

Treasury Select Committee inquiry into private equity

Further evidence from the Association of Investment Companies

Executive summary

1. The Association of Investment Companies (AIC) welcomes the opportunity to submit further views to the Committee's inquiry into private equity.
2. The AIC believes that listed investment companies already represent excellent standards of public reporting at fund level within the private equity sector and welcomes measures to further enhance transparency within the industry. The Walker Guidelines represent a suitable means to achieve this outcome and should be given time to have an impact on reporting practice before an full assessment of their effectiveness can be made.
3. However, the AIC remains concerned that some owners (i.e. sovereign wealth funds and private corporate entities) of large private businesses with a substantial public impact are not covered by the Guidelines and **recommend** the Committee give consideration to securing greater transparency by these organisations and the businesses they own.
4. The AIC has also explored the reasons why private equity funds may require different information from owners of publicly quoted shares. There are various factors involved but one of the most critical is the way in which different investors engage with the companies concerned. The AIC has concluded that this issue raise no matters of public policy concern.

Transparency

5. The AIC welcomes the Walker Guidelines (the Guidelines) on disclosure and transparency in private equity. They provide a proportionate and flexible basis for the private equity sector to report to the public. They identify areas where there may be a legitimate public demand for information (i.e. where a large portfolio company is involved) and balance the need to disclose against the legitimate commercial interests of the fund and its investors.
6. The private equity industry has engaged closely with the development of the Guidelines and we anticipate it will take a responsible attitude to future disclosure. With this in mind, we have been disappointed with the critical reception the proposals have received from some quarters. All parties should be prepared to give the industry time (we **recommend** at least two reporting cycles) to develop its approach before making further judgements. This will allow best practice to emerge and provide evidence on whether or not the approach embodied in the Guidelines needs to be revised.

7. As explained in our previous submission, listed investment companies (which are represented by the AIC) are already highly transparent. Regulations already require information to be published on their shareholders and directors, investment strategy, governance and major transactions (amongst other issues). They already offer excellent standards of public disclosure.
8. The AIC believes the scope of the proposed disclosure for private equity vehicles set out in the Guidelines is appropriate. Private equity funds which fully engage with the Guidelines in good faith will make significant strides towards the levels of transparency already achieved by our members. In addition, the Guidelines' 'portfolio company' disclosures are properly targeted on larger companies likely to have a significant public impact and cover appropriate issues. However, the AIC remains concerned that, even with the Guidelines in place, there are potential gaps in disclosure.
9. These gaps involve owners of large UK private businesses which are not conventional private equity funds but are so-called 'sovereign wealth funds' or private corporate entities. Organisations of this type are not covered by the Guidelines nor are the portfolio businesses which they own. The AIC highlighted these gaps in its response to the Walker review as it believes the locus for the debate on transparency should not be ownership by a private equity fund *per se* (which is, of itself, an entirely legitimate form of ownership). Instead, the transparency debate should be driven by the need for private businesses with a significant impact on the public sphere – however they are owned – to be suitably transparent. If they have a major impact on public life they should make suitable disclosures and, where appropriate, so should their owners.
10. The AIC therefore **recommends** that the Committee consider these remaining 'gaps' and how they can be addressed to secure the disclosure standards set out by the Guidelines.

Investor information requirements

11. The information made available to investors in public companies does differ from that which private equity funds receive (and pass on to their own investors). This is not inherently surprising and reflects the different nature of the investment proposition and the approach taken by the funds. After all, even shareholders in the same public companies may have different information requirements.
12. For example, passive investors, such as tracker funds, have little need for specific company data as they are simply seeking exposure to a particular index. Other shareholders with a more active approach might be concentrating on selecting asset classes, so again may not be so concerned with huge amount of detail on the operation of individual companies they are exposed to. Still other approaches will involve investors looking more carefully at the specific circumstances of

investment targets. This would include, for example, 'value' strategies where prospective purchasers are seeking to identify stocks where the full value of the company has not been expressed in the share price. Perhaps the investors likely to be most keen on securing detailed information and analysis on individual listed companies will be those with an 'activist' remit. That is, they seek to make strategic, governance or other adjustments to enhance the performance of the company by making representations to the board and other shareholders.

13. Given that there are diverse information needs for investors in publicly quoted companies it is not surprising that private equity funds also have different information needs. The general view is that private investors demand, and secure, more information from portfolio companies than is available to public investors. There are a number of reasons why this is likely to be the case.
14. The **investment approach** of the private equity owner is likely to differ from public investor as private equity funds will usually seek to implement specific strategic changes. They might be thought of as 'super-activist' investors, who require information to determine and direct their strategic interventions as well as to judge their effectiveness. As a consequence, private equity owners will also customarily be represented on the board of the investee company and may even recruit a new management team to implement the desired strategy. Of course, the fact that the company is owned by a private equity fund also means that the fund is also in a position to demand that the required information is provided.
15. Greater amounts of information may also be required by private equity investors because the nature of the risks they face are different. For example, private equity investors face far greater **liquidity risk**. Shares in public companies are easily tradable. By comparison, it might take significant effort to sell a private business, or a stake in one, within a reasonable timeframe and at an acceptable price. This is an additional risk and it also helps explain why private equity investors may demand greater information so that they can assess the risks of a lack of liquidity against the attractions of the business as an investment proposition.
16. Private equity funds may also be exposed to greater **diversification risk** than funds exposed to publicly quoted stocks. It would not be uncommon for a fund investing in public companies to hold many small stakes in a large number – even hundreds – of companies. In contrast, private equity funds are likely to either own outright, or have very large stakes in, a smaller number of companies. This (combined with the greater liquidity risk) is likely to mean that private equity funds and their investors need more information to make an ongoing assessment of their exposure to particular companies.
17. While private equity owners may be in a position to secure more in-depth information from portfolio companies – and may have a greater need for that information because of the risks they face – it should also be

recognised that there are good reasons why public companies limit the information they provide in the public domain.

18. Portfolio companies providing information to their private equity fund owners, who may in turn pass it on to their own shareholders, are able to do so on a confidential basis. They do not have to post information publicly to maintain an orderly and fair market in their shares. This means that they can restrict circulation and are able to provide material that might be more speculative or commercially confidential. The nature of private equity ownership reduces the risks of creating misunderstandings about the prospects of the company or compromising its ability to pursue its business objectives.
19. It is reasonable that private businesses issue different information in comparison with publicly owned ones. A critical reason for this is that they can circulate that information on a confidential basis, which creates fewer risks. Similarly, it is not surprising that investors with different strategies have different information needs. The AIC does not believe that this situation provides any issues of general public policy concern.
20. The critical lesson from this discussion is that, if a potential shareholder does not believe that a company (private or otherwise) provides sufficient information to enable it to assess it as an investment proposition, then they should simply not purchase those securities.

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