

# **Preparation of the Commission's formal response to the Rasmussen and Lehne reports**

## **Submission by the Association of Investment Companies**

The Association of Investment Companies (AIC) notes with concern the adoption of the Rasmussen and Lehne reports by the European Parliament. While there may be issues relating to private equity and hedge funds which require consideration by the Commission, we have been disappointed with the negative tone of the reports which directly link hedge and private equity fund activity to problems which have much broader origins and implications.

In contrast, the AIC warmly welcomes the considered and proportionate responses the Commission has made to these reports to date. Particularly helpful was Commissioner McCreevy's initial reply in the Parliamentary debate and his speech to the European Private Equity and Venture Capital Policy Meeting. The AIC understands that the Commission is now preparing its detailed reflections on these reports and we are keen to make some observations.

### **AIC perspective**

The AIC represents investment companies - closed-ended funds, whose shares are traded on a stock exchange and which invest in a portfolio of assets to provide their shareholders with an investment return. The vast majority of our members are UK listed, although some also trade on other markets, such as AIM and Euronext.

A number of investment companies are dedicated private equity vehicles and compete directly with limited partnership structures. Other private equity investment companies are 'funds of funds' which invest into a number of unlisted private equity funds.

Where hedge fund strategies are concerned, our members tend to be either funds of funds (investing in a number of unlisted hedge funds) or 'feeder funds'. Feeder funds invest in one hedge fund only and the investment company (which has its own board representing shareholder interests) sits alongside the other investors in the unlisted hedge fund.

The AIC supports both private equity and hedge fund strategies as potential means of diversifying asset exposure and securing investment returns. Aside from that, our specific interest is how these strategies are used within the quoted, closed-ended, investment company structure.

Our view is that the investment company structure can provide benefits for investors who seek hedge fund and private equity exposure through that route. For example, most investment companies have lower barriers to entry because they have no minimum size for investment. Investors do not have constraints on exit as they sell their shares on a public market.

## Overview

While both reports make passing references to the value of private equity and hedge fund strategies, they seem to be driven by an underlying suspicion of these investment approaches. Most notably, the Lehne report even implies that private equity investors 'plunder' the companies they invest in. This view of private equity is entirely wrong. Private equity funds seek to build businesses and create value – not destroy it. With this in mind, we hope the Commission's formal response to these reports reaffirms its overall support for these strategies.

The reports also fail to properly define (and distinguish) between private equity and hedge fund investment. This makes their recommendations somewhat difficult to understand and evaluate.

Both reports fail to fully recognise that, for example, sovereign wealth funds and traditional investment funds increasingly use the same strategies as hedge and private equity funds, which should therefore not be unfairly singled out for attention. The Commission should ensure that its response is non-discriminatory. This will be most deliverable where its regulatory response is focussed on investment practices, not vehicle types.

However, before making any proposals for regulation, the Commission must identify the problem it is trying to address. The reports themselves fail in this key task. For example they identify high levels of debt as a potential threat to market stability – and we agree that may be a concern. That said, the problem primarily lies with the capital adequacy and lending practices of debt providers, not with their clients. Also, while private equity and hedge funds have taken out debt, they are not the only customers involved. Therefore the reports' focus on vehicles rather than lending practice is both unhelpful and inaccurate.

In responding to these reports we **recommend** that the Commission should focus on generally accepted principles of good regulation. That is, it should only propose legislation which is:

- **targeted** on a specific problem, with identified policy outcomes;
- **consistent**, so that legislation affects all parties in the same way and is in line with the existing regulatory requirements;
- **proportionate**, so that regulation is only introduced if it creates benefits greater than the cost of its introduction and administration;
- **evidence-based**, in that there is substantive evidence that there is a problem which needs addressing and that the proposed approach has a real prospect of securing the correct outcome.

By and large, the Lehne and Rasmussen reports recommendations fail to meet these requirements. If the Commission's response takes account of these principles it will be far more credible and likely to deliver a successful regulatory response.

## **Detailed observations**

This section comments on only those issues which are of most relevance to our members.

### **Rasmussen Report recommendations**

#### ***Recommendation 1 on financial stability, capital and universal regulatory coverage***

**Capital requirements:** We do not believe that capital adequacy requirements should be applied to investment firms. Regulation should focus on the originators of lending – not the client. With this in mind, we note the recently published proposal to amend the Capital Requirements Directive. This is not directly within our sphere of interest but we are generally supportive of the proposals. We would strongly **recommend** that the Commission resists attempts to significantly broaden the scope of the CRD as suggested by the European Parliament.

**Valuation:** The AIC supports proper valuation of assets, which is extremely important for investors. However, the Commission has already taken action to deliver accurate valuation of illiquid assets by adopting IFRS. The report's recommendation is problematic as it fails to distinguish between vehicles which may already be providing robust valuations and those which are not. It is unclear what further action is being requested.

Notwithstanding our concern about the specifics of the 'valuation' recommendation we do welcome the call for 'principles-based' regulation, which the AIC **recommends** should be adopted more widely in European legislation. Principles-based regulation, which focuses on outcomes rather than processes, has the potential to secure a far more robust regulatory framework than detailed rules. It is not the easy option portrayed by its critics. If implemented correctly it should ensure that compliance with regulatory obligations is an integral part of the management of financial institutions rather than a low-level 'bolt-on'. The potential for principles-based regulation to deliver better outcomes for consumers and markets should not be ignored if regulations are to be successfully introduced to deal with evolving market circumstances.

#### ***Recommendation 2 on transparency measures***

**Private equity and protection of employees:** The impact that private equity activity has on workers' rights has been significantly misrepresented in the recent public debate. In the UK the Transfer of Undertakings (Protection of Employment) Regulations 2006, known as TUPE, have implemented the relevant EU requirements which provide a guarantee of workers' rights. Where TUPE does not apply (for example, where a business is bought through the purchase of its shares) other employment law protects workers and ensures their rights are maintained. The activities of private equity funds do not, of themselves, create new risks for workers. The recycling of

criticisms regarding workers rights' in this report reflects prejudice about the role of private equity, not the reality of the situation.

### ***Recommendation 3 on excessive debt measures***

**Leverage for private equity:** The AIC **recommends** that the proposal to limit leverage for private equity funds should be very strongly resisted. There may be a case for regulating lending more closely to protect financial stability, but there is no convincing case for a debt ceiling for borrowers. Sustainable debt levels will be different for different entities depending on a range of factors. The current capital adequacy proposals are correctly targeted and will address market stability issues. Once an appropriate framework for lenders, including risk management controls, has been established, it should be a commercial matter for borrowers to determine their debt levels.

In addition, placing restrictions on private equity companies risks unfair discrimination against their business model. Why single them out instead of other vehicles, such as sovereign equity funds or traditional corporates (who may also borrow for investment purposes). Regulating the originators is the only way to ensure risks are managed properly without the danger of discrimination.

**Capital depletion:** The suggestion that private equity funds pursue 'asset stripping' is strongly rejected by the AIC. Private equity aims to build value not destroy it. Private equity investment may sometimes involve significant restructuring in portfolio businesses, but this is part of a positive process of effective capital allocation which will ultimately allow the European economy to compete more effectively. The report does not make clear what these so-called 'asset stripping' activities involve. The AIC **recommends** that there should not be any moves to regulate on this agenda unless specific activities are identified that are unique to private equity (rather than the general operation of capital markets) and evidence is provided that they cause a real market failure. Given our strong reservations about the tone of the report, we reiterate our support for the constructive tone adopted to date by Commissioner McCreevy in his initial comments on the role of the sector.

### ***Recommendation 5 on existing financial services legislation***

**Review of Community regulation:** We support any measures designed to ensure that existing regulations are able to respond proportionately and effectively to current market conditions. However, any legislative review must consider issues in the round and not simply focus on private equity and hedge funds. To do so could be discriminatory and create the risk that wider issues with existing legislation are not identified and dealt with. Any review must take account of the principles of good regulation discussed above. That is, it should consider identified problems, and devise proportionate, evidence-based regulatory responses. This offers the best prospect of developing an effective and proportionate regulatory regime.

## **Lehne Report recommendations**

**Call for additional transparency:** The report's introduction to its detailed recommendations proposes legislation to secure 'a common standard of transparency'. The purpose and nature of these disclosures are not properly defined throughout the report. The paper also fails to make clear distinctions between the hedge fund and private equity strategies, which makes it difficult to evaluate the policy proposals on transparency (or other issues) effectively. The AIC **recommends** that the Commission should resist general requests to increase regulation which are not focussed on clearly identified problems and market failures.

### ***Recommendations on hedge funds and private equity***

**Review of existing legislation – proposals on disclosures:** We note with concern the suggestion that investors in private equity and hedge funds are not given sufficient information to make informed investment decisions. In fact, investors in limited liability partnerships, the traditional hedge and private equity vehicles, are customarily very well informed. This information may not be made public but this is because confidentiality is required to protect the commercial interests of investors. The Commission should not introduce disclosures which will harm the legitimate interests of these funds simply to satisfy calls for public information. A general 'desire to know' does not create a policy rationale for regulation.

**On hedge funds specifically:** It is difficult to see why hedge funds alone should be singled out to disclose their voting policy. If there is a case for disclosure of voting policies – which we doubt – then all investment vehicles should be required to disclose. This still begs the question, what would disclosure achieve? We can identify no benefit, only costs. The overriding principle should be that all shareholders can vote their stake if they wish. All investors in the same class of shares should have the same obligations and rights. The report's recommendation seems to suggest that some shareholders are less welcome or legitimate than others. The AIC **recommends** that this perspective should be strongly refuted. There is no such thing as a 'bad shareholder', just different shareholders.

More positively, we note that the report suggests that the Commission should examine whether or not 'indirect acquisitions of voting rights via option arrangements' should be disclosed. The AIC agrees that options, which allow investors to gain exposure to voting rights, should be disclosed. Failure to do so could distort the market for corporate takeovers.

The AIC also supports the disclosure of other derivative instruments (such as contracts for difference) which allow investors to gain control of voting rights without a formal option. The AIC campaigned on this issue in the UK and is pleased that the FSA is to introduce measures in this area. This should reduce the risk that control over voting rights can be built up without proper market disclosure. We **recommend** the Commission should review its policy in this area to identify what action it could take to secure better disclosure

over formal and informal rights to control, or acquire control, of voting rights. However, any measures introduced should apply equally to any holder of the interest. Hedge funds should not be singled out for attention.

**On private equity specifically:** While the tone of much of this report is disappointing, the references to the ‘plunder’ and ‘asset stripping’ of companies are particularly concerning. We **recommend** that the Commission firmly rebut this accusation in its formal response. The AIC also **recommends** that the Commission should reject limits on the operation of private equity funds. It has not been made clear what specific activities are supposed to be problematic or that they are unique to private equity vehicles.

We are also concerned at the suggestion that banks should be given some sort of oversight of the use of money borrowed by private equity vehicles. Of course, lenders should have appropriate regulatory controls on their borrowing activities and should conduct proper due-diligence. However, the notion that their obligations should, or could, go further than this is difficult to countenance. Banking regulation should be looked at in its overall context; the Commission should not be distracted by prejudices relating to the type of customers involved.

## **Conclusion**

While we have difficulties with many of the recommendations in these reports we do recognise that regulatory intervention may be appropriate in some areas – as long as the issue is approached in a sensible way. For example, the Rasmussen report suggests oversight of credit rating agencies. On first examination there seems to be a clear market failure here as these agencies often failed to correctly identify risks which subsequently emerged. They also face conflicts of interest which may exacerbate these problems. This failure is likely to have contributed to current market problems and there may be a case for regulation to correct a market failure and enhance confidence.

In contrast, complaints that, for example, private equity purchases lead to redundancies are ill-conceived as they do not relate to a specific market failure. Redundancies (unfortunate as they are) are a natural function of the market and happen independently of private equity involvement with a business.

The Commission must be mindful that regulation is effective and accepted when it is properly targeted and constructed. We hope that this perspective will determine the way it responds to the Rasmussen and Lehne reports.

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