

Disclosure and transparency in private equity

Submission by the Association of Investment Companies to the Walker Review consultation

The Association of Investment Companies (AIC) represents some 300 investment companies, including UK investment trusts, offshore investment companies and Venture Capital Trusts (VCTs). Virtually all of these are listed on the London Stock Exchange (although we also have a few members traded elsewhere, for example, on AIM). Investment companies invest in shares and other assets with the objective of spreading risk and providing an investment return. A significant number of them have private equity interests.

Investment companies provide an important alternative vehicle to private equity funds based upon limited partnerships. Overall, there are 20 London listed investment companies dedicated to private equity with assets of around £10 billion. We estimate that around £3 billion more of private equity is held by other investment companies with general mandates. In addition, VCTs, which are focussed on small private businesses, hold just over £2 billion of assets. In total, therefore, the investment company industry invests around £15 billion in private equity.

The AIC supports the private equity model as a legitimate form of ownership and believes that the techniques used by private equity funds can deliver significant benefits in enhancing the performance of companies the sector is engaged with. Ultimately this creates benefits for investors and helps maintain the vibrancy of the UK economy.

Investment companies represent a relatively small part of the total UK private equity market in comparison with limited partnerships. However, we believe that they offer an excellent means of securing access to this asset class and anticipate that their role will expand. This should be supported, in particular, by recent and impending changes to the Listing Rules that will remove regulatory burdens that have previously discouraged UK listings by private equity vehicles. (A number of helpful changes were introduced at the end of September, and we anticipate possible further adjustments in the first quarter of next year.)

Transparency provided by listed investment companies investing in Private Equity

Listed investment companies already offer a high level of transparency through public disclosures. These include:

- **Published investment policy:** Annual financial reports of listed investment companies must now include an investment policy covering the company's

approach to asset allocation, risk diversification and gearing – including maximum exposures.

- **Annual statement on the delivery of the investment policy:** This explains how the company has invested its assets with a view to spreading risk and delivering its investment policy.
- **Disclosure of principle contents of the management agreement:** This is required annually and must include details of any termination arrangements and the basis for the manager's remuneration.
- **Statement on the continued appointment of the manager:** Directors must also state annually their view on why the continuing appointment of the manager on the terms agreed is in the interest of shareholders.
- **Portfolio disclosure:** The company must annually disclose a comprehensive analysis of its portfolio.
- **Annual financial reporting:** This financial data is fully audited.
- **Half-yearly report and interim (quarterly) management statement:** The half-yearly report is more substantial than the quarterly requirement, and includes financial statements. The interim management statement explains the general financial position of the company and the material events and transactions that have occurred since the last report was made.
- **Major acquisitions and disposals and price sensitive information:** Specific disclosures must also be made for events that could have a significant impact on the price of the shares of the listed vehicle. This explicitly includes major acquisitions and disposals of major shareholdings.

The requirement for listed investment companies with private equity interests to make these disclosures allows two headline conclusions to be drawn:

- Further disclosure could be made by unlisted private equity funds without fundamentally undermining their operational or investment effectiveness. Some administrative obligations will be created but this need not necessarily damage their overall commercial position.
- As these disclosures are compulsory (rather than 'comply or explain') stakeholders and policymakers who desire higher levels of transparency should support the private equity market moving towards the listed investment company model.

Transparency by portfolio companies

All privately owned companies have to prepare annual financial accounts in accordance with company law. These ensure that the shareholders in those businesses have the information they require to understand the way in which the company is being managed. These accounts, which explain the way in which a company has performed over the previous year and its position at the end of its financial year, are filed at Companies House and are publicly available.

Report and accounts prepared by private companies may be less detailed than those provided by listed companies in certain areas (for example, governance reports). These differences reflect the fact that unlisted companies have no need to provide information to support a public market in their shares. The AIC would reject any suggestion that companies owned by private equity funds necessarily provide lower quality reports than any other privately owned company. The public statements issued by private and public companies are simply different reflecting the different roles they are designed to fulfil.

The AIC is sceptical that there is any difference in principle between the disclosures that should be required of a large privately owned company which has never been listed and one which has previously been listed. It is concerned that there should be no automatic view that private equity owned companies should be viewed as inherently suspicious or deserving of additional public scrutiny.

However, the AIC recognises that large private companies are likely to have a wider range of stakeholders than smaller organisations and that they may have a prominent position in the UK's public domain. In these circumstances there may be good reasons for them to make public disclosures to provide interested parties – for example, suppliers, customers or employees – with additional information on their activities. That said, this does not deflect from the AIC's belief that those owned by private equity funds should not be singled out for special consideration.

In considering the need for additional disclosure it should also be borne in mind that the first priority of the management of any company is to secure its future commercial success. This will create the best prospect of delivering value for shareholders and providing benefits for other stakeholders, such as its employees. After all, if the business is not successful it will ultimately be unable to sustain jobs and support the UK economy.

It is also worthwhile noting the requirements of the Companies Act 2006. Section 172 creates explicit obligations for directors to act in a way which will promote the success of the company and, in doing so, requires them to have regard to the interests of the company's stakeholders, including employees. Directors are also required to have regard to the need to foster the company's business relationships with suppliers and customers as well as to consider the possible impact of the company's operations on the community. This list of obligations is not exhaustive,

but illustrates the high standards which directors are already expected to uphold – regardless of the ownership structure of the company they run.

These circumstances lead to some general conclusions which have informed our view on the need for further public disclosure by large private companies:

- There is no inherent reason why companies owned by private equity funds should be required to act any differently from other private companies;
- Nevertheless, any private company which occupies a prominent place in the public domain (by virtue of, for example, its overall size and market presence or because it has a significant number of employees) may face legitimate demands for engagement with and disclosure to legitimate stakeholders;
- UK companies are already subject to high standards. This makes it appropriate to consider the need for further disclosures by private companies within a 'comply or explain' framework;
- However, companies owned by UK listed private equity companies may have less need to make disclosures to satisfy the legitimate demands of stakeholders because of the high levels of disclosure already required at the fund level.

Detailed comments

The AIC's comments relating to the specific questions raised by the consultation document are set out below.

What are the correct reporting thresholds for portfolio companies?

The consultation suggests the creation of guidelines to enhance public disclosures by any private company which:

- was previously a FTSE-250 listed company; or,
- where the injection of capital by a private equity fund was £300 million or more; or,
- where the company has over 1,000 employees and a value of over £500m.

It suggests there may also be a case for enhanced disclosure where a deal falls somewhat short of these thresholds.

The AIC agrees that, if any enhanced disclosure guidelines are to be introduced, the case is greatest where the businesses are of significant size. The thresholds set out by the consultation would focus attention at an appropriately high level. The AIC **recommends** that these thresholds be adopted.

However, the AIC retains some scepticism that private equity owned companies should be candidates for special attention just because of their ownership structure. Insofar as enhanced disclosure is required the same standards should be applied to all private companies. The AIC therefore **recommends** that the Walker review team engage with other types of private company to explore if there are any reasons why additional disclosure should not apply to them and to seek buy-in for enhanced disclosure by these companies.

The AIC would also contend that, where a portfolio company is considering its disclosure obligations, the need for additional reporting may be less where it is owned by a listed investment company which already makes compulsory disclosures. The AIC **recommends** that the Walker team consider this factor when drawing up any final guidance.

What should be disclosed by portfolio companies?

The AIC would support any disclosures being made either as a stand alone annual review or as part of the annual financial report filed at Companies House.

Broadly speaking the AIC agrees with the overall direction of the disclosures suggested, but would make some comments on the detail.

- The AIC **recommends** that the guidelines set out explicitly that no disclosure need be made where including information could compromise the commercial interest of the company and its shareholders.
- It is not clear what the reference to the 'company's attentiveness to the interests of employees' implies. Clearly a portfolio company must attend to its legal obligations in relation to employees. It may also have plans for the workforce, e.g. redundancies, that it is appropriate to disclose. However, in such circumstances it may not be credible to make a statement on the 'interests of employees', as clearly different employees have different interests. If the expectation is that the disclosure should include reference to possible changes in employment levels and conditions of employment this should be made explicit.

However, the AIC would think it very likely that companies may not choose to include information on these issues, particularly where a final decision has not been reached or other relevant negotiations are taking place. The AIC supports effective communication with workforces but is not clear that a statement on 'attentiveness to the interests of employees' would be helpful in this context.

- The AIC **recommends** that the reference to reporting on debt should include a dedicated reference to possible commercial constraints as this area might have particular sensitivities, specifically in relation to ‘restrictions and conditionality’ of debt. We note that, depending on how the guidelines are framed, this requirement could go further than the obligations placed on listed companies. It is not clear that private companies should face greater disclosure obligations than their quoted counterparts. Including details of this nature could well undermine the likely uptake of the guidance. With this in mind the AIC would **recommend** that any final guidelines should not include references to detailed commercial arrangements surrounding debt obligations.
- The AIC is unconvinced of the need for a half-yearly report and believes increasing expectation about the frequency of reporting may compromise take-up in general. It may also lead to lower quality reporting in the full year report. The AIC **recommends** that the Walker review team consider recommending reporting on an annual basis.

If a half-yearly report is to be proposed, it is not clear that it will be helpful to suggest such a short reporting timeframe. Take-up may be increased by extending the proposed time to 3 months. The AIC **recommends** that this approach be taken if a half-yearly report is adopted.

Also, while the AIC would support hard copies being given to the workforce if the management thinks this will aid effective communication; in the internet age it is not clear that such specific reference to distribution methods is a matter for the guidelines. With this in mind we would **recommend** that any final guidance say that information be made available to the workforce and public. This would ensure the legitimacy of website publication, which is also cost-effective.

Is there any value in making proposals on the composition of boards of portfolio companies?

The AIC agrees with the consultation’s conclusion that it would not be worthwhile proposing a ‘blueprint’ for board composition.

The AIC would not support the creation of general guidelines on the composition of the boards of portfolio companies. This would be extremely inappropriate as the experience and skills required for boards will vary from business to business. Ultimately, it is up for the shareholders to decide who is in the best position to run the company (notwithstanding the fact that the skills set required should take into account the whole range of CSR and other issues now facing managers of large commercial organisations).

What reporting to limited partners by the general partner is required?

The AIC does not represent limited partners and has no detailed views on reporting obligations. However, we understand that limited partners are, in general, well informed about the activities of any private equity fund they are invested in. They are also able to request further information if the material they receive is not sufficient.

What generic communication should be made by general partners?

The consultation makes the case for greater generic information to be made by general partners to increase knowledge about the role of the sector. It is suggested that this could have various functions, for example, including giving reassurance to employees, customers and other stakeholders in a business which is a potential target for a private equity fund.

The consultation suggests that the general partner could include information in an annual review, which might be made available on a website and which would include a narrative on issues relevant to the fund and relevant stakeholder interests.

The AIC notes that listed investment companies are already required to make a number of announcements at the level of the fund itself (as set out in the first section of this paper). These do not present commercial barriers to the involvement of listed vehicles in the private equity market. The AIC therefore believes that there are unlikely to be any insurmountable barriers to general partners making disclosures about the overall approach of the fund.

The AIC also **recommends** that, in determining what the guidelines might say in relation to disclosure by general partners of larger funds, account be taken of the disclosures already made by the listed sector.

With this in mind, most of the disclosures suggested for general partners are compatible with those for listed vehicles. One reservation we would have is discussing companies which have been sold by the business. In the first instance, it is difficult to see that it is desirable for a fund to comment on a business with which it has no interest. Secondly, the prospects of that business will be out of the hands of the fund. It would be inappropriate for it to try (or be seen to try) to take credit for the continuing success of a company it has sold in the same way that it should not be blamed for any problems which occur. The AIC **recommends** that exercises of this nature would be better addressed, if at all, at an industry level.

The AIC is also cautious about the singling out of areas of “special importance” in relation to the values of private equity funds, particularly with respect to “employees and the working environment”. We recognise that there has been significant political attention paid to this issue. However, we are wary about setting expectations which in reality it may be difficult to meet.

We have no doubt that private equity funds will be committed to upholding the legal standards required of them. They will also want portfolio companies to offer pay levels which are sufficient to attract and maintain a suitably skilled labour force. This will be critical to securing the skills needed to maintain, run and expand the business. A fund might be able to make a general comment on its outsourcing policy, but it is difficult to see that this would be very detailed as each portfolio company may have different specific needs. It may be very difficult for a fund to make anything but very general statements on any issues related to employees. Singling out this issue in the way suggested might therefore raise expectations which cannot be met, which might not be particularly helpful.

We would have similar concerns about raising expectations over what a private equity fund might do where one of its portfolio companies faces an uncertain future. A general disclosure (even at the discretion of the general partner) may be of little value when each situation is likely to be judged on its particular circumstances.

What industry-wide data should be collected?

The AIC agrees that it is sensible for industry-wide data to be collected on behalf of the private equity sector. We believe the BVCA is best placed to undertake this activity.

The range of data collection suggested by the consultation is sensible. Of course, it may be that there are ultimately practical and resource issues to be resolved before a final range of data sets is finalised, but if a wide range of material can be collated this is likely to help the industry in effectively communicating its role, and the benefits it can generate for the UK economy, to the public.

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For more information on any of the issues raised in this note please contact:

Guy Rainbird, Public Affairs Director, Association of Investment Companies

Tel: 020 7282 5553 or e-mail: guy.rainbird@theaic.co.uk