Thoughts on Improving the Incentive and Restraint Mechanism of Private Equity Investment Fund

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Abstract: Benefiting from the national policy support and the gradually-improving capital market environment, the domestic private equity investment fund business starts late, but the capital scale has grown rapidly, and has become an important force that can not be ignored in the financial market. Although the prospect is broad, but private equity investment fund in each stage of the business may contain different nature of huge risks.The research results of domestic scholars on private equity investment fund are still in the stage of exploration and development. Therefore, this paper has important theoretical and practical significance to the research on the risk prevention countermeasures of private equity investment fund. For fund investors, it is necessary to screen managers with good reputation, adopt supporting incentive and restraint mechanisms, and implement necessary supervision on managers in order to get better development.

Keywords: Private Equity; Incentive Mechanism; Restraint Mechanism

Introduction

The domestic private equity investment fund business has a relatively short development period. It needs to be continuously perfected in many aspects, such as policy, regulation system and risk control system. As a new type of high-risk and high-yield investment industry, the business process is complex and changeable, and every business link is faced with many uncertain factors.The management level of managers is uneven, and it is difficult to make professional and timely judgment on risks in the business process. However, the investment level of investors is limited by their theoretical knowledge, growth environment and investment experience, and it is difficult to understand and predict various risks of fund products. Compared with developed market countries, there is a great gap in private equity investment fund business in China in terms of the degree of policy support, system improvement or market maturity. Therefore, private equity investment funds are worthy of attention and research for the improvement of theoretical guidance and the improvement of practical operation.

1. Overview of private equity investment funds

1.1 The concept of private equity investment funds

As a form of financing in the capital market, private equity refers to a class of equity that is not publicly traded on a stock exchange. Private equity-style investments typically involve investing in a running company or buying a running company.The concept of private equity originated from the field of venture capital. In the early stage of its development, private equity was mainly aimed at the venture investment of small and medium-sized enterprises to support their expansion and financing. Private equity capital originally come from institutional investors.

Private equity fund is commonly called "industry investment fund" in China. As for the definition of a private equity fund, Wu Xiaoling says it invests in unlisted company shares by raising money from a large number of wealth holders. Zhu Qifeng's point of view is: a profit-oriented financial investment in shares of an unlisted company by raising funds through private channels, which is managed by professionals and exits at an appropriate time within a certain period of time. Some scholars believe that private equity investment should only include investment in the equity of mature unlisted companies rather than start-up companies. From these definitions, it can be seen that there are big differences in the definition of investment objects and investment scope of private equity investment funds, which are basically the same in legal attributes.

Therefore, the definition of private equity investment fund can be briefly summarized as: investors raise funds from investors in a non-public manner, then invest in unlisted companies, and participate in the unlisted company's operation and management in order to realize profits and earnings; the goal is to finally exit through IPO, merger or acquisition; the organization form of the fund mainly includes partnerships, corporations and trust.

1.2 The characteristics of private equity investment funds

First, the investment objects of private equity investment funds are usually equity investments of unlisted companies, and they are mainly industrial investments, especially high-tech industries and high-efficiency infrastructure construction industries, such as urban public facilities construction and power engineering construction. In order to promote further industrial upgrading and highly structured through investment, it usually has the characteristics of obtaining high profits with high risks.

Second, private equity funds are usually medium and long-term investments, with the investments lasting 3 to 7 years. Generally, private equity fund invests in the enterprises while they are at early stage. It witnesses the development of the enterprises and fininally exit when it is appropriate_that means an expected return can be gained. In general, the investment lasts a very long time.

Third, private equity investment funds adopt the method of "investment + management". On the one hand, private equity funds provide capital for enterprises . On the other hand, investors must participate in the specific operation and management of the invested enterprises and provide them with professional management services, such as how to improve profits and build a reasonable corporate framework. Therefore, on the whole, private equity investment fund is different from pure capital investment behavior. It is a kind of capital investment mode that combines investment attribute with professional management.

1.3 The Organization of private equity investment funds

According to the difference of organization form, private equity investment fund can be divided into trust type, company type and partnership type in practice.

Trust type private fund refers to a kind of private fund formed by parties agreeing to sign special trust terms to stipulate their respective rights and obligations. Trust type reflects a legal relationship between trust and trustee. In practice, the trust private fund itself is a collection of property. The fund manager is entrusted by the investor to operate and manage the fund in his or her own name, while the investor only distributes the interests as the entrusting party and has no right to participate in the important decisions about the fund operation and management. The organizational structure of the trust private fund is relatively simple and clear. The manager and the trustee manage and operate the fund property by agreeing trust terms.

Corporate private equity fund uses the structure form of a company to organize and operate funds. Corporate fund contains a legal relationship between principal and agent. It makes investment in the name of the fund company and undertakes corresponding risks and responsibilities. In practice, the fund manager must manage the fund in the name of the fund company, but not in the name of an individual. At the same time, investors become shareholders of the company by investing and buying a certain number of fund shares. They have the right to attend the shareholders' general meeting of the company, enjoy the shareholders' right to know and participate in the election of directors and other major decisions of the company, thus limiting the rights of fund managers. Corporate private equity funds are registered and registered in the name of the company according to relevant laws. The structure of the company is complete, and the operation and management are in accordance with the explicit provisions of the Company Law, which is relatively standard.

Partnership private equity fund is established according to the partnership agreement signed by the parties. It reflects a legal relationship of partnership, and the specific partnership matters are agreed upon in accordance with the partnership agreement. Partnership private equity fund is divided into two types: limited partnership and non-limited partnership. At present, limited partnership private equity fund is the mainstream model in the global developed capital market represented by the United States. Partnership ensures the realization of the respective interests of investors and fund managers with its own unique institutional attributes, thus effectively diminishing moral hazard to a certain extent and making the establishment, operation and withdrawal of private equity funds efficient and convenient.

2. The problems of the incentive and Restraint mechanism of private equity investment fund

2.1 The incentive mechanism of private equity investment fund is unreasonable

The incentive mechanism of fund for manager is the key area to be studied in private equity fund governance. A rational design of the incentive mechanism of fund can improve the efficiency of internal governance and encourage the manager to work for the interests of fund investors to the greatest extent.

In private equity funds, the incentive mechanism generally includes the management fee of the fund, the dividend of the proportion of equity invested by the manager in the project, and the right to distribute the fund's profits after the project exits. In practice, this issue of interest distribution has been decided at the beginning of the foundation of the fund, with the principle of good reward with good performance. Investors and managers agree with this principle.However, for most funds, there is still no conclusion on how to calculate the reward of the fund managers who have decided to invest but have not completely withdrawn from the fund manager's resignation.

In recent years, with the rapid development of domestic private equity investment funds, fund general partners leave frequently. Kleiner Perkins, for example, has had five general partners left in just four years. CDH Venture capital's Wang Gongquan quit the case, and its bonus rights had not been excercised by the time this article went to press.

There are two usual pracitces in the industry. One is to give up bonuses altogether. The exceptions are for excusable reasons such as good health and leaving China to reunite with family. Some Renminbi funds are doing this because they want to make their partner teams more stable and enterprising. Second can be found in relevant practices of foreign funds, which divided into the following situations:

One is that if the fund pays dividends on a transaction-independent basis, departing partners usually get a return on what they have invested. That is, when a project is invested and the transaction is completed, the partners can receive dividends from the transaction even if they leave.

Second, if the fund carries out dividends according to the overall profit method of the fund, it can be divided into two situations: one is that the retained partner buy out the departed partner's dividend right by means of transfer, and the other is to retain part of the departed partner's dividend right. This part may be specified in a supplementary agreement to the partnership agreement or in a pending option.

Third, if you join a rival fund, or even take away the project you are looking at, you will have to withdraw your bonus rights, and you may be sued for violating the confidentiality clause.

2.2 The restraint mechanism of private equity investment fund is not perfect

Restraint mechanism and incentive mechanism are two systems of mutual fund internal governance. The purpose of the incentive mechanism is that the principal adopts a certain way to urge the agent to take actions that are beneficial to the principal's interests and not to damage the principal's interests.The purpose of the restraint mechanism is to design a series of restrictions on the fund manager in the process of fund operation, so that the fund manager can regulate the fund under the supervision of investors, and prevent the manager from damaging the interests of the fund. The ultimate goal of both is the same.

Restraint mechanism usually describe how to improve the fund's governance structure and how to reduce the agency cost of the fund. For example, in the limited partnership fund, the mandatory regulation on the amount of the manager's capital contribution is a restraint clause, and at the same time, to a considerable extent, it restrains the high-risk behavior of the fund manager. Another example is that it is stipulated in the fund that a risk control director such as the investment promotion model of Zhongke should be established to conduct risk assessment, which is to allocate rights and assume responsibilities from the perspective of governance structure. Therefore, due to the imperfect restraint mechanism, the governance structure is not perfect, and finally the agency cost problem is significant.

3. Thoughts on improving the incentive and restraint mechanism of private equity investment fund

3.1 Establish the reference standard of bonus right,and remedy the defects of incentive mechanism

Generally speaking, the biggest chunk of the fund manager's income is the right to share the fund's profits after exit.

After the expiration of a fund, according to the regulations, the principal of the external investors will be rewarded first, and the other profits will be shared between the manager and the external investors, with the customary 20-80 split.Taking Wang Gongquan's resignation as an example, in addition to Wang Gongquan and the other four partners of CDH Ventures, Wu Shangzhi, chairman of CDH Investments, will be able to participate in the 20% distribution of the fund's profits. This requires partners to stay for the full duration of the fund before it is fully owned by them in the legal sense. There is no industry standard for determining bonuses when a fund's general partner leaves.

In the author's opinion, it is reasonable to refer to the option standard of foreign funds, and the quitters should not be forced to give up the bonus right completely.The option to be held means that according to the provisions of the agreement or industry practice, the partner staying for the full year specified in the option,will be fully entitled to the bonus, or will be converted to a certain percentage according to corresponding years. The selection of the number of years to be authorized is often related to the investment period of PE fund. A fund usually has a duration of 7 years. GP will invest firms in first 5 years, and wait for the opportunity to exit in the next two years to. So a fund with a duration of seven years tends to have a investing period of five years. If the waiting period is 5 years, then Wang Gongquan's may have 3/5 of the total bonus if he has stayed for nearly 3 years. Unless he joins a rival, the other partners have no right to punish him and take back his bonuses.

At present, it is still not mandatory for all funds to apply this standard, but it should be recognized that a specific standard that can be referred to must be the direction of the future standard development of the fund.

3.2 Strengthen the restriction of partnership matters and shape the reputation restraint mechanismConclusion

According to Article 63 of the Partnership Law, the partnership agreement shall specify the authority to execute the partnership affairs. But the current law has no specific restrictions on partnership matters, so specific terms should be agreed in the partnership agreement, to restrict the personnel involved in the implementation of partnership affairs. To be specific, limited partners can restrict general partners' daily management behavior and prevent their abuse of management power by stipulating various restrictive terms in the partnership agreement. For example, limited partners can add restrictive terms related to fund management, investment types and general partners' activities. Meanwhile, in the practice of our country, the limited partner with the largest fund share can attend the advisory committee of the fund. Although he/she has no right to interfere in the management of concrete issues, he/she can participate in the proposal and supervision work of the important decisions, and play a role in restricting the general partner.

When a limited partnership private equity fund is freely formed in the capital market, the composition of partners conforms to the principle of two-way selection.When accepting the selection of general partners, the market reputation of LPs as investors is a very important criterion. Only those LPs with good market reputations are likely to raise a large amount of capital in a relatively short period of time.Similarly, when accepting the selection of limited partners, the market reputation of the general partner as the fund manager is also very important. The general partner with a good market reputation may occupy a favorable position in the negotiation of the benefit distribution with the limited partner, and obtain more more compensation.Therefore, a reasonable reputation restraint mechanism can effectively play the role of external supervision of the market.

Since the reputation of partners is derived from their long-term investment and operating performance, fund managers will actively improve their investment performance and market reputation even without obvious income incentives, so as to improve their future income and development prospects. It is suggested that China should strengthen the construction of fund managers' market reputation mechanism, formulate operable reputation evaluation standards, and pay attention to the binding effect of reputation restraint mechanism.

Conclusion

Private equity investment fund plays an important role in promoting the adjustment of industrial structure and the development of strategic emerging industries, which is a major trend of the global financial market. Domestic private equity investment fund industry started late, and there is a big gap compared with the market of foreign developed countries. At the same time, with its complex business process, long operation cycle, serious information asymmetry problem uneven management level of managers, and investors who usually cannot realize the risks because of limited investment knowledge and experience, it is of great practical significance to promote the development of the industry and provide investment decisions and policy recommendations by studying the existing problems, risks and countermeasures of the industry.

Investors need to carefully select fund managers in terms of management team professionalism and market credibility; Supporting incentive and restraint mechanisms can be adopted, which includes: choosing limited partnership fund products, requiring the fund property to adopt custody system, and adopting the incentive excess performance commission distribution system for the manager. Through the fund contract, the decision-making system of the fund share holder meeting, the fund internal governance structure and other protection mechanisms, the manager's behavior can be monitored and encouraged to protect the investment rights and interests in the investment agreement; In addition, the obligation of information disclosure can also be clearly agreed in the fund contract to implement necessary supervision over the manager.

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