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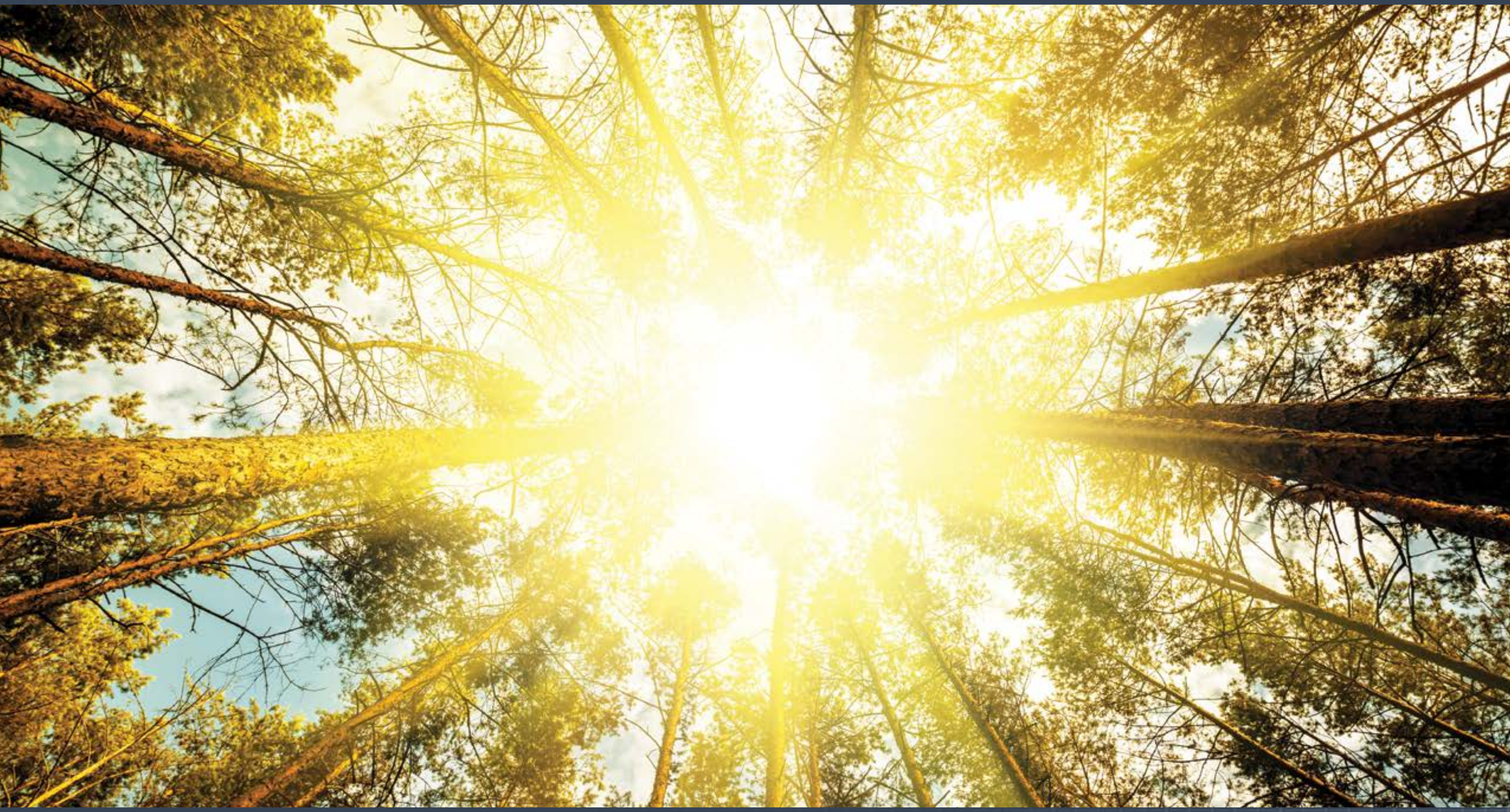
GOVERNANCE IN EMERGING MARKET PRIVATE CAPITAL

A practical resource for investors and fund managers



A product of the Governance Working Group of the EMPEA ESG Community

EMPEA

About the EMPEA ESG Community

The EMPEA ESG Community is open to all individuals at EMPEA member firms who have an active interest in environmental, social, and governance issues (ESG) in the emerging market space. This Community provides a platform to share resources and advice with EMPEA members considering how to build and/or expand their ESG management strategy and offers practitioners and experts a forum to advance the development of ESG best practices through information exchange, research, and the aggregation and development of innovative resources.

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Project Contributors

FMO Entrepreneurial Development Bank · Debevoise & Plimpton · AfricInvest · I Squared Capital · EMPEA

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Letter from Debevoise & Plimpton LLP

Quality decision-making and prudent risk management—the essential components of good governance—have long been critical components of the private equity success story. By the same measure, failures in governance have damaged and even destroyed portfolio companies and private equity firms alike. Given the centrality of governance in business outcomes, it is imperative for firms to get governance right.

More broadly, regulators and investors are exhibiting renewed interest in governance issues, and they are expanding its remit from a relatively narrow historical conception of shareholder rights, to one that is more inclusive of stakeholders and society writ large. For instance, recent requirements in the United Kingdom call for effective employee engagement mechanisms to ensure that employees have some voice in the decision-making process of a company. Meanwhile, responsible investment is gaining traction amongst asset owners, and the themes of stakeholder engagement and sustainability are becoming important factors in how investors decide to allocate capital.

Governance, therefore, has become more topical of late, and it is growing as a focus for many firms. This is particularly the case in emerging markets, where a wider group of stakeholders stand to benefit more, where risks are arguably higher, and where quality decision-making can make a huge difference in returns. It is fitting that EMPEA has undertaken this initiative to demystify governance practices across the fund, fund manager, and portfolio company levels, while providing practical resources for firms to gauge the level of governance throughout their operations.

Debevoise & Plimpton LLP is proud to support EMPEA in this initiative to reinforce the importance of good governance practices, and to provide market participants with practical guidance on the questions they should be asking themselves and their business partners. This publication provides a helpful framework for industry participants to think through some of the key governance considerations that they are bound to encounter throughout the lifecycle of a fund.

While this report synthesizes good governance practices, nothing in this publication should be construed as legal, tax, or investment advice. Indeed, one of the principal takeaways is the need for each organization to develop an approach to governance that is customized to its objectives.

Debevoise & Plimpton LLP has a wealth of experience advising clients in the private equity industry. This includes a deep bench of expertise in the governance of fund managers, funds, and companies, as well as a market-leading global fund formation practice. If you seek customized guidance on governance practices, do please let us know how we may be of assistance.

Geoffrey P. Burgess and Geoffrey Kittredge
Debevoise & Plimpton LLP

Debevoise
& Plimpton

Letter from EMPEA's Governance Working Group

The Governance Working Group of EMPEA's ESG Member Community is pleased to present *Governance in Emerging Market Private Capital: A Practical Resource for Investors and Fund Managers*.

As investors and fund managers active in the emerging market private capital industry, we should all be well aware of the importance of good governance—not only as a means to mitigate risk, but also as a way to create value. Indeed, embracing active management and improving governance practices are key tools in every fund manager's toolkit.

However, governance is a broad theme, incorporating corporate governance as well as business integrity matters. In addition to its breadth, there is an overwhelming amount of guidance and reference material on the topic, making it difficult for investors and fund managers to wade through the content, and then identify and enact the key principles in an efficient manner.

As we took stock of the existing repository of resources, we realized that there was no single source that integrated governance considerations across the three levels of our industry—investment funds, fund managers, and portfolio companies—and distilled them in a usable format. Given the valuable platform that EMPEA offers for promoting good standards across the industry, we sought to create a practical guide for industry participants that would rectify this gap in the market.

This product is the result. Through a structured exploration of corporate governance and business integrity topics at the fund, fund manager, and portfolio company levels, this paper provides concise and actionable guidance on key considerations that all industry participants should consider. For those short on time, we've included checklists covering the main points for each topic.

We would like to thank our project underwriters—AfricInvest, Debevoise & Plimpton, FMO, and I Squared Capital—for providing us with the financial support needed to undertake this research effort, as well as the dozens of interviewees who took time to share their expertise and perspectives on this vital topic. We'd also like to thank Portico Advisers for its assistance on the project.

Our aim with this report has been to create an actionable document. We hope that you find this publication useful, and we welcome your comments and feedback at research@empea.net.

Sincerely,

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Definitions

What do we mean when we talk about governance? There is no single definition for governance, but for the purposes of this study, the term 'governance' will refer to two concepts: corporate governance and business integrity considerations.

According to the OECD, corporate governance (CG) "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."[1]

According to the Dutch development bank Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO), business integrity (BI) is "the extent to which [a] company exhibits honesty, integrity, fairness, diligence, and respect in all business dealings."[2] While FMO does not consider BI an integral part of its CG assessments, it is the organization's long-term ambition to do so. As an additional layer of considerations beyond traditional CG matters, BI includes anti-corruption and whistleblower policies and procedures, as well as compliance policies and practices—most notably on anti-money laundering (AML), Know Your Customer (KYC), and economic sanctions.

Introduction

Marlon's head was pounding. His firm had spent 18 months negotiating an investment with a market-leading food and beverage company whose customers included the largest retailers in the country. It was meant to be a highlight of the portfolio and showcased prominently at today's annual general meeting (AGM).

However, Marlon recently learned that—after making the investment—the founder had set up a parallel company and transferred the customers' contracts to the new entity. It was an utter violation of the agreement; and while the legal system might eventually provide recourse, it wouldn't help him today as he met with a room of investors who trusted his firm with their capital.

Throughout the courting process, Marlon's firm conducted due diligence on the founder and the company, but nothing untoward emerged. Sure, the founder was egotistical, but this strong-willed entrepreneur had built a prominent company with promising avenues for continued growth—maybe his attitude was justified.

In addition, an international financial institution had extended a loan to the company. Surely the bank had done its own diligence, the team thought. As it turned out, it hadn't—the founder had furnished the bank with false information.

Reflecting on his decision points and partner selection, Marlon committed to learn from the experience and enhance his firm's processes and procedures. He swallowed some Tylenol, donned a smile, and walked into the AGM with a commitment to be honest with the firm's investors.

While the foregoing story from the early days of emerging market (EM) private equity (PE) has been lightly doctored and anonymized, it's based upon one of many instances in which EM PE professionals have learned first-hand of the value of good governance.

The EM PE industry has experienced some high-profile instances of weak governance of late—not only within portfolio companies, but also at the fund manager level. In the case of the latter, the rapid collapse of The Abraaj Group—once one of the largest EM PE firms, with USD13.6 billion in assets under management at the beginning of 2018—offers a cautionary tale of what can go wrong when poor governance is embodied within a PE firm.

Globally, corporate governance practices have been reassessed periodically in light of failures—be they micro or macro. For instance, the negligence of non-executive directors in the hedge fund Weavering Capital in 2009—where fraud resulted in investors losing USD530 million—led industry participants to delve deeper into the governance of alternative investment funds. Similarly, in 2011, the European Union created the Alternative Investment Fund Managers Directive (AIFMD) in response to the fallout from the Global Financial Crisis. The Abraaj case is the latest incident leading investors, regulators, and industry bodies to demand greater transparency and enhanced governance from participants in PE strategies. These developments are welcome.

However, the reality is that demands for improved governance and transparent reporting in PE have been building over time—from institutional investors, regulators, and societal stakeholders alike—and not just in EM. For instance, a 2017 survey of global PE professionals conducted by IFI Global and the fund administrator Vistra revealed that 100% of surveyed limited partners (LPs) were dissatisfied with the governance structures used within the industry.[3] Clearly, the growing demand for improved governance is about more than one firm, and more than EM.

This paper provides an overview of governance best practices and guidelines across three levels within the EM PE industry: the investee company, the fund manager (i.e., the General Partner, or GP), and the fund. Following a brief discussion of the evolution of corporate governance in EM PE and an articulation of why good governance matters, the paper explores key corporate governance and business integrity considerations across these levels, and touches upon some cross-cutting governance themes.

By necessity, this document provides a high-level overview of the key ingredients of good governance. It does not go into great detail on the individual components; rather, it is meant to be a resource to assist practitioners in thinking through this vital topic. As appendices, we have included a master checklist to help you think through key good governance considerations, as well as a repository of resources to which you may refer to get further details on specific topics.

The fundamental takeaway is that the governance of a portfolio company, fund management firm, or fund is not one-size-fits-all. Each country is different—with its own regulations and governance standards—each sector is different, and each firm is different. Therefore, good governance requires a thoughtful consideration and tailoring of policies, processes, and procedures, and the cultivation of an ethical culture.

Why Good Governance Matters

Good governance is core to private equity's value proposition in emerging markets—and it always has been. As active investors, PE firms can play a material role in an organization's performance, in terms of both supporting sustainable growth through value creation and mitigating risks. Good governance policies are also often required by the regulatory environment(s) in which a PE fund / investor operates—though these vary significantly across EM. This section briefly examines these three themes.

An Opportunity to Create Value

In highly fragmented markets—often with an array of informal operators—PE firms can create substantial value by professionalizing management teams, formalizing accounting and controls, and bringing access to knowledge and networks that can accelerate a firm's growth.

International Finance Corporation (IFC) recognized this early on in its work in developing countries. Following the collapse of the Soviet Union, in the 1990s, IFC began to focus on corporate governance enhancements in transition economies—such as Czech Republic, Hungary, and Poland—and the former Soviet states.[4]

Working with regulators at the national level, and newly privatized enterprises at the firm level, IFC recognized that quality corporate governance would be key to private sector development and properly functioning market economies. In addition, good governance would be critical for attracting private investors into these new markets, thereby expanding local firms' access to capital.

Consider the case of Żabka S.A., a convenience store operator in Poland.[5] Founded in 1998 with an initial launch of eight stores, the company expanded rapidly and built up a footprint of approximately 400 stores by 2000. However, the company's plans for further growth were stymied by local banks and financial institutions, which were unwilling to finance its plans.

Żabka's founder, Mariusz Świtalski, had not heard of private equity, but when an advisor suggested he consider PineBridge Investments, a PE firm that was actively sourcing deals in the region, he seized the opportunity. Governance enhancements were a core value driver for Żabka and PineBridge alike—not only would they facilitate Żabka's access to much-needed follow-on financing, but they also would actualize the firm's growth potential and exit opportunities.

Following its investment, PineBridge worked with Żabka to professionalize the company's Board of Directors and to adopt International Financial Reporting Standards (IFRS). In addition, it helped develop a corporate strategy and expansion plan that identified several key performance indicators (KPIs) that were crucial to the plan's success, notably new store openings, sales per store, and supply chain efficiencies. Therefore, the team implemented SAP Management Information Systems (MIS) to track Żabka's performance.

Żabka's and PineBridge's efforts succeeded. The company was able to secure debt financing from local banks to finance its further expansion, while PineBridge and Świtalski exited to Penta Investments, another PE firm, realizing a 3.5x cash-on-cash return. Reflecting on the transaction, Świtalski said, "Żabka was able to implement international accounting standards and efficient management systems. These initiatives helped us increase our credibility among local financial institutions and prepared the company for sale."

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In fact, PE firms have helped Żabka become a category leader across convenience stores, freshmarkets, and supermarkets. The Central and Eastern Europe-focused PE firm Mid Europa purchased Żabka from Penta Investments in 2011 and grew the company's revenues and profits by roughly 3x and 4x, respectively, while opening 500 stores per year during its holding. Mid Europa sold Żabka to the global PE firm CVC Capital Partners in 2017 for approximately USD1.2 billion.[6]

While the creation of a national champion may appear to be an outlier, the reality is that successful investors recognize good governance is a driver of alpha. In part, this is because less institutionalized, or more informal, governance practices are often more prevalent in EM, thereby creating an opportunity to close a gap with developed market practices.

According to Mike Lubrano, Co-Founder and Managing Director at Cartica Management, "You can potentially make more money as a governance-focused investor both on the risk and opportunity side in emerging markets than in developed markets. By definition, developing countries have weaker institutional frameworks; therefore, generally there are more opportunities for firms to distinguish themselves by voluntarily demonstrating transparency and good practices."

In fact, Chuck Canfield, Senior Corporate Governance Officer at IFC, notes, "Individual companies, despite the laws, can have better corporate governance practices because they see the value that it brings." For example, an IFC survey of investors in EM revealed that "100% of interviewed firms would pay a higher premium for good governance in an emerging market firm than what they would pay for a similar firm in a developed market."[7] Separate analyses by McKinsey & Company show that this premium could be as high as 28%.[8] In addition, a recent academic study exploring corporate governance across Brazil, India, South Korea, and Turkey discovers that disclosure—particularly financial disclosure—and board structure are predictive of higher market values.[9]

A Way to Mitigate Risk

Good governance plays an important role in mitigating risks—indeed, this has been the traditional viewpoint toward the topic. Though data on governance's role in business failures are hard to come by, Jasper Veel, Corporate Governance Officer at FMO, states, "Our special operations department conducts post-mortem analyses when investees go belly-up, and corporate governance is one of the main indicators or amplifiers for why companies fail."

Even in less extreme situations than outright business failures and bankruptcies, good governance can reduce operational risks and drive environmental and social (E&S) enhancements. For instance, Actis—an investor in growth markets across Africa, Asia, and Latin America—took over the Ugandan electricity distribution company Umeme in 2009. Years of underinvestment and neglect prior to Actis's investment had taken their toll on the distribution network, with a dilapidated infrastructure posing health and safety (H&S) risks to the local population.

From the outset, Actis recognized that in its efforts to meet Ugandans' burgeoning demand for energy at affordable prices, it would have to reduce risks. In fact, at the time of its initial investment, Umeme had neither H&S policies nor environmental management systems in place, nor did it invest in local communities.

The firm quickly set about strengthening Umeme's governance, leveraging its network to recruit a new Managing Director in 2009,[10] as well as a new Chief Financial Officer in 2011. In addition, Actis instituted new governance structures, including a Board of Directors, as well as several Board sub-committees—including one on Environmental, Social, and Governance (ESG) standards—that would monitor and ensure remediation of financial and operational risks.

Alongside its network refurbishment plans, Actis worked with Umeme to identify behavioral and operational changes that would improve the network's safety. This included robust community outreach and education campaigns, as well as the development of staff remuneration policies that were tied to safety KPIs. In addition, the company's 25 district managers became directly responsible to the Board and its ESG sub-committee for safety incidents. As of March 2016, nearly two years had passed without a single network-related 'attributable' fatality. The elevation of ESG and H&S standards played an important role in Umeme's ability to secure a USD25 million debt package through IFC.

Environmental, Social, and Governance

ESG is a broad term used to define a variety of non-financial investment issues.[11] While the "G" in "ESG" pertains to governance, investors interpret it in different ways (e.g., corporate governance, business integrity and ethics, or the governance of environmental and social issues). Notably, the inclusion of E&S variables can enhance governance quality and contribute to positive investment outcomes. Similarly, good governance is necessary to establish sound E&S practices.

In recent years, there has been growing demand for investors to embrace ESG—from both value creation and risk management perspectives. Traditionally, EM PE investors have been early adopters of ESG policies, processes, systems, and reporting, in part because the development finance institutions (DFIs) have mandated ESG reporting as part of their commitments to funds.

Moreover, Actis utilized a World Bank partial risk guarantee—the first application for a regulated utility—as well as political risk insurance from the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) to reduce the investment's financial risks. While serving as CEO of Umeme, Charles Chapman said of the partnership, "Actis's involvement has helped to systematize our safety processes and has also significantly improved our management systems, corporate governance and operations, helping us to build a positive trajectory of customer growth and satisfaction." The company was listed on the Uganda Securities Exchange in 2014, and it is cross-listed on the Nairobi Securities

Exchange. Actis believes its approach to governance and responsible investment—elements of its Values Drive Value ethos—were crucial to the investment's financial and non-financial performance.

A More Varied Regulatory Environment

As if cases pulled from countries as disparate as Poland and Uganda weren't telling enough, emerging markets constitute a richly diverse grouping of countries. Each country has its own regulatory requirements, and most have their own corporate governance codes.[12] Irrefutably, a critical step toward good governance is compliance with all applicable laws and regulations. This means being in compliance with local securities and capital market laws, any listing requirements in cases where the company is publicly traded, broader regulatory requirements, and country- and municipality-specific laws.

In addition, firms should comply with local codes of corporate governance. These may vary materially across different jurisdictions. For example, while many EMs operate a unitary Board of Directors, some—such as China—operate a two-tiered system comprised of a Management Board and a Supervisory Board. Further, in some countries—such as Vietnam—compliance with the local corporate governance code may be mandatory, while others may adapt an "apply and explain" (e.g., Kenya, Mauritius, Nigeria), "comply or explain" (e.g., South Korea, Morocco, Singapore), or voluntary approach (e.g., Brazil, Ghana, Russia).[13]

From a fund manager perspective, there are a number of statutory requirements that must be fulfilled to maintain one's licenses, and these will differ depending upon the jurisdictions where the firm and its funds are domiciled.

All of this creates a degree of complexity for firms investing and operating across EM. However, in spite of this complexity, there are some commonalities in governance systems at the country and firm levels (see Exhibit 1).

Given the value that good governance can deliver for investors, what are the principles of good governance?

Useful Resource

The European Corporate Governance Institute ("ECGI") has compiled a searchable database of national corporate governance codes, providing investors, fund managers, and management teams with a useful tool for guidance on governance issues across EM jurisdictions.

Exhibit 1: Common Characteristics of Governance in Emerging Markets

Country Level	Laws and Regulations	Lower degree of sophistication re: local laws, regulations, and standards than typically seen in developed markets.
	Regulatory Capacity	Regulators may not be as sufficiently equipped to ensure compliance with local standards.
Firm Level	Ownership Structure	Tends to be concentrated.
	Boards of Directors	May not serve as an adequate counterbalance to founder / company leadership; poorly composed and / or structured; may lack terms of reference.
	Controls	Tend to be weaker and viewed more as a police on activities, rather than as a tool to properly manage risks; may be missing governance manuals.
	Transparency	Weaker transparency, both in terms of insight (level of detail) and reliance (quality of information).

Source: Interviews with experts, EMPEA.

Getting Governance Right—FMO's Approach to Governance Bodies

Jasper Veel, CFA, *Corporate Governance Officer*, and Walter van Helvoirt, *Environmental and Social Officer, FMO*

Corporate governance practices vary significantly across the emerging markets, often in accordance with local regulations and cultures. We try to work within the limitations that are presented to us across the regions where we invest, but we always look to see that CG structures are fit-for-purpose. In other words, they should align with the company's shareholding structure, complexity of operations, and risk profile, among other variables.

The fundamental core of CG in any company is its Board of Directors, as this is where the shareholders and the management team come together to drive the company forward. When we are evaluating a potential investee, we look at a company's policies, procedures, processes, and the structure of its governance bodies, and we also conduct a large number of one-on-one interviews with the Board, the executive team, employees and outside stakeholders in order to get a true understanding of the Board's dynamics and actual practices.

Is the Board being used to ensure adequate oversight, scan for emerging risks, set strategy, and provide critical outside views? Is there room to speak up when disagreements occur? Or is everyone in the room just nodding yes and the meetings end in 20 minutes? Is there a clear separation (at least in duties and responsibilities) between the Chair of the Board and the CEO? There is a prominent business model across a number of emerging markets where a strong founder is both the CEO and Chair. This characteristic tends to be accompanied by 'rubber-stamping' boards which fall short on the strategic discussions and the value they can add to the company.

Perhaps the most critical component to getting governance right is the composition of the main decision-making body of the company or institution, irrespective of whether it is an advisory or supervisory board or a board of directors. Everything may look good on paper but if a company's board isn't fully embracing good practices, using its committees properly, and having the right discussions, then it's fairly difficult to change CG without also changing the Board composition.

"Perhaps the most critical component to getting governance right is the composition of the main decision-making body of the company or institution.

It is important that the Board be diversified and rotated on a regular basis. You don't want a board with members who have all been at the table for the last 12 years—board membership needs to evolve as a company grows, and its ambitions increase. For example, many of the clients and investees in our portfolio of financial institutions are currently talking about digital transformation. But when their Boards are comprised entirely of men over 70 years old, the question arises as to whether this is the best Board to drive that sort of transformation.

We take all of these factors into account when we acquire a board seat, which often happens when we own more than 10% of a company's shares. However, our nomination process varies significantly from many commercial PE firms that typically place the person responsible for the investment on a company's board. Instead, at FMO we make a concerted effort to nominate the person with the skill-set that best matches the needs of the company or is able to cover an important gap, and this translates into recruiting externally from our network instead of nominating our own staff.

The reason we take this approach is our belief that such individuals are in a better position to put the interests of the company first. Most of the time, as a long-term investor, we're very aligned with the company but there can be situations—for instance, deciding on a dividend policy—where a conflict of interest may arise. While we may advise these external board members to promote FMO's development mandate, such as professionalizing the Board or focusing on environmental and social matters, we don't give them voting instructions or direct them to act in the best interests of FMO. An external nominee is one step removed and thus better able to represent the interest of the company / institution than our own FMO staff, who are more easily perceived as a shareholder representative.

In addition, our view is that a board member should allocate sufficient time for his or her role, including attending and preparing for the Board and committee meetings, communicating with the executive management between meetings, visiting branches and clients, etc. Board members should spend roughly 30 days annually on their position including time for preparation for board meetings. For FMO's professionals who are building and monitoring an investment portfolio, this is simply time they do not have. Slowly, we are seeing more investors, particularly in the DFI community, also adopt this approach.

Beyond the Board, one aspect of governance that is incredibly important but not always well understood by investors is the role of the Limited Partners Advisory Committee. The LPAC is different than the Board of Directors—whereas the Board has fiduciary duties to the company, the LPAC is there on behalf of the investors, and there are neither fiduciary duties to the fund nor to any other LPs. As a result, the roles are fundamentally different. There are risks if someone oversteps his or her responsibilities as an LPAC member that may put their limited liability on the line. For LPACs to be effective, we recommend that they not be too big, and that they have clearly defined parameters and objectives.

While there are difficulties to getting the right CG practices in place in every country, companies should look to the global standards on CG as a starting point for crafting their own frameworks. But more importantly, they should do so with the understanding that CG should never be assessed in isolation. What does the company want to achieve? What is its risk profile? What is its level of complexity? What is often missing in EM is an effort to ensure that the governance strategy is aligned with the overall objectives of the organization. Having a framework that is fit-for-purpose is the best way to realize success.

General Principles of Good Governance

There is a general consensus on the foundations and principles of quality governance amongst investors in EM PE. This is in large measure due to the efforts of the DFIs, which have pioneered the adoption and advancement of corporate governance and business integrity best practices. These principles are applicable across all three layers of the industry—fund managers, funds, and portfolio companies—and they are relevant in each region of the world.

Each organization's governance framework should be tailored to its goals and objectives, and it should take into consideration the market(s) and sector(s) in which it is operating, the scale of its activities, and the breadth of its shareholders, among other variables. That said, this section provides an overview of the key corporate governance and business integrity principles that all firms should consider (see Exhibit 2).

Exhibit 2: Foundations and Principles of Good Governance

Corporate Governance	Business Integrity
Commitment to corporate governance	Commitment to ethical conduct
Proper composition / functioning of Board of Directors	Abidance with anti-money laundering laws
Quality control environment	Adoption of anti-corruption policies
Policies that promote transparency and disclosure	Awareness of economic sanctions
Protection of shareholder rights	Implementation of whistleblowing policies

Source: CDC Group plc, Corporate Governance Development Framework, IFC, EMPEA.

Corporate Governance

As previously noted, corporate governance is the overarching system of policies and processes that control an organization's operations, as well as the structure that determines the relationships among its numerous stakeholders, including the management team, the Board, customers, and investors. A strong CG framework is essential to establishing an organization's goals and objectives, outlining the action plans necessary to achieve those aims, and monitoring both positive and negative developments along the way.

While the complexity of a firm's governance depends upon its size, sector, and ownership structure—among other variables—there are several broadly agreed-upon elements to good corporate governance (see "Corporate Governance Checklist").

Corporate Governance Checklist

- ✓ A commitment to corporate governance
- ✓ Proper composition and functioning of the Board of Directors
- ✓ Quality control environment and processes
- ✓ Policies and processes that promote transparency and disclosure
- ✓ Protection of shareholder / investor rights, particularly minority

The five governance attributes listed in the CG Checklist are featured in the Corporate Governance Development Framework (CGDF), which is a helpful baseline—and a great starting place—for the development and / or assessment of any firm's approach to CG.[14] Thirty-five DFIs have adopted the CGDF as of March 2017, and the group has assembled several useful tools, such as a progression matrix, which provides qualitative indicators for four levels of governance practice ("basic" through "best"). Organizations may use these matrices to assess the level of a firm's current CG practices, and then think through how they may be improved. Notably, each of the DFIs that has endorsed the CGDF may take a different approach and pace to its implementation, in line with its own objectives and internal processes.

For example, Sarita Bartlett, Head of Environment, Social, and Governance at Obviam, notes that while her organization requires fund managers to use the progression matrices as a condition of its investment, the application of the matrices requires judgment and common sense. "It would be irresponsible to tell an investee in small-scale agriculture that produces one or two products for the domestic market that it needs to adopt advanced practices. It could sit at level one (out of four) on the progression matrix and have a robust framework for its operations. On the other hand, a multinational bank operating at level one would set off alarm bells."

Useful Resources

CGDF Corporate Governance Progression Matrix
CGDF SME Governance Assessment Tool
IFC Progression Matrices

An additional useful tool for firms seeking to craft a CG framework comes from IFC, which has developed a set of progression matrices for six types of firms—listed companies, family- or founder-owned businesses, financial institutions, state-owned enterprises, funds, and SMEs—that provide additional nuance on the relevant levels of practice. A fundamental implication of the progression matrices is that every firm, regardless of size and structure, can take steps to enhance its level of CG.

Commitment to Corporate Governance

Whether it's an institutional investor considering a potential fund commitment, or a GP evaluating the management team of a prospective portfolio company, the demonstration of a clear commitment to CG is a critical component in their decision-making process. But how does a firm show such a commitment?

Demonstrating commitment to CG necessitates thinking through the mechanics of how an organization should be directed, and then putting pen to paper. A first step is the *adoption of a company code* (or governance handbook) that details the organization's governance structure and outlines how decisions will be made. This document should establish the terms of reference for the Board of Directors, as well as the roles and responsibilities of management, but it will often include details on the topics explored in this section (see Sidebar with Simon Witney for further details and key questions to consider).

Subsequently, the firm should *develop CG policies, processes, and procedures* that ensure its effective operation. These documents will ideally address topics that include: conflicts of interest between and among various stakeholders, related-party transactions, protection of shareholder rights, disclosure and transparency of information, and auditing and financial accounting functions. More detail on each of these themes can be found in the sections below.

Though this abundance of documentation may seem to be a mere formality, in reality it is core to having a well-run business. Each individual policy or procedure is a critical tool for helping individuals think through the nuts-and-bolts of how their organization operates and ultimately achieves long-term results.

Commitment to CG Checklist

- ✓ Adoption of a company code / governance handbook
- ✓ Development of CG policies, processes, and procedures
- ✓ Establishment and firm-wide acceptance of a governance culture

While a firm's governance policies, processes, and procedures are foundational components of a governance framework, due consideration must also be given to a firm's *governance culture.* "You can put all of these manuals, protocols and guidelines together," notes Leo Chiu, Senior Principal, Private Equity Asia at CPPIB, "but an equally important element is the softer side—how our partners on the fund management side think about governance and approach transparency with their LPs."

This is particularly true for emerging markets, where corruption continues to be a problem, markedly so in certain countries. As an example, firms may craft the right policies, but what happens if an employee believes that engaging in a corrupt practice is the only way to achieve an operational goal?

Hany Assaad of Avanz Capital believes that the culture is the most important aspect to get right with respect to governance. "All of a firm's governance procedures and policies flow from the culture. This is always led from the top, as the principals have to be aware of the value that governance brings to its investment and returns, and why it is therefore critically important to develop a governance culture for the entire firm." (See Hany's Sidebar "Cultivating a Culture of Business Integrity" for further details).

While there are no rigid rules on how best to implement a sound governance culture, many industry participants agree that people and incentives are critical ingredients to success. An ethical founder or chief executive plays a critical role in setting a constructive tone from the top. "Leading by example is the most important driver of a governance culture," says Helmut Schuehsler, Chairman and CEO of TVM Capital. "Rather than simply telling people we're transparent and have good governance, you must live it."

In addition, leaders need to surround themselves with people who have the right skillsets and mindset to embody the desired governance culture. "Having good structure and processes in place is important, but you also really need to focus on people," says Athanasia Karananou of the PRI. "Most governance issues can be addressed appropriately if you have the right people on the board."

In partnership with having the right people at the helm, incentives play a critical role in setting a governance culture. "Once you confirm that you're dealing with people of integrity," says Cartica's Lubrano, "the strongest way to create a governance culture is through incentives." Examples include tying remuneration and promotions to corporate governance actions, and ensuring that all employees are engaged and have a stake in the governance process. Every employee should feel empowered to speak up, and

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Private Equity Investors Should Take a Holistic Approach to Governance in Their Investees

Simon Witney, *Special Counsel, Debevoise & Plimpton LLP*

My view is that 'governance' is about a lot more than compliance. For me, a well-governed company is one that has the structures and processes in place to facilitate the appropriate management of a company's risks and opportunities, to make good strategic and operational decisions, to set the right culture, and to ensure effective leadership and oversight by having the right people with the right skills at the helm.

This is a very broad definition of governance, and it differs from the narrower approach that many in the industry have adopted. However, building stronger and more sustainable long-term businesses is at the core of what governance is trying to achieve—and I believe that having a comprehensive governance framework is an excellent way for investors to realize success. It is, in my experience, something that private equity investors do very well. Indeed, many public or family-owned companies can learn a lot from the PE governance model.

Companies and their investors should first ensure that they have a clear understanding of how the governance of the organization works, and a good place to start is with the Board's terms of reference. This document should answer any questions surrounding the role and remit of the Board, including the limits of its role—something that some people who sit on boards do not always understand.

The level of responsibility and the role of the Board differs significantly from company to company, and will also differ over time. In a PE context, many boards take major operational decisions that might be decided several layers below the Board in a large listed company. The terms of reference should address which decisions must go to the Board (sometimes *en route* to a required investor approval), which matters must be reported to the Board but do not need its prior approval, and which matters are just part of the day-to-day operations of the company.

If too much comes to the Board, it will slow down decision-making and not leave the Board enough room for long-term strategic planning. On the other hand, if not enough comes to the Board it is impossible for Board members to oversee management and maintain ultimate control. Getting the balance right is crucial, and that often falls to the Chair.

The terms of reference will also outline how the Board functions. For instance:

- How often should it meet? This will of course largely depend on how many decisions it has to take and how quickly it has to take them. Many PE boards meet monthly, and can be convened on short notice if urgent decisions need to be taken.

- How will the agendas be determined? They will usually be set by the Chair and the CEO jointly, but it is important that management is not in sole charge of the agenda. Sometimes the Board will be tasked, often at the insistence of the investor, with focusing on very specific topics at every meeting, or at least on a regular basis. If the company faces particular risks, these should be front and center of the Board's agenda.

- Which Board committees does the company need to have? It is common to have an Audit Committee, which is sometimes also responsible for monitoring risk. Remuneration and Nominations Committees tend to be less needed than in public companies, but can also be useful forums to decide specific issues, depending on the size and composition of the main Board. Each committee should also have a clear role and responsibility, with delegated authority to take decisions in appropriate cases.

The composition of the Board—as well as the committees—is another key area to consider in the governance framework. The size of the Board is crucial, with many PE firms preferring relatively small Boards, while also recognizing that the Board needs to include the skill sets required to make good, informed decisions on the key issues facing the company. There will need to be a balance between executive and non-executive members, and the investor will usually want at least one seat at the table (often more). But should other stakeholders, such as customers and employees, also be represented? Many PE firms opt not to have these constituencies directly represented on the investee Board, but will want to put in place mechanisms to ensure that the views and perspectives of any important stakeholder group are heard around the boardroom table. The Board's composition should also take into account the need for diversity and the importance of an effective Chairperson.

Boards should also compile and regularly review a risk register that actively tracks risk concerns. The first task is to identify the key risks that a particular company faces—both business and so-called 'non-financial risks' (although if a risk is material it will almost certainly have financial consequences). The legal, regulatory, and compliance issues that could potentially impact the business should be an important part of the risk assessment process. What could cause the company to have a real crisis? Which issues, such as a government investigation or a regulatory breach, could give rise to a problem? Are there any compliance issues that could create material risks for the company? Are there any concerns regarding bribery and corruption, health and safety, or modern slavery and human rights, and if so, how are they being mitigated and managed? It should be clear that ultimate responsibility for managing these risks rests with the Board.

> "What could cause the company to have a real crisis? Which issues, such as a government investigation or a regulatory breach, could give rise to a problem? Are there any compliance issues that could create material risks for the company?

While some of these aspects of governance are quite detailed and do not necessarily need to be spelled out in the beginning of a company's operations, the Chair of the Board should be thinking about governance holistically. It is incumbent on the Board to manage all of the risks and opportunities that a company faces, and therefore the Chair needs to ensure that strong controls are in place, and that everyone else around the Board table has a clear understanding of, and buy-in around, the governance components that have been established.

However, businesses are all different—they face different opportunities, risks, and challenges at any particular moment in their history. As a result, the governance mechanisms have to be specific to the company, and they also need to evolve as the organization develops and changes. Some companies may have corruption issues, some may be navigating a big health and safety violation, and some may face problems with competition law. But whatever the challenges, establishing an appropriately tailored governance framework is crucial. The Board must also recognize its role in setting the culture of the company—deciding what it stands for, what the values of the organization are, and making sure that it is clearly understood throughout the business. That is a critical function of the Board and essential to achieving that larger goal of building a stronger and more sustainable long-term business.

Cultivating a Culture of Business Integrity

Hany Assaad, *Co-Founder and Chief Portfolio & Risk Officer, Avanz Capital*

Reputation is a key factor in determining the ability of fund managers to raise their first and subsequent funds. Therefore, investing in and breeding a culture of business integrity is critical to sustaining sound governance and ensuring an EM PE fund manager's lasting success.

It is the organization's culture that informs how daily decisions and actions are made, which in turn drives ethical standards and determines the quality of governance. Well-managed EM PE funds are achieved through a well-governed fund management company and its team of professionals. The culture of this team is what drives governance, behavior, and outcomes.

Culture is a highly valuable asset that defines the organization's identity for its employees, investors, portfolio companies, and others. The essence of a culture is the unifying values that are demonstrated by key leadership, captured in the fund's code of ethics, and reinforced daily via processes and procedures that are aligned with the firm's code of ethics and compliance policies. There are three requirements to achieve a culture of integrity: (i) ethical leadership; (ii) embedded values; and, (iii) a peered commitment to ethics.

> "The essence of a culture is the unifying values that are demonstrated by key leadership, captured in the fund's code of ethics, and reinforced daily via processes and procedures that are aligned with the firm's code of ethics and compliance policies.

Ethical Leadership

It is the responsibility of a firm's leadership team to inspire ethical behavior and to be role models for the organization. In order to embed values within an organization, the leadership team must embody them at all times. The critical point is to be consistent—leaders must not be selective in applying these values in certain situations and not others. Consistency fosters ethical behavior across the organization.

Embedded Values

A PE firm's stated values should inform daily behaviors that are exhibited by all employees—regardless of department or seniority. Moreover, they should be expected by a fund's portfolio companies and other stakeholders. Embedding values is a continuous process that must be constantly revisited and reinforced.

For example, many fund managers—particularly those investing across different countries—have teams comprised of different nationalities and cultural backgrounds. In addition, the companies that the teams invest in and do business with can have different cultural considerations. Simply put, business integrity can be perceived differently across cultures.

Consequently, a sustainable culture of business integrity is one that is built on ethical values and processes that, as far as possible, do not compete with these cultural variations. A clear understanding of employees' social norms and cultures, as well as the geographic region(s) in which an EM PE fund operates, is essential to embedding values and aligning the fund manager's code of ethics with those of its employees and portfolio companies. In cases where there is a conflict, the organization must articulate and substantiate its position from the perspective of upholding business integrity.

A Peered Commitment to Ethics

Breeding a culture of integrity starts with people. Employees must feel aligned with the values captured in the code of ethics and demonstrate a genuine commitment to the organization. A good practical example of how to remind employees of the details of the code of ethics is to have every employee confirm annually to have read the code of ethics. Many firms ask their employees to sign a declaration to commit to the code of ethics annually. Many firms also have a regular review of their code of ethics and engage employees to have open discussions about business integrity and ethical issues that are facing the firm, such as corruption.

Strengthening the relationship between employees, their colleagues, and the company is vital. This can be achieved by encouraging a culture of respect, recognition, openness, and trust. Furthermore, leadership must encourage positivity, collaboration, and meaning in work.

In summary, achieving good governance is a complex and dynamic process, informed by the daily behaviors and values of the organization, in other words its culture. It requires constant proactive and passive management. The ability of fund managers to achieve and sustain a culture of business integrity is directly linked to the fund's performance and the fund manager's ability to raise capital for future funds. This dynamic is acutely relevant for fund managers operating in EM, where governance risks relating to compliance, transparency, and corruption are greater felt. Cultivating a common culture for EM PE fund managers is further complicated by a host of social norms and region-specific considerations. However, it is possible to build a strong shared culture based on business integrity—and this can drive good governance, reduce compliance risk, and create long-lasting value for the fund manager and its stakeholders.

confident that their voices will be valued as opposed to ignored. Medina Jett, President and Founder of Integrated Compliance Solutions Group, notes this is particularly true around compliance issues: "Compliance has to be embraced as a cultural competency of the firm, not merely a back office function."

Incentives can also spring from external stakeholders. Philip Armstrong, Director of Governance at Gavi, notes, "When an EM firm decides to raise capital, there are a variety of incentives that come into play for enhancing governance, simply because the owners of capital will scrutinize how the businesses operates and whether it's capable of attaining its long-term objectives. Moreover, there are strong downside consequences if a respected international investor exits the business for the wrong reasons." When institutional investors demand certain CG enhancements as a condition of their investment, a broader culture can begin to develop as the team learns how such initiatives ultimately increase the value of the company.

Lastly, it is important to note that whether you are a fund manager seeking an investor commitment or a portfolio company hoping to partner with a PE fund, it is not necessarily critical to have all of the foregoing considerations fully executed on day one. What *is* essential is having an open mindset and a willingness to change in ways that will improve governance based upon feedback. A common theme amongst institutional investors interviewed for this report—whether they be DFIs or commercial investors—is that fund managers must be willing to work with them and be open to change. Similarly, governance enhancements constitute one of the critical value creation levers that fund managers can bring to the table when negotiating a partnership with a potential investee. David Risser, Director at the corporate governance advisory firm Nestor Advisors remarks, "This willingness to be challenged and implement change is *the* fundamental aspect in a sound governance culture."

Proper Composition and Functioning of Boards

Many industry experts argue that an engaged, diverse, and well-functioning Board of Directors is the single most important element to strong corporate governance. A quality Board of Directors is crucial for good governance, and—as many PE investors know first-hand—actualizing the potential of a business. As Kripa Miriam Joy, General Counsel of Aspada Investments, concisely puts it, "An effective Board solves for a lot of governance issues."

Board of Directors Checklist

- ✓ A well-composed and diverse Board of Directors
- ✓ Inclusion of independent members
- ✓ The presence of meaningful and active committees
- ✓ Structured practices, including regularly scheduled meetings
- ✓ A strong Chairperson

> "There is a tendency in some companies to put former government officials on the Board because they will presumably have good connections. And we've found that they always bomb. It's such a waste of a Board seat. But what always works is someone who has run a similar business in another country—that person will add a lot of value.

Thoughtful consideration should be given to the composition of the Board of Directors. Typically, a Board consists of a combination of company representatives (such as the CEO and CFO), individuals affiliated with the company (such as a relative or former employee), and completely independent directors. A seat on the Board should not simply be viewed as a formality; rather, a company's Board offers an opportunity to bring together valuable knowledge, skills, and perspectives while providing oversight. What sort of guidance is critical to moving the firm forward? Does the company need someone on the Board who can offer advice on operations, the finances, or simply connections to potential partners?

At the portfolio company level, while some PE firms that are able to nominate a Board member appoint a member of staff so as to closely monitor their investment, others may wish to appoint someone who brings missing skills to the table. Cartica's Lubrano relays that their firm—which invests in public securities—conducts a Board skillset evaluation that entails a comparison against peer companies, enabling discussions with management that focus on Board quality. Bringing in someone with prior experience in a vertical can be particularly valuable. Chris Freund, Founder and Partner of Mekong Capital, notes, "There is a tendency in some companies to put former government officials on the Board because they will presumably have good connections. And we've found that they always bomb. It's such a waste of a Board seat. But what always works is someone who has run a similar business in another country—that person will add a lot of value."

In addition to having complementary skillsets around the Board table, composition is about diversity—gender, age, sociological, educational, occupational, geographical, etc. David Risser of Nestor Advisors offers an interesting perspective on diversity. "I would define it as a composition that is capable of breaking groupthink. There is research showing that diversity has an impact on governance and performance. But for diversity to work, it can't just be cosmetic; it's about genuinely seeking alternative points of view, regardless of who it comes from."

In particular, growing attention is being paid to gender diversity as evidence suggests it leads to better outcomes. Risser, for example, notes that female directors have a higher attendance rate for Board meetings, tend to arrive better prepared, and positively impact the performance of male directors. In fact, Queensland Investment Corporation (QIC), which manages USD60 billion in assets on behalf of its clients, views diversity as a core driver of good governance. "We ask our managers to identify the number of female partners they have," says Kate Bromley, QIC's Head of Responsible Investment. "We believe that diverse teams outperform and that talent generates exceptional investment returns. Groupthink, as well as domineering thinking, are both major risks we work to mitigate. QIC seeks to bring this perspective to our investment portfolio and advisory partners." Underscoring the role of gender diversity are organizations such as TheBoardroom Africa, which facilitates the ability of firms to secure female talent to serve on Boards of Directors across the continent.

Of course, diversity should be considered in an emerging market context. While Boards are sometimes driven by quotas, it is important to keep cultural issues in mind, as well as the fact that talent can be extremely scarce as a general rule in certain countries. It may not always be easy to find available directors that are competent, knowledgeable in the relevant fields, and independent—and as a result, the desire for diversity may need to be balanced appropriately. That said, directors from other countries may bring fresh perspectives to the Board.

Independence, meaning that the majority of the directors are not closely affiliated with company management and have no direct business ties, is another critical component to a proper Board—and this can also be a challenge in EM. Boards that have an overbearing founder can lack a counterbalance, potentially leading to blind spots from both a risk and opportunity perspective. Asapda's Joy shares, "While many of our companies don't have an independent director, because Indian law states that private companies under a certain size don't need to have one, we do look to ensure a balance of power on the Board." The Board should also have *committees* to address material elements of the business. Examples include executive, finance, audit, remuneration, and nominating / governance, to name a few. These committees may vary depending on the nature of the company's operations and regulatory ambit; however, there is consensus of opinion on the value of an independent audit committee.

Private equity firms seeking to exert influence on an investee will often do so through Board committees. For instance, Actis's General Counsel Paul Owers notes, "We will always have an ESG plan when we make an investment, and we will often push for an ESG committee of the Board." Skander Oueslati, CIO Sub-Saharan Africa at AfricInvest, indicates that, "At AfricInvest, we systematically require the investee companies to put in place a Strategy Sub-Committee of the Board. This is a way to align, reach a common understanding, and provide guidance on future strategies and expansion plans." Albert Alsina, Founder, CEO, and Managing Partner of Mediterrania Capital Partners, says that his firm typically seeks seats on the remuneration and audit committees, as "remuneration aligns the company with its objectives for growth, while audit is tasked with the critical job of setting up the parameters for the auditors."

The Board, as well as the committees, should adhere to *structured practices, including regularly scheduled meetings*, ideally with at least one in-person meeting per year. Information should be circulated to Board members in advance so that the discussions are fruitful, and the meetings should be well documented and approved. The Board should also regularly meet separately from the management team. In addition, a system for rotating directors on and off the Board should be established. Also, the company should cover the costs for the Board, including travel, to make sure that there is no hindrance for directors to attend meetings.

D&O Insurance

Directors and officers (D&O) liability insurance indemnifies the directors and officers of a company from the legal defense costs and settlement losses associated with a legal action brought against them. It protects their personal assets. As such, D&O insurance is an important protection for investors of all stripes.

Private equity fund managers and investors that appoint representatives to a company's Board of Directors should ensure that these individuals are covered by a D&O policy. In addition to this 'Side A' or 'direct' coverage that protects individuals' personal assets, firms should explore 'Side B' coverage that reimburses the company and advances legal fees on behalf of D&Os.

Finally, the Board needs a *strong and effective chairperson* to ensure all of the foregoing components come together in a synchronistic whole. This can be a challenge at the portfolio company level in cases where a founder or promoter views the Board as a hindrance and challenge to his or her role, rather than as a source of support. Ideally, the chairperson is the voice of a company's vision; and she or he will be able to organize the Board around it in a manner such that each director is contributing to the company based on his or her individual skillsets.

Quality Control Environment and Processes

Companies should *document their internal operational and financial control processes*, including those related to risk management and compliance. While it may not be attainable on day one, funds and companies should strive to match international best practices. This should include an *independent audit function*, which may be either internal or outsourced. Independent external auditors can provide enhanced supervision and provide investors with a greater degree of comfort; however, it is good practice to rotate external auditors on a regular basis to ensure their independence.

Control Environment Checklist

- ✓ Document internal operational and financial control processes
- ✓ Have an independent audit function
- ✓ Invest in a quality Management Information System

Still, external auditors may not be a sufficient check on a company. As one investor recounts, "One family business that we invested in had weak auditors—they were under-resourced, and our investee represented too much of the auditor's total revenues. We told the company that we expected to see them rotate in a firm like Deloitte or EY, and what we found after the rotation was that they selected an even smaller firm for which our investee would represent an even larger portion of revenues. Moreover, the lead partner at the new firm had been their auditor at the old firm three years prior, and he had just finished his cooling-off period. That was totally corrupt. We asked them to explain. They couldn't. They were lying to us, so we got rid of our investment."

In addition, a *quality Management Information System with meaningful key performance indicators* can enable verifiable corporate reporting and facilitate board oversight—and, in fact, drive value creation initiatives across a PE fund. For example, Mekong Capital shifted from using an approach called a Waterfall methodology, which necessitated a complex architecture development process up front, to one based on the Agile methodology, which allows firms to start small with an initial batch of KPIs and iteratively build toward the long-term architecture over a period of months. "This shift to the Agile framework was a huge breakthrough," says Chris Freund. "In the past, it was hard enough to get monthly data, and it was so infrequent that a lot of valuable information would fall through the cracks. Now, we are able to track KPIs, such as daily sales, in real time and we can establish and track progress toward weekly and monthly targets."

Similarly, at Actis, the firm uses a cloud software solution called iLEVEL to collect data on non-financial and ESG metrics. "The system provides key inputs that enable us to review how we're doing and where intervention may be required," notes Paul Owers, "and this facilitates our decision-making in our quarterly portfolio review process." At AfricInvest, a tailored IT system enables the investment professionals to communicate and share data in a timely manner. "This multifaceted in-house solution is used across the group and facilitates the decision-making process, capturing the different aspects of the investment (financials, ESG, legal, and others)," notes Skander Oueslati. Information technology (IT) systems, such as iLEVEL and eFront, can capture data input at the investee company level, and enable greater transparency on portfolio company operations for professionals at the fund manager and fund levels, all while increasing the efficiency of the reporting process.

Policies that Promote Transparency and Disclosure

Promoting transparency and disclosure goes hand-in-hand with many of the best practices mentioned above. Companies and fund managers should provide investors audited financial statements. These should go back for a period of five years and account for any qualifications and material restatements. Companies that publish their financial statements, whether in annual reports or on their website, provide greater transparency and thus reduce the likelihood of malfeasance.

Emphasizing the importance of transparency, AfricInvest's Skander Oueslati shares, "Lack of transparency is something that we can't tolerate. At a very early stage of any investment process, we make it clear to each one of our prospective investees that transparency is a key prerequisite to our potential partnership. If they are not willing to cooperate, we just don't make the investment. It is as simple as that. If there's no relationship of trust and there is no transparency, then there's no point in pursuing the investment."

In addition to financial statements, there is growing activity around the dissemination of non-financial disclosures and integrated reporting. These can take the form of reports on

CG practices, ESG issues, and stakeholder impact, among other topics. Shareholders / investors should be provided any material information and / or documentation upon their request.

Transparency & Disclosure Checklist

- ✓ Provide audited financial statements
- ✓ Disseminate material non-financial disclosures
- ✓ Consider integrated reporting

Protection of Shareholder / Investor Rights, Particularly Minority

Ensuring that shareholders' rights are protected is an integral component of any CG framework. *Common rights* include the ability to vote on 'major' issues—including clear instructions on how to do so—entitlement to an ownership stake (and thus participation in profitability), access to information regarding the investment (including financial records and filings), and the right to seek recourse if shareholder rights have been violated. While the details differ for each shareholders' agreement, this notion of protection extends to both LPs that have taken an interest in a PE fund, as well as fund managers that have made an investment in a portfolio company.

In the case of the latter, the majority of historical EM PE investments have been for minority stakes in growing businesses. As a result, most EM PE investors are familiar with the principle that minority shareholders' interests should be protected, and that minority shareholders should receive equitable treatment. Private equity investors will also often negotiate certain rights that maximize their individual ability to influence or have a say in material matters related to the company (such as rights of first refusal, drag-along rights, and tag-along rights).

There are two additional elements germane to EM PE investors. The first pertains to *related-party transactions* (RPTs), which are more prevalent in EM. A related-party transaction is a transaction between two individuals or parties that have a pre-existing relationship; for instance, doing business with a family member or a company directly owned by an employee or Board director.

Shareholder Rights Checklist

- ✓ Establishment and documentation of basic common rights
- ✓ Process for managing related-party transactions
- ✓ Ongoing disclosure of conflicts of interest

Companies should identify and disclose RPTs to shareholders; however, they should also implement decision-making processes that give confidence to outside shareholders. According to governance expert Simon Wong, "The OECD has a wealth of guidance on this topic, but two ways to address RPTs are: (i) through reference pricing (near to a market equivalent); or, (ii) an independent body that would either have decision-making authority or provide a review / endorsement of the transaction."

The second element is that the company should disclose any conflicts of interest to shareholders, in addition to developing strategies on how to address them. Fund managers, their funds, and portfolio companies should all have clear policies, processes, and procedures for dealing with *conflicts of interest* and RPTs. In the case of funds, these may be addressed via the Limited Partners Advisory Committee (see next section for further details on this body).

As one example, oftentimes in EM, family members serve as employees, managers, and shareholders, all of which can add a degree of complexity for ensuring quality CG. Therefore, consideration should be given to implementing policies that ensure these individuals will be managed like other employees of the firm. IFC's Family Business Governance Handbook provides useful information for investors to consider.

Speaking to how shareholder rights must be viewed in an emerging market context, one fund manager notes, "The difference between emerging and developed markets is basically the question of how you protect yourself when you are a minority versus majority investor. The biggest mistake people make is thinking that legal documentation will protect against those risks—in reality, it won't. Of course, we have legal protection and it is essential to have shareholder rights in minority investments so that you have a voice when it comes to capital increases, the buying and selling of assets, budget approval, etc. These are protections that you need to put in place—but the most important thing is the quality of the promoters and ensuring that your and their interests are in line."

Useful Resources

FMO has developed an ESG Toolkit, which is a practical tool built in Microsoft Excel that enables investors to score companies' governance indicators and track companies' performance quantitatively over time.

Similarly, CDC created its ESG Toolkit for Fund Managers, which provides practical and detailed guidance on how to incorporate business integrity assessments across each stage of the investment process.

Business Integrity Checklist

- ✓ Commitment to business integrity
- ✓ Abidance with anti-money laundering laws
- ✓ Adoption of anti-corruption policies and procedures
- ✓ Awareness of economic sanctions
- ✓ Development and implementation of whistleblowing policies and procedures

Business Integrity

The expansion of governance considerations to include business integrity matters addresses some key gaps of traditional CG topics, and provides for a more holistic assessment of governance. Mark Butler, Director of Business Integrity and Compliance at CDC, relays, "For us, business integrity is as critical an element in creating a sustainable institution as environmental, social, and commercial elements. Fundamentally, business integrity is about being able to manage the integrity risks you face in the markets in which you operate."

Business integrity should be embedded throughout a PE fund's lifecycle—from initial screening, through due diligence, investment, monitoring, and exit. Equally important is the exhibition of BI in the underlying portfolio companies. There are five key BI considerations (see "Business Integrity Checklist").

Commitment to Business Integrity

Certainly the best way to demonstrate a commitment to BI is to be honest and ethical in business dealings, and to ensure that all employees do the same. To assist in this effort, *a code of ethics should be established* to outline clearly the ethical standards to which all employees will be held. Common topics for a code of ethics include:

- Compliance;
- Confidentiality;
- Conflicts of interest;
- Disclosures;
- Fair dealing;
- Insider trading;
- Treatment of company property; and,
- Guidance regarding where and to whom employees can report concerns or violations.

Commitment to BI Checklist

- ✓ Adoption of a Code of Ethics / Conduct

Abidance with Anti-Money Laundering Laws

Anti-Money Laundering laws are in place in most of the jurisdictions where EM PE firms invest. Therefore, fund managers must *familiarize themselves with all relevant local laws*, and ultimately ensure that they and their portfolio companies are compliant. Doing so is a critical step to ensuring that your firm does not incur reputation risk by associating with potential criminal or terrorist activities, in addition to other types of financial malfeasance.

Prior to accepting investors' capital or investing in a company, fund managers should *conduct KYC checks* on the organizations and individuals in question. With regard to vetting investors in PE funds, fund managers should have policies, processes, and procedures in place that provide comfort to early investors, such that they may be confident that subsequent investors in the fund will not create reputational risks for them. A key component of this is running KYC checks on all investors, and there are numerous service providers that can assist fund managers with these tasks.

Useful Resources

One resource that industry participants may wish to consult is the CFA Institute Asset Manager Code, which "outlines the ethical and professional responsibilities of firms that manage assets on behalf of clients." The code is available in 16 languages—including Arabic, Chinese, French, Indonesian, Portuguese, Russian, Spanish, and Vietnamese—and the CFA Institute's recommended guidance is available in most of these languages as well.

Several publicly listed PE firms, including Apollo, Blackstone, The Carlyle Group, and KKR post their codes of ethics and other corporate governance documentation—such as whistleblower policies—on their websites' investor relations webpages. Perusing these documents could be helpful for firms that seek examples of how these documents read in practice.

Anti-Money Laundering Checklist

- ✓ Familiarization with AML laws in relevant jurisdictions
- ✓ Completion of Know Your Customer (KYC) checks on potential business partners, including investors
- ✓ Identification of ultimate beneficiary owners (UBOs), directors and managers
- ✓ Fund's custodian bank located in Financial Action Task Force (FATF) member country

Maria Knapp, Senior Partner at the global risk consultancy Control Risks, advises, "There are often limitations in terms of what types of information you can access on investors, and that can be a red flag in itself. But you need someone who can work around reliable sources, media research tools, and a variety of public records to understand the risk profile of investors in a fund."

> "There are often limitations in terms of what types of information you can access on investors, and that can be a red flag in itself. But you need someone who can work around reliable sources, media research tools, and a variety of public records to understand the risk profile of investors in a fund.

With regard to investing in companies, KYC checks should include *identifying ultimate beneficiary owners (UBOs), directors and managers.* These always require a deep and thorough due diligence process, but this can be particularly challenging in EM, where transparency may be limited. Knapp notes, "There is a distinction between satisfying regulatory requirements and understanding the broader reputational risk issues. Given the lack of data in EM, it's important to have local teams that can identify patterns that uncover hidden UBOs or conflicts of interest, and conduct proper assessments on investors and the track record of management teams." In some cases, some of these individuals may be identified as politically exposed persons (see "Who Is a Politically Exposed Person?"), which creates additional considerations.

How Do You Run a KYC Check?—Advice from a Fund Manager

We use third-party vendors to run KYC checks; however, our Operations Director checks the KYC that our vendors provide. We actually conduct portfolio-level KYCs ourselves and then we pass them along to the fund administrators, which serve as a double-check on our own diligence.

You have to be careful with whom you choose to run these checks. In fact, a previous administrator missed red flags on an individual that we uncovered internally. We don't use them anymore. We couldn't afford to—whatever is not done properly by a vendor or fund administrator can impact a deal, or even cancel a bank account. You have to have a system that checks your own work, as well as those of your service providers.

Who Is a Politically Exposed Person?

CDC defines politically exposed persons (PEPs) as "people who hold or have held (during the previous year) prominent political positions, either domestically or internationally." These include:

- Head of State or government;
- Senior politicians (e.g. Ministers and Deputy or Assistant Ministers);
- Senior government, judicial or military officials;
- Senior executives of state-owned enterprises or important political party officials;
- Members of Parliament or high-level judicial bodies; and
- Members of the administrative, management or supervisory bodies of state-owned enterprises, among others.

Notably, family members and close associates of PEPs should also be treated as PEPs.*

**CDC Group plc, ESG Toolkit for Managers.*

Sarita Bartlett of Obviam remarks, "The industry is fairly aligned with respect to making sure that GPs have the adequate AML / KYC programs in place to ensure integrity, and that there is someone in the fund management firm who can drive those programs. However, where there is a divergence in risk tolerance would be on how the GPs work with the investees and the involvement and status of different type of partners. For instance, there are a variety of definitions for politically exposed persons—maybe you have a cousin who happens to be one, or maybe there is an affiliation with a state-owned enterprise. We all have different risk tolerances toward these types of circumstances."

Nevertheless, Nick Panes, Senior Partner at Control Risks, cautions, "PE firms are coming under much greater scrutiny with respect to their broader social and community impacts. Therefore, as they conduct KYC checks, they're looking for vendors that have an established track record and a rigorous methodology that not only gives them confidence in their investment decisions, but also adds local context and a fuller appreciation of the risks and local conditions that can have material impacts on the success of the business."

Separately, the fund and its custodian bank should be located in jurisdictions that are committed to transparency and AML (e.g. Financial Action Task Force, or FATF, member countries).

Adoption of Anti-Corruption Policies and Procedures

Corruption may be defined as, "The offering, requesting, giving, or receiving of a financial or other advantage in order to induce or reward the improper performance of a rule, duty, or function."[15] Corrupt practices include: bribery; kickbacks; facilitation payments; fraud; and, extortion.

Companies should have *clear anti-corruption policies and procedures* that ensure competitive procurement processes and reputational screening of contractors. One professional provides an overview of how this can look in practice. "We worry about corruption in the United States just as much as we do in EM, it's just that the risks are perhaps more easily seen in foreign companies. We train all of our employees on our zero-tolerance policy toward corruption, including courses offered through TRACE International, which can be distributed via iOS and Android mobile devices and are available in numerous languages. We also harness technology to ensure continuous monitoring of places where corruption can occur. For example, we own and operate a toll road in India and we video every single toll transaction, and software recognition determines what the toll for each vehicle should be. But much more importantly, at all levels we are focused on driving governance policies that maximize the community's acceptance of us as a benign actor."

At the fund level, key anti-bribery considerations should include those pertaining to fundraising (e.g., raising from state-related entities, such as sovereign wealth funds), the use of placement agents and consultants, and regulatory approvals for investments / exits.

In addition, fund managers should *comply with extraterritorial anti-corruption regulations*, such as US FCPA and the UK Bribery Act. Fund managers should adopt rigorous anti-corruption policies that extend from the fund management company through to the portfolio companies. Managers may be held liable for corrupt practices taking place at the portfolio company level.

The penalties for violations of anti-bribery conventions can be stiff. For example, the hedge fund Och-Ziff Capital Management admitted to a role in African bribery conspiracies, agreeing to pay a criminal fine of USD213 million and approximately USD199 million in disgorgement to the SEC.[16]

All anti-corruption / anti-bribery policies should be *clearly communicated* to employees and the public.

Anti-Corruption Checklist

- ✓ Adoption of rigorous anti-corruption policies (including anti-bribery)
- ✓ Compliance with extraterritorial anti-corruption regulations, such as US FCPA and the UK Bribery Act
- ✓ Broad communication of company position on anti-corruption

Awareness of Economic Sanctions

Economic sanctions may be placed on countries, companies or individuals—and they can change rapidly. Breaching sanctions can trigger fines as well as potential criminal penalties, and investors should be cognizant that foreign businesses that transact in US dollars may be subject to US jurisdiction.

Prior to investing in, or engaging with, a business, firms should *consult the US Treasury's Office of Foreign Assets Control (OFAC) sanctions lists and the UK government's financial sanctions targets list.*

Given the speed with which sanctions can change, firms should develop a system to *closely monitor relevant sanctions on an ongoing basis*. In the case of PE funds, the portfolio companies' compliance policies and practices should be actively managed.

Useful Resources

US Treasury's OFAC Lists
Her Majesty's Treasury Financial Sanctions Target Lists

Economic Sanctions Checklist

- ✓ Familiarization with any relevant sanctions on countries, companies, and / or individuals
- ✓ Consultation of the US Treasury's Office of Foreign Assets Control sanctions lists
- ✓ Consultation of the UK government's financial sanctions targets list
- ✓ Close monitoring of relevant sanctions on an ongoing basis

Development and Implementation of Whistleblowing Policies and Procedures

A whistleblower is someone who reports knowledge or information about attempted or actual misconduct—be it illegal or unethical. A whistleblower may be a member of staff or a third party, and s/he may communicate her or his concerns to the company, investors, or authorities.

Whistleblowing strengthens accountability and combats corruption.[17] In addition, it can help to uncover cases of fraud, which can be exceedingly difficult to detect. One academic analysis of 216 fraud cases in large US companies between 1996 and 2004 reveals, "Fraud detection does not rely on standard corporate governance actors (investors, SEC, and auditors), but takes a village, including several non-traditional players (employees, media, and industry regulators)."[18]

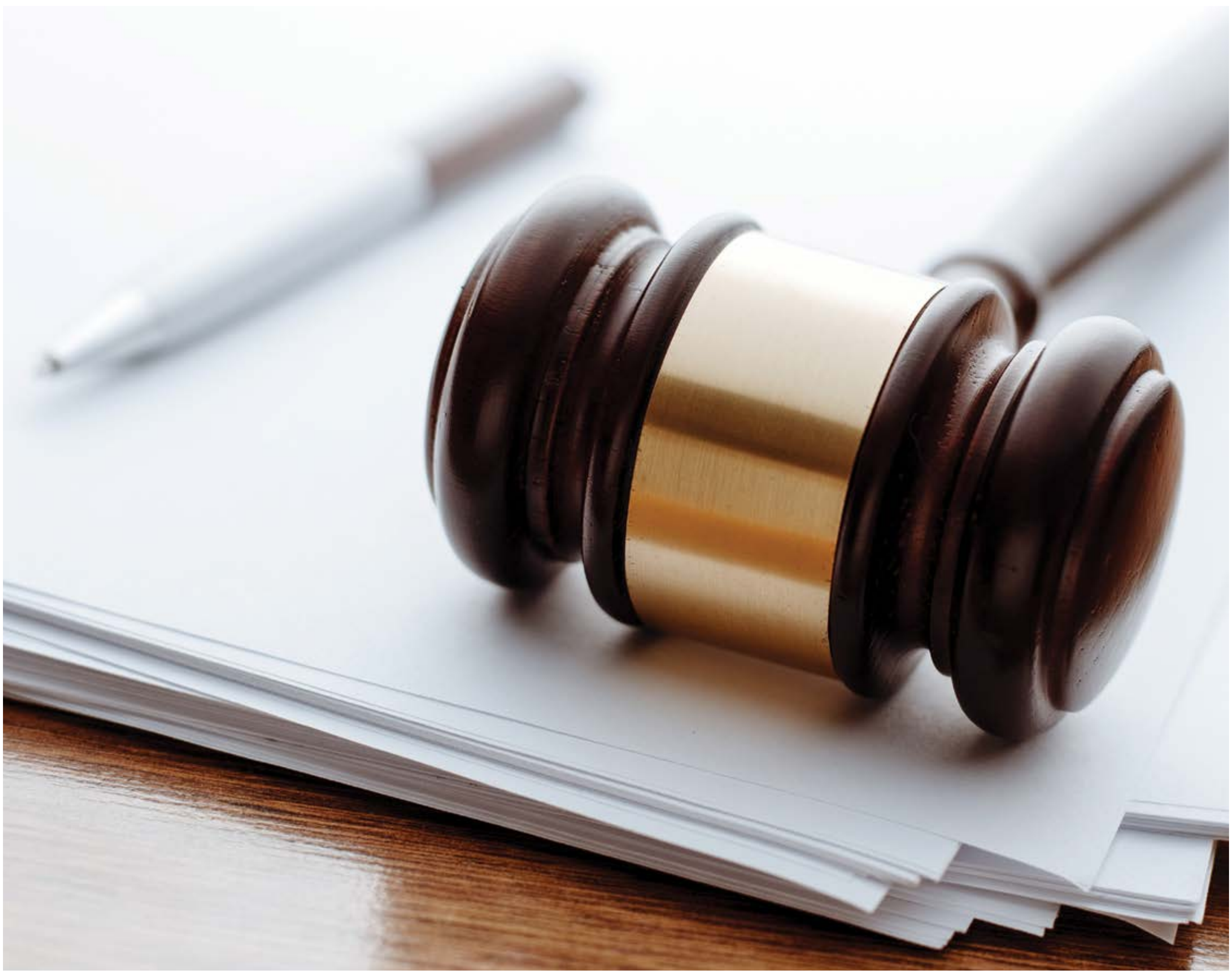
Whistleblowing Checklist

- ✓ Adoption of a formal whistleblowing policy
- ✓ Broad communication of company position on whistleblowing
- ✓ Verification of effectiveness through policy audits

Thus, *whistleblowing policies and procedures* are a key element to good governance, and companies should *clearly communicate* their whistleblowing policies and procedures to employees and the public. In addition, these should be *audited* to ensure their effectiveness.

Hany Assaad says, "Transparency is the most important element in creating a strong governance culture. We like everyone in our firm to speak up if something is wrong, and our whistleblowing policy provides an avenue if they don't feel comfortable speaking up internally. We have outside advisors whom our employees can contact with advice or complaints."

> "Transparency is the most important element in creating a strong governance culture.



Specific Considerations at the Fund Manager and Fund Levels

LP views toward governance have evolved over the last decade. Today, the governance of a fund manager—or 'operational risk'—is one of the key variables that LPs consider when evaluating a commitment to a PE fund. Indeed, Mounir Guen, Chief Executive Officer of MVision Private Equity Advisors, relays that operational due diligence (ODD) is now a main area of focus for LPs. "They really hone in on how these companies are run, what values the ownership of the GP instills, and what governance mechanisms the GP has internally to promote the right views and good outcomes."

At CPPIB, in addition to the investment team's due diligence, an ODD team examines the controls and processes of a prospective GP. Notes Leo Chiu, "We have an internal assessment comparing each firm across our GP relationships so that we can identify areas where we can work with them to ramp up their governance standards."

Nevertheless, while some investors may rank EM managers along a spectrum of governance policies, processes, and procedures, there absolutely are minimum requirements that GPs need to meet. "There's no reason to accept lower standards because it is an emerging market," cautions Anne Fossemalle, Director of Equity Funds at EBRD, "We are not going to do anything weaker in terms of standards even if the starting point is less sophisticated."

Given the smaller size of many EM PE funds, GPs often operate under tight resource constraints, which necessitates a thoughtful approach to managing firm and fund governance. Often, this requires a blend of internal and external capabilities. In addition, fund governance structures (i.e., Limited Partner Advisory Committees, or LPACs) are evolving, while investor demands for more granular and frequent reporting are on the rise. In this section, we explore five additional governance considerations that are particularly germane to participants in the industry (see Exhibit 3). These include: ownership and management of the GP; compliance; fund structure and domicile; LPACs; and, reporting requirements for funds.

Exhibit 3: Governance Considerations for Fund Managers and Funds

Corporate Governance	Business Integrity
Commitment to corporate governance	Commitment to ethical conduct
Proper composition / functioning of Board of Directors	Abidance with anti-money laundering laws
Quality control environment	Adoption of anti-corruption policies
Policies that promote transparency and disclosure	Awareness of economic sanctions
Protection of shareholder rights	Implementation of whistleblowing policies

+

Fund Manager Level	Ownership and Management of the GP
	Compliance
Fund Level	Fund Structure and Domicile
	Limited Partner Advisory Committees
	Reporting Requirements for Funds

Source: CDC Group plc, Corporate Governance Development Framework, IFC, EMPEA.

Fund Manager Level Checklist

- ✓ Disclose / identify beneficial owners of the fund management company
- ✓ Establish and vet governance policies for the fund manager
- ✓ Formalize compliance policies and procedures through the creation of a compliance manual
- ✓ Conduct periodic reviews and refresh policies as needed

Fund Manager Level

In addition to the CG and BI principles that all firms should follow, there are several governance considerations at the fund manager level that merit further treatment (see "Fund Manager Level Checklist").

Ownership of the Firm

Investors should be able to identify the beneficial owners of a fund management company—be they individuals, organizations, or states. Transparency on the beneficial owners—including any affiliated entities or holding companies—is important for several reasons, including tax transparency and agency costs. For example, a recent IFC study discusses how "controlling shareholders may use several strategies to extract resources and assets from firms they control … includ[ing] withholding important information from prospective investors, allocation of corporate opportunities and business activities, and related-party transactions."[19]

Sometimes, identifying beneficial owners can be a more complicated process in EM. In some countries, prominent families and business groups may have ownership stakes or claims on a GP. In others, byzantine shareholding structures may obscure just who a beneficial owner may be. Furthermore, some GPs may sell stakes in the firm—or even list publicly—creating additional layers of consideration regarding who benefits from the performance of the firm and the funds it advises.

With regards to the benefits of ownership, investors generally prefer that management fees are paid to cover the operating costs of the management company. Therefore, no excessive returns are expected from said fees. Investors prefer to have incentives aligned through carried interest.

The aforementioned IFC study highlights six prevalent strategies that can be used to conceal the identity of beneficial owners:

1. Nominee shareholders — a company created for the purpose of holding shares on behalf of investors.
2. Omnibus accounts — a securities account for many investors.
3. Derivatives — can enable effective control of shares without need for disclosure.
4. Pyramid structures — complex control and ownership arrangements via cross-shareholding structures, multiple voting-rights shares, etc.
5. Multiple voting-rights shares — provide control in excess of share ownership.
6. Chains of corporate vehicles — complex ownership structures and arrangements.[20]

Management of the Firm

PE firms should have governance policies that establish a clear conception of the organization's objectives and how it will attain them. There should be a straightforward delineation of individuals' roles and responsibilities within the firm, as well as a decision-making framework that ensures decisions are reached through transparent and accountable processes.

EM fund managers can take a cue from Invest Europe (formerly the European Private Equity and Venture Capital Association, or EVCA), which produces a Professional Standards Handbook that provides useful guidance on key issues regarding the governance of firms, funds and portfolio companies.

Much like EM today, at the time of the Handbook's development, Europe's PE industry was comprised of a multiplicity of actors. TVM Capital's Helmut Schuehsler previously served as Chairman of EVCA's Professional Standards Committee, and ultimately as Chairman of the organization as a whole. "EVCA was an emerging organization representing about 1,000 funds and service providers, with a disparate group of countries and legal prescriptions," recalls Schuehsler, "but the Professional Standards had a positive impact on the industry because members had to sign on to a compulsory code of ethics. They improved transparency and governance across Europe, and they facilitated managers' ability to operate at a pan-European level."

Some general principles and considerations for GP governance include:

- Controls;
- Risk assessment and management;
- Human resources;
- Remuneration;
- Capital adequacy;
- Segregation of assets;
- Procedures and compliance; and
- Information systems.[21]

Fund Manager Governance Requires Constant Review—The View from AfricInvest

Abir Attia, *Director, Responsible Investing*

In the specific case of funds and management companies operating with a broad geographic reach and a sector agnostic approach, rigorous governance procedures and discipline adopted by the firm are vital, both from a risk management perspective and from a business continuity angle.

With growth, risks naturally increase, and they can be magnified by a context of crises of all sorts: economic, political, social, pandemic, and reputational. Over the past few years, several companies have endured the consequences of poor governance, triggering acute interest and scrutiny from investors, as well as the investment management community.

> "With growth, risks naturally increase, and they can be magnified by a context of crises of all sorts: economic, political, social, pandemic, and reputational. Over the past few years, several companies have endured the consequences of poor governance, triggering acute interest and scrutiny from investors, as well as the investment management community.

Through 25 years of existence, our firm grew from three initial partners to nearly 80 investment professionals—including 25 equity partners with 30% female staff, working across seven offices in Africa and two in Europe. Together, we have built a track record of around 155 investments in 25 countries. Along the way, sound governance practices have been tested, adopted, and reinforced, evolving with the pace and size of our activity.

With our group becoming a more complex organization, as a priority, we work consistently on improving the dynamics of internal communication to ensure that our decision-making process is clear, sequenced, and inclusive. Investing in a customized, proprietary, in-house IT system is the cornerstone to achieving a transparent and timely internal communication process. This solution, built around our structured investment process while taking into account the requirements (reporting, legal, etc.) of our different departments (Front Office, Middle Office, Responsible Investing, Compliance, Investor Engagement and Legal), is now the main tool used across our group. It allows the team to work closely together, follow the same process, and access the platform from any location.

In addition to this virtual solution, we have adopted organizational mechanisms. Through the creation of several committees and the identification of key business units over the past few years, we have implemented different levels of approvals and established a system with proper checks and balances conforming to the roles and responsibilities of each department and investment professional. For instance, by establishing Screening and Review Committees, which consider new opportunities for the pipeline, review the performance of the various investees, and evaluate exits, the team members not only share experiences, but also raise red flags at early stages of the process, keep track of the performance of the portfolio, and set the pace of investments and exits.

While setting a Board of Directors may seem like the first priority in establishing good governance standards, most of the work takes place in the structure underneath the Board. For instance, we have put in place an Executive Committee comprised of senior investment professionals who focus on key matters, such as agreeing

on the firm's strategy, recruiting senior-level hires, evaluating the launch of new initiatives, exploring the opening of new offices, and deciding on corporate social responsibility programs. Other committees have been established in order to streamline operations such as:

- A Risk and Compliance Committee, which oversees regulatory compliance and risk management activities across the firm and provides guidance on arbitrating conflicts of interest.
- A Valuation Committee that independently reviews the valuations of the different funds.
- A Human Resource Sub-Committee, which is organized by region and is in charge of HR themes, such as training and performance appraisals.

For each committee, it is crucial to have the discussions and decisions properly documented. All of these different committees—complemented by a set of policies built up over the years around human resources, compliance, investor engagement, accounting, etc.—have resulted in a more engaged team, as well as a more effective and efficient Board of Directors. Ultimately, the role of the Board is overall oversight of the operations. It takes a holistic view of the firm and ensures that interests are aligned—internally as a GP, as well as with our LPs and other stakeholders.

Through the different stages of our growth, governance has always been an integral part of our culture. It is our belief that if a firm wants to grow sustainably, it must continue to put the emphasis on adapting its governance and organizational processes to its size, and on adopting best-in-class policies. An investment firm also has to lead by example as it strives to establish good governance standards within the portfolio companies. Good governance is a virtuous circle and a living standard that requires constant improvements.

In the adjacent article, Abir Attia, Director of Responsible Investment at AfricInvest, discusses how the firm has evolved its approach to governance and management as the firm has scaled its activities—adopting technology systems that facilitate communication, embracing a structure that provides clear roles and transparent processes, and empowering more employees with decision-making authority. This provides but one example of how a fund manager deals with the specifics of governance within its own operations.

Compliance

Fund managers must adopt and establish compliance policies, processes, and procedures. This includes the creation and maintenance of a compliance manual with a code of ethics (as discussed in the prior section), which a fund manager's employees should confirm that they have read and understood.

These policies should be realistic and adapted to the firm. David Risser notes, "We have seen cases where the best practices and codes in a particular country or industry were almost impossible to apply. Policies should be suitable for the institution and actually be able to be implemented. We often see huge differences between what a firm's formal policies say and the actual functioning and informal practices. This gap—translating policies into practices—is key."

Depending upon the jurisdiction where the fund manager is located, these policies may need to be reviewed and refreshed on a periodic basis. For example, US Securities and Exchange Commission (SEC) regulations state that firms registered under the Investment Advisers Act of 1940 are required to conduct annual reviews of compliance policies. These reviews should address items such as conflicts of interest, RPTs, and fees (charged both to the fund and to the portfolio company), among others. Nevertheless, annual reviews can uncover gaps, shortfalls, or lessons learned, and help managers adjust their policies and processes on a go-forward basis.

Fund managers should also ensure that portfolio companies adhere to the GP's policies. Board meetings, committee meetings, and monthly / quarterly portfolio reviews offer natural check-in points to gauge whether a company is abiding by compliance policies and to develop remediation plans, if necessary. Some firms use a systematic approach to portfolio company compliance. For example, one fund manager employs a 'quarterly compliance checklist,' which the firm's compliance officer uses as s/he meets with each investee company, and collects relevant documentation, such as Board meeting minutes, agendas, and background materials, as well as shareholder resolutions and signed legal documents.

Useful Resources

Invest Europe's Professional Standards Handbook

IFC's Information Request List for Funds **provides detailed listings of the types of information investors may request as part of a due diligence examination. GPs may find it useful as a basis for thinking through their governance policies and developing a due diligence questionnaire (DDQ).**

What Goes in a Compliance Manual?

Each firm should develop a compliance manual that is tailored to its own operations and needs, as well as its own regulatory environment.

There is a risk that firms may 'over-engineer' these documents. As one fund manager relays, "We started with a compliance manual that was way too big for the size of our firm, and way too complicated. A specialist firm developed it for us, but after the regulator looked at it, the examiner told us to shrink it so that it made sense for the size of our firm."

Notwithstanding the potential for a doorstop-sized manual, it may benefit GPs to outsource this work to a third party. Obviam's Sarita Bartlett says, "I tend to recommend that firms use a consultancy, because more often than not, it helps them to do it right; to do it in a way that is tailored both to the culture of the fund manager—whether it's compliance- or values-based—and to the regulatory environment."

In addition, consultancies can also be more effective in terms of developing an approach that's in-line with market practices. Medina Jett advises, "It used to be the case that regulators' demands would set investors' expectations. However, now I see that regulators may have 10 focus areas, while LPs may have 15 areas of concern—of which only five overlap. While tailoring to the regulatory conditions is important, it's also critical that managers meet industry best practices."

Some common topics that compliance manuals cover include:

- Overview of the compliance program;
- AML;
- Annual compliance reviews;
- Business continuity / disaster recovery plans;
- Compliance officer;
- Confidentiality / privacy policy;
- Employee Retirement Income Security Act (ERISA) plans;
- Fiduciary responsibility;
- Marketing;
- Recordkeeping;
- Registration; and
- Third-party service providers.

Cybersecurity:
A Cross-Cutting Governance Challenge

Cybersecurity is a growing concern to governments, businesses, and individuals alike—and private equity investors are no exception. To illustrate, an EY survey of global PE firms reveals that 22% have recently experienced a cybersecurity breach or incident.[22]

"PE firms hold a lot of confidential data, mostly sensitive financial information on themselves, their clients, investee companies, and prospective targets. However, it also includes personally identifiable information on employees," notes Sadiq Edu, a Cyber Consultant with Control Risks. "This all needs to be protected in a thoughtful manner."

Cybersecurity Checklist

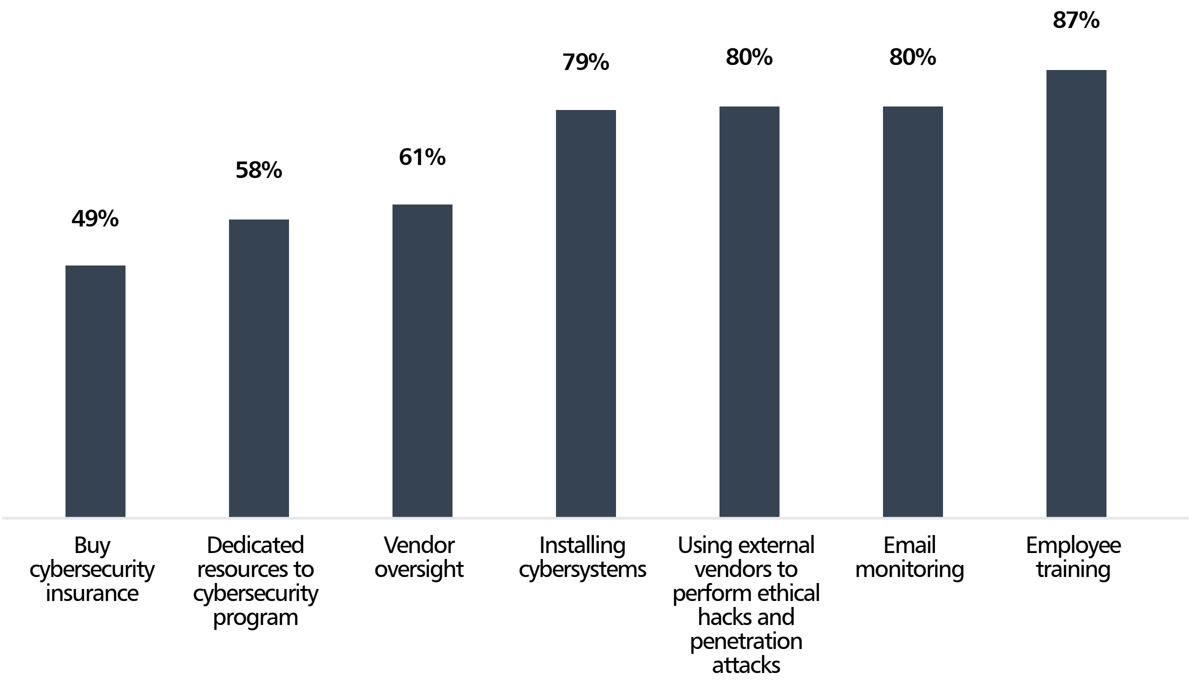
- ✓ Adopt controls and policies for safeguarding personally identifiable and confidential information
- ✓ Implement access rights and control policies
- ✓ Prevent data loss
- ✓ Conduct annual cybersecurity vulnerability assessments, potentially including penetration tests
- ✓ Train employees on cybersecurity issues, including data security while traveling
- ✓ Review third-party vendors' cybersecurity capabilities
- ✓ Develop a cybersecurity incident response plan

From a regulatory perspective, the SEC Office of Compliance Inspections and Examinations established cybersecurity as one of its 2018 priorities, with a focus on, "among other things, governance and risk assessment, access rights and controls, data loss prevention, vendor management, training, and incident response."[23] In its examinations of registered broker-dealers, investment advisers, and investment companies in 2016, the SEC noted that the majority of advisers and funds conduct periodic risk assessments, penetration tests, and vulnerability scans of critical systems, and that all firms use a system or tool to prevent and / or detect data loss as it relates to personally identifiable information.[24]

While each jurisdiction will face its own regulatory requirements, EY survey data suggest that 70% of firms are relying on externally developed threat intelligence tools to keep abreast of cybersecurity issues.[25] However, Medina Jett cautions that reliance on technology controls is no panacea, "GPs must recognize the role their employees play in mitigating cyber risks. A firm's employees must have awareness and focus to keep from negligently exposing the firm to a cyber breach, which is the number one cause of cyber breaches. Firms must have clear policies and robust employee training in place." In fact, 87% of PE firms surveyed by EY conduct employee training to improve their cybersecurity—the most frequently used form of cybersecurity risk mitigation (see Exhibit 4).

Industry experts recommend that firms undertake a cybersecurity assessment or review once per year to assess the firm's people, processes, and technology. Rather than viewing these as tick-the-box exercises that audit compliance with local regulations, the mindset should be one of securing your business. In addition to the annual reviews, experts recommend that cybersecurity be added as a topic for board meetings, with operational reviews undertaken for each meeting.

Exhibit 4: Steps PE Firms Are Taking to Improve Their Cybersecurity



Source: EY, 2018 Global Private Equity Survey.

Useful Resource

As part of its Private Equity Regulatory & Compliance Principles, the Association for Corporate Growth has developed a detailed set of required and recommended actions that PE firms can take to enhance their compliance with cybersecurity regulations.

There are a variety of solutions available to firms depending upon their risk profile and budgetary constraints. For instance, Control Risks offers three layers of assessments. The first is an outside-in assessment that examines communications leaving an external network and a non-obtrusive interrogation of a firm's public-facing infrastructure for vulnerabilities. These passive assessments can be completed for roughly USD10,000. The second layer includes interviews with the management and IT teams of the subject companies to discuss findings from the first layer, and to understand the firm's cybersecurity capabilities and processes. Finally, there is a deeper level of engagement that entails onsite verification of the cybersecurity controls discussed in the interviews in the second layer.

Beyond assessments of GPs' own operations, due consideration should be given to including a cybersecurity assessment prior to each transaction. Edu explains, "Cyber due diligence, often overlooked, should be a central component of any pre-deal assessment. This applies to PE firms making an investment as much as it does to insurance companies considering offering a policy. The common factor is that the cyber risk needs to be understood before those commitments are made, so the decision makers can take informed, confident steps."

Ensuring Good Governance Across the GP, Funds and Portfolio Companies

Albert Alsina, *Founder, CEO and Managing Partner, Mediterrania Capital Partners*

At Mediterrania Capital Partners we are committed to the highest standards of corporate governance. Our governance framework is applied to our own policies and procedures at the GP and fund levels, and those of our portfolio companies, providing rigor, consistency, accountability, and transparency in the way we conduct business. We firmly believe there is a strong correlation between good corporate governance and delivering top-quartile returns.

Firstly, a GP is a regulated entity and so there are several statutory requirements to be fulfilled in order to maintain its licenses. These requirements may differ depending on whether it is domiciled in Mauritius, Spain, Malta, Luxembourg, Cayman Islands, etc., but the fundamentals are similar. In the case of GPs with a small team like Mediterrania Capital Partners, the challenge lies in how you deliver strong governance without incurring an overburden of costs. We have found that using a combination of inside resources and external providers is key in maintaining a good cost-quality balance. As a result, we have inside resources that control the mechanics of the GP and the fund, and external providers delivering highly specialized services at a very reasonable cost.

There are good service providers in the PE industry, such as fund administrators, compliance officers, risk officers, accountants, etc., but even so, in order to ensure that our standards of good corporate governance are rightly applied, it is important to always have them overseen by our own team members who have a very strong financial and / or legal background.

We usually employ external auditing firms to conduct independent valuations of our portfolio companies and confirm their market value. Investors always look at returns, but most of the returns in this industry are unrealized, meaning that these portfolio valuations are key information that we give our investors on a regular basis. As part of our corporate governance framework, and in order to maintain the credibility of existing and potential investors, we always ensure that the valuation provided by our team, as well as by the external auditing firm, is a fair market value of our portfolio companies.

At Mediterrania Capital Partners, we have two controllers—an operations controller and a financial controller—for the fund and the GP. These controllers conduct regular checks with the fund administrators, compliance officers, external auditors, etc.

On the other hand, a process we have never externalized are the drawdown facilities—calculating how much each investor must pay into the fund or as management fees, and then making the capital calls to each investor accurately and precisely. We do this internally because this is an area where there is a high risk of potential mistakes.

At the portfolio company level, we see governance as a social operating system that covers all formal and informal touchpoints. Our formal process, therefore, begins with a General Assembly of shareholders to ensure everyone is informed. The second step lies in establishing a Board of Directors to define the company's vision and strategy. Next, we have several executive committees that ensure the proper implementation of our governance process, which in turn helps to implement our value creation model. We believe in sitting on at least two of these committees: the remuneration committee, which creates alignment for company growth, and the audit committee.

Our governance framework also includes the three enterprise processes common to every company. First, the strategic process, which connects where the company is today with where it is going. Second, the human resources (HR) process—what kind of team we need to deliver on the strategic plan, and how we align this team with the strategy and interests of the PE fund. And finally, the budgeting process, which matches resources with strategy.

Here at Mediterrania Capital Partners, we find that combining these formal operating processes with informal touchpoints with members of the portfolio company helps us achieve our high standards of corporate governance. We often come across highly valuable information through the informal channels.

Fund Level

The governance of funds is evolving and practices can vary widely depending upon the GP and the fund's investor base. Despite the heterogeneity of fund terms, there are several governance matters that should be considered during the launch and operation of an investment fund. These include the choice of structure and domicile for the fund, the establishment and role of a Limited Partner Advisory Committee (LPAC), and ongoing reporting to the fund's investors.

Fund Level Checklist

- ✓ Give thoughtful consideration to how the fund is structured and where the fund is domiciled
- ✓ Utilize an LPAC to keep investors informed of fund developments and to resolve any conflicts of interest
- ✓ Provide investors with detailed financial and operational reporting regarding the fund's investments
- ✓ Utilize a governance and business integrity management system

Structure and Domicile

Due consideration should be given to *how the fund is structured*. Most EM PE funds are structured as traditional limited partnerships (also referred to as Limited Partner-General Partner, or LP-GP structures; see Exhibit 5).[26] In these structures, an investment manager typically sponsors the fund and serves as the GP, while international investors participate as LPs.

The fund is typically domiciled in a tax-efficient jurisdiction so as to minimize the leakage of cash flows amongst the LPs and portfolio companies. For example, some institutional investors—such as university endowments in the United States—do not face tax liabilities on their investments, and therefore would effectively pay a 'penalty' for investing outside of their home markets when confronted with additional layers of tax. As such, tax-efficient jurisdictions open up a broader swathe of international investment opportunities (i.e., EM PE) and expand international capital flows.

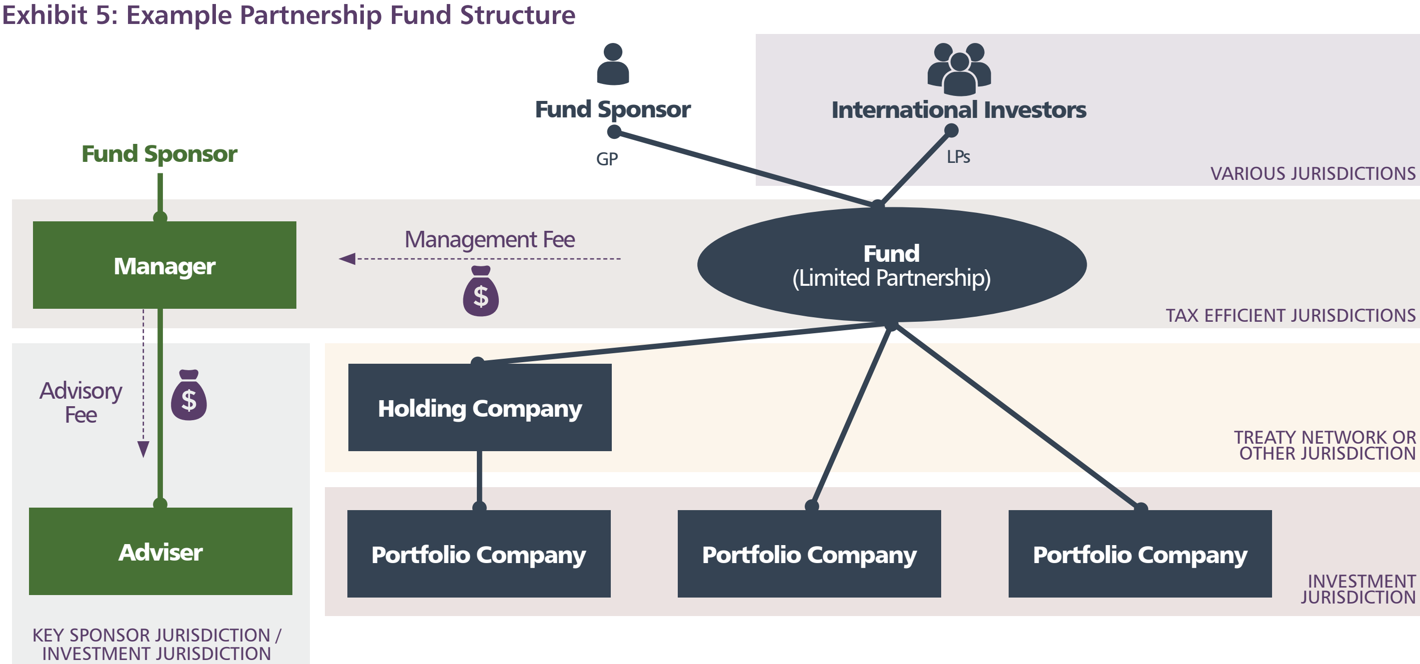
Useful Resources

ICGN's Model Mandate
IFC's Progression Matrix for Funds
ILPA's Private Equity Principles **(Version 2.0; Version 3.0 expected to be released in 2019)**

Fund Structuring Checklist

- ✓ Select a fund structure that allows for tax transparency and flexibility for investments
- ✓ Consider the tax efficiency of the fund's jurisdiction, as well as any tax treaties or legal protections the jurisdiction may enjoy with the fund's target markets
- ✓ Ensure the structure and domicile meet any limited liability needs of investors

Exhibit 5: Example Partnership Fund Structure



Source: Debevoise & Plimpton LLP.

In addition, *certain jurisdictions may enjoy tax treaties or legal protections with the countries in which the fund is expected to invest*, facilitating the ability of a fund to transact. Moreover, certain jurisdictions may have clusters of service providers—such as fund administrators—that smooth the operation and reporting of a fund.

All of which is to underline the point that the choice of domicile can play an important role in practitioners' decisions to invest in—or raise—a fund. To illustrate, an FSD Africa / EMPEA Consulting Services survey on African fund domiciles reveals that 64% of respondents believe the location of a fund domicile is important to their decision-making, with tax efficiency and transparency being the most important considerations.[27]

As one fund formation lawyer states, "Fund structure and domicile can have a tremendous impact on the governance of EM PE funds. For example, for a long time, Mauritius was a significant domicile for Africa- and South Asia-focused funds, but it didn't have the limited partnership form, so you had to have Boards of Directors. That form of governance is very different from a partnership or from a limited liability company (LLC) form, such as a Delaware fund. There are different liabilities that a managing member of an LLC faces compared to the unlimited liability of a GP of a limited partnership."

In addition to the liability profile besetting GPs, LPs can face different liabilities as well. "With limited partnerships," the lawyer continues, "there are statutory carveouts in each jurisdiction as to what constitutes managing a business, what is safe harbor, and what you can do as an LP or LPAC member and not be deemed to be managing the business. There are even differences between Delaware and New York in this regard."

Legal counsel should be sought to *ensure that the choice of fund structure and domicile are suited to the fund's activities and the liability profiles of the various parties*. Funds should be domiciled in jurisdictions that provide for transparency, and GPs should be cognizant of the fact that some jurisdictions may create problems for investors from certain countries (for example, some LPs have refused to commit to funds in Bermuda, the British Virgin Islands, the Cayman Islands, Luxembourg, and Mauritius, among other jurisdictions).[28]

Ultimately, however, Debevoise & Plimpton's Simon Witney believes, "While you have to work within the tax and legal rules of the country where the fund and its manager are organized, which can affect where, and by whom, decisions must be taken, you can—and must—find ways to ensure that decision-making structures meet the needs of the fund and its investors. This is vital, of course, but in my experience can usually be achieved with careful structuring." As always, seek legal counsel and tailor to your objectives.

Limited Partner Advisory Committees

Fund managers should *utilize LPACs to keep investors informed of fund developments and to resolve any conflicts of interest* within the fund's activities. According to the Institutional Limited Partners Association (ILPA), an LPAC is meant "to provide a sounding board for guidance to the GP and a voice for LPs when appropriate.[29] The LPAC is not meant to govern or audit the fund. Indeed, LPs should not be involved in fund operations, nor should members of the LPAC possess fiduciary duties.

The ILPA Principles establish three common objectives for LPACs:

- Facilitating the performance of the responsibilities of the advisory board without undue burden to the GP;
- Creating an open forum for discussion of matters of interest and concern to the partnership while preserving confidentiality and trust; and
- Providing sufficient information to LPs so that they can fulfill these responsibilities.[30]

Jen Choi, Managing Director of Industry Affairs at ILPA notes, "Expectations and norms around transparency and disclosure are heightened relative to where they were when we issued the last edition of the Principles in 2011—as are penalties—and there is an opportunity to reset to more LP-friendly terms." To capture these ideas, ILPA is currently working on issuing a revised edition of the Principles that will pay particular attention to governance concerns. Choi points out there is added complexity created by participation from groups of investors, such as sovereign wealth funds, that may attach different expectations or fewer requirements to their commitments.

"Depending upon who you talk to," continues Choi, "the scales are tipped even more in the favor of GPs than they used to be. That's why a lot of LPs will be more intentional about investing in funds in which they may be more aligned

LPAC Checklist

- ✓ Consider including different types of LPs on the LPAC
- ✓ Embrace structured practices, such as scheduled meetings
- ✓ Attain legal opinion from fund counsel stating that LPs retain their limited liability
- ✓ LPs: be cognizant that operational or managerial engagement may incur loss of limited liability

with the manager (i.e., more meaningful portion of capital in the overall fund)."

However, there appears to be a divergence in practices between developed markets—where multi-billion-dollar funds are sometimes able to close in record time—and emerging markets, where fundraising can drag on for a long time. Given the relative scarcity of commercial capital heading toward EM, the DFIs continue to play a critical role in anchoring funds. And, as catalytic investors, they seek to inculcate quality governance practices from the outset of their investments—including on the LPAC.

"We like to play an active role in the governance structures of a fund," notes EBRD's Anne Fossemalle. "For us, the governance of a fund includes the LPAC, the Investment Committee, and the Board of the GP. In EM, the LPACs are very important because they maintain close oversight on the fund and management activities, and they can advise the fund on a consultative basis. They offer a useful means of keeping up with how the fund is progressing. DFIs have a role to play in encouraging best practices—if anything, we're going to be even more demanding than the ILPA Principles."

According to MVision's Mounir Guen, "When commercial LPs go into EM, the fact that a DFI is in a fund is actually quite important to them. They know that the DFI has very strict guidelines on the governance of the fund, the GP, and the portfolio companies. They are a seal of quality, and a comfort to other investors to partake in these strategies."

AfricInvest, whose fund investors include both DFIs and commercial investors, views the LPAC as a valuable source of knowledge transfer. Skander Oueslati explains, "We have two meetings per annum, and at least one of them is physical. We notify the LPAC well in advance when we're considering an investment or action, and revert to them with a proposal or with the way the issue was resolved once we have finalized our analysis. That way they are notified about the issues and we can have fruitful discussions during our meetings. It is very important to communicate well with your LPAC so that everyone is comfortable and has the same level of information."

While LP advice is important, industry participants note that—in some instances—LPs may be overstepping their bounds and putting their limited liability at risk. Says one participant, "I've seen situations where LPs in EM funds—and these aren't commercial LPs—are communicating directly with the underlying team members at a GP and it's undercutting the authority of the fund's principals. I've also seen instances where LPs are capping the GPs' salaries below market rates. This is pushing too hard, and in some cases the tone has turned a bit ugly in terms of positioning the manager as the enemy." An appropriate balance of oversight should be sought, as our interviews revealed (see "Views on Best Practices for LPACs").

Views on Best Practices for LPACs

The LPAC can be a suitable form of oversight and independent governance of a fund. If you have an LPAC that has key person provisions, a special committee that can review conflicts of interest, an adequate Investment Committee with a level of independence on it, and if each LP has veto rights regarding key person provisions, then functionally you can achieve decent governance. But it has to be structured the right way. An LPAC's members should have sufficient time and commitment to serve on it, and the meetings should be conducted properly, with adequate record keeping and notice. Disclosure and transparency are key. — Investor

We take our contracts seriously, and the LPAC can require a delicate balance. You always want good business interactions, to provide them with the information they require, and of course generate the returns. Our LPAC members serve as the primary conflict of interest resolution committee, and we also have a strategy committee that oversees what we do with investors' money and ensure that we're not investing outside of the fund's strategy. At the same time, we see it as our responsibility to make investment decisions, so we don't want any interference regarding investment and divestment decisions. And the LPAC members shouldn't want to take on such responsibilities. — Fund Manager

As a representative body of LPs, the LPAC should ensure that different types of LPs are included. While for the most part LPs share an alignment of interest in the fund, there may be circumstances when they have different needs and requirements—when one may have a large co-investment, for example. So, a rounded selection of LPs is quite important for us to ensure that different LP voices can be heard. — Investor

The role of LPACs is an area that's still developing. In our view, LPAC meetings should be about information flows and not decision-making. If the LPs get operational, then there is a problem. In my opinion, it's a manager's own responsibility to ensure that what it does is proper from a governance perspective. Investors should listen, take notes, and then leave. — Fund Manager

What we treasure the most is having no surprises. In that regard, we tend to think that the mindset of being transparent is more important than protocols. Whether the GP has good or bad news, we are open to working with them on it if they're open. We recognize that funds exist along a spectrum—some funds don't share information on who's in the LPAC or don't host many in-camera meetings. We just try to move the dial for each of them as we go along. I've had some situations where the GP will approach us and tell us about an issue, and we will share our opinion with them, but at the same time we will tell them to run it through the broader LPAC in an open forum as opposed to one-by-one. We actively try to foster an atmosphere and environment of transparency. — Investor

We go along with the terms that our LPs require and there are some differences among them. For instance, the DFIs want to have more frequent meetings and they'll almost always attend in person, whereas the more commercial investors may prefer an annual meeting, and they may not even always come. But I've found the commercial investors can be the more value additive—the DFIs focus on minimizing risks while the commercial LPs are focused on how to drive the upside. It's good to have a balance of those two perspectives. More generally, we try to be transparent and let them kick the tires of our portfolio companies. We don't restrict their exposure, and if we're having challenges, then we will put it on the table. Oftentimes, the LPs will want to see the challenging portfolio companies. — Fund Manager

Evolving Views toward the Limited Partner Advisory Committee—A View from Counsel

In the old days, LPACs would try to do certain things that were probably risky in terms of being managerial. It took a while for certain LPs in EM to realize that you could actually run into trouble and lose your limited liability if you insisted on doing certain things, whether as LPs or as an LPAC.

One of the things that has become standard practice (and is very important) is to insist on getting a legal opinion from fund counsel that confirms that the LPs and LPAC representatives retain their limited liability. This shouldn't be just a statement of the law, but rather it needs to say that there are no provisions in this specific set of documents that grant LPs or LPAC members rights that could be deemed running the business of the fund, such that they lose limited liability. Funds need to force fund counsels to actually read the documents and see if there is anything that could potentially cause the loss of limited liability.

LPs used to want to put members on a fund's Investment Committee. That is not a good idea, not only because you can lose limited liability for acting like a Board or managing member, but also because if you want to sell funds to the broader market, then they will want a manager who has the expertise to be making the decisions itself.

Sunlight and transparency are what LPs should be pushing for, so that they have a really good idea of what's going on in a fund. They should have removal for cause, removal not for cause, termination of the investment period, and termination of fund rights. These are the ways LPs should handle problems, but they should let the GPs do their jobs.

Transparency and ongoing monitoring and communications are what will enable investors to detect when things are wrong. Insist on good reporting. Insist on face-to-face meetings. Do onsite due diligence trips on a periodic basis. But LPs should give managers the latitude to learn and grow, without being micromanaged.

Fund managers can benefit hugely from what DFIs have to say regarding governance and developing appropriate systems, when it's done through a partnership approach. It's quite interesting that some of the more sophisticated commercial institutional investors are getting very concerned about ensuring that their fund managers have the freedom to do their jobs. If the goal of the DFIs is to catalyze commercial money, then we have to take a big-picture view on this asset class and the role of the LPAC in a fund's governance. It can't be a formulaic check-the-box exercise. It has to be a good partnership built on trust between the managers and their investors.

Reporting Requirements for Funds

Fund managers should provide investors detailed financial and operational reporting regarding the fund's investments. To produce quality reports, GPs must have the capacity to demand particular information from the fund's portfolio companies, and the underlying companies themselves must have the tools and capabilities to furnish the required information.

These may include the following types of reporting:

- Fees and expenses — to include the management fees charged to the fund, transaction and advisory fees charged to the fund and / or portfolio companies, and expenses charged to the fund.
- Capital calls and distributions.
- Financial information — to include quarterly and annual reports, as well as bespoke reporting.
- Upstreaming — sharing portfolio company reports and information.
- Performance — clarity on performance and how valuations are calculated.
- ESG.

From a financial reporting standpoint, IFRS and ISA audits are now fairly standard across the globe. Moreover, the ILPA Principles provide reporting and disclosure best practices that fund managers should consider for many of the aforementioned information requests. ILPA has helpfully created several templates to facilitate GPs' reporting (see Appendix II for direct links).

However, there is a multiplicity of non-financial reporting frameworks, including the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB), and the International Integrated Reporting Framework (IR). Complicating matters, the DFIs each have their own non-financial and / or ESG reporting requirements. "Investors, fund managers, and portfolio companies are confused by the proliferation of ESG reporting frameworks," says IFC's Chuck Canfield, "and operators, especially in emerging markets, would like to have a clearer set of rules so that they can report on ESG and attract capital."

> "Investors, fund managers, and portfolio companies are confused by the proliferation of ESG reporting frameworks.

Nevertheless, investors predominantly look for GPs to choose an approach that works for them. "There is a range of ways to do this," says QIC's Kate Bromley. "We survey our

pool of managers every year and we have seen a lift in the percentage of GPs that have signed up to UN PRI over the last three years. However, approximately 10% of our managers claim to follow the framework but haven't signed up to it, as it can be costly for smaller managers to do so. There is no single best practice, but we want to see how they are managing ESG risks and opportunities."

This is a sentiment shared by Marcelo Jordan, Senior Portfolio Manager (ESG), of the World Bank Pension. "We do not have a mandatory set of principles or benchmarks, but we like to see that our fund managers are aware of the different tools available. For example," continues Jordan, "SASB has issued a Materiality Map that touches on different ESG factors. We like when the manager actively uses this tool, or others that are publicly available and widely recognized. But if they don't, then we ask which tools, data sets, or criteria they use and then we determine whether these make sense for what we consider the most material issues in their investments."
One of the complexities of reporting on EM funds emerges when the investor base is predominantly comprised of local investors. "Domestic investors may have different reporting requirements as well as different views toward non-financial / ESG issues than international investors," notes MVision's Guen. "In addition, reporting may be produced in local languages, currencies, and accounting methods. So there is a fair amount of digging that needs to be done in such situations."

Fund Administration

Third-party fund administrators can play a critical role in ensuring the integrity of information regarding a fund's activities, and enable efficient reporting. In addition, fund administrators can provide transparency over drawdown requests, and facilitate the control and audit of cash flows from the fund to the GP and portfolio companies (and back). For instance, Hany Assaad notes that at Avanz, "We have an external fund administrator that provides a check on cash management, how we allocate fees, expenses, and assets between funds. We are constantly three-way checking across the administrator, the accounting / finance team, the partners, and the investment team."

Albert Alsina agrees on the utility of external providers, but he cautions, "There are good service providers in the market, but they must always be overseen by a team member with a financial and / or legal background." In his estimation, the more funds an administrator has worked with, the greater the likelihood that it will be a quality administrator. The EMPEA Member network includes several fund administrators that GPs should diligence. If a manager is focused on a specific region, it may wish to consult the member rosters of regional associations, such as AVCA, LAVCA, or Invest Europe. In

Useful Resources

ILPA Reporting Template

ILPA Capital Call & Distribution Notices, and Quarterly Reporting Standards

ILPA Portfolio Company Reporting Metrics

International Private Equity and Venture Capital Valuation ("IPEV") Guidelines

Non-Financial / ESG Reporting

GRI Standards

PRI Reporting Framework for Private Equity

SASB Materiality Map

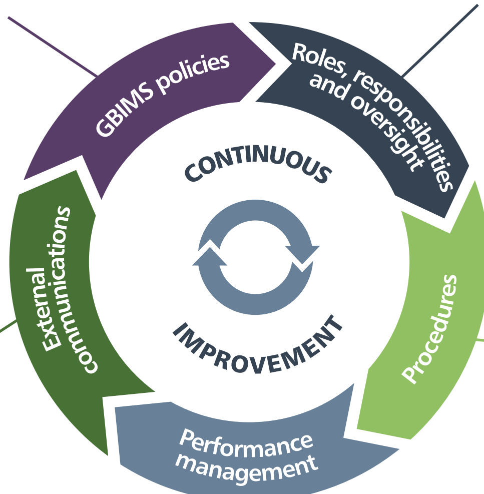
addition, GPs could solicit investors' opinions regarding which administrators they trust.

Governance & Business Integrity Management System

The *adoption of a governance and business integrity management system* (GBIMS) can help to ensure that all of these issues are managed well. Several of the DFIs have developed approaches for a GBIMS that are worth considering. CDC offers one example as part of its ESG Toolkit for Managers, which lays out five key components of a GBIMS (see Exhibit 6). These include:

- Policies — guide the fund manager / fund and portfolio companies.
- Roles, responsibilities and oversight — clearly state who is responsible for what.
- Procedures — establish clear actions required throughout the investment cycle.
- Performance management — periodic reviews ensure adequacy of policies and highlight areas for improvement.
- External communication — report to fund LPs and select stakeholders.

Exhibit 6: Components of a Fund Governance and Business Integrity Management System



- Articulate the fund's commitment to high integrity standards.
- Defines the various requirements and standards to be applied.
- Owned and led by senior management.
- Communicated to staff and, in some cases, external stakeholders.

- Appoint a senior manager or director to lead on implementation.
- Establish day-to-day working practices.
- Build in checks and balances.
- Design effective reporting processes.
- Ensure sufficient resources and training.

- Reporting to and engagement with LPs regarding implementation of BI policies and performance of portfolio companies.
- Reporting to and engagement with other stakeholders.
- Responsiveness to unforeseen events and incidents.

- Documented set of practical procedures for implementing governance and BI policies, covering all investment stages.
- Process and development guided by simplicity and pragmatism.

- Monitor and periodically review adequacy of the individual policies.
- Identify successes and improvement areas in the implementation of the BI policies and procedures.
- Ensure revision of policies as appropriate; continuous improvement as ultimate goal.
- Define KPIs.

Source: CDC Group plc.

Call to Action

This report was conceived as a practical resource for investors and fund managers in EM PE. While it provides a comprehensive overview of key corporate governance and business integrity considerations across the three layers of the industry—PE fund managers, PE funds, and portfolio companies—it's important to realize that good governance is not a static state. As numerous interviewees told us throughout the process of researching this report, there is always progression and every organization can pursue continuous improvement. Moreover, regulations are constantly in flux, creating new governance and compliance requirements.

Indeed, one can read the tea leaves on the direction of travel for what may constitute good governance in the years to come. For instance, in December 2018, the UK's Financial Reporting Council issued the Wates Corporate Governance Principles for Large Private Companies, which discusses remuneration structures and embraces stakeholder relationships and engagement as elements of good governance. In addition, the concept of integrated reporting is gaining traction, giving weight to the importance not only of developing ESG policies, but also holding firms to account for non-financial performance.

Regardless of where the path ahead leads, participants in the EM PE industry should take confidence from what's visible in the rear-view mirror. EMPEA has produced dozens of case studies demonstrating that good governance leads to positive performance—both financially and from an E&S perspective. So have other organizations.

That said, every company is different. Sometimes you can do everything right, and yet things don't turn out well. That is the nature of the industry. Following the checklists in this document can help anyone think through the key governance issues impacting their investment decisions; and doing so will put them on a good path.

GLOSSARY

Glossary of Abbreviations

- AGM ... Annual general meeting
- AIFMD ... Alternative Investment Fund Managers Directive (AIFMD)
- AML ... Anti-money laundering
- BI ... Business integrity
- CDC ... CDC Group plc
- CG ... Corporate governance
- CGDF ... Corporate Governance Development Framework
- DFI ... Development finance institution
- E&S ... Environmental and social
- EM ... Emerging markets
- ERISA ... Employee Retirement Income Security Act
- ESG ... Environmental, social, and governance
- EVCA ... European Private Equity and Venture Capital Association
- FATF ... Financial Action Task Force
- FMO ... Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden N.V.
- GBIMS ... Governance and business integrity management system
- GP ... General partner (i.e., a PE fund manager)
- GRI ... Global Reporting Initiative
- H&S ... Health and safety
- HR ... Human resources
- IFC ... International Finance Corporation
- IFRS ... International Financial Reporting Standards
- ILPA ... Institutional Limited Partners Association
- ISA ... International Standards on Auditing
- IT ... Information technology
- KPI ... Key performance indicator
- KYC ... Know Your Customer
- LLC ... Limited liability company
- LP ... Limited partner (i.e., an investor in PE funds)
- LPAC ... Limited partner advisory committee
- MIGA ... Multilateral Investment Guarantee Agency
- MIS ... Management information system
- ODD ... Operational due diligence
- OFAC ... Office of Foreign Assets Control
- PE ... Private equity
- PEP ... Politically exposed person
- RPT ... Related-party transaction
- SASB ... Sustainable Accounting Standards Board
- SEC ... Securities and Exchange Commission
- UBO ... Ultimate beneficiary owner
- VC ... Venture capital

Note: In this report, "PE" is used as a catch-all term for private capital investments (i.e., private credit, private equity, venture capital, etc.).

Appendix I: Good Governance Checklist

	CORPORATE GOVERNANCE	BUSINESS INTEGRITY	CYBERSECURITY
ALL FIRMS	**Commitment to corporate governance** ✓ Adoption of company code / governance handbook ✓ Development of CG policies, processes and procedures ✓ Establishment and firm-wide acceptance of a governance culture	**Commitment to ethical conduct** ✓ Adoption of a Code of Ethics / Conduct	✓ Adopt controls and policies for safeguarding personally identifiable and confidential information ✓ Implement access rights and control policies ✓ Prevent data loss ✓ Conduct annual cybersecurity vulnerability assessments, potentially including penetration tests ✓ Train employees on cybersecurity issues, including data security while traveling ✓ Review third-party vendors' cybersecurity capabilities ✓ Develop a cybersecurity incident response plan
	Proper composition and functioning of Board of Directors ✓ Well-composed and diverse Board of Directors ✓ Inclusion of independent members ✓ Presence of meaningful and active committees ✓ Structured practices, including regularly scheduled meetings ✓ A strong Chairperson	**Abidance with anti-money laundering laws** ✓ Familiarization with AML laws in relevant jurisdictions ✓ Completion of KYC checks on potential business partners, including investors ✓ Identification of UBOs, directors and managers ✓ Fund's custodian bank located in FATF member country	
	Quality control environment ✓ Document internal operational and financial control processes ✓ Have an independent audit function ✓ Invest in a quality Management Information System	**Adoption of anti-corruption policies** ✓ Adoption of rigorous anti-corruption policies (incl. anti-bribery) ✓ Compliance with extra-territorial corruption regulations (e.g., US FCPA, UK Bribery Act) ✓ Broad communication of company position on anti-corruption	
	Policies that promote transparency and disclosure ✓ Provide audited financial statements ✓ Disseminate material non-financial disclosures ✓ Consider integrated reporting	**Awareness of economic sanctions** ✓ Familiarization with any relevant sanctions on countries, companies and / or individuals ✓ Consultation of US Treasury's OFAC lists and UK government's financial sanctions list ✓ Close monitoring of relevant sanctions on an ongoing basis	
	Protection of shareholder / investor rights ✓ Establishment and documentation of basic common rights ✓ Process for managing related-party transactions ✓ Ongoing disclosure of conflicts of interest	**Implementation of whistleblowing policies** ✓ Adoption of a formal whistleblowing policy ✓ Broad communication of company position on whistleblowing ✓ Verification of effectiveness through policy audits	
FUND MANAGER LEVEL	**Ownership and management of the GP** ✓ Disclose / identify beneficial owners of the fund management company ✓ Establish and vet governance policies for the fund manager		
	Compliance ✓ Formalize compliance policies and procedures through the creation of a compliance manual ✓ Conduct periodic reviews and refresh policies as needed		
FUND LEVEL	**Fund structure and domicile** ✓ Select a fund structure that allows for tax transparency and flexibility for investments ✓ Consider the tax efficiency of the fund's jurisdiction, as well as any tax treaties or legal protections the jurisdiction may enjoy with the fund's target markets ✓ Ensure the structure and domicile meet any limited liability needs of investors		
	Limited Partner Advisory Committees ✓ Consider including different types of LPs on the LPAC ✓ Embrace structured practices, such as scheduled meetings ✓ Attain legal opinion from fund counsel stating that LPs retain their limited liability ✓ LPs: be cognizant that operational or managerial engagement may incur loss of limited liability		
	Reporting requirements for funds ✓ Provide investors with detailed financial and operational reporting regarding the fund's investments ✓ Utilize a governance and business integrity management system		

Source: EMPEA.

Appendix II: Governance Resources

Key Corporate Governance and Business Integrity Toolkits

Resource	Provider	How to Use It	Website URL
DFI Toolkit on Corporate Governance	CGDF	Assess the corporate governance of companies and identify ways to improve governance practices.	http://cgdevelopmentframework.com/cg-development-framework/toolkit-corporate-governance/
ESG Toolkit for Private Equity	FMO and Steward Redqueen	Quantify ESG risks, the effectiveness of ESG risk management, and identify ESG opportunities.	https://www.fmo.nl/esg-toolkit
ESG Toolkit for Fund Managers	CDC	Identify key business integrity considerations for EM fund managers.	https://toolkit.cdcgroup.com/

Fund Manager Governance

Resource	Provider	How to Use It	Website URL
Professional Standards Handbook (April 2018 Edition)	Invest Europe	Glean insights on best practices re: governance, transparency, and accountability for PE funds.	https://www.investeurope.eu/media/710939/IE_Professional-Standards-Handbook-2018.pdf
CFA Institute Asset Manager Code	CFA Institute	Consider key ethical issues and professional responsibilities.	https://www.cfainstitute.org/ethics/codes/asset-manager-code
Information Request List for Funds	IFC	Understand the scope of documents LPs may request, and consider developing responses to the questions as part of a DDQ.	https://www.ifc.org/wps/wcm/connect/adef63004a0aa2a68c37afe54d141794/Funds+Document++Information+Request+List.pdf?MOD=AJPERES
Private Equity Regulatory & Compliance Principles	Association for Corporate Growth	Take advantage of guidance regarding cybersecurity practices for PE firms.	https://www.acg.org/sites/files/ACGPERT_PERCPrinciples.pdf

Fund Governance

Resource	Provider	How to Use It	Website URL
ILPA Private Equity Principles v2.0	ILPA	Review LPs' preferred fund terms and best practices, including the role of LPACs. Note that a third version of the Principles is under development.	https://ilpa.org/wp-content/uploads/2018/02/ILPA-Private-Equity-Principles-version-2.pdf
Fund reporting template	ILPA	Provide LPs with a uniform report that details monies paid to the fund manager, affiliates, and third parties.	https://ilpa.org/reporting-template/get-template/
Capital call & distribution notices template	ILPA	Provide LPs with transparency on how capital is being allocated, and efficiently manage cash flow requirements.	https://ilpa.org/capital-call-distribution-quarterly-reporting/
Portfolio company metrics template	ILPA	Provide LPs with details about the individual portfolio companies in a fund using a standardized template.	https://ilpa.org/portco-metrics-template/
Progression Matrix for Funds	IFC	Assess the level of governance within an investment fund and identify ways to improve governance practices.	https://www.ifc.org/wps/wcm/connect/0f1ba3004a05d803afc7afe54d141794/Funds-Progression-Matrix.pdf?MOD=AJPERES

Resource	Provider	How to Use It	Website URL
Private Equity Funds: Key Business, Legal and Tax Issues	Debevoise & Plimpton	A helpful guide for thinking through the key issues in launching, structuring, and raising a PE fund.	https://www.debevoise.com/~/media/files/insights/news/2015/pe_fundskey%20business_legal_tax_issues.pdf
ICGN Model Contract Terms Between Asset Owners and Managers	ICGN	Consider fund terms that can achieve strong alignment between fund managers and investors.	https://www.icgn.org/sites/default/files/ICGN_Model-Contract-Terms_2015.pdf
International Private Equity and Venture Capital Valuation Guidelines	IPEV	Utilize best practices in the valuation (i.e., determination of Fair Value) of private capital investments.	http://www.privateequityvaluation.com/Portals/0/Documents/Guidelines/IPEV%20Valuation%20Guidelines%20-%20December%202018.pdf?ver=2018-12-21-085233-863&timestamp=1545382360113
Corporate Governance			
National CG codes	ECGI	Search through a database of national corporate governance codes to access relevant guidance in the jurisdictions in which you invest.	https://ecgi.global/content/codes
CG progression matrix	CGDF	Assess the level of corporate governance within a company and identify ways to improve governance practices.	http://cgdevelopmentframework.com/wp-content/uploads/2014/12/CGMatrix.pdf
Industry-specific progression matrices	IFC	Access tailored governance progression matrices for the following types of companies: listed; family- or founder-owned; financial institutions; state-owned; funds; and, small and medium enterprises.	https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/investment+services/corporate+governance+tools
SME Governance Assessment Tool	CGDF	Use a simple tool to analyze risks related to governance of small and medium enterprises, and identify suitable mitigating factors.	http://cgdevelopmentframework.com/wp-content/uploads/2017/07/SME-Governance-Assessment-Tool-Beta-Jun17.pdf
IFC Family Business Governance Handbook	IFC	Identify and address basic family business governance issues.	https://www.ifc.org/wps/wcm/connect/ed06f88048a7e741aad7ef6060ad5911/Family_Business_Governance_Handbook.pdf?MOD=AJPERES
2018 Africa Sustainability Study: Creating Value through CG	AVCA	Access data on governance practices within Africa's PE industry and review cases of good governance.	https://www.avca-africa.org/research-publications/data-reports/2018-africa-sustainability-study-creating-value-through-corporate-governance/
G20/OECD Principles of Corporate Governance	OECD	This is one of the foundational documents on corporate governance principles.	https://www.oecd.org/corporate/principles-corporate-governance.htm
ICGN Global Governance Principles	ICGN	Reference the ICGN's primary standard for well-governed companies. While primarily focused on publicly listed companies, they are also relevant to private companies that aspire to high standards of CG practice.	http://icgn.flpbks.com/icgn_global_governance_principles/

The Wates Corporate Governance Principles for Large Private Companies	Financial Reporting Council	Develop a sense of the direction of travel for what constitutes a well-governed private company.	https://www.wates.co.uk/wp-content/uploads/2018/12/Wates-Corporate-Governance_Screen_2018-2.pdf
What Makes a Great Independent Board Member	Mark Suster	Read one VC's view on how to think through appointing a Board member to a portfolio company.	https://bothsidesofthetable.com/what-makes-a-great-independent-board-member-4f2837963e30

ESG

Resource	Provider	How to Use It	Website URL
Integrating ESG in Private Equity: A Guide for General Partners	PRI	Learn how to integrate ESG into a PE firm's organization, operations, and investment process.	https://www.unpri.org/download?ac=252
EMPEA ESG Reference Guide (Second Edition)	EMPEA	Access a repository of ESG resources.	https://www.empea.org/app/uploads/2017/12/ESG-Reference-Guide-2.pdf
MJ Hudson book of Environmental, Social and Governance Factors in Private Equity Investing	MJ Hudson	Understand how PE firms are treating ESG issues and identify how your firm can implement an ESG policy that fits your objectives.	https://www.mjhudson.com/esg-a-guide-to-implementing-in-your-pe-portfolio/

Case Studies

Resource	Provider	How to Use It	Website URL
CG success stories in the MENA region	IFC	Review practical examples of how PE firms are enhancing governance.	https://www.ifc.org/wps/wcm/connect/6fd9498048ec689da2c9fe1b17326f85/CG_success_stories_MENA062015.pdf?MOD=AJPERES
CG in Vietnam success stories	IFC		https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/resources/lessons+learned/cg_in_vietnam_success_stories
EMPEA Case Studies	EMPEA		https://www.empea.org/research/case-studies/

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Appendix IV: Footnotes

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Project Contributors

FMO

FMO is the Dutch development bank. Since 1970 we have been a driving force behind investments empowering local entrepreneurs in emerging markets. We believe in a world in which, in 2050, more than 9 billion people live well and within the means of the planet's resources. We invest with the aim of enhancing local prosperity in places where this is needed most. We focus on the private sector in the following three industries: Energy, Financial Institutions and Agriculture, Food & Water. In these markets we empower entrepreneurs to build a better world. We take risks that the commercial sector is not willing to take. Our role extends beyond financing, as we challenge businesses to meet high international standards regarding the welfare of people, corporate governance and the environment. These businesses in turn create jobs, decrease inequality and improve climate. We have a strategy that aims to be your preferred partner to invest in local prosperity. FMO has its head office in The Hague, the Netherlands with a local office in Johannesburg, South Africa. www.fmo.nl

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