

Code of Private Equity Governance

In association with

FOREWORD

The Australian private equity (PE) industry is a major provider and manager of patient risk capital for Australian businesses. It currently manages capital in the order of \$25 billion. Although still a young industry in Australia, PE attracts a relatively large amount of interest from regulators, the government and the financial press. The industry, by its nature, is often involved in high profile public transactions involving well known Australian businesses. However, what is less well known is that the majority of PE investments are made in small and medium-sized Australian businesses, many of which will go on to form part of the bedrock of the future Australian corporate landscape.

AVCAL is publishing this Code of Private Equity Governance (the Governance Code) with the twin objectives of making the activities of Australia's PE industry better understood and helping PE fund managers (General Partners) discharge their duties to their stakeholders (including investors, regulators and employees of the PE fund's Portfolio Companies).

The Governance Code sets out principles and guidance to inform decisions about how PE funds and Portfolio Companies might be better governed. It also recognises that good corporate governance is a key element in value creation. Ultimately, whether or not the PE industry is seen as responsible in its governance and successful in the discharge of its duties to various stakeholders will depend on the commitment and efforts of individuals working in the industry. Nonetheless AVCAL expects that this Governance Code will be a useful tool in the hands of those individuals.

The Governance Code has been developed in consultation with a wide range of stakeholders, and with reference to a number of other existing corporate governance guidelines such as the ASX Corporate Governance Principles and Recommendations and the EVCA Corporate Governance Guidelines. This has been done in order to provide a robust governance framework for the Australian PE industry that incorporates widely accepted governance standards relevant

to the Australian PE industry, but which also takes into account important distinctions between private and public markets.

General Partners' primary responsibilities are owed to the investors in their funds (Limited Partners); they are first and foremost custodians of their investors' capital. Nevertheless, General Partners make investments in Portfolio Companies and so they owe a responsibility to a range of stakeholders for ensuring that those Portfolio Companies are well governed and comply with statutory and common law duties.

The Governance Code acknowledges and reflects some key aspects of PE investing:

- There are two levels of governance involved in PE investing: the governance of the PE fund itself which focuses on the relationship between the General Partner and the Limited Partners, and the governance of the fund's Portfolio Companies.
- In contrast to their investors and the funds through which they invest, General Partners are active managers. Through the boards of their Portfolio Companies and working closely with their management teams, General Partners strive to assist their Portfolio Companies to become more productive and more profitable.
- The PE industry invests with a view to value creation over the long term. While General Partners work to realise investment gains within the lifespan of the funds, they must have a long-term perspective of value creation and put in place structures which endure beyond their exit from a Portfolio Company.
- The development of appropriate governance structures occurs within the period of PE ownership. Often this begins from a very low starting point, for example, where PE invests in Portfolio Companies that need to build up their governance structures in preparation for their next stage of expansion. Where the exit from a PE investment may take the form of a public listing, those governance structures must be appropriate to support the initial listing and the sustained operation of the Portfolio Company as a stand-alone listed entity.

 The ownership of Portfolio Companies is concentrated. PE funds typically have large stakes in a relatively few number of Portfolio Companies compared to managers of listed equity funds.

The most effective mechanism by which the activities of a General Partner are prescribed and monitored is the investment agreement between the General Partner and the Limited Partners (as manifested, for example, by a limited partnership deed or trust deed). The Governance Code seeks to supplement such documents and to provide external PE industry stakeholders such as regulators, government and the financial press with an appropriate level of assurance that General Partners are responsible stewards of their investors' capital and of their Portfolio Companies' businesses.

The Governance Code recognises and builds on the various international initiatives aimed at promoting corporate governance best practices in recent years. In particular, the global push towards well-defined environmental, social and governance (ESG) policies and practices calls for an active response by the PE industry itself. The introduction of AVCAL's Governance Code is, accordingly, consistent with other initiatives by the international PE community to foster widely accepted governance practices within the PE industry, in a transparent and consultative manner.

The Governance Code is to be read and implemented by AVCAL members in conjunction with the AVCAL Code of Conduct. Implementation of the Governance Code is to take effect from 1 July 2012.

Similar to the ASX Corporate Governance Principles and Recommendations, the Governance Code is intended to provide a series of guidelines, rather than prescriptive rules. The application of the guidelines will have to be tailored to the individual circumstances and needs of General Partners, their funds and their Portfolio Companies. If a General Partner considers that any aspect of the Governance Code is

inappropriate to its particular circumstances, it has the flexibility not to adopt it. However, AVCAL members who elect not to adopt any aspect of the Governance Code must be in a position to explain why – the "if not, why not" approach.

Corporate governance is a dynamic concept that must necessarily evolve with changing circumstances. AVCAL's challenge is to ensure that the Governance Code remains relevant to the PE industry and AVCAL's members. If you have any suggestions on how the Governance Code may be improved or queries about how the Governance Code operates, please address your comments and questions to the Chief Executive Officer of AVCAL (members@avcal.com.au).

Finally, we would like to thank Blake Dawson, the AVCAL Council and the other parties that have generously contributed their time and insights towards the production of the Governance Code.

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Katherine Woodthorpe Chief Executive, AVCAL 7 September 2011

INTRODUCTION

- ¹ The ASX Corporate Governance Council, Corporate Governance Principles and Recommendations with 2010 Amendments, 2nd Edition, 2011, 3.
- ² Blake Dawson has advised AVCAL in respect of the relevant legal and regulatory background to corporate governance in Australia.

RELEVANCE OF CORPORATE GOVERNANCE TO THE PRIVATE EQUITY INDUSTRY

The importance of effective corporate governance in the efficient operation of companies is well understood.

"Effective corporate governance structures encourage companies to create value through entrepreneurialism, innovation, development and exploration, and provide accountability and control systems commensurate with the risks involved."

Effective corporate governance structures are as essential to value creation in the PE industry as they are in any other type of industry. Building strong businesses with robust and embedded governance structures and processes creates value for Limited Partners which is realised when Portfolio Companies are divested from the PE fund. Building strong, well governed businesses also helps to develop the reputation of the PE industry as a source of high quality businesses with long-term sustainability.

APPLYING CORPORATE GOVERNANCE PRINCIPLES TO THE PRIVATE EQUITY INDUSTRY

Corporate governance is relevant to the PE industry at both the fund investor level and the Portfolio Company investment level. There are some key characteristics of the PE industry which influence the content of the Governance Code:

- In the context of the fund, a General Partner is
 often a fiduciary and its primary responsibility
 is to act in the best interests of the Limited
 Partners. However, when acting in the capacity
 of director of a Portfolio Company, an
 executive of a General Partner must put the
 interests of that company uppermost.
- The relationship between General Partners and Limited Partners is heavily regulated and monitored via a complex contractual framework.

- Portfolio Companies are generally closely held by the PE fund, usually in conjunction with members of the senior management team of the Portfolio Company.
- In contrast to the investors in a PE fund and the PE fund itself, the General Partners and Portfolio Company management co-owners are not passive investors; the nature of the PE model means they are necessarily active stewards of the Portfolio Companies they own.
- By investment industry standards, PE investments are usually held for a long period of time.

To be effective, corporate governance structures applied to PE funds must recognise and reflect these fundamental characteristics of PE investing.

BACKGROUND TO THE AVCAL GOVERNANCE CODE

The Governance Code has been prepared having regard to the substantial body of law, regulation and literature in the field of corporate governance, as it applies to both the PE industry and more broadly.² The appended bibliography sets out the wide range of guidelines and regulations that have been taken into account in developing the Governance Code.

The Governance Code draws and elaborates on the underlying values which shape the way in which General Partners carry on their business:

- Responsibility for taking into consideration the interests of key stakeholders.
- Accountability of General Partners and the board and management of Portfolio Companies.
- Transparency of the PE fund's activities and those of their Portfolio Companies.
- Integrity in General Partners' dealings with Limited Partners and Portfolio Companies.
- Stewardship of the funds they manage and of the Portfolio Companies in which they invest.

In issuing the Governance Code, AVCAL aims to promote greater understanding of the PE industry, promote industry transparency, inculcate appropriate industry best practice and provide guidance to our members on these matters.

HOW TO APPROACH THE GOVERNANCE CODE

The Governance Code recognises and builds on the various international initiatives designed to promote corporate governance best practices in recent years. These include initiatives by other national industry associations, Limited Partner associations, responsible investment advocacy groups, and public markets stakeholder groups.

The Governance Code does not prescribe how it is to be implemented. Rather, the Governance Code recognises the diverse nature of PE investment activities and the need for General Partners to respond quickly to changing economic and regulatory environments.

Nevertheless, it does establish a set of basic principles that General Partners who are AVCAL members are obliged to adopt and implement (on an "if not, why not" basis). Each principle acts as a touchstone for General Partners to inform their decision-making.

Given the principles-based approach of the Governance Code, it falls to the General Partners to apply the principles in a consistent and effective manner.

The Governance Code deals with governance at the fund level and at the Portfolio Company level. Each of the principles potentially impacts upon the role of the General Partner at both of those levels, and so the Governance Code does not seek to limit the operation of the principles to one or other level.

AVCAL encourages Limited Partners to require that General Partners adopt the Governance Code by incorporating such a requirement into constituent documents of future funds (for example partnership or trust deeds). We encourage General Partners to publicise (for example on their websites) the approach they have adopted in implementing the Governance Code.

It is also recognised that good governance is not restricted to applying the Governance Code alone. These principles should be considered in conjunction with other relevant legal and regulatory requirements governing the fund and its Portfolio Companies.

PRINCIPLES OF THE GOVERNANCE CODE

Principle 1:

Promote and safeguard the interests of the fund's investors, recognising the diverse nature of those interests

Principle 2:

Embed ethical, responsible and rigorous decision-making by General Partners and Portfolio Company boards and management

Principle 3:

Promote effective Portfolio Company board composition and structures

Principle 4:

Respect the interests of stakeholders at both fund and Portfolio Company levels

Principle 5:

Ensure the integrity and utility of reporting by Portfolio Companies to General Partners, Limited Partners and other stakeholders (*Private Disclosure*)

Principle 6:

Be transparent in dealings with other key stakeholders in Portfolio Companies (*Public Disclosure*)

Principle 7:

Align financial reward with financial performance

THE GOVERNANCE CODE:

PRINCIPLES AND GUIDANCE

Principle 1: -

Promote and safeguard the interests of the fund's investors, recognising the diverse nature of those interests

BACKGROUND AND GUIDANCE

- This principle recognises that a General Partner is often a fiduciary and its primary responsibility is to act in the best interests of its Limited Partners. Effective stewardship of Limited Partners' capital is the mainstay of this responsibility.
- Limited Partners are drawn from a broad range of investor classes, including wholesale investors such as superannuation (or pension) funds, endowment funds and insurance companies. Limited Partners' interests may, during the life of a PE fund, diverge and potentially conflict with those of other Limited Partners and/or those of the General Partner.
- · Fund structures and contractual terms should align the interests of General Partners with those of the Limited Partners. In preparing fund documents and throughout the life of a PE fund, General Partners should frame their contractual obligations and put in place structures and processes which:
 - are consistent with their primary responsibility to act in the best interests of their Limited Partners;
 - deal transparently and fairly with conflicts of interest.
- General Partners should give particular attention to governance mechanisms (such as Limited Partner advisory committees), annual general meetings and to the scope and timeliness of disclosures to their Limited Partners.

Principle 2:

Embed ethical, responsible and rigorous decision-making by General Partners and Portfolio Company boards and management

- This principle draws on AVCAL's activities in encouraging greater implementation of environmental, social and governance (ESG) policies and practices in PE investment activities. It also reflects global trends, driven largely by institutional investors, in support of integration of ESG policies and practices in PE investing. AVCAL has taken on a leadership role among its peers globally, working with the United Nations-backed Principles for Responsible Investment and a working group of global PE associations to achieve consistent approaches to ESG around the world.
- This principle must be understood in the following context:
 - General Partners work towards achieving an optimal capital structure for each Portfolio Company and its shareholders and developing appropriate growth strategies, in each case for building value in Portfolio Companies.
 - PE investing requires General Partners to assume and manage financial and business risks, not to avoid them. In discharging their responsibilities, General Partners often adopt a risk-return profile which might differ significantly from that of most public companies.
- AVCAL encourages General Partners to develop responsible investment policies and practices that define their approach to managing and reporting on ESG factors within their Portfolio Companies.
- General Partners are encouraged to disclose publicly (for example by publishing on their website) the ESG policies and practices which they have developed or adopted in the operation of their Portfolio Companies.
- AVCAL's Council encourages General Partners to consider becoming signatories to the United Nations-backed Principles for Responsible Investing (PRI).

Principle 3:

Promote effective Portfolio Company board composition and structures

BACKGROUND AND GUIDANCE

- The directors and officers of Australian-incorporated Portfolio Companies are subject to the same statutory and common law duties that apply to directors and officers of all incorporated Australian companies.
- Portfolio Company boards should be:
 - composed of appropriately qualified, competent directors who have the resources to perform their roles. In some circumstances, this may require appointing one or more external directors with specialist industry expertise;
 - sufficiently familiar with the current and emerging issues of the Portfolio Company's business to
 provide strategic guidance to the company and effectively supervise and review the performance
 of management, including oversight of risk management; and
 - flexible enough to enable timely decision-making and quick responses to changing circumstances.
- While the interests of the Portfolio Company will generally be aligned with the interests of the fund and the Limited Partners, this may not always be the case. An individual appointed to a Portfolio Company board by a General Partner will, like any director, have an obligation to act in the best interests of the Portfolio Company.

Principle 4:

Respect the interests of stakeholders at both fund and Portfolio Company levels

- The primary business of General Partners is to invest in appropriate Portfolio Companies, support and, where appropriate, develop and grow the businesses of those companies, and ultimately realise the value in those companies in a manner that provides the best returns to Limited Partners. This cannot be done consistently without respecting the interests of key stakeholders in the Portfolio Companies.
- General Partners should therefore actively seek to identify:
 - key stakeholders at both the fund and the Portfolio Company levels whose relationships with the Portfolio Company are material to its long-term success (such as employees, suppliers, and customers);
 - those stakeholders' legitimate interests; and
 - the manner in which those interests may be affected by the business operations of the Portfolio Company and the investment decisions of the General Partner and its representatives.

THE GOVERNANCE CODE: PRINCIPLES AND GUIDANCE

Principle 5: -

Ensure the integrity and utility of reporting by Portfolio Companies to General Partners, Limited Partners and other stakeholders (Private Disclosure)

BACKGROUND AND GUIDANCE

- Australian-incorporated Portfolio Companies are subject to the financial and administrative public reporting obligations imposed by the Corporations Act. General Partners who are AVCAL members are also required to comply with the International Private Equity and Venture Capital Valuation Guidelines (relating to the valuation of investments) and AVCAL's reporting guidelines.
- In addition, in order to fulfil their own duties to stakeholders, Limited Partners require extensive reporting from General Partners, including reporting on risks faced by individual Portfolio Companies and aggregated risks across the fund. Typically these reporting obligations are included in the PE fund's constituent documents.
- General Partners should embed effective reporting structures within Portfolio Companies to ensure management and boards receive the information which they require to report to General Partners, so that General Partners can in turn effectively discharge their reporting obligations to Limited Partners.

Principle 6: -

Be transparent in dealings with other key stakeholders in Portfolio Companies (Public Disclosure)

³ Walker Working Group, Guidelines for Disclosure and Transparency in Private Equity, 2007 at www.walker-gmg.co.uk

- The approach to this principle is aligned with similar initiatives across the world and reflects some of their language, including for example, the Walker Guidelines in the UK.3
- A General Partner should ensure that the management of a Portfolio Company communicates in a timely and effective manner with its employees, in particular at the time of a strategic initiative or a transaction involving the Portfolio Company, as soon as confidentiality constraints permit.
- · General Partners should publish and regularly update their websites to communicate the following information:
 - a description of the General Partner's history and investment approach, including investment holding periods, where possible illustrated with case studies;
 - information and biographies of the senior partners of the General Partner; and
 - a description of Portfolio Companies in the General Partner's portfolio.
- In the event that a Portfolio Company encounters difficulties that leave its equity investment with little or no value, the General Partner should be attentive not only to the full discharge of its fiduciary obligations to the Limited Partners but also to its responsibilities to other key stakeholders.

Principle 7: -

Align financial reward with financial performance

- General Partners are charged with the stewardship of Limited Partners' capital and are obliged to act in the best interests of Limited Partners. PE funds should be established and governed in a way which is consistent with this responsibility (see Principle 1). In particular:
 - fund structures and constituent documents should align the interests of General Partners with those of their Limited Partners; and
 - contractual arrangements with management co-owners at Portfolio Company level should, to the maximum extent possible, align their interests with those of Limited Partners.
- Contractual terms dealing with General Partner remuneration should be clearly drafted, readily understandable by Limited Partners and certain as to their application.
- General Partners may wish to refer to the Institutional Limited Partners Association's Private Equity Principles for a detailed discussion on the alignment of General Partner and Limited Partner interests.

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GLOSSARY

Corporations Act

The Corporations Act 2001 (Cth).

ESG or Environmental, Social and Governance

ESG or environmental, social and governance factors are typically non-financial risks and opportunities that can affect the performance of PE investments.

General Partner

The managers of the PE fund are typically described as "general partners" in the fund because they manage the fund and are often liable for its debts and obligations. The term should be read to include all managers of PE funds, whatever the legal structure of the fund or manager.

Limited Partner

The investors of the PE fund are typically described as "limited partners" in the fund as their liability for debts and obligations of the fund is limited to the amount of their investment in the fund. The term should be read to include all investors into PE funds, whatever the legal structure of the fund or limited partner.

Portfolio Company

An investee company of the PE fund. The terms should be read to include all investment vehicles of PE funds, whatever the legal structure of the investment vehicle.

Private Equity (PE)

PE refers to investment by fixed term funds in unlisted businesses, with the aim of building and improving these businesses over a period of years and then selling them at an increased value. PE is frequently categorised according to the stage of development of the company being invested in, for example: seed investment, early stage investment, expansion stage investment, and buyout investment.

PRI

The United Nations-backed Principles for Responsible Investment is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact to identify and act on the common ground between the goals of institutional investors and the sustainable development objectives of the United Nations. They reflect the view that ESG factors can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfil their fiduciary (or equivalent) duty. They provide a voluntary framework by which investors can incorporate ESG factors into their decision-making and ownership practices and so better align their objectives with those of society at large.

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