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Professional Investment Standards in the Private Equity Sector: Selected Aspects

ABSTRACT

Investments made by private equity funds must abide by the highest ethical standards as the framework within which their stakeholders operate is very much based on broadly understood trust. The paper discusses selected professional standards especially important for private equity transactions. It is based on *the Professional Standards Handbook*, a set of principles focusing on integrity and acting with fairness, keeping one's promises, disclosing conflicts of interest, maintaining confidentiality, and promoting best practices for the benefit of sustainable investment and value creation. We also address the ESG issues which – besides financial aspects – exert substantial impact upon sustainable development of the private equity market. Ethical standards have gained in importance especially with the adoption of the AIFM Directive designed to regulate the operations of alternative investment funds.

Keywords: private equity, professional standards, AIFM Directive, sustainable investment, ESG

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1. Introduction

Private equity is a form of equity investment which consists in providing financial resources, knowledge and experience to start-ups as well as to established renowned companies.

Private equity investment allows enterprises which face difficulties in raising capital from other sources to achieve durable and sustainable growth.

In order to produce expected effects, the private equity investment process must, inter alia, abide by the highest ethical standards. Although the requirement concerns not only the industry in question and ethical standards should be observed in any investment process¹, due to the specificity of the environment in which private equity stakeholders operate, broadly understood trust is its crucial building block. That is why the private equity sector plays a key role in developing corporate governance standards in unlisted companies. The essence of corporate governance lies in acting in the joint interest of portfolio companies, General Partners, and Limited Partners, who are expected to operate in the environment that generates mechanisms and behaviours that ensure informed and efficient decision-making.

The goal of the paper is to identify selected professional standards that are especially important for investments made by private equity funds.

The paper is based on *the Code of Conduct* adopted for the first time in 2013 by Invest Europe². Since then, the code has been constantly improved and it fits and mirrors basic objectives of the AIFM Directive (AIFMD)³. It is known as the *Professional Standards Handbook*⁴ and contains a set of principles that should stand together as a whole. These principles are designed to ensure: acting with integrity, keeping one's promises, disclosing conflicts of interest, acting in fairness, maintaining confidentiality, and promoting best practices for the benefit of sustainable investment and value creation. All private equity funds, and members of Invest Europe in particular, are obliged to comply with the principles explained in *the Handbook*.

The long-term nature of the partnership formed through negotiations and ongoing cooperation between General Partners and Limited Partners sets private equity

¹ See P. Roszkowska, *Business ethics. Evidence from the world of finance*, SGH Publishing House, Warszawa 2015.

² The association bringing together the biggest private equity/venture capital funds operating in Europe; it was established in 1983, earlier known as EVCA; the earliest version of the Handbook was drafted in 1983 and since then it has constantly evolved.

³ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers.

⁴ *Professional Standards Handbook*, The Voice of Private Equity, Invest Europe, November 2015.

apart from other asset classes. Both parties expect from each other accountability, transparency, acting in accordance with expectations and timely delivery. General Partners, who are active and responsible owners of portfolio companies, operate in line with corporate governance principles striving to create lasting value. Relationships among the actors of the private equity market should also be based on mutual trust understood as social capital⁵.

2. Principles of Ethical Conduct to Be Observed Prior to an Investment

Principles of ethical conduct should be binding already at the early-stage planning, before a fund is formed. Pursuant to the AIFMD, there are specific registration requirements for those who market units or shares in funds and manage fund management entities⁶.

The primary goal of the AIFMD was to provide a regulatory framework for the operations of alternative investment funds (AIF) in order to minimise the risk they pose to investors and other market participants. Funds that are run like companies, i.e. alternative investment companies [AIC – PL: alternatywne spółki inwestycyjne (ASI)], previously unknown to the Polish market, are a specific category of AIF. It marks a specific revolution in the Polish private equity market since typically funds are established as standard commercial law companies⁷.

Advance planning is vital for future smooth performance of a fund. Aspects to be considered include fundraising timing, taking account of ramifications imposed by contractual provisions as well as human and financial resources. Besides, it is necessary to plan the budget, adopt an investment strategy, identify goals and an investment

⁵ Literature provides many definitions of social capital. Their overview can be found, e.g., in Z. Staniek. *Ekonomia instytucjonalna*, Difin, Warszawa 2017, p. 42 and the following pages.

⁶ The Act on the Amendment of the Act on Investment Funds and Some other Acts became effective on 4 June 2016 (Dz. U. [Journal of Laws] 2016, item 615). The main goal of the Amending Act was to transpose the Directive of the European Parliament and of the Council No. 2011/61/EU of 8 June 2011 on Alternative Investment Funds Managers, the amendments of Directives 2003/41/EC and 2009/65/EC and the implementation of Regulations EC 1060/2009 and EU 1095/2010 to accomplish goals identified by the EU legislator within the framework of the national law.

⁷ A. Kowalska, T. Koellner, *Miliardy za ASI*, “Puls Biznesu”, 06.11.2017; pursuant to the Amending Act an alternative investment fund can be a specialist open or closed-end investment fund. Moreover, the Amending Act covers a new group of actors, i.e. alternative investment companies [PL: alternatywne spółki inwestycyjne – ASI] and entities which manage them, i.e. ASI General Partners. In accordance with the Act, an ASI may operate as a share-holding company (limited liability company, joint stock company, European company), a limited partnership or limited joint-stock partnership; the Polish Financial Supervision Authority, *Zarządzający alternatywnymi spółkami inwestycyjnymi*, knf.gov.pl

policy, and reflect on the fund structure. Other important issues cover the target group of fund investors and fund economics meaning management fees, provisions for future costs to be incurred, the profit share or the timetable of payments.

Fundraising is also influenced by the subject-specific regulatory framework of a particular country. Some legal systems restrict marketing solicitation to specific categories of investors, which is why General Partners should be familiar with any legal limitations in order to avoid negative consequences. They should also propose a structure of the fund that would include the allocation of ongoing costs of its maintenance resulting from the planned structure.

3. Ethical Fundraising

It is in the fundraising stage when the relationship between the General Partner and investors (Limited Partners) takes shape. This relationship is based on interpersonal relations usually maintained not exclusively by the General Partner but also by its external experts. Tasks to be delivered should be clearly divided between the General Partner's in-house team and external experts. There should also be adequate financial resources available to cover the costs of the fundraising process. These costs can be substantial especially when fundraising engages many external actors, hence it is fundamental to allocate⁸ and communicate them to potential investors.

Practice has shown that the fundraising team approaches the existing investors first, which later translates into a positive image of the fund in the eyes of "new" investors and increases its credibility. The General Partner should bring together a group of potential investors capable to ensure a sustainable source of financing for the fund and help minimise the negative impact of a single investor's non-compliance with their obligations. To prevent money laundering or other illicit practices, it should also refuse any potential investment offer where the source of investment causes concern.

By default, all Limited Partners receive the same fair treatment, however, different terms may be offered to individual investors or groups thereof. In such cases a detailed justification needs to be provided as Limited Partners (the privileged ones) may also have an issue if some investors have influence over the fund's investment decisions. All the granted preferences should be disclosed to all investors already at

⁸ These are the so-called transaction costs, which are the costs of coordination resulting from the cooperation of many economic operators in the market, see: M. Garbicz, Z. Staniek, *Mikroekonomia. Problemy zawodności rynku*, Wydawnictwo Wyższej Szkoły Menedżerskiej w Warszawie, Warszawa 2010, p. 28 and the following pages.

the outset of fund organisation. The requirement is laid down in the provisions of the AIFM Directive⁹. Privileged treatment of some Limited Partners means the General Partner must take care of the alignment of interests of all Limited Partners and take care of potential conflicts of interests, which is not an easy task, especially when the Most Favoured Nation clauses granted to some Limited Partners may lead to other investors' claims to be offered similar beneficial terms.

The fundraising team should draft two basic sets of documents: a private placement memorandum as the core part of the offering and the constitutional documents of the fund. The private placement memorandum should be finalised before the first closing and, if necessary, updated before each subsequent closing. As these documents may be amended over the course of negotiations until the final closing, there is a risk that not all Limited Partners will receive the same information about the fund. In such cases it is critical to ensure that all investors receive a complete and final version of documents prior to the closing.

The fundraising team may also set up a data room, where investors will find documents about the fund, its investment strategy and the General Partner's prior track records. These materials are often confidential because they contain sensitive data concerning the General Partner and its portfolio companies, which is why they need to be handled appropriately and kept secure and confidential.

Any efforts exercised by the fundraising team should be compliant with the requirements of the laws in all jurisdictions where the fund is marketed. That is why legal advice should be sought with regard to regulatory requirements binding in a given country as it helps reduce transaction costs.

Fund documents made available as part of due diligence¹⁰, which explain the key operating environment and management of the fund, need to address a series of aspects connected, inter alia, with the investment strategy, structure, allocation of responsibilities, funding terms, the period for which the fund has been established, risk factors or tax considerations.

From due diligence investors expect detailed information about the General Partner's track history. All disclosed information should be credible and fully based on the fund's documentation. Calculations and valuation must follow valuation principles and accounting standards required in any given jurisdiction.

⁹ K. Siczka, *Fundusze inwestycyjne zamknięte w Polsce – przewidywane skutki zmian w legislacji*, www.prawobiznesu.com (accessed on 12. 11. 2017).

¹⁰ In-depth checks carried out by the General Partner prior to the closing.

4. Socially Responsible Investment

Responsible investment in accordance with the ESG¹¹ principles (environmental protection, social aspects and corporate governance) is gaining in importance in the private equity industry. As the sustainable growth agenda has become a social issue, General Partners and Limited Partners alike strive to ensure the ESG compliant investment throughout the entire investment process¹². It is vital to outline the responsible investment policy of the General Partner not only during due diligence but also throughout the life of the fund. Investors should be able to find out whether the General Partner's ESG-related policy is aligned with their own policy, if the General Partner supports its portfolio companies in ESG-related risk management and in seeking possible new development opportunities, and whether it will help monitor acting consistently with the ESG policy adopted when the fund was established.

As we have already mentioned, responsible investment is a crucial element of private equity investment not only at the fundraising stage but also later during the closing and when continuous monitoring of the investment. At each of these stages, the General Partner must be aware of ESG-related risks and opportunities seeking to integrate responsible investment principles into due diligence and all of the investment decision-making¹³. Having identified potential opportunities and threats prior to the closing, the General Partner should immediately develop rules that would minimise such threats and help exploit the opportunities. Acting with this respect should be monitored continuously through ESG-related information received from portfolio companies, which needs to be updated in line with the evolution of market trends.

ESG factors remain vital at each stage of an investment but before contributing capital to any portfolio company special attention should be paid to due diligence, which examines a wide scope of the company's business performance including commercial, market, financial, tax, legal, regulatory, technological, intellectual property, management quality, and, obviously ESG-related aspects. Due diligence identifies potential risks involved in a particular investment and examines other aspects that may impact the investment decision, company valuation or attainable rate of

¹¹ Environment, Social, Corporate Governance, see T. Czerwińska, *Na styku dwóch światów, czyli jak łączą się dane finansowe i pozafinansowe na polskim rynku kapitałowym*, [in:] *Raportowanie danych niefinansowych ESG, a odpowiedzialne inwestowanie*, R. Sroka (Ed.), Stowarzyszenie Emitentów Giełdowych, Warszawa 2014.

¹² *Environmental, Social and Corporate Governance Disclosure Framework for Private Equity*, 25 March 2013.

¹³ *Integrating ESG in private equity, a Guide for General Partners, Principles for Responsible Investment; ESG Considerations for Private Equity Firms*, PricewaterhouseCoopers 2015.

return. Appraisal covers opportunities and risks involved in them contrasted with potential benefits of a planned investment. Besides the results of due diligence, an investment decision is also influenced by recommendations of the General Partner's top management, which form part of an investment application. When the application is examined, checks are carried out to find out if the transaction complies with investment criteria and does not infringe provisions set out in the fund's documents.

Prior to the investment an exit strategy should be decided. Divestment is not always feasible because expected results have not been achieved or potential buyers cannot be found. Already at an early stage of investment planning, the exit process should be discussed with all the co-investors and the management of a given portfolio company. When making an investment, the General Partner should already have the negotiated mechanisms in place to ensure the protection of the fund's interests in case of any deadlock regarding divestment.

5. Investment Agreement

Issues to be regulated by the Investment Agreement depend on local legal requirements, tax considerations and the structure of a transaction in question. Investments made by the fund can take a variety of forms: the fund may act as a passive minority shareholder or it may take full control over a portfolio company. It depends on the jurisdiction, in which a particular investment is to take place, investment strategy, and the holdings in the company. Possibly, shares in a portfolio company can be owned by investors other than the fund, who may enjoy various rights dependent on the role these investors play in the transaction in question, the risk involved and the size of their contribution. Negotiations concerning the rights of different shareholders should be clearly understandable to all investors and potential conflicts should be identified well in advance. Conflict resolution should take place in a fair manner to avoid a negative impact upon the portfolio company.

The Investment Agreement needs to precisely identify the scope of influence of the General Partner upon day-to-day business operations. If the fund is a majority shareholder, it will exercise decision-making rights reserved to shareholders but it may also acquire additional rights specified in the Investment Agreement or in the portfolio company's constitutional documents. They mainly address the requirement of investor consent to certain actions of the company and the right to make appointments to the company's statutory bodies. The obligation to seek investor consent covers a long list of issues, however, it should not be abused to avoid limiting the management ability to manage the company or to excessively engage the General Partner.

6. Management of an Investment

Appropriate management is essential to maximise the fund's returns. Private equity specificity consists in active management and long-term value creation combined with investment monitoring based on adopted criteria. Usually funds require quantitative and qualitative information, whose scope is more detailed than the one stipulated in general regulations. The scope of information depends on how the General Partner wishes to impact a company's strategy and value creation and on his/her holdings in the company. Information about the company includes, besides financial indicators, ESG-related non-financial information. When analysing environmental information, we need to assess the environmental impact of portfolio companies, their products and supply chains and, conversely, the impact of environmental factors upon portfolio companies and their suppliers.

The evaluation of social factors covers issues relating to workers, clients, suppliers and local communities. Appropriate management of social factors may produce real value through, e.g., a progressive employment policy leading, in the long-run, to higher productivity, winning the support of local communities or ensuring the continuity of supplies as a result of active co-operation with suppliers. Neglecting social factors may potentially damage the company's brand or reputation, which impacts the company's value.

Corporate governance, if effective and properly implemented, supports decision-making and ensures the alignment of interests of all stakeholders in the company, i.e., the management, employees, the General Partner, and investors in the fund. It is the key area, which reveals much about the effective running of the business and contributes to steadily building up its value. The General Partner should be up to date with binding legal rules and best practices in all the jurisdictions in which portfolio companies are based. He/she should also review and assess the adequacy of applied practices and standards.

The General Partner should be able to demonstrate to the stakeholders that its ESG-related practices are appropriate, effective and in line with General Partner's business profile¹⁴. The company's board members should be actively involved in opportunities and risks' identification and management across all business areas, including financial and non-financial factors.

¹⁴ P. Crifo, V.D. Forget, S. Teyssier, *The price of environmental, social and governance practice disclosure: an experiment with professional private equity investors*, "Journal of Corporate Finance", Vol. 30, February 2015, pp. 168–194.

7. Disposal of an Investment and Distributions to Investors

It is up to the General Partner to decide which moment is appropriate to dispose of an investment by comparing the present value of the investment, its potential future value and the opportunities to receive an adequate price within a planned period. The result of the disposal of an investment decides on the return to investors and provides grounds for the assessment of the General Partner's performance. The assessment is made by the current and potential investors and observers from the industry. A change in the ownership of a company involves changes to various stakeholders while the disposal of an investment as well as its timing may be influenced by many ESG factors essential to the portfolio company and to the potential buyer of its shares. Divestment leads to financial transactions, in which financial resources are transferred between the parties, hence we need to follow anti-money laundering regulations.

Sometimes, on disposal, the new purchaser expects to receive contractual warranties and indemnification from the fund formulated in indemnification clauses¹⁵. Indemnification clauses are negotiable as they may be detrimental to the benefits of the fund. On the other hand, if the agreement includes such clauses, they may produce an enhanced return on investment. During negotiations the parties may agree the time limit and financial caps for future claims arising under indemnification clauses.

The adequate specification of how distributions are made to investors following the disposal of an investment by the General Partner will help avoid disputes over the allocation of profits and losses. The calculation of the General Partner's share in profits and identification of the order in which payments will be made to Limited Partners and to the General Partners would also be helpful. On top of that, it must be decided when distributions of profits shall be made to the General Partner and when investors may demand their contributions made to the General Partner.

Upon the disposal of an investment, when all distributions have been made to investors and on final closing of the fund, the General Partner should take care of maintaining good relations with them. Adequate procedures followed in maintaining contacts with investors, reporting and seeking transparency of relationships with them are vital foundations of their strong partnership.

¹⁵ These clauses limit the risk in financial transactions and clearly divide responsibility for specific events between the parties to the contract. They may protect against third party claims or address relations between the parties. Usually, they form part of contracts on the transfer of rights or cooperation.

Conclusion

The implementation of the AIFM Directive fits the framework created by professional investment standards that were put in place already some time ago and are observed by the private equity industry. We need to stress that private equity funds in the European market play a key role in promoting ethical standards. Funds' representatives, portfolio companies, service providers or the remaining stakeholders are obliged to promote and abide by the highest standards in investing in non-listed assets. Importantly, market participants are aware not only of financial aspects relating to their respective investments but also of the impact of environmental, social and corporate governance factors on the private equity market growth.

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