

Substance, governance and impact – the hot topics from HKVCA Asia Venture Capital Forum 2019

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Economic substance, fund governance and ESG were the three key topics discussed by the technical panel at the HKVCA Asia Venture Capital Forum 2019 moderated by Ogier partner Kate Hodson yesterday.

Kate was joined on the panel by Simon Ho (CFO, IDG Capital Partners), Grace Lee (Partner & CFO – Qiming Venture Partners) and Paul Ma (CFO & Managing Director – Hillhouse Capital).

The Ogier delegation at the event included Eric Chow (Head of Business Development, Greater China), Lin Jacobsen (Associate), Alan Wong (Legal Manager), Graham Gurney (Director, Ogier Global), Bill Chiang (Associate Director, Ogier Global) and Sisi Fan (Manager, Ogier Global).

The panel gave their views and experience on the three key topical issues of substance, governance and ESG investing for the PE & VC funds industry:

- **EU substance legislation – funds industry able to quickly adapt**

The overwhelming feeling was that there is no need to panic about the new EU substance legislation within the funds industry. The implementation of FATCA and CRS and changes to the Cayman AML regime over the last few years have forced all Cayman funds to raise their game when it comes to regulatory compliance and the industry has already shown how capable it is of adapting.

On the basis that Cayman Islands investment funds are excluded from the requirement to put in place substance under The International Tax Co-operation (Economic Substance) Law, 2018, the main focus for many in the industry will be those that have in place Cayman fund managers.

You may refer to Ogier's briefing on this topic for further information:

<https://www.ogier.com/publications/cayman-islands-economic-substance-requirements->

- **How the Abraaj case is a reminder of the need for good governance and transparency**

The high profile Abraaj case and the ongoing disputes around the group's collapse is still focusing minds on governance at the GP level. Abraaj had positioned itself as an impact investor and had investors such as the Bill & Melinda Gates Foundation and IFC and the collapse was therefore particularly shocking to the industry.

Again and again we hear about investors getting their own legal advice before making significant decisions on fund investment. In Asia, we had traditionally seen a lot less of this "LP work" compared to Europe, but this has changed over recent years with more Asian investors looking to negotiate the terms of the LPA and enter into side letters.

In many countries PE/VC is a relatively unregulated space, with LPs in many ways policing their own investments. It is therefore not surprising that the due diligence process and documentation negotiation has heated up.

The panel gave their experience on the sorts of areas that investors care about when doing due diligence prior to investing and there was an emphasis on operational DD. Investors will want to know how the fund supervises third parties providing services for fund operations as well as deal sourcing, screening, due diligence processes and portfolio monitoring. They will also want to know how the fund's governance systems work, for example, looking at conflict of interest policies, whether the GP has a code of ethics and professional conduct and will want to be provided with details of the fund's compliance policies. One of the panellists commented that they are now asked questions by LPs on how they would handle harassment complaints. It is clear that corporate governance is not just a board level matter and investors will look to do a deep dive into the operations of the GP and fund processes when conducting due diligence.

- **Gaining momentum – the ESG Conversation**

Environmental and social issues are increasingly important to companies and their stakeholders in the VC/PE industry. The United Nations-supported Principles of Responsible Investment, drafted by an international network of investors, provides a framework for incorporating sustainability and ESG management best practices into investment decisions and ownership practices across asset classes.

The LP due diligence process has expanded to cover not just governance matters but now social and environmental considerations as well. Certain investors already require investment funds in which they invest to ensure all portfolio companies complete an ESG questionnaire as part of the investment due diligence process.

ESG is becoming a hot topic globally and one which investors and managers will find harder and

harder to ignore.

It was noted that this is not just a "European" phenomenon. China has risen to being of the 2nd largest green bond markets in the world, and in Japan the GPIF have given a strong endorsement of ESG investing, offering a compelling argument for fund managers to adopt ESG principals. The Stock Exchange of Hong Kong recently released a consultation paper to support and improve issuers' governance and disclosure of ESG activities and metrics. One of the key proposals is to introduce mandatory disclosure requirements to include a board statement setting out the board's consideration of ESG issues.

The panel also highlighted the relationship between ESG and long-term value, namely the need for "patient capital" in this area.

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