:

What is the board's role in relation to the management of risk?

#### Explanation:

The components of risk management include the values of the organisation, the allocation of roles and responsibilities and the design and implementation of processes relating to the identification and control of risk, and the measurement of and reporting on performance.

# Principles of conduct

## Recommendation:

All members of the board have a responsibility towards risk identification and risk control and should take an active interest in establishing effective procedures which allow such identification and control of risk. Members of the board should actively seek assurance that risk management procedures are in place and are operating effectively.

## 5.4 The board are responsible for setting the remuneration of key executives and senior management.

### Question:

How should the board determine what a reasonable structure for and level of remuneration are?

### Explanation:

Remuneration and reward mechanisms in private equity and venture capital investments will include incentives which are determined by the Investor as well as those determined by the board.

The structure and remuneration of company executives and senior management should provide incentive for performance and reward for results. Balancing remuneration in the context of the relevant industry, the expertise and contribution of individuals and the long-term needs of the business are key roles of the board.

However, frequently in private equity and venture capital investing, the executives will have built in incentivisation at the time that the deal is structured and executed. The board's role is therefore more appropriately focussed on ensuring that incentives established continue to be appropriate as the circumstances of the business change.

### Recommendation:

The board should determine appropriate levels of remuneration of executives and should keep levels of remuneration under review. Conflicts of interest in establishing remuneration levels for board members should be avoided where possible and managed openly and constructively in all cases.

## 5.5 Management agreements

### Question:

What is the role of the management agreement?

### Explanation:

It is common practice for the conduct of the Private Equity and Venture Capital Investor, board and management of the investee company in relation to the management of the investee company to be set out in a management agreement at the time of the investment.

### Recommendation:

Where and to the extent appropriate, management agreements should be used to set out the interactions between the Private Equity and Venture Capital Investor, board and management of the investee company.

Where used, management agreements should be developed so as not to conflict with these guidelines.

# Principles of conduct

## 6 Principles of conduct for management

Management are those members of the board who have executive roles within the organisation and those other employees of the organisation who work with the executives to deliver the business strategy. Their responsibilities in relation to governance of the business include responsibility for the specific and detailed implementation of strategy.

### 6.1 Management are responsible for establishing the control environment

#### Question:

How should management go about establishing the control environment?

#### Explanation:

Management are responsible for ensuring that throughout the organisation employees recognise and respond to the need for integrity and ethical behaviour in relation to the achievement of the investee company's goals.

There are many different approaches available to follow so as to achieve good governance.

#### Recommendation:

Management should identify, select and adopt a particular appropriate control framework taking into account the size and complexity of the business and should apply that framework appropriately, consistently and effectively.

### 6.2 Management are responsible for establishing procedures for risk assessment

#### Question:

What should the procedures for risk assessment involve?

#### Explanation:

Risk assessment includes determining risk appetite, identifying specific risks, assessing the effectiveness of controls over specific risks and comparing residual risk to risk appetite. Effective procedures for risk assessment cover strategic and operational matters and operate on a regular and rolling basis.

Any procedures or processes introduced to an organisation should be subjected to an analysis comparing cost and benefits. The introduction of risk assessment procedures should acknowledge that much of what happens in business process is the proactive assessment and mitigation of risk and that therefore the introduction of risk assessment procedures is partly a matter of making explicit what is already in place.

#### Recommendation:

Risk assessment should cover at least:

- Strategic risk;
- Risk within the core business processes;
- Risk within the processes to manage resources.

Where appropriate, specialist help and advice should be sought when dealing with specific risk areas, for example market/public relations risk, treasury risk or information technology risk. The assessment of risk should be a regular on-going process and not a "once a year" exercise.

# Principles of conduct

## 6.3 Management are responsible for control activities

### Question:

How can management fulfil their obligations in respect of control activities?

### Explanation:

Control activities are those elements in business and financial processes which help prevent errors and omissions from occurring or which detect when errors or omissions have occurred.

In a well-governed organisation all members of the management team are aware of the importance of control activities and acknowledge their responsibility for control activities in their particular area. Control activity is not just the remit of one particular function within the organisation, e.g. finance, and it is important for all members of the management team to acknowledge this.

### Recommendation:

Management should conduct a review of control activities on a regular basis covering both the design and operation of those activities.

## 6.4 Management are responsible for the organisation's information and information systems and for communications within and outside the organisation

### Question:

What are management's responsibilities in relation to information?

### Explanation:

Effective management depends on the ability of individuals to make well-informed decisions. The accuracy, timeliness and relevance of information on which to base decisions is therefore of paramount importance.

Businesses generate large amounts of information: about customers and markets; historic, current and future performance; profitability, efficiency and effectiveness; and about risk and the management of risk.

### Recommendation:

Management should ensure that the organisation's information is:

- Accurately compiled;
- Clear and unambiguous;
- Kept secure and confidential; and
- Provided in a timely and appropriate manner

### Question:

What are management's responsibilities in relation to information systems?

### Explanation:

Business is largely dependent on up-to-date computer technology for the recording, storing, processing and reporting of information. The security and relevance of information systems are vital to the ability of the business to operate with continuous efficiency and effectiveness.

### Recommendation:

Management should assess regularly the security, relevance and reliability of their business information systems.

**Question:**

How should management approach communication of information?

**Explanation:**

Management need to communicate both internally within the organisation and externally. For example management will inform employees about strategy and expected performance and will give investors and commentators trading updates and other information.

**Recommendation:**

Internal and external communication should be:

- Based on accurate information and honest interpretation;
- Clear and unambiguous; and
- Timely

## **6.5 Principles of conduct in relation to monitoring of governance**

**Question:**

How regularly should management review the performance and appropriateness of their corporate governance procedures?

**Explanation:**

The governance of the business should be kept under continuous assessment to ensure that it remains appropriate. However, the frequency and detail of review will be different for different companies.

**Recommendation:**

Review should be timely but not excessive.

Management should establish a monitoring programme which as a minimum ensures that all elements of the corporate governance framework are reviewed at least annually.



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