Discussion Paper

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Financial Services Authority

Private equity: a discussion of risk and regulatory engagement

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1 Executive summary

Introduction

1.1 In the first quarter of 2006 we published the FRO (Financial Risk Outlook), which outlined our assessment of the key risks arising to the statutory objectives that guide our regulatory activity. We also published our Business Plan, which drew attention to areas where we might undertake investigatory work to increase our understanding of those risks and ensure that our regulatory response to them is both effective and proportionate. Private equity was mentioned several times in those papers as there are a number of recent developments in the private equity market which are either linked to previous areas we have focused on or where new issues arise. We have recently undertaken a wide-ranging review of the private equity market, drawing together different themes, with a view to ensuring that the overall level and form of regulatory engagement is optimal. We now wish to communicate our findings to the market and to other regulators and public policy makers.

1.2 There are six main reasons why we feel that it is appropriate to publish a paper specifically on the subject of private equity:

- There has been significant growth in the capital flowing into private equity funds. In the first half of 2006 UK-based private equity fund managers raised £11.2bn[1] of capital. By contrast, £10.4bn[2] of funds were raised via IPOs (Initial Public Offerings) on the London Stock Exchange's public equity market in the first half of 2006, a rise of 64% compared to the same period in 2005. Despite recent IPO growth, private equity fund raising currently outstrips public market capital raising in the UK.
- Leveraged finance provision to private equity transactions has increased. 13 banks who responded to a recent FSA[3] survey reported a combined exposure to leveraged buyouts at June 2006 of €67.9bn compared to €58.0bn at June 2005, an increase of 17%. System-wide exposures are, however, substantially greater as banks are increasingly distributing debt to non-banks such as CLO (Collateralized

1 Source Private Equity Intelligence. Includes final, second and first closes.

2 Source LSE Annual Report.

3 We recently surveyed banks headquartered in the UK or outside of the EU asking for information on their exposures to leveraged buyouts. For UK headquartered banks global data was requested, for non-EU headquartered banks only information related to leveraged buyout activities managed from EU subsidiaries/branches was required. This survey was developed jointly with other European public bodies that will be using the survey within their own jurisdictions.

Loan Obligation) managers, CDO (Collateralized Debt Obligation) managers and hedge funds. On average banks distribute 81% of their exposures to their largest transactions within 120 days of finalising the deal.

- Raising larger individual funds and undertaking 'club deals' – where private equity fund managers cooperate on a single transaction – together with the increased availability of debt finance, has extended the reach of private equity. This has enabled far larger transactions to take place, including taking significant public companies private. A potential new global record has been set with the proposed $33bn acquisition of US based health care services company HCA.[4] A new European record was set by the €12.9bn acquisition of TDC[5].
- Secondary markets have developed in both individual investor commitments to private equity funds and private equity funds' holdings of entire companies. This enhances liquidity for private equity market participants but may result in reduced capital flows to the public markets.
- Despite the growth of public market capital raising, the UK equity market capitalisation shrank by a net £46.9bn[6] in the first half of 2006 and has not grown since the last quarter of 2004. This reflects (in addition to share price movements) the impact of public to private transactions, widespread share buy backs/payment of special dividends (sometimes as part of a defence against a private equity bid) and reduced capital flows from the private market.
- Market participants have expressed concerns about a perceived lack of understanding amongst public policy makers, potential future investors and commentators with respect to the nature of private equity business models and their inherent risk.

1.3 In response to these developments, we are publishing this Discussion Paper (DP) to:

- stimulate informed discussion amongst public policy makers and industry participants about the development of the private equity market;
- clarify our current assessment of the risks posed by the private equity market to our statutory objectives, and more broadly;
- inform key stakeholders about actions to mitigate these risks that are already in place at both a domestic and global level – highlighting the significant variation in national regulatory regimes;
- identify further proportionate risk mitigation steps we could consider taking; and
- solicit views from stakeholders that would help us reach a conclusion on whether these steps merit further consideration.

4 Source HCA press release.

5 Source TDC press release.

6 Source Citigroup.

Who should read this paper?

1.4 This paper is addressed to investment managers and advisers (particularly those involved in alternative investment strategies or considering involvement), providers of leveraged finance, participants in the syndicated debt markets, wider market participants, commentators and analysts. It is also explicitly addressed to public policy makers such as Her Majesty's Treasury, the Bank of England, the European Commission, and Central Banks and other regulatory bodies around the globe. It is not addressed to retail investors. UK retail investment in this market is currently limited both in terms of direct investment and indirect investment via pension and investment funds.

1.5 We intend Chapter 3 to be factual in nature, outlining market practice. It should be particularly helpful for those wishing to increase their understanding of the private equity market. Experienced market professionals are asked to review it only in so far as it would be helpful for us to obtain their assessment of whether our understanding is accurate.

Summary of key risks and regulatory responses

1.6 This paper seeks to address the question 'what is the appropriate level and form of regulatory engagement with the private equity sector'? We ask this question against the backdrop of a number of very different regulatory regimes being applied to the private equity market around the globe, including within the EU. Any disproportionate regulatory requirements could damage the competitive position of capital markets and should therefore be avoided. Too much regulation could be detrimental to capital market efficiency and/or cause the private equity industry to move to more lightly regulated jurisdictions; and too little regulation could damage market confidence.

1.7 We believe that the best way to begin answering the question about the optimal regulatory approach is to identify risks posed by the private equity market to our statutory objectives.

1.8 The analysis of risks set out in this document does not include comprehensive market failure analysis. Rather, we set out an initial risk analysis based upon historical industry views and recent regulatory assessments. The paper does not claim to provide a final assessment of the impact and probability of these risks. We intend to identify potential risks and stimulate an informed debate that will lead to a more accurate identification of those material risks that need further analysis or mitigation. This debate should also help us to decide which risks associated with private equity are not material and do not therefore merit any form of regulatory engagement.

1.9 We believe that the private equity market is an increasingly important component of a dynamic and efficient capital market. Private equity offers a compelling business model with significant potential to enhance the efficiency of companies both in terms of their operation and their financial structure. This has the potential to deliver substantial rewards both for the companies' owners and for the economy as a whole. This positive contribution to capital markets is expected to increase over time as the private equity market continues to grow and mature. It is in this context that we have analysed the risks inherent in the sector and the appropriate regulatory response.

1.10 The private equity fund management/advisory industry is somewhat stratified with:

- a relatively small number of major firms typically undertaking fairly large domestic and international transactions;
- a second, larger group of firms who tend to focus on mid-size (predominantly) domestic transactions; and
- a third, large group of firms focusing on smaller domestic transactions.

1.11 In preparing this report, we have mainly focused on the elements of the private equity market where individual transactions were of a material size and complexity and therefore their potential impact on our statutory objectives was most significant. We have therefore focused predominantly on the mid and large cap markets. There are elements of this report which may not directly apply to the venture capital/small cap parts of the private equity market. This paper does, however, provide a platform for engagement with the whole of the private equity market and does raise issues and risks affecting all types of market participant.

1.12 The risks inherent in the private equity market are not confined to the private equity fund managers/advisers. Rather, they affect all types of participant in varying proportions including, in particular, fund managers/advisers, leveraged finance providers, transaction advisers and investors in the relevant equity, debt and related derivative products.

1.13 We reviewed private equity market risk in the context of other alternative asset classes. We noted that the risks inherent in private equity are generally less significant than, for example, the risks found in the hedge fund sector, although we do note increasing convergence between these asset classes. Private equity funds' lower typical risk profile has it origins in their pursuit of a single, relatively simply, corporate transformation and improvement strategy compared to some hedge funds' pursuit of complex and diverse strategies involving derivatives, short selling etc.

1.14 The following table provides a brief summary of the key risks we have identified arising in the private equity market and our response to them. These risks are discussed in more detail in Chapter 4 and the responses are discussed in more detail in Chapter 5. Chapter 5 also sets our response to these specific risks in the context of our overall regulatory approach to firms active in the private equity market. In it we discuss specific Handbook and other requirements and describe the nature of our relationship management of a small number of higher impact private equity fund managers and our thematic reviews which affect these and other firms.

Risk	Our response
Excessive leverage: The amount of credit that lenders are willing to extend on private equity transactions has risen substantially. This lending may not, in some circumstances, be entirely prudent. Given current leverage levels and recent developments in the economic/credit cycle, the default of a large private equity backed company or a cluster of smaller private equity backed companies seems inevitable. This has negative implications for lenders (particularly before distribution), purchasers of the debt (particularly where these positions are concentrated or leveraged), orderly markets and conceivably, in extreme circumstances, financial stability and elements of the UK economy.	We routinely undertake prudential supervision of banks. We undertook a detailed analysis of the exposures of major UK banks within the leveraged lending market in 2005. This has recently been followed up with a broader scope survey which encompassed UK and non-EU banks (in the context of a wider ECB initiative). This LBO (Leveraged Buy Out) survey revealed that the average debt/ebitda[7] ratio on banks' five largest transactions in the 12 months to June 2006 stood at 6.41 – a high figure relative to both leverage levels observed in large deals historically and leverage levels typically observed today in smaller transactions. Leverage levels appear to be high and rising, but no longer rising rapidly – they may be approaching their peak. Leverage increases appear, in part, to be driven by rising purchase price multiples. Our LBO survey revealed that in 2005 the average maximum purchase price/ebitda multiple of all transactions to which the surveyed banks had committed debt capital was 11, whereas in 2006 this figure had risen to 14. Leverage increases also seem to be driven by rising debt/equity ratios. Equity represented just 21% of the capital structures of the five largest transactions to which each surveyed bank had committed capital in the 12 months to June 2006. We are considering repeating such surveys on a regular basis.
Unclear ownership of economic risk: The duration and potential impact of any credit event may be exacerbated by operational issues which make it difficult to identify who ultimately owns the economic risk associated with a leveraged buy out and how these owners will react in a crisis. These operational issues arise out of the extensive use of opaque, complex and time consuming risk transfer practices such as assignment and sub-participation, together with the increased use of credit derivatives. These credit derivatives may not be confirmed in a timely manner and the amount traded may substantially exceed the amount of the underlying assets. The entrance of new types of market participant with business models that may not favour the survival of distressed companies adds further complexities. These factors may create confusion which could damage the timeliness and effectiveness of work outs following credit events and could, in an extreme scenario, undermine an otherwise viable restructuring.	We published a Dear CEO letter on operations and risk management in the credit derivatives market in February 2005. Since then we have been working with the industry and with other national regulators to address trade confirmation backlogs. We are continuing to monitor this issue and will observe standards in the developing LCDS market to see whether any action is required. We have highlighted, in a number of recent speeches, various issues arising in the credit markets, including those facing firms when managing credit events. We now intend to undertake, as a matter of priority, a fact-finding exercise involving trade associations and experienced market practitioners. This will increase our understanding of the specific issues and risks firms would face in handling the default of a heavily traded corporate body or multiple concurrent defaults. We wish to understand firms' (and their representative bodies) preparations for such events. In particular, we intend to explore whether the development of an industry code of practice in this area would be beneficial. This initiative is likely to have a broader scope than private equity backed transactions – it will focus on companies whose debt/credit is heavily traded. We anticipate that this issue may be a key area of our focus during the next 18 months.

7 Earning Before Interest, Taxes, Depreciation and Amortization.

Risk	Our response
Reduction in overall capital market efficiency: The substantial inflows of capital into private equity funds combined with the considerable appetite of the debt market for leveraged finance products is fuelling a significant expansion of the private equity market. The quality, size and depth of the public markets may be damaged by the expansion of the private equity market. An increasing proportion of companies with growth potential are being taken private and fewer private companies are going public (as a consequence of the development of the secondary private equity market). Also, the growth potential of those companies that do go public may already have been fully exploited. These factors need to be considered against the backdrop of the enhancements private equity practices can make to capital market efficiency (including with respect to public market efficiency). These enhancements include widening the availability and source of capital, increasing the accuracy of company valuations (factoring in their growth potential), enhancing the efficiency of corporate capital structures, facilitating corporate development and transformation etc.	Our statutory objectives do not differentiate between public and private markets and therefore we maintain a watching brief on overall market quality (both public and private), identifying and analysing potential issues and risks on a case by case basis. We continue to review our Listing Regime to ensure that the Rules are proportionate and respond to an identified risk such that there are no regulatory requirements which unduly influence firms to be either publicly or privately owned. We are highlighting to other public bodies the issues and risks arising from developments in the private equity market, including where these go beyond our statutory objectives, helping them to take an informed view on their optimal response.
Market abuse: The significant flow of price sensitive information in relation to private equity transactions creates considerable potential for market abuse. This flow is increasing as the complexity of the transactions grows and more parties become involved. The involvement of participants in both public and private markets and the development of related products traded in different markets, e.g. CDS (Credit Default Swaps) on leveraged loans, increases the potential for abuse.	We have recently conducted discussions with a number of market participants about information flows in respect of private equity transactions. During those visits we have identified the biggest risk as the potential for the leakage of information. This risks exists because of the large number of individuals involved in private equity deals and because not all participants will be successful in their proposed participation. Visits to firms have demonstrated a reasonable level of understanding of the application of the Code of Market Conduct to private equity business. Nevertheless, we took the opportunity to remind the firms of their obligations under the Code. It is essential that participants in the private equity market understand their obligations in respect of the market abuse regime. We undertake regular transaction monitoring and are in the process of developing an enhanced transaction monitoring system. We have also recently acquired an additional source of credit trading information and are proactively monitoring the credit markets. If, through this surveillance and monitoring, we identify any incidences of market abuse by private equity firms or in relation to private equity deals we will follow them up and take the appropriate action. If participants in the private equity market are uncertain about their obligations under the Market Abuse regime they are reminded that we operate a Market Abuse Helpline which they can call if they have queries about the application of the Code. We are also monitoring the progress of industry initiatives to establish principles and recommendations regarding the handling of material non-public information by credit market participants.

Risk	Our response
Conflicts of interest: Material conflicts arise in private equity fund management between the responsibilities the fund manager has to itself (including its owners/staff), the investors in the separate funds/share classes it manages and the companies owned by the funds. Advisers and leveraged finance providers also face significant conflicts (particularly where they take on multiple roles in relation to an individual transaction) between their proprietary and advisory activities and between their different clients.	Our principles for business state that firms must manage conflicts of interest fairly, between both themselves and their customers and between a customer and another client. In November 2005 we issued a Dear CEO letter with respect to senior management responsibilities: conflicts of interest and non-standard transactions. This letter set out a composite view of best practices which emerged from thematic reviews of the risk management of conflicts of interest and financing transactions. We continue to give these issues priority within our risk-based approach to supervision. Also in November 2005 we published an article in List! – the UKLA's newsletter – highlighting the potential for enhanced conflicts of interest in competitive IPOs. We used this newsletter to remind firms of the specific application of our Listing and conduct of business rules in the context of competitive IPOs. Conflicts of interest management in private equity fund managers is likely to be the subject of a thematic exercise in 2006/07. As market practice evolves, we will continue to use vehicles such as speeches and List! articles to provide additional insight into conflict of interest issues.
Market access constraints: UK retail investors currently only have limited access to the private market via venture capital trusts (which offer access to arguably the riskiest part of the market) and a small number of private equity investment trusts. Indirect access is also limited as few UK pension or insurance vehicles have committed significant capital to private equity. This is partly because of the need for frequent re-negotiation of limited partnership agreements and the substantial delays before committed capital is drawn down. These factors enhance the perceived complexity and reduce the internal rate of return associated with private equity investing. The UK aims to have broad, deep and liquid capital markets. There may, however, be a gap in UK markets as there is no market listing certain types of private equity related vehicle, which are consequently seeking a listing in other EU jurisdictions instead.	In March 2006, we published CP06/4 setting out proposed changes to the listing rules for investment entities. The proposals outlined in the Consultation Paper (CP) aim to replace the existing listing regime with one of similar standard in terms of shareholder protection. However, by adopting a more principles-based approach towards the need to spread investment risk, the proposals are intended to provide a more modern and flexible platform that gives investment entities greater choice in selecting their investment strategies. In the CP we included questions on the continuing need for provisions (such as those on board independence, control of investees and the use of feeder funds) which may in the past have been perceived as potential barriers to the listing of private equity funds in London. We have evaluated the feedback we received and looked at market issues that have surfaced since we published the CP, and we have now decided to publish a further CP in December 2006. The December CP will propose removing the prohibition in the Listing Rules on primary listed investment entities taking control of the companies in which they invest. We have also concluded it is not appropriate to prevent overseas investment companies from taking up the directive minimum regime currently embodied in Chapter 14 of the Listing Rules (LR14). We will not therefore continue with proposals made in CP06/4 to prohibit secondary (directive minimum) listings of investment entities. Unlike primary listed investment companies, companies listed under LR14 will have no obligation under the UK Listing Rules to spread investment risk or to maintain a board of directors that is independent of its manager.
Market opacity: Although transparency to existing investors is extensive, transparency to the wider market is limited and is subject to significant variation in methodology (e.g. with respect to valuation, fee disclosure etc) and format. This makes relative performance assessment and comparison complex, which may deter investment by various professional investors who may not be comfortable interpreting the information. It could also lead to ill-informed investment decisions by such investors.	We are maintaining a watching brief on this issue. We will observe the progress of industry initiatives to raise standards, such as the adoption of the International Private Equity and Venture Capital Valuation Guidelines and the development of Global Investment Performance Standards provisions on private equity. Clearly the appropriate level and form of transparency is linked to the nature of the investor base. We will consider our position in the light of any enhanced retail involvement in to private equity. We do not, however, currently intend to impose any form of transparency requirements on this market.

Risk significance

1.15 We consider risk to be the combination of impact (the potential harm that could be caused) and probability (how likely the event is to occur). The risk descriptions in the summary table above provide an indication of impact but do not comment on probability. As our response to these risks is driven by not only impact but also probability, we believe it would be beneficial for the purposes of debate to attempt to provide an initial assessment of the relative significance of these risks after taking into account the probability of these risks crystallising. Any assessment of the probability of these risks crystallising is, however, by its nature, a matter of judgement and is something that can evolve over time.

1.16 The table below shows our provisional assessment of the significance of these risks taking into account both impact and probability. For example, although the potential impact of the risk related to the reduction in overall capital market efficiency is significant, its probability of crystallisation in the short term appears sufficiently low to merit an overall score of 'low'.

Significance	Risks
High	Market abuse, conflicts of interest.
Medium high	Excessive leverage, unclear ownership of economic risk.
Medium low	Market access, market opacity.
Low	Reduction in overall capital market efficiency.

Q1: Are the key risks to our statutory objectives outlined in this paper the correct ones? These risks include excessive leverage, unclear ownership of economic risk, reduction in overall capital market efficiency, market abuse, conflicts of interest, market access constraints and market opacity.

Summary conclusions and next steps

1.17 This DP sets out the belief that, despite our regulatory approach to the private equity market being substantially different from that in a number of other jurisdictions, our current regulatory architecture is effective, proportionate and adequately resourced.

1.18 Our risk-based approach to supervision, supplemented by targeted thematic work, responds effectively to the stratified private equity market. This market contains a cluster of major firms (≈ 14) raising large funds and undertaking significant, complex and often highly leveraged transactions which often involve public companies. It also involves a much larger number (>200) of firms raising smaller funds and engaged in smaller, relatively simple transactions, typically with limited leverage.

1.19 As is always the case with a developing market, there is potential to improve the focus of regulatory activity after having undertaken analysis to identify more clearly the market's inherent risks. We highlight and discuss these enhancements in Chapter 5 of this paper.

1.20 Chapter 5 notes two enhancements that we have already begun to undertake. These enhancements include:

- Establishing an alternative investments centre of expertise by integrating private equity firms and relevant supervisory staff into the existing hedge funds centre of expertise. Our alternative investments team will carry out relationship management of all higher impact hedge and private equity fund managers/advisers and carry out relevant thematic work. We are supporting the operation of this restructured team by creating two discrete sub-sectors (hedge fund managers/advisers and private equity fund managers/advisers) under the revised ARROW 2 model. This approach will ensure that supervisors developing risk mitigation programmes and thematic reviews are able to draw upon issues and risks relevant to the specific business model of the firm, based upon a broad understanding of the entire alternative investment sector.
- Undertaking proactive market surveillance targeting the credit markets. This will build on our enhanced understanding of the specific nature of private equity transactions and use our recently acquired ongoing source of credit market trading data.

1.21 Chapter 5 also outlines a number of potential additional enhancements on which we are seeking insight and comment from key stakeholders. These possible enhancements include:

- Requesting one additional data point (committed capital) from private equity firms to identify better the higher impact firms and therefore target supervisory resources more effectively. While this may, at the margins, affect which firms are likely to be relationship managed, we do not intend it to substantially alter the number of firms supervised in this way. Other firms will continue to be included in thematic reviews and case work where applicable.
- Regularly surveying leveraged lending and distribution.
- Engaging in a targeted fact-finding exercise with trade associations and experienced market practitioners to understand the issues and risks inherent in dealing with corporate defaults (whether or not these companies are private equity backed).
- Undertaking targeted thematic reviews responding to identified risks, such as the significant conflicts of interest arising in private equity structures.
- Removing provisions in the Listing Regime which were perceived to create a barrier to the listing of private equity funds.

1.22 We will engage in informal dialogue with key stakeholders based on the analysis set out in this paper. We will also review formal written responses to this consultation and we encourage you to respond. There will be separate opportunities for discussing the potential Listing Regime changes in the context of the supplementary CP that we will issue in December 2006.

1.23 It is our intention to deliver a Feedback Statement in 2007 highlighting key comments that we have received and explaining our reaction to them. Should this exercise result in a perceived need to make any policy changes, this would be addressed in a separate CP that would include full market failure and cost benefit analysis.

8 We are updating our risk based approach to supervision, the Advanced Risk Responsive Operating frameWork.

2 Background

Describing the private equity market

2.1 The private equity market matches medium- to long-term capital with companies that are not quoted on a public equity market and which need financing to fund growth, development or business improvement. The capital takes the form of both equity and debt. The equity elements are typically provided by private equity funds, which in turn raise their capital from investors such as funds of funds, pension funds, investment funds, endowments and high net worth individuals. The debt is typically provided by banks, including investment, commercial and retail banks. Large proportions of this debt are often distributed to other entities, either other investment, commercial or retail banks who were not the primary finance provider or institutional debt market participants. The private equity business model is not constrained to capital provision, rather it extends to the application of expertise and strategic vision to the privately owned companies.

Size of the private equity market

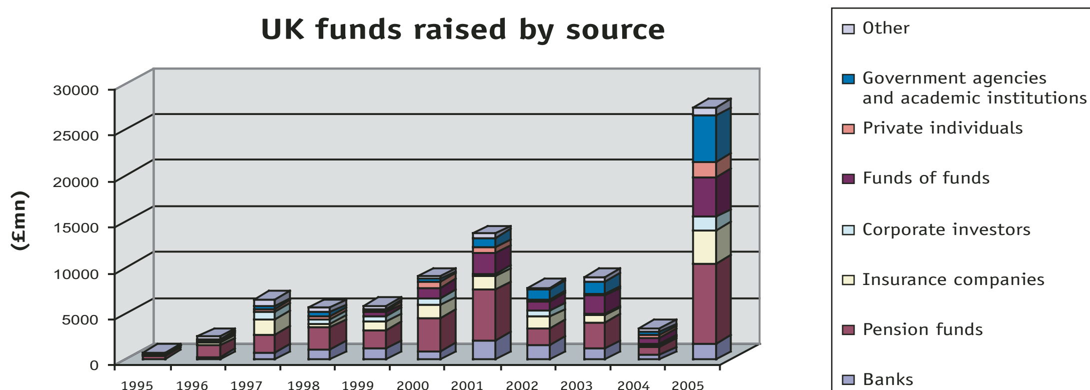
Private Equity Funds

2.2 In the first half of 2006, UK-based private equity fund managers raised £11.2bn[1] of capital. The strong fund-raising trend appears to be continuing with £9.8bn of funds already having been committed in the first closes of just four UK based private equity fund managers in July and August 2006. UK fund-raising may therefore surpass the record set in 2005 of £27.3bn[2].

2.3 The sizes of funds raised appears to be growing both in the UK and globally. A new record has been set by the close in September 2006 of a €11.0bn[3] (£7.5bn) fund by a UK based private equity firm. This compares to a new global fund-raising record set by a US based fund manager in July 2006 of $15.6bn[4] (£8.3bn). Such funds are not isolated examples. Fifteen[5] funds of over a billion dollars were raised in the first half of 2006 alone.

1 Source Private Equity Intelligence. Includes final, second and first closes.
2 Source: BVCA
3 Source FSA authorised firm.
4 Source Private Equity Intelligence.
5 Source Private Equity Intelligence.

2.4 The funds are raised from a predominantly institutional base. The table below shows the sources of private equity capital for UK based firms from 1995 to 2005. We have noted that fund-raising is volatile and tends to spike around periods of fund-raising by major buyout fund managers. This may explain a large part of the variation in fund-raising between 2004 and 2005/6.



Source: BVCA

2.5 It is worth noting, however, that a considerable proportion of these funds come from overseas[6]. In 2005 just 21% of funds raised by UK fund managers came from UK sources. North America was the far larger contributor, providing 45% of committed capital[7]. Continental Europe provided 22% and Asia 7%. Consequently, although overseas pension funds were the largest single capital contributor (providing £7.2bn or 26% of funds raised), UK pension funds (despite being the largest UK contributor) provided just £1.5bn or 5% of funds raised by UK private equity firms. There are, however, signs that capital commitment by UK pension funds (and other UK investors) is rising. The total capital committed by UK sources in 2005 of £5.9bn was over five times the £1.1bn raised in 2004 and the £1.5bn committed by UK pension funds in 2005 was more than four times the £359mn committed in 2004[8].

2.6 Commitments by UK pension funds may be driven by the growing need of defined benefit fund managers to increase their return on assets to address funding deficits. This is something that typically prompts an increasing risk appetite and a consequential enhanced appetite for alternative investments. As the proportion of defined benefits schemes to defined contribution schemes declines, it becomes uncertain as to whether the growth in alternative asset investment will continue.

Leveraged lending

2.7 To increase their understanding of banks' exposures to leveraged buyouts, regulators and central banks from across the EU have worked together to develop a survey which can be applied to firms based within their jurisdiction. We surveyed a number of banks with headquarters in the UK and a number of banks with headquarters outside of the EU that had significant operations within the UK. Our LBO survey revealed that the

6 These figures are based upon location of fund manager – it is feasible that these managers may have raised funds from investors based in other jurisdictions.

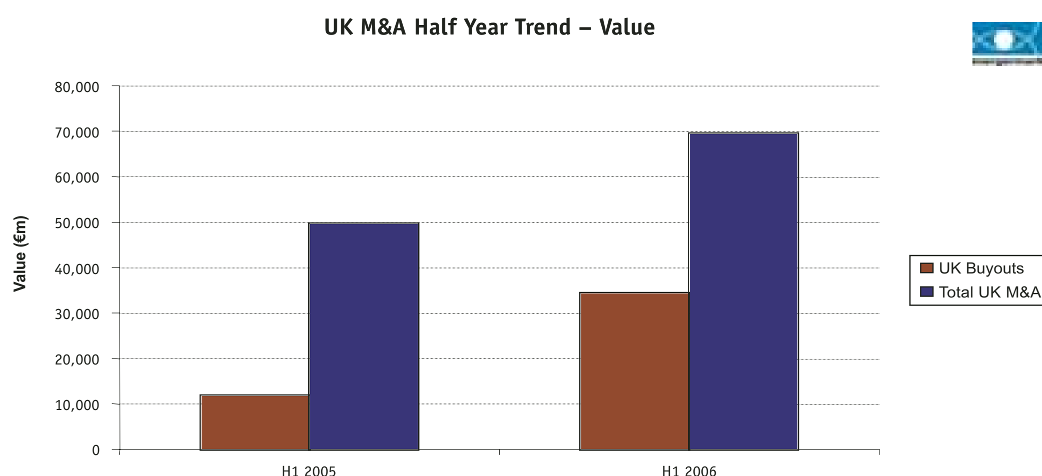
7 Source: BVCA.

8 Source: BVCA.

total amount of respondent banks' exposures to LBOs grew 17% from €58.0bn at June 2005 to €67.9bn at June 2006. These exposures can be relatively concentrated with firms' top five deals representing on average 47% of their exposure. Banks' exposures are also increasingly complex with enhanced use of second lien, mezzanine, high yield, bridge and payment in kind debt. This may be a response to the increased institutional debt market appetite for such products. Banks are increasingly distributing the debt that they underwrite. One hundred and twenty days after transaction finalisation, banks only hold, on average, 19.4% of their original exposure to their top five transactions. Anecdotal evidence suggests that the final hold level of many banks, usually achieved within six months, is substantially lower than this.

Deal activity

2.8 All of this available capital, both equity and debt, is used in the acquisition of companies, providing a strong input to the buyout and wider M&A (Merger and Acquisition) markets. In the first half of 2006 the total value of UK mergers and acquisitions was £69.5bn, an increase of 40% on the same period in 2005[9]. Buyout activity[10] almost trebled in value in the first half of 2006 compared to the same period in 2005, reaching £34.4bn, or 50% of total M&A activity[11].



Source: Mergermarket - Announced, excluding lapsed and withdrawn deals.

Shape of the private equity market

Geographical Locations

2.9 Private equity funds can be national, regional or global. An increasing number of UK managed funds, particularly the larger funds, are investing overseas as the UK private equity market is maturing and competition for deals in the UK market is increasing. A number of US-based fund managers are setting up operations in the UK, acting as a base for their European activities. The largest buyout markets in continental Europe are France, Germany and the Netherlands[12].

9 Source Mergermarket.
10 Including BIMBO, EBO, IBI, IBO, MBI, MBO and secondary buyout activity.
11 Source Mergermarket.
12 Source CMBOR.

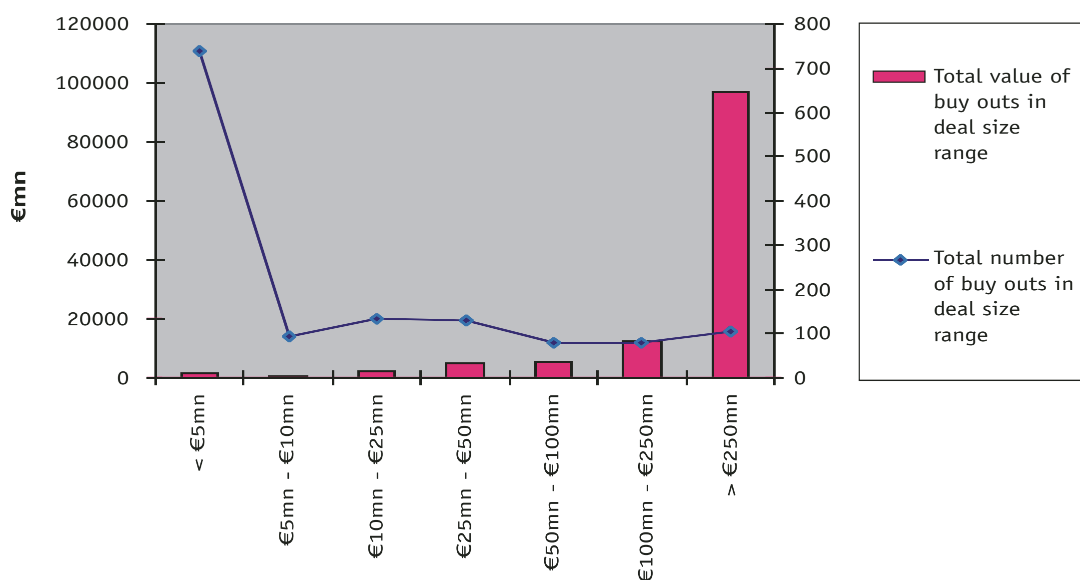
Deal size range

2.10 The private equity market is highly diverse and encompasses everything from funding new company start-ups, helping existing companies grow and develop through to increasing the operating potential of mature companies and turning failing companies around. Private equity firms characterise their funds as venture capital, expansion, buyout or distressed according to the life stage of the companies in which they invest.

2.11 Individual private equity firms often target deal sizes within a particular range (which naturally correlates to the life cycle stage of their target companies). For example, in the UK market, some fund managers specialise in the venture/small cap market, others operate in the mid market and others focus on larger deals.

2.12 The chart below indicates that, despite their very high volume, smaller transactions represented an extremely small share of total buyout value. By contrast, the 104 buyouts of over €250mn represented only 8% of total buyouts by number but 78% by value. An incredible 21 buyouts took place whose value was over €1bn.

Total number and value of European buy outs in 2005



Source CMBOR

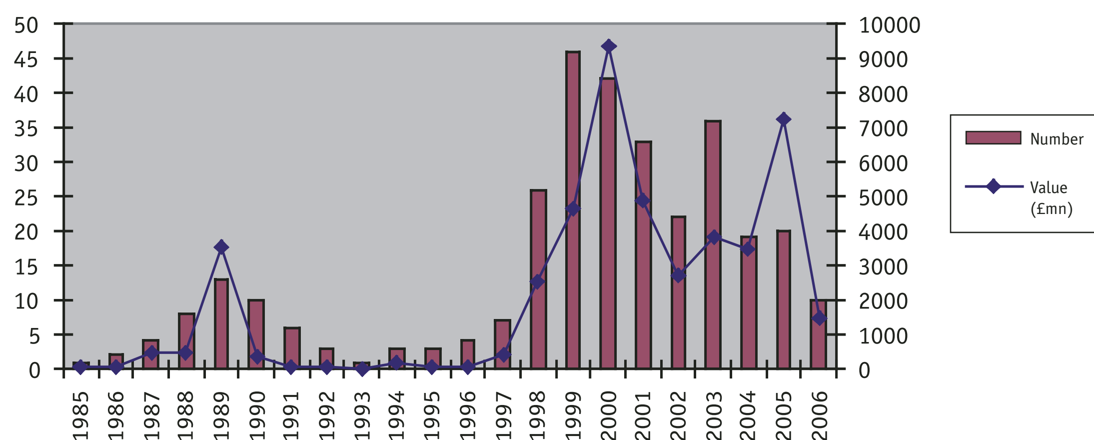
2.13 Historically, venture capital funds were such an important subset of private equity that the term 'venture capital' became used to mean 'private equity'. Today the market environment is quite different. Although the venture capital segment of the private equity market remains essentially unchanged, the top tier of the private equity market (and to a lesser extent the mid-market) has evolved substantially. The increasing scale and complexity of the large cap transactions (some of which is filtering down into mid-market deals) is having a growing impact and therefore profile.

2.14 One feature of the developing private equity market in recent years has been the emergence of the 'club deal' where multiple fund managers back a single transaction. This has enabled a significant expansion in the size of transactions that may be undertaken - the €12.9bn transaction in the Danish Telecom company TDC surpassed all European records. However, this transaction is dwarfed by the recent

proposed acquisition of the US based health care services company, HCA[13], which, at $33bn would overtake the 1988 RJR Nabisco buyout as the largest ever private equity transaction.

2.15 As potential deal sizes grow, so market participants are starting to view large publicly quoted companies as potential acquisition targets. The value of public to private (PTP) deals in Europe (ex UK) in 2005 reached a record €21bn in 21 transactions. The UK PTP market reached £7.2bn in 2005, well ahead of values seen in recent years but behind the record total of £9.4bn in 2000. The number of UK PTP deals was stable, with 20 in 2005 relative to 19 in 2004. In the first half of 2006 PTP activity in the UK has stalled (in large part due to a number of potential acquisitions being rejected by boards/shareholders) with just 10 deals being completed for a value of £1.5bn. Activity is, however, picking up and the market is stronger in continental Europe.

Public to Private Buy-outs/Buy-ins 1985-2006



Source: CMBOR - Year 2006 statistics are for the first 6 months only.

Describing the private equity market participants

Equity capital providers

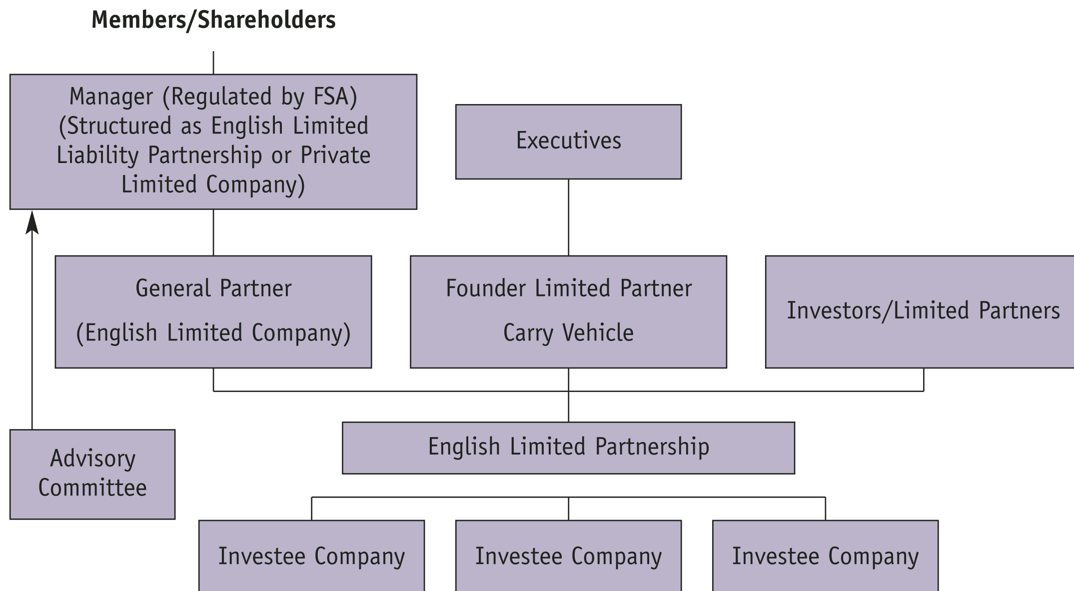
2.16 Equity is provided to investee companies either directly by an investor or several co-investors or via a private equity fund structure. Investors are typically institutional in nature and, despite recent domestic investment growth, are predominantly based overseas, with US investors remaining the most significant providers of equity capital.

2.17 Private equity funds and their investors and managers[14] exist in a variety of legal forms. The choice of structure depends on the location and tax concerns of the fund manager and investors as well as the protections/burdens/benefits afforded by the different legal and regulatory regimes operating in different jurisdictions.

13 Source HCA press release.

14 Private equity fund managers are frequently referred to as 'sponsors' or 'financial sponsors'. However, to avoid confusion with the UKLA sponsor regime, these terms are not used in this document.

2.18 Private equity fund structures can take the form of onshore limited partnerships, offshore limited partnerships (e.g. Jersey/Guernsey), UK quoted Private Equity Investment Trusts (PEITs), and UK quoted Venture Capital Trusts (VCTs) and offshore tax exempt corporate vehicles. The most commonly seen UK private equity structure is shown below:



Source: BVCA

2.19 In this structure the private equity fund takes the form of an English Limited Partnership established under the Limited Partnership Act 1907. English Limited Partnerships have no 'legal personality'. Each limited partnership must have one general partner which has unlimited liability, other partners have limited liability provided they do not take part in the management of the partnership. All limited partners are treated equally. The limited partnership agreements set out the rights and obligations of the partners.

2.20 The private equity firm usually establishes a subsidiary, as an English Limited Company, that becomes the general partner. Investors in the private equity fund become limited partners and generally have a passive role. An additional limited partner (often called the founder limited partner and structured as a Limited Partnership) is typically created as a carry[15] vehicle for the executives in the private equity firm.

2.21 The Limited Partnership fund will usually be an unregulated Collective Investment Scheme (CIS) under S235 of the Financial Services and Markets Act (2000). Establishing and operating a CIS is a regulated activity. General partners are usually not regulated. They will appoint a regulated entity to act as the manager/operator of the fund. The private equity fund manager, regulated by us if located in the UK, can be structured as an English Limited Liability Partnership (LLP) or Private Limited Company (plc). LLPs are increasingly popular for owner-managed fund management businesses.

15 See Chapter 3 for an explanation of the concept of 'carried interest'.

2.22 It is important to note that the fund (rather than the individual investors) is the 'customer' of the manager/operator. The management agreement entered into by the fund and the manager needs to comply with FSA requirements. If the fund is offshore, the UK entity will usually be an 'adviser' rather than a manager/operator[16].

2.23 The private equity fund manager may be independent or captive (part of a larger financial group such as an investment, commercial or retail banking group). They may provide management/advisory services to a fund whose limited partners are (i) external investors (ii) other group entities or (iii) a combination of external investors and group entities.

2.24 The regulations surrounding listed private equity investment vehicles (private equity investment trusts and venture capital trusts) are defined under separate tax legislation[17] which sets out various constraints surrounding the investments which these vehicles may make. In addition, Chapters 15 and 16 of the Listing Rules[18] set out the various rules which apply to listed investment companies and venture capital trusts.

2.25 There are a number of private equity funds listed on the London Stock Exchange including buyout funds, development capital funds, general funds, turnaround/re-structuring funds, venture capital funds, and funds of funds. This represents quite a broad range of funds but is not necessarily representative of the private equity market as a whole as, to achieve a listing, entities must comply with a number of specific requirements. Some of these market participants are actively exploring alternative structures and vehicles for private equity investment as they have found some elements of these traditional structures to be cumbersome.

2.26 A number of hedge funds are also investing in the equity element of private equity transactions. A hedge fund is typically structured as an unregulated collective investment scheme (often with feeder funds to segregate US and non-US investors for tax purposes) based in an offshore tax haven with an onshore regulated investment manager or adviser. The manager or adviser will typically be structured as a limited liability partnership.

2.27 Although this paper focuses predominantly on fund structures, these are not the only possible vehicles for engaging in equity investments in the private equity market. For example:

- Some banks choose to invest their own money in private equity. Typically where they wish to combine this with third party money they will establish an independent fund structure but, where it is just their own cash, they may make investments directly (from their own balance sheet).
- There have been a number of examples of conglomerates engaging in private equity related activity recently. Under this approach a financial group will acquire companies with growth potential, applying management and financial expertise to that company before divesting of the company at a profit. The

16 The term manager is used throughout the rest of this paper for reasons of simplicity but can be interpreted as a reference to an adviser or operator as well.

17 Section 842AA and Schedule 28B Income and Corporation Taxes Act 1988.

18 Currently the subject of Consultation: CP 06/4.

purchase of such companies is usually undertaken on a leveraged basis. The companies are bought with the specific intention of transforming them and so increasing their value. There may be no particular synergies between the businesses of the companies that make up the conglomerate, rather the synergies may relate to the application of transformational skill across a number of entities that merit such development. These conglomerates may themselves have publicly quoted shares and therefore investing in them can provide a means of exposure to the private equity market for institutional and retail investors.

- Also large corporate entities may also make direct private equity investments. Typically this occurs where they see potential applications to their core business of the products under development in a small/start up company.
- Finally, wealthy individuals are also sometimes observed making direct private equity investments, either in isolation or as part of a joint/club approach. Frequently these individuals have extensive industry experience and may have acquired their wealth in the corporate sector.

Debt capital providers

2.28 When a private equity manager has identified a potential investee company, they will then go on to seek providers of debt to complete the financing of the transaction. Retail, commercial and investment banks all provide debt to companies but their target markets vary in size, location and sometimes sector. Some firms are able and willing to structure highly complex transactions, whereas others focus on vanilla bank lending.

2.29 Increasingly, rather than retaining the debt on their balance sheets in the medium to long term, banks are distributing some or all of this debt to other market participants. A bank's distribution of debt will depend upon its own desire and/or ability to retain exposure to the transaction, the size of the transaction, the credit quality of the company being financed and the appetite of other finance providers and investors for debt products. In smaller transactions containing vanilla structures the debt finance is often kept within the banking community. In larger, more complex transactions much of the debt will be sold on to participants in the institutional debt market such as hedge funds, investment banks, pension funds and insurance companies. The debt is also sold to structured product managers – increasing proportions of such debt are being re-packaged in the form of Collateralised Loan Obligations (CLOs) and Collateralised Debt Obligations (CDOs).

2.30 Annex 1 shows how, in a typical buyout structure, the layers of equity and debt finance are injected into a series of holding companies so that the equity and debt providers can obtain the precise exposure to the investee company which they require.

Service providers

2.31 Private equity fund managers typically employ relatively few people and so they sometimes rely on a range of advisers to work with them to help them source deals and execute transactions. Sometimes they engage placement agents to help them with fund-raising. Many of them outsource a significant amount of their accounting and administration functions to third party providers. The main advisers on transactions are investment banks, accounting firms and lawyers.

2.32 The global investment banks are important advisers to trade buyers/sellers and private equity firms. As well as identifying potential deals, the investment banks advise private equity firms on both the purchase and sale of assets including flotations into the public markets. Indeed, the investment banks depend on the private equity firms for a significant share of their revenues from mergers and acquisitions.

2.33 Similarly the corporate finance groups within accounting firms act for trade buyers/sellers and private equity firms to identify possible deals (sales and purchases) and advise on the sale and purchase of assets including managing any auction process. The transaction services groups within the accounting firms are also actively involved in conducting due diligence on behalf of private equity firms and in preparing vendor due diligence packs. The audit teams may provide accounting assistance to private equity firms subject to compliance with auditor independence requirements.

3 Market practice

3.1 The following chapter outlines in a relatively detailed way the various different aspects of the private equity business model. There is a market perception that the characteristics of the private equity market are poorly understood by both public policy makers and various potential future investors and commentators. Industry participants[1] have called on European policy makers to consider the specific characteristics of the private equity industry when reviewing or drafting legislation so that any measures will have the intended outcomes. There have also been calls for European regulators to share their knowledge and understanding with their peers. We attempt to take a thought leadership role where relevant, given the highly developed state of UK capital markets. In line with this approach, we believe that it is important to communicate our understanding of how the private equity market operates in order to both verify the accuracy of our information and help raise awareness and understanding in general.

3.2 This chapter is intended to be factual in nature rather than offering an opinion on the market practices it outlines. The chapter should be particularly helpful for those wishing to increase their understanding of this market. Experienced market professionals are asked to review this only in so far as it would be helpful for us to obtain their assessment of whether our understanding is accurate.

Fund raising

3.3 Private equity funds are typically raised with an expected life of around ten years, with the possibility of a further pre-determined extension (to be used only in exceptional circumstances and only with the agreement of the investors). This life span is established in the Limited Partnership agreement and will be communicated to investors accordingly.

3.4 The limited life of the fund means private equity fund managers might typically invest the capital committed to the fund during the first five years of the fund's life, allowing enough time to improve the performance of each of the companies invested in and arrange their divestment before the end of the fund's normal life span. So the expected hold period for an individual private equity investment is frequently well

1 Report of the Alternative Investment Expert Group: Developing European Private Equity – European Commission Internal Market and Services DG July 2006.

below ten years and is often around three to five years. Once all capital is committed, the fund manager's attention will turn to completing the transformation and disposal of those investments and raising the next fund. Where a private equity fund manager is able to exit investments and return capital earlier, demonstrating a faster return on investment, it will do so as this typically helps it to raise new funds in the future.

3.5 As private equity funds typically do not use the full life span of the fund, and as fund-raising can take quite a long time, a private equity fund manager will typically need to raise funds every five years or so. Some fund managers may be engaged in fund-raising more frequently than this if they raise and manage concurrent funds. This is perhaps because each individual fund is not large enough to take advantage of all of the available opportunities. Alternatively it could be because their mandates are not sufficiently broad to allow the fund manager to take advantage of all of the different types of investment opportunity that are available e.g. they may be subject to geographical constraints.

3.6 In addition to reinvesting retained earnings, private equity fund managers will typically raise a new fund by offering additional investment opportunities to any existing investors, i.e. any investors in other private equity funds already being managed by the firm. The fund manager will then offer investment opportunities to potential investors who expressed interest in the past, perhaps conducted due diligence, but did not ultimately commit. The next option in fund-raising is to engage in a road show to attract new investors. Private equity fund managers who already have a reputation for delivering strong performance are, however, increasingly finding themselves able to raise enough new capital from their existing investors. This is a distinct benefit for the firm as it saves management time both on marketing the fund and helping potential investors perform due diligence, and so allows the manager to concentrate on delivering investment performance.

3.7 Where a firm does not already have a track record it may turn to placement agents to help it raise new funds. These agents have significant networks of contacts with third parties interested in making private equity investments. The placement agents introduce these potential investors to the fund managers. The agents may also help prepare relevant documentation. The role of placement agents is similar to the capital introduction services offered to hedge fund managers by prime brokers.

3.8 Private equity investors typically complete an application form subscribing for a number of Limited Partner interests, where each of these interests has a pre-determined value. So, for example, if each interest is worth £1mn, then 300 interests may be subscribed for at a total value of £300mn. The amount subscribed for may be dictated both by the willingness of the investor to commit capital but also by the availability of partnership interests – the fund manager frequently chooses to place a cap on the fund size and therefore investor commitments may need to be scaled back if demand exceeds supply.

3.9 In the last year, gaining access to private equity funds, particularly the top performing funds, has become a significant issue for some investors. The push of (predominantly non-UK) institutional capital into the asset class has been so great that even the largest funds have been unable - or unwilling - to accommodate fully their clients' target allocations, much less accept new clients. There is no price mechanism to correct this

problem as private equity funds are not structured with units that have a price which could be bid upwards - investors simply commit cash. This access issue has had a significant effect on the relationship between limited partners and fund managers with existing and prospective investors now having to promote themselves to private equity firms. Many smaller institutional funds now gain access to private equity funds via larger funds of funds that have more negotiating influence.

3.10 There is usually a relatively high minimum subscription for new private equity fund offerings, often in the range of €5-10mn for mid and large cap funds. Even in the (usually smaller overall) funds specialising in the UK smaller cap market, minimum subscriptions will tend to be at least £500k. These high minimum subscriptions reduce the number of investors a fund manager needs to deal with and thereby reduces administration costs, plus it helps ensure that the investor base is professional/expert and helps avoid direct retail investment (with all the inherent regulatory implications).

3.11 The total commitment made is not transferred to the fund manager immediately. Rather, private equity funds typically operate with a structure where cash is only drawn down from investors when an investment has been arranged, and then only the money needed for that transaction is drawn down. Investors typically invest non-drawn down cash in liquid instruments to allow them to meet any draw down requirement as and when it arises.

3.12 Sometimes private equity firms have a bridge finance facility which enables them to carry out a transaction before receiving the cash from their fund investors. The bridge facility is usually provided by a bank and is secured against the investor commitments. These facilities enable private equity fund managers to invest more rapidly, without the risk of losing a deal because they could not draw cash sufficiently quickly from their investors. The facilities also help reduce administration costs because they allow the fund manager to identify the financing and transaction costs accurately before making a capital call, removing the need for any adjustments i.e. additional calls or returns of excess capital.

3.13 To reduce the risk that an investor in the fund does not meet capital calls, the fund manager will conduct a review of the investor's ability to meet commitments before accepting them as an investor in the fund – a type of credit check. Furthermore, the investor will typically be told that they could be subject to quite a punitive response to any actual failure to supply committed capital, involving interest and administration charges, loss of rights to future distributions etc. This will prompt investors to review their proposed commitments in advance to ensure that they will be able to meet them.

3.14 To save the fund manager from being at risk of not being able, due to a lack of funds, to make an investment that it had committed to, the fund manager generally has a right to request that the other partners make good the missed capital call. Alternatively, the fund manager may have put in place a 'funder of last resort' arrangement.

3.15 When an investment is divested, the private equity fund manager will typically return the realised capital to investors. There are, however, some exceptions to this. First, a capital disbursement may be offset against a planned capital call if the fund is still in its investment stage. Second, depending on the fee structure in operation, some of the

capital may be taken in the form of fees or carried interest by the general partner (who will generally have a first call).

3.16 The fee structure for private equity funds is frequently complex and made up out of a variety of different component parts including (but not always limited to):

- A priority profit share payable to the general partner, who will then typically use this to pay the private equity firm a management/advisory fee. These payments are typically set at approximately 1-2% of committed capital during the initial investment period (of about five years). Usually these payments fall back to a (sometimes lower e.g. 1%) percentage of the total of un-drawn capital commitments plus the acquisition cost of investments still held (i.e. not the capital already returned to investors). Such fees are typically payable from the outset of the fund's life. To avoid some investors paying for the firm's overheads twice, the management fee may be reduced further or removed if a younger but concurrent fund is set up.

- Transaction fees (these are typically only found in funds run by managers with strong track records of performance). Transaction fees can amount to 0.5% to 1% of deal enterprise value and they essentially represent a success fee for identifying and completing a transaction. Transaction fees are usually credited to the fund or split with the fund on a pre-agreed basis. Abort fees (i.e. fees to recover expenses involved in pursuing deals which are eventually not consummated) have traditionally been charged to the fund. However, this can be a point of negotiation between the general partner and limited partners, with investors increasingly seeking to have abort costs netted against transaction fees.

- Monitoring fees may be charged for continuing to ensure that the transformation process of a company invested in is going to plan. These tend to be relatively small, usually no more than a few hundred thousand pounds.

- Carried interest (similar to a performance fee) usually equates to approximately 20% of capital gains. This is typically not paid out until all limited partners' capital has been returned and an internal hurdle rate has been met e.g. until the investors have received their capital back and a return of, say, 8% on their investment no performance fee is paid out to the general partner. This is designed to incentivise the fund manager. It does, however, delay the moment at which a fund becomes profit making from the fund manager's perspective.

3.17 Clearly the more money a fund manager has under management, the higher the management fees it will earn. If, however, this large sum of money is more difficult to invest profitably, the firm's performance fees and/or ability to raise new funds may be impaired. Firms need to strike a balance between these different elements.

3.18 Fund-raising in the private equity market is currently prolific, with ever larger funds being raised. In a decade where yields in the mainstream asset classes have reached historical lows, many investors have engaged in a search for yield, seeking out new return opportunities in alternative investments. This strong flow of institutional capital was until very recently directed towards the growing hedge fund industry. However, a period of relatively lacklustre hedge fund returns during 2006 may have led some investors to turn to private equity.

The hedge fund approach

3.19 It is worth noting that hedge funds do not share the fund structures used in private equity, nor the need for frequent rounds of fund raising, nor indeed the fee structures. Hedge funds tend to be open-ended/evergreen, i.e. they do not have a finite life span. This means that hedge fund managers have a quasi[2] permanent source of capital to be invested at their discretion. Hedge fund managers can open their funds to new investment if they want to increase their capital base but there is no need for them to frequently re-raise their original capital.

3.20 The reward structure in private equity is arguably less advantageous than that found in the hedge fund sector. Hedge fund managers generally earn 2% management fees and 20% performance fees based on regular (current) valuations of the fund with no hurdle rate and with all fees being payable in the year[3] they were earned.

3.21 Finally, hedge fund managers generally operate under flexible mandates and are unlikely to face significant constraints in their private equity investing. For example, they are unlikely to be barred from hostile deals and may participate in both the debt and equity elements of a transaction. It is therefore possible that we will see an increase in private equity investing out of hedge fund style structures. It is, however, also worth noting that the very broad mandates for the hedge fund managers may mean that hedge fund investors are unaware of the potential for their money to be invested in illiquid private assets and may only discover this after it happens.

Investor liquidity

3.22 Investors are typically obliged to remain committed (for the total amount committed less any cash returned to them following deal exits) for the total life time of the fund or until all of the investments have been successfully divested. This means that their investments are viewed as completely illiquid. To meet investors' needs for greater liquidity and lower 'vintage' risk (i.e. greater portfolio diversification in terms of the age of the funds invested in) the market has developed a secondary market in investments in private equity funds. This allows an investor who no longer wishes to hold their investment to transfer it to another investor (with the general partner's consent, such consent not to be unreasonably withheld). The secondary market in private equity fund commitments (a separate concept from the secondary market in private equity owned companies, which we discuss later in this paper) has grown in depth and breadth. It does, however, still only provide limited liquidity. This is because it can still take a considerable period of time (sometimes as much as six months) for an investor to conduct the necessary due diligence on the underlying investments to value and therefore price their potential investment.

3.23 In the early days of the development of this secondary market, positions were transferred at a discount – i.e. a party selling a stake would get less than its true worth as buyers knew that the vendor was keen to sell. Today, stakes can be transferred at a premium. The prices of these assets are rising both because the

2 See section on investor liquidity which describes how the total volume of available capital may ebb and flow.

3 Most funds are structured with yearly fee structures however some may be structured with other fee periods e.g. quarterly or semi-annually.

demand for any form of private equity exposure is great and because investors who are new to private equity frequently want to back-fill their portfolios. They want to develop a portfolio that is more rounded in its age/investment cycle profile, giving the appearance of a portfolio having been built over a longer time.

3.24 The secondary market started with an advisory model in which specialist professional advisers used their network of contacts to help vendors place their stake. This model evolved over time to include professionally managed competitive auctions. Auctions have not entirely replaced advised sales – some vendors try to avoid auctions because they are concerned that purchasers may club together in auctions, reducing competition for the asset and therefore the price paid.

The hedge fund approach:

3.25 The investment strategies a hedge fund manager is able to pursue are dictated by its investment mandate, the liquidity offered to investors in the fund(s) it manages and the liquidity of the fund's investments. Hedge funds offer liquidity on an ongoing basis rather than after each divestment. For example they may offer quarterly liquidity with a 90 day notice period. Hedge fund managers have therefore (with some exceptions) traditionally been short term investors in relatively liquid instruments as they need to be able to meet any redemption requests as they arise. There has, however, recently been some evolution in the investment strategies of hedge fund managers.

3.26 When setting up new funds, hedge fund managers are increasingly implementing long term lock ups in their fund structures i.e. they do not allow investors to redeem their money for a set period (often two years) after making their investment. Longer notice periods are also being introduced i.e. the period between an investor's redemption request being made and them getting their money back is lengthening. In addition the frequency of dealing dates can also be lower e.g. semi annual or annual liquidity rather than monthly or quarterly. Furthermore, gates, which place an upper limit on the absolute amount of money that can be redeemed on any one redemption date, are being added. All of these mechanisms facilitate a longer-term investment strategy without unduly increasing liquidity mismatch risk. Even so, this may be insufficient protection in the context of highly illiquid private equity investments. In response to this, hedge fund managers are increasingly employing side pockets.

3.27 Side pockets are essentially a different class of shares in the hedge fund where the shares are subject to a different (lesser) liquidity profile. A hedge fund manager may choose to 'drop' an illiquid instrument into a side pocket i.e. purchase the asset just with the capital from the side pocket shares. Where investors commit capital to a hedge fund after a side pocket has been established, they would not be allowed to participate in that particular side pocket investment. It is typical for side pocket shares to only become liquid once the relevant asset has been sold or it has been deemed liquid again (perhaps because the asset was unquoted shares but they have now been listed) and moved back into the main fund. Side pockets therefore allow hedge fund managers to invest in illiquid investments without creating any liquidity mismatch risk between the liquidity of their investments and the liquidity they offer to their investors.

3.28 Developing these techniques for managing liquidity mismatch risk means that hedge fund managers are now perfectly able to invest in private equity. Their participation has, so far, generally been limited to purchasing debt securities in the syndication of private equity transactions. A number of funds are, however, actively participating in the equity tranches. These firms tend to have a significant involvement in the deal structuring phase and may take significant equity stakes or debt stakes with equity-like characteristics.

Direct investments:

3.29 As we noted in Chapter 2, fund structures are not the only possible vehicles for private equity investments. The liquidity profile of direct investments can vary significantly and will be determined on a case-by-case basis.

Deal origination

3.30 The total private equity transaction opportunity set is a function of the economic, political, commercial, M&A, market, legal and regulatory environments around the world. Taking each of these in turn, the profitability and therefore viability of any private equity transaction is a function of the following factors:

- *Economic environment:* the economic environment in which the company operates, including the prevailing interest rates, productivity, taxation, supply and demand for products and services will affect the underlying profitability of companies and therefore private equity transactions.
- *Political environment:* political stability creates an environment in which companies have the confidence to invest. Political instability, or a tendency of governments to intervene in commercial environments, creates risk and uncertainty which tend to deter investment.
- *Commercial environment:* the maturity of any market, the number of firms competing for market share, the ownership structures i.e. a tendency towards small, private, family-run businesses or the prevalence of large, professional commercial enterprises and/or consolidated financial groups affects the opportunity set.
- *Mergers and acquisitions:* levels of M&A activity generally are a major driver of private equity activity.
- *Market environment:* the proximity of the investment to a strong banking sector and/or deep, liquid capital markets can affect the ease of financing, although the opening and globalisation of financial markets and the increase in cross-border transactions means this factor is having less of an effect.
- *Legal environment:* the ease of engaging in mergers or making acquisitions is a function of the competition regime in operation and the openness of the market (including the existence of any barriers to foreign and/or private equity investors, particularly with respect to so called ‘national champions’). Contract certainty and the availability of financing and secure collateralisation will also have an impact.

- *Regulatory environment:* the regulatory environment, both in terms of corporate governance standards imposed on public and private companies and financial services regulatory requirements imposed on entities making investments or giving investment advice can affect the attractiveness of a market place.

3.31 The total scope of a fund manager's transaction opportunity set may be further constrained by the investment mandate granted to it by the fund investors. For example, it is common to see a restriction imposed on the manager's ability to engage in hostile transactions.

3.32 There is a limited range of potentially profitable private equity transactions. The recent phenomenon of larger absolute amounts of capital (both equity and debt) being committed to the private equity market, has led to increased competition for individual private equity investment opportunities. As more money competes for the same deals, individual fund managers are inevitably failing to succeed in many of their planned acquisitions because they are being outbid by other firms. This has two obvious potential implications. Firstly, purchase price multiples are rising as firms are increasing their bids to enhance their chances of winning. Data from our LBO survey reveals that in 2005 the average maximum purchase price multiple of transactions to which the surveyed banks had committed debt capital was 11, in 2006 this figure had risen to 14. Secondly, deals may be done that firms would not historically have considered i.e. deals which are larger, riskier or in new markets.

3.33 As prices rise, inevitably the amount of both equity and debt finance required to make the transaction tends to rise. We discuss the relative amounts of equity and debt financing and the implications of leverage in private equity transactions in the financing section below. Clearly, where firms are paying higher prices for private equity assets this will have an impact upon returns. Generally we would expect future average returns from private equity funds to be lower than the recent, sometimes stellar, returns as competition will drive out any excess returns. Furthermore, the time taken to generate profit is likely to be longer (not least because of the extra interest payments being made on any increased use of debt finance) so holding periods may increase. These developments may, in the long term, discourage additional private equity investment, so market forces may actually mean that any excessive investment in the asset class will be self correcting. As private equity markets become increasingly competitive, there is a natural, but as yet unproven, concern that there will be a race to the bottom in terms of deal quality, with transactions being completed at prices that would not historically have been contemplated.

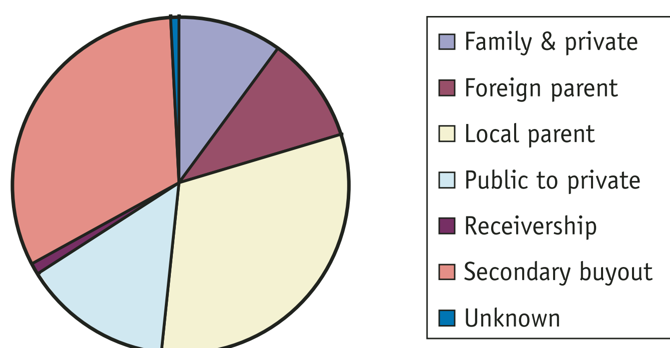
3.34 It is also natural to expect firms to look for opportunities in new geographical markets, although this is typically a slow process as market expertise is a core element of the private equity business model and this takes time to develop. The US is a very mature market with a declining number of investment opportunities available that are likely to generate required internal rates of return. This does not seem to be a market UK-based fund managers are particularly focusing on. In fact, many US private equity firms are in the process of opening UK offices to help them seek out European opportunities because they view Europe as a less competitive market place. UK-based fund managers talk about there still being opportunities in Germany due to the significant number of family-owned businesses, and in France

and Italy due to the potential for consolidation and professionalisation. Despite this, there seems to be little in the way of concrete plans to expand into the rest of Europe e.g. the recent accession states. Other areas being targeted for expansion include Hong Kong, Japan and the various countries experiencing high growth within Asia. However, although some deals are being done and some offices are being set up, it does not yet tend to involve large scale operations and frequently not even the establishment of bespoke funds.

3.35 Firms are also looking to expand their opportunity set by considering larger deals e.g. acquisitions of very large public companies that would historically have been regarded as out of reach. This phenomenon is prompting the increase in very large public to private transactions. At the moment these are generally having to be financed via a club deal i.e. more than one private equity fund (run by more than one private equity fund manager) will be a material investor. This collective approach may bring increased opportunities but the deals are also harder to manage, with more parties being involved. Inevitably this increased complexity is prompting many private equity firms to seek alternative approaches e.g. raising larger funds themselves such that they are able to undertake larger transactions on their own. We can see evidence of the growth of the public to private market from the fact that in 2005 the UK PTP market reached £7.2bn, well ahead of values seen in recent years. In the first half of 2006 PTP activity in the UK has however stalled with a number of potential transactions falling through. Ten deals have so far been completed for a value of £1.5bn.

3.36 Private equity fund managers are also increasingly looking at assets already owned by other private equity funds, there is a developing secondary market in private equity assets. Secondary buyouts in the first half of 2006 represented 32.4% of the total value of UK management buy outs and buy-ins.

Sources of UK MBO/MBI Value (%) - H1 2006



Source: CMBOR

3.37 Private equity firms active in the secondary market claim not to be recycling assets. Rather, they explain that they are taking companies through the next stage in their life cycle e.g. if the first private equity firm supported it in its expansion phase, a second (usually larger) private equity fund manager might finance a management buy out and support the company through this stage in its development. There are, however, now a reasonable number of deals that have been through three private owners and we are starting to see quarternary transactions. Questions are being

asked about whether each of these owners can really develop a company further and extract additional value, although performance to date has been positive. Furthermore, experience in the public markets suggests that some companies can continue to grow and develop over a long period of time.

3.38 Another consequence of this enhanced competition for deals is that the manner in which the transactions are arranged is changing. It is currently very much a sellers' market in which sellers use vendor packs[4] and stapled finance[5] to set guide prices and then arrange a competitive auction for the asset. There are still some proprietary deals, which do not involve an auction but these are usually in the lower and lower-middle segments of the market in terms of deal size, or specialist transactions requiring a non-standard approach. Furthermore, we have seen an increasing number of failed transactions recently as the seller refused to divest unless it achieved a particular price for the asset.

3.39 Some private equity firms appear to hold the view that in the long term only big global players, some sector/country specific operators and venture capital firms will survive. Other firms will generate weak returns and therefore find it difficult to raise new funds. This view is not universally held. While most firms claim that they are experiencing greater competition for deal flow, many say the situation is perfectly manageable. They note that although the total value of committed but un-invested private equity cash has grown substantially, the percentage of committed funds that remain un-invested has not risen.

The hedge fund approach

3.40 Hedge fund managers' activist techniques in the public markets can put certain companies 'into play', facilitating private equity bids by illuminating strategic failures and agitating for management change. This can happen whether or not the hedge fund manager ultimately intends to participate in any private equity transaction.

3.41 Otherwise, deal origination by hedge fund managers tends to be similar to that of the private equity firms, although it is harder for them to demonstrate a track record (as this is a new business line for them). Hedge fund managers also have to struggle against perceptions that they are all short-term investors, even though some of them have been relatively long-term, fundamental investors in the public markets for some time. This may explain the relatively small number of hedge fund managers (so far) who have successfully made equity investments in the private equity market.

Investment decision making

3.42 A private equity fund investment decision is typically made by an investment committee. The committee is formed from senior personnel from the fund manager together with, in some cases, a number of investor representatives. The committee operates in accordance within predetermined rules. The committee will generally

4 A glossy brochure typically prepared by advisors to the vendor setting out details of the company/asset highlight positive aspects, such as growth potential, and guiding firms towards particular multiples/prices.

5 A pre-prepared finance package offered to potential bidders to facilitate the transaction. The amount of finance offered and the terms available give clear indications of the vendor's expectations in terms of the sale price.

receive a briefing pack and presentation from an investment officer or investment team. They will review these materials, explore the assumptions made, the risk factors and the recommendations and then come to an independent, informed decision about the optimality of the proposed investment. Where this decision leads to a bid for the company, the committee will typically give the investment team a mandate to bid at a set price, which would be subject to certain specific conditions.

3.43 When deciding how much to bid for a company, firms proactively develop business models which would invigorate and transform the target company, facilitating value creation and medium- to long-term growth. A private equity fund manager's bid for a company is therefore very much a function of the growth potential they perceive rather than just current fundamentals.

3.44 In preparing its bid price a fund manager will have considerable regard to the following key ratios (in addition to standard balance sheet, profit and loss account and cash flow measures):

- Purchase Price/EBITDA (Purchase Price/Earnings Before Interest, Taxes, Depreciation and Amortization) also known as the Purchase Price Multiple – a measure which enables the investor to compare the price of the transaction to other transactions in the same sector and/or other transactions of a similar size.
- Debt/Equity (Total Debt/Shareholder Equity) – a simple but good measure of a company's financial leverage or gearing.
- Debt/EBITDA (Total Debt/Earnings Before Interest, Taxes, Depreciation and Amortization) also known as the Leverage Multiple - a good measure for analysing a company's debt burden in relation to its profitability relative to its peers within the same sector.
- EBITDA/Cash Interest (Earnings Before Interest, Taxes, Depreciation and Amortisation/Interest Payments) – a good measure of a company's ability to meet its debt finance obligations in the short term.
- [EBITDA – Maintenance Capex]/Cash Interest ([Earnings Before Interest, Taxes, Depreciation and Amortisation – Maintenance capital expenditure]/Interest Payments) – a measure of a company's ability to meet its debt finance obligations over the medium term as it takes account of the capital expenditure which is necessary to maintain the business.
- (EBITDA – Capex)/Cash Interest – a measure of a company's ability to meet its debt finance obligations over the long term as it takes account of the total capital expenditure needed for the business to continue operating at planned levels.

3.45 These ratios will frequently be reworked separating senior and non-senior debt given the different cost and servicing requirements typically associated with these different types of financing.

3.46 The final valuation of a target company (taking into account all these ratios) may not drive the first price at which the fund manager will bid. Sometimes, a fund manager will not conduct exhaustive due diligence before making its first bid in the auction process. Instead it will rely on vendor information packs and stapled finance, plus a limited amount of in-house due diligence, to develop a conditional offer which is subject to certain issues being worked through. The fund manager need only do enough at this stage to persuade the auction manager to put them through to the second round of the auction (although they may in fact do more). They must therefore, as a minimum, convince the auction manager that they are serious about completing the transaction and willing to make a competitive final offer. It is in advance of the second round of bidding that the real due diligence must be completed.

3.47 The total due diligence conducted on private equity transactions before they are finally completed is usually very extensive. It is conducted by highly qualified, experienced professionals who may have been closely following an industry sector or even the target company for a period of years. The firms are committing large sums of capital and senior management time to a bid and need to be confident that it is worthwhile. Due diligence can be very costly (running into millions of pounds) as it often involves extensive use of external auditors, advisers and consultants in addition to internal expertise.

3.48 The development of vendor due diligence packs may have helped this process, allowing private equity fund managers to target their own due diligence more effectively on issues of particular concern to them rather than needing to start with the basics. Vendor due diligence is produced for the vendor company with a view to securing the highest possible valuation and therefore sale price – it is essentially a marketing pack. This means that there may be incentives to flatter the company, highlighting its stronger points, drawing attention away from any areas of weakness. Vendors typically try to mitigate the risk that this devalues the pack by engaging a reputable professional firm, such as a respected accountancy firm, to prepare it.

The hedge fund approach

3.49 One advantage hedge fund managers have over private equity firms is their ability to invest quickly. The lack of specific due diligence obligations, the general absence of formal committee structures to approve investments and the pre-existing funding means they can make and implement an investment decision far more quickly than a typical private equity firm. There are circumstances, such as where a company needs capital quickly to pay bills or make an acquisition, where this speed creates a significant competitive advantage.

Capital structures

3.50 A private equity transaction will generally be financed using a capital structure involving both equity and debt. Private equity transaction structures can be relatively complex, so the market is characterised by sophisticated participants. The equity is typically injected by the private equity fund and staff (particularly the executives) of the company being acquired. To source the debt financing, the fund manager will usually run what is effectively a competitive auction amongst banks for the right to

underwrite the debt element (assuming the fund manager itself wins the right to buy the company). Banks compete on the volume of finance they are willing to offer, the terms on which they are willing to offer it and, to an increasing extent, the expertise of their staff with respect to structuring and distribution.

3.51 A firm appointed as an adviser to the seller of the target company may offer stapled finance i.e. they will guarantee to offer debt finance to the successful bidder, up to a specified amount and on terms indicated in the staple finance document pack. These structures help set a guide price for the auction but are frequently not taken up in practice as potential purchasers show the offer to other banks and ask them to beat it. Excess liquidity and competition to finance leveraged buyouts has meant that the balance of power in negotiating debt packages has shifted somewhat in recent years from the banks to the fund managers.

3.52 The precise composition of the capital structures used by private equity fund managers for the companies they acquire is something that is evolving over time, reflecting changing market conditions and financial innovation. The capital structures also vary considerably according to the size and nature of the transaction. Structures for venture capital and small cap transactions tend to be relatively simple, being comprised generally of just equity, shareholder loans[6] and (sometimes) senior amortizing[7] debt. Leverage levels are usually very low or zero. By contrast, in mid-market transactions (i.e. transactions above the venture capital market but below say €500 million) the debt component of the transaction is typically material and includes both senior[8] debt and mezzanine[9] debt. Large cap transactions increasingly involve the use of exotic and complex capital structures incorporating a variety of senior and subordinated debt tranches, together with a relatively small, equity tranche.

3.53 A significant recent development in the structuring of mid and large cap transactions is the increasingly common use of non-amortizing 'bullet' debt. Non-amortizing bullet debt is debt where no capital repayments will be made for a pre-agreed period of time (often around eight years), after which a large payment falls due. Non-amortizing debt has the benefit of allowing a company to use debt finance without having to eat into its short-term cash flow to make large debt repayments. A lack of amortization typically allows companies to bear a significantly higher amount of debt financing than they might otherwise have been able to afford. Such debt is generally re-financed before the bullet date – it often has to be as deals are frequently completed with negative forecasts for cash flows in the bullet year. Ordinary, amortizing senior debt is typically termed 'Senior A' debt, whereas the non-amortizing debt will typically be termed 'Senior B' or 'Senior C'. The share of B and C debt in total senior debt is growing. This is moving European capital structures into closer alignment with the US model, where it is common to see Senior A debt representing just a few percent of the total capital structure.

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6 Instruments with equity-like characteristics – their inclusion in the capital structure allows the right reward structure to be granted to the management of the company.

7 Amortization is the process of paying off debt in regular instalments over time.

8 Debt that takes priority over other debt securities sold by the issuer (i.e. it is repaid first in a credit event).

9 Debt that is generally subordinated to senior debt (i.e. in a credit event it would be repaid out of any funds left over after senior lenders were repaid). It can give the lender the right to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full.

3.54 In larger top-tier transactions, i.e. transactions of over €500mn, it is typical to see far more tranches in the capital structure (in addition to Senior A, B, and C and mezzanine debt). For example, structurers are sometimes including second lien debt. This is senior debt that ranks pari passu in right of payment with first lien debt. It is secured on the same collateral, but inter-creditor arrangements are put in place that, amongst other things, prohibit or restrict the ability of second lien creditors to exercise remedies against the collateral and challenge any exercise of remedies by the first lien lenders[10]. Furthermore, structurers may include payment in kind loans or notes (securities which give the issuer an option to make interest/capital payments in the form of additional securities or to postpone such payments if certain performance triggers have not been met). We are also beginning to see the use of 'toggle' instruments (cash pay/pay if you can instruments). Some of these new debt products have equity-like characteristics.

3.55 When deciding what type of debt to issue, the private equity fund managers will consider whether issuing the debt will involve a public or a private placement. A private placement is typically far quicker and easier to organise as it avoids the need for approved offering documents. However, private placements limit the number and type of potential investors that can be approached and typically require a higher yield as investors seek an illiquidity premium. They can also involve bilaterally negotiated terms which may be onerous for the issuer (e.g. attached warrants). Where public offerings (typically required for high yield debt issuance) are to be made, it is standard practice to put bridge financing in place to cover the period between when the transaction is first launched and the actual public debt is raised. It can take up to 12 months to arrange a public issue, although it is often completed in much less time. Bridge finance is typically structured as a long term (e.g. ten year) subordinated loan. Its tenure is in fact generally more limited as it will typically be structured to convert into loan-like securities after 12 months. The punitive cost of this converted capital incentivises the private equity fund manager to re-finance the bridge (e.g. through the issuance of high yield bonds) before its conversion.

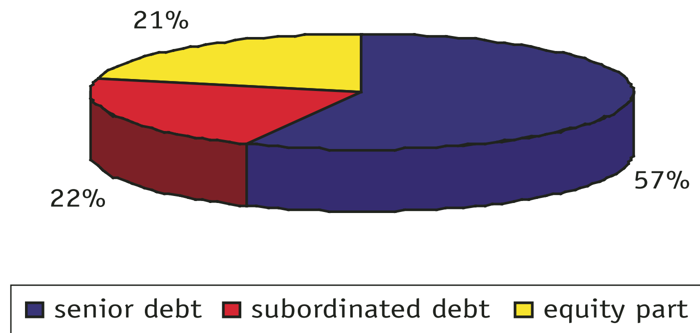
3.56 The preference of private equity fund managers to use either high yield or mezzanine debt is fluctuating not only according to the market conditions, pricing and ease of issue for these products but also their desire to undertake re-financing of the companies. High-yield debt is not easily withdrawn – it often includes call protection for up to half of the period of maturity of the debt, although the amount of call protection has been significantly reduced in some recent transactions. Mezzanine debt may also have some call protection but this often lasts for just a year or two and involves a prepayment fee rather than an absolute ban. As a result, where a re-financing is anticipated, mezzanine debt is typically favoured.

3.57 One effect of these additional layers in the capital structure is to adjust the relative proportions of equity, subordinated debt and senior debt in capital structures. In particular it can adjust the debt/equity ratio as the innovative debt tranches, with more flexible re-payment mechanisms, allow companies to carry a larger debt burden.

10 The real value of second liens has yet to be tested extensively. Following a credit event, second lien lenders could find that their lien gives them no particular advantage over subordinated debt holders if the first lien lenders exhaust the collateral leaving little or nothing for the second lien lenders.

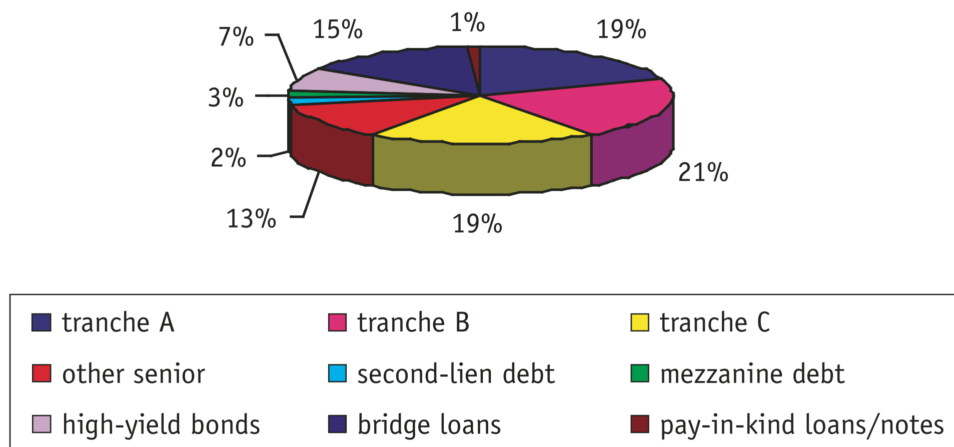
The diagram below shows the average share of equity, subordinated debt and senior debt in banks' five largest LBO transactions during the 12 months to June 2006 (according to our LBO survey) - the average size of which was €4.6bn. The equity component, just 21%, is surprisingly small relative to historical levels – equity appears to be being partially replaced with subordinated debt (some of which has equity like characteristics). However, this development does not appear to significantly increase the risk to senior debt holders as the equity and subordinated debt are, together, still providing a material layer of protection.

Capital Structure - High Level Breakdown



3.58 The chart above understates the complexity of these capital structures. The chart below illustrates the average breakdown of the debt components in firms' five largest LBO transactions during the 12 months to June 2006 (according to our LBO survey). It shows an extremely diverse array of debt being used and highlights the relatively significant share of this debt that is comprised of innovative financial instruments.

Debt Breakdown by tranche



3.59 The risk profile of the tranches varies considerably (the equity and subordinated debt provides a significant cushion of protection for those that provide the senior debt) and so therefore does the compensation offered to the providers of this finance. However, the spreads between senior and subordinated debt have narrowed recently as demand for high-yield debt has pushed up its price and reduced its yield. The market is increasingly discussing the potential that risk is currently being significantly under priced.

3.60 Yield is not the only element of these products that is under competitive pressure. Covenant packages are also being eroded with less robust triggers, reducing protection and removing early warnings of distress. Indeed a handful of transactions have now been arranged with 'covenant light' packages in which the covenants are only tested when an event occurs rather than being continuously tested. So, for example, a covenant capping the company's debt/ebitda ratio would only be tested if an event such as a major acquisition or unplanned capex programme were to be implemented rather than the traditional model where the company's compliance with that cap would be monitored on an ongoing basis.

3.61 Covenants are also becoming more innovative. We have recently seen the use of covenants to facilitate transferable recapitalisations - change of control covenants are attached to the debt but with specific exemptions relating to named private equity fund managers. The rationale for this is to allow a re-financed capital structure to simply transfer to a new owner should a secondary buyout be achieved by an approved private equity fund manager.

3.62 It is, however, worth noting that holders of public company debt without adequate covenant protection may find that the value of their debt falls significantly in the event of a private equity acquisition of the relevant company – a form of event risk. Private equity transactions that inject new debt into a capital structure can, in certain circumstances, lead to the subordination of existing debt. If the existing debt does not include robust change of control/negative pledge provisions, the debt holders have no protection against such developments. Institutional debt market participants frequently hold paper that contains no such protection (covenants are usually – but not always - more strict in senior, bank financed, debt). Effective due diligence before acquisition of such debt should ensure that this risk is factored into its price, although anecdotal evidence suggests that this may not have always been the case. This situation is beginning to change as investors, including institutional debt market participants, are increasingly demanding robust protection in newly issued debt (in part prompted by trade association initiatives and the advent of covenant rating services by credit rating agencies). There is still, however, a lot of older paper in existence than affords no such protection.

3.63 In terms of the risks the debt poses to the companies invested in, it is usual for the lenders to require the companies to engage in a certain degree of interest rate hedging, i.e. the firms are obliged to reduce their exposure to future interest rate rises. This too has seen a loosening of standards recently, with typical protection requirements now standing at around 50% of floating rate debt being hedged for three years rather than 70% for five years. In practice the companies sometimes hedge far more than the 50% required by the banks, particularly if the finance package is highly leveraged or volatile.

The hedge fund approach:

3.64 Hedge funds are typically subject to far fewer limitations than private equity fund managers on the types of product that they can invest in. This means they are able, amongst other things, to invest in equity, debt with equity like characteristics, debt, structured products and derivatives. Depending on the precise financing needs of a company (which may be a subject of free cash flow, taxation, planned expenditure

etc) this flexibility can sometimes give a hedge fund manager a competitive advantage over the private equity fund managers.

Leverage

3.65 Leverage can occur at four levels in private equity investment:

- At the transaction level: The average debt/ebitda ratio (at the time the transaction was finalised) for the top five deals reported in firms' responses to our LBO survey was 6.41. This high leverage level comes against a backdrop of rising purchase price multiples, rising debt/equity ratios (our LBO survey revealed that equity represented just 21% of the capital base of the 5 largest transactions to which each bank committed capital). Leverage in transactions – particularly in large transactions – has been rising over recent years. However, the rate of change appears to be slowing as both the interest rate cycle is turning and the ability of companies to support additional debt (even with advances in financial structuring) is becoming exhausted. As room for manoeuvre in the top tier transactions declines, we may see the complex financial structures and higher leverage levels that typify this part of the private equity market extend their reach into smaller, mid-market, transactions.

- At the fund level: Typically, private equity funds are not leveraged. Individual managers may find that the Limited Partnership agreement prevents them from leveraging the fund (i.e. their investors may not want them to take on the additional risk inherent in leveraged investment) or there may be a cap on allowed leverage. Even where leverage is allowed, this may not be employed – fund managers have typically been generating sufficient return without needing to have recourse to leverage in recent years. As competition increases and the ability to generate substantial non-levered returns declines we may see the use of leverage increasing.

- At the fund of fund level: The BVCA noted in a public report[11] that private equity performance was strongly correlated to manager selection. This would suggest that leverage need not be employed at fund of fund level as they would be able to generate substantial unlevered returns as a consequence of their advanced manager selection techniques. In practice leverage facilities at the fund of fund level do occur. Leverage levels are rising but from a low base, according to firms visited in our thematic review, typically fund of funds leverage may be around 10-20% of the fund.

- In investment products based on the equity component of private equity investments: These are still rare[12] but do exist. An example of such a structure might be a CFO (Collateralised Fund Obligation) based on private equity funds. This type of fund might comprise around 2mn of investment grade bonds for every 1mn of preferred equity shares. The investment grade bonds are included to allow international fixed income investors exposure to the private equity asset class at various levels of credit risk. The CFO could incorporate drawable equity investments and over commitment strategies (e.g. an over commitment facility of say 133%, i.e. substantive leverage is included).

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11 Source: BVCA Private Equity and Venture Capital Performance Measurement Survey 2005.

12 Leveraged vehicles related to the debt component of private equity transactions are far from rare. Hedge funds, mezzanine funds, CDOs and CLOs frequently employ leverage – see below.

The hedge fund approach:

3.66 The leverage levels evident in the hedge funds invested in the equity component of private equity transactions are relatively low. The managers of these funds appear to be seeking value by carefully investing in high yield investments and do not feel the need to leverage these up further. Credit hedge funds, CLOs and CDOs investing in the debt components of private equity transactions do, however, typically employ relatively large amounts of leverage.

Distribution

3.67 The decision by lenders on how much debt finance they are willing to supply for a particular private equity transaction, and of what type, is in part a function of the business model pursued by the leveraged finance provider. There are two very different approaches to private equity market leveraged lending in existence within the banking community.

3.68 In the first of these approaches, the 'portfolio model', lenders provide leveraged finance with the aim of retaining a significant portion of this position on their books. They earn both fee revenue for arranging the financing (and any ancillary services e.g. advisory work) and interest revenue from holding the positions. Typically firms following the portfolio model will also buy into transactions arranged by other banks, ensuring a diversified portfolio that is not unduly exposed to the risk of the failure of any single transaction. However, this may not be necessary where the firm underwrites a large volume of deals itself and therefore already has a diversified portfolio. This lending and investment appears to still be subject to robust credit controls as a significant amount of the debt is held on the banks' balance sheets. Their absolute holdings may, however, be growing as more transactions are being completed. Leverage multiples are rising in this part of the market, albeit not to the same extent as in the top tier. The portfolio model is typically followed by retail (and commercial) banks with significant balance sheets. The portfolio model is typically associated with small- and medium-sized transactions.

3.69 The alternative approach, which is typically followed by investment banks, involves a high velocity of capital turnover, with a focus on earning fee revenue rather than fee and interest revenue. Such providers of leverage finance aim to reduce their exposure to a very low target (for some of these banks this target is frequently zero) as quickly as possible. This is because they rarely want to keep a substantial proportion of the exposure on their books in the medium/long term. To achieve this, the finance providers routinely distribute (via syndications[13], assignments[14] and sub-participations[15]) the debt to other capital providers or otherwise reduce their economic risk exposure (perhaps using credit derivatives or credit insurance). This model is typically associated with large transactions involving complex capital structures.

13 The process of involving multiple parties in the provision of debt capital.

14 The process wherein a creditor assigns the debt that is owed and all rights associated with it to a third party. This may occur at a personal or corporate level, and the debtor should remain unaffected unless new terms are agreed upon. Depending upon any restrictions contained within the loan documentation permission may be required from the debtor before an assignment can take place.

15 The process wherein a lender of record contractually agrees to give a third party rights relating to the debt but the third party acquires no contractual rights against the debtor. This process has the advantage of preserving the lender of record's relationship with the debtor/the private equity fund manager that arranged the transaction because the transfer of the risk of the lenders books may not be transparent to them.

3.70 The greatest risk exposure these 'capital turnover' leveraged finance providers experience (assuming the manager they are offering a debt finance package to wins the right to buy the potential investee company) occurs between when they commit in principle to provide the finance, (where even if they can legally extricate themselves from the exposure they may not wish to do so for reputational reasons), their legally binding agreement to provide the capital[42] (which usually occurs in the second round of the target company auction in which the private equity fund managers are competing) and the date that the transaction formally occurs. Syndication can only really begin after the formal transaction completion date. Clearly underwriters are vulnerable to any change in corporate or market circumstances during this period that may damage their future ability to distribute the debt.

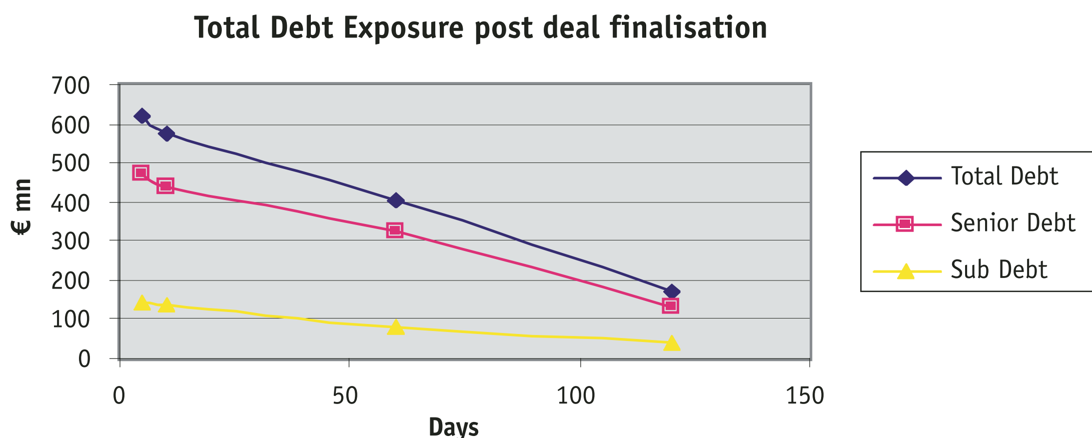
3.71 Responses to our LBO survey indicate that, for their largest transactions, timescales for banks to go from commitment in principle to a fully executed and confirmed transaction vary enormously. This perhaps reflects both the range of complexity of private equity transactions and the variance in size of deals. On average, it took around 24 days for firms to go between commitment in principle and a firm legally binding agreement. However, this number was skewed by a small number of large delays of greater than 130 days. In practice, for the other deals, this part of the process was almost always completed within 50 days and on many occasions a legal commitment was signed within a week of agreement in principle. Once legal commitment had been obtained, it then took an average of 50 days for firms to then get transaction documentation finalised. Again there was a wide variance in these numbers with a high of 173 days and, on some deals, the process being completed on the same day as legal commitment was gained. In terms of total transaction timescale, this implied an average of 74 days to get the whole transaction finalised. Variance by firm was, however, relatively significant.

3.72 However, in terms of the overall need to distribute risk it is worth noting that private equity fund managers are increasingly awarding the mandate to provide transaction finance to multiple banks from the outset. This typically involves each bank providing a strip of finance (running right through the capital structure), so individual banks' exposures are not, from the outset, as significant as they would be if they were underwriting the whole transaction. On average, banks underwrote 24% of their five largest transactions.

3.73 Once the transaction is finalised the distribution of the debt can begin in earnest. The distribution process, and therefore speed, differs according to the type of instruments involved. Distribution capabilities have been improved, so it is now possible to distribute parts of the capital structure that traditionally had to be retained by the underwriting banks. For example, it now possible for bridge finance to be syndicated. The private equity fund manager typically requires the leveraged finance provider to retain 51% of the bridge finance because it needs to maintain control in order to facilitate the issuance of the (cheaper) replacement capital from the high yield market. In practice, however, some investment banks appear to be silently offloading all of the economic risk associated with the remaining 51% (while retaining control of the voting rights) using sub-participation techniques or derivative contracts.

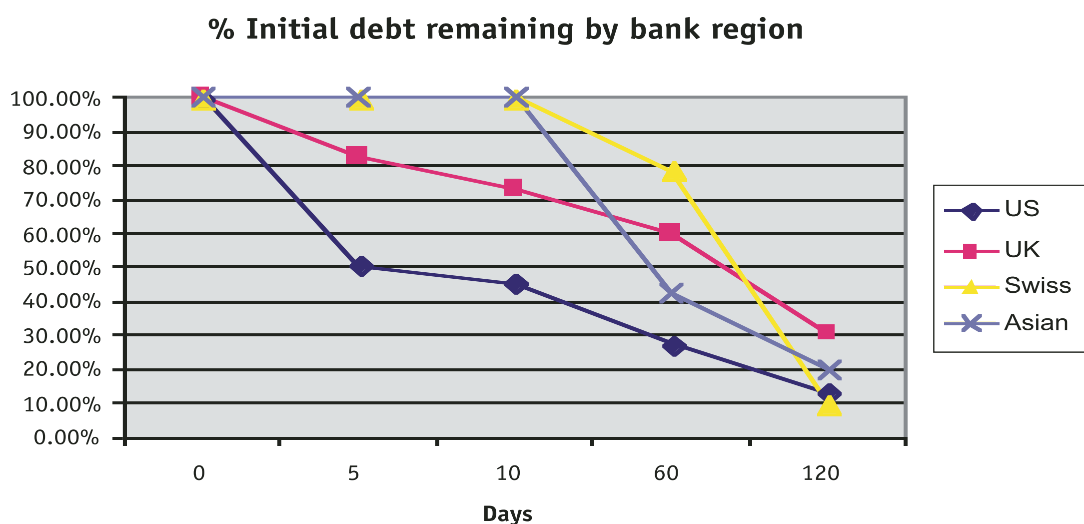
16 No actual cash transfer occurs this early in the process.

3.74 The chart below shows banks that responded to our LBO survey's changing exposures to their top five transactions over time (not including exposures before the deals were finalised). Given that the bulk of exposure is made up of senior debt, this is where firms typically concentrated on reducing their exposure in the first days after the deal.



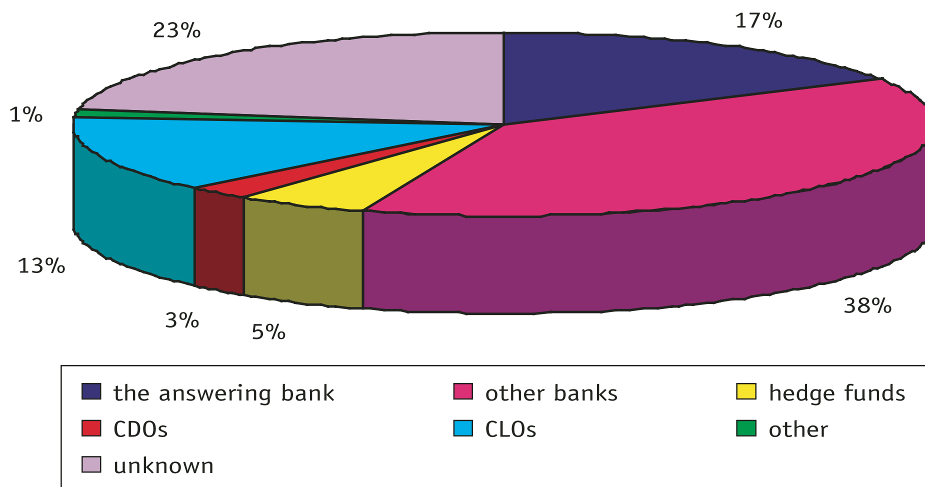
3.75 There was significant variance around the risk tolerances of the respondents to our survey. Some firms were extremely diligent, distributing almost all of their risk within 60 days of transaction execution; others retained material exposures over time (testament to the existence of capital turnover and portfolio business models). The following graph shows banks' from particular regions reduction in exposures over time. There is significant variation in the risks profiles of each region. The US and, to a lesser extent the UK, banks are most efficient in terms of the speed at which they are initially able to start distributing risks. However, while the American banks typically continue reducing their risk quickly, the UK banks slow their distribution, and are overtaken by the Swiss and Asian banks, reflecting the higher proportion of portfolio models banks in the UK.

3.76 On average banks had just 19.4% of their exposure left after 120 days. Market commentators suggest that it can take three to six months to achieve a final hold of zero.

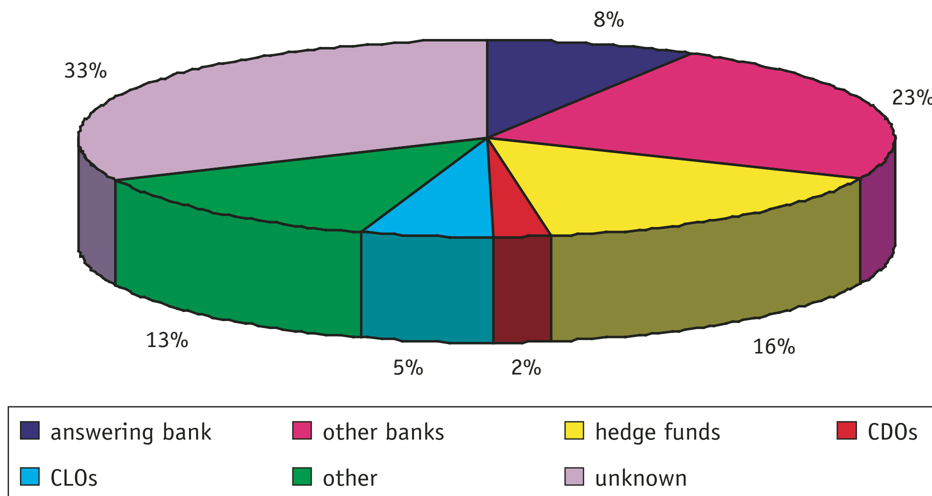


3.77 The final destination of all the debt distributed by the underwriting banks is somewhat uncertain. Only around 50% of respondents to our LBO survey were able to provide an indication of where they believed the debt had initially been distributed to. Even where an indication was provided, this clearly does not offer insight into the effect of subsequent secondary market activity and financial risk transfer. No firm identifier details were collected as part of this survey so the data cannot show how concentrated exposures may be in individual entities or small groups of entities (other than the reporting banks). Despite this, the responses provide an interesting approximation as to the destination of distributed debt. The charts below show the breakdown of senior and subordinated debt by type of acquirer.

Senior Debt - Investor breakdown



Subordinated Debt - Investor breakdown



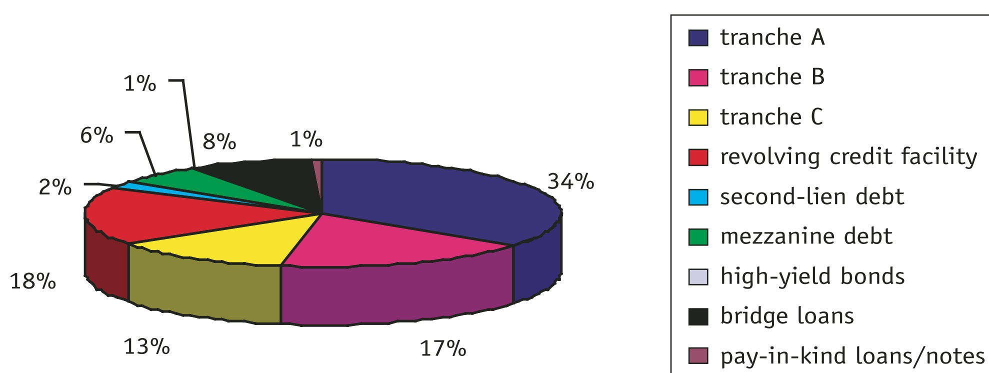
3.78 The graphs show the banking sector *initially* retaining 55% of senior debt and 31% of subordinated debt. Interestingly, when considering the type of debt acquired by institutional debt market participants, CLOs are taking 13% of the senior debt and 5% of the subordinated debt – a clear bias towards senior debt. Hedge fund managers take 5% of the senior debt and 16% of the subordinated debt – a clear bias towards subordinated debt. The role of CDOs in both senior and subordinated debt is still

relatively immaterial. The proportion of 'destination unknown' responses is material for both senior and subordinated debt, but particularly so for subordinated debt. This is unsurprising given the greater institutional debt market participation in subordinated debt tranches. The institutional debt market has a more diverse array of market participants compared to the relatively small, close knit, banking community. The other category may include significant participation by the insurance sector who have been known to purchase (and frequently package for onward distribution) subordinated debt.

3.79 Clearly, in addition to their pre-distribution risk, banks are vulnerable to anything that will devalue their retained exposures. Thirteen banks who responded to our recent LBO survey reported a combined debt exposure to leveraged buyouts at June 2006 of €67.9bn compared to €58.0bn at June 2005, an increase of 17%. This indicates that, although distribution is becoming more efficient, because deal volumes/values are increasing so are banks' exposures.

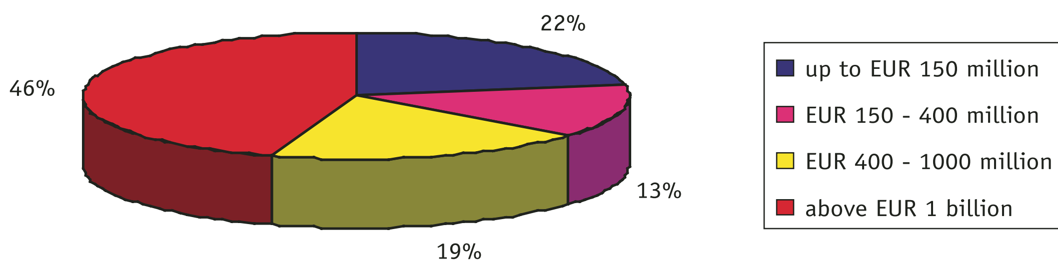
3.80 The nature of banks' retained exposures is shown below, split according to type of instrument. Just 18% of retained exposures are to subordinated debt – so the majority of this riskier debt must be concentrated in the institutional debt market.

Share of total exposures held by banks by tranche - June 2006



3.81 Banks' exposures can also be differentiated according to the total size of the deals to which they are exposed. Notably, only 35% of exposures are to deals below €400mn, i.e. the majority of their exposures are to the large, more complex transactions.

Share of total exposures by total transaction value - June 2006



3.82 Banks' exposures can be relatively concentrated with some banks highly vulnerable to the failure of just a few big deals. Analysis of the responses to our LBO survey reveals that exposures to their top five deals amount to more than three-quarters of total LBO exposures for four out of thirteen banks.

3.83 Banks are not the only entities vulnerable to shocks affecting the value of their exposures. The risk for the institutional debt market participants is who will be holding significant or leveraged concentrations of the risk when a default/market dislocation occurs and how deep and liquid is the market in those instruments (and therefore how easy would it be to exit the investment)? Clearly, in the institutional market, it is the responsibility of the purchaser of the debt to understand what they are buying, including its inherent risk. Distributors may, however, find themselves with legal, financial and/or reputational risk exposure if they have provided inadequate or misleading disclosures about the risk profile of instruments they distribute. An arranging bank's name can often be found on the paper even after it is distributed, and has potentially changed hands in the secondary market, so it will be vulnerable to challenge following a credit event.

3.84 Although the entire capital structure for private equity transactions is usually underwritten entirely by banks, in a small number of private equity transactions mezzanine funds may inject capital directly into the capital structure rather than participating in a bank led syndication. Such transactions are rare as private equity fund managers typically have strong relationships with banks and prefer to interact only with them, but some mezzanine fund managers with a strong track record may be considered as acceptable counterparts. Other types of funds, such as CLOs, do not tend to be able to adopt such a model as they cannot usually hold un-drawn exposures over a long period of time (i.e. over the relatively lengthy period it may take to finalise a private equity transaction).

Developing market in credit default swaps on leveraged loans

3.85 LCDS (Loan Credit Default Swaps) are perceived in the market as a potentially more efficient route to effectively managing leveraged loan risk than sub-participation or ordinary credit default swaps (either on single names or indices).

3.86 An ordinary CDS (credit default swap) transfers credit risk associated with a specific reference entity (i.e. company) from one party to another. An LCDS transfer credit risk associated with a specific leveraged loan or indeed with individual tranches of a specific leveraged loan. In addition to allowing straightforward hedging of credit risk exposures, the LCDS market is also perceived to offer substantial trading opportunities in relation to basis, the credit curve, capital structure arbitrage etc.

3.87 Under an LCDS contract, the protection buyer pays a regular premium to the protection seller until such time as the reference obligation is repaid or discharged in full[17] or a credit event occurs. The protection seller will make a payment to the protection buyer should a specified credit event occur. In Europe credit events typically include:

17 The US market had developed slightly differently. US LCDS do not terminate with the repayment of the reference obligation.

- failure to pay;
- bankruptcy; and
- restructuring[18].

3.88 These events are defined by ISDA (the International Swaps and derivatives Association), although specific amendments are made to ISDA's restructuring definition.

3.89 Settlement can either be physical or cash. Under physical settlement arrangements the protection buyer delivers the defaulted obligation (i.e. the loan/tranche which has been subject to the credit event) and the protection seller pays the protection buyer the par value of that obligation. Under cash settlement arrangements the protection buyer delivers nothing but the protection seller pays the protection buyer the par value of the obligation minus its perceived recovery value (e.g. minus however much the debt holder would get back in an insolvency procedure). Physical settlement is the standard option, however, the protection seller typically has the cash settlement option if they are unable or unwilling to accept physical participation.

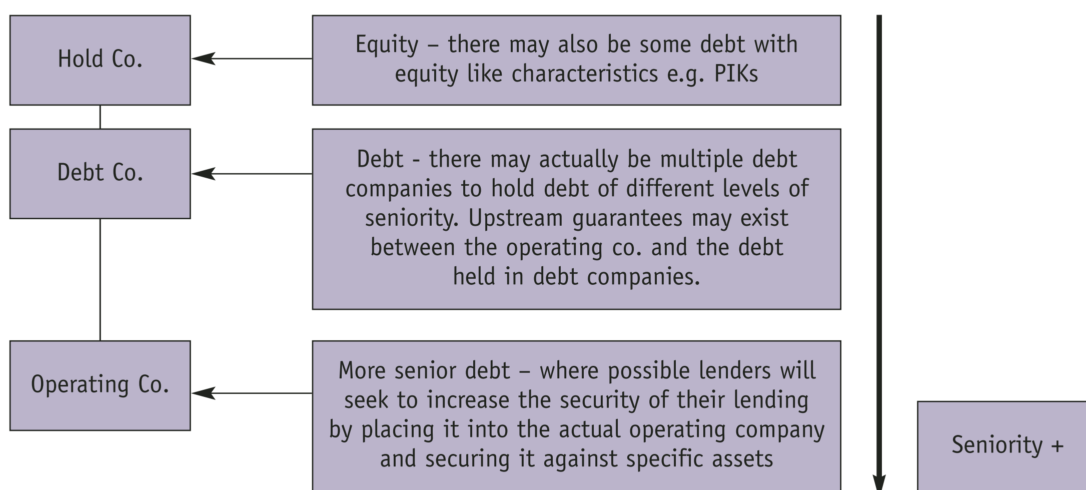
3.90 Market participants are aware of the massive boost to the 'traditional' CDS market that was provided by the launch of the i-traxx index. The impact of the launch of an LCDS index is therefore being monitored with interest. Market participants had been eagerly awaiting an anticipated kick start to the LCDS market following the launch of this new index. In anticipation of this market taking off, an industry working group was established to attempt to resolve issues surrounding documentation, structure and other significant operational aspects of the market – a welcome development in forward looking operational risk mitigation.

3.91 Hand in hand with the growth in the leveraged buyout market we may therefore see a brand new market in LCDS develop. What impact this will have on transmission mechanisms in the event of a shock is as yet unclear, but it would appear to merit monitoring. It is clear that at the very least the LCDS market will contribute to the uncertainty as to who actually owns the economic risk and therefore how individual actors will behave in the event of a crisis. This will be particularly true if operational infrastructure is not developed in such a way as to allow the back offices of banks trading in these instruments to keep pace with front office growth.

Overall LBO structure

3.92 The total capital raised to fund a private equity acquisition is usually injected into the investee company via a series of holding companies in order to achieve the appropriate seniority (via a form of structural subordination) and efficient capital treatment for individual components/tranches of the capital.

18 US LCDS do not generally include restructuring as a credit event.



3.93 Typically, capital is injected into each of the companies in exchange for securities with guarantees that are increasingly subordinated the further removed the issuing company is from the operating company. The use of multiple structures means that, at times of company difficulty, whilst the operating company may appear financially sound, its need to upstream funds to meet interest payments on debt held in holding companies may mean that the whole group is not. Commitments at operating company level are likely to be met before any up streaming of capital, so the holding company/debt companies can become bankrupt while the operating company remains solvent.

Transformation

3.94 The control that private equity fund managers exercise as owners of the companies that they invest in is what truly defines the private equity business model. Private equity fund managers will, almost without exception, take a seat or seats on the board of each investee company. Exceptions most frequently occur where the fund manager has brought in a new chief executive/managing director of the investee company, who is not a partner/employee of the fund manager, who they believe can adequately represent them on the board.

3.95 The fund manager may enact detailed legal agreements ensuring that any potentially material decision affecting the company is taken at board level. From this position of power the private equity fund manager will set about transforming the company. The precise nature of this transformation entirely depends on the circumstances of the company and the business plan that the private equity fund manager will have designed during its pre-acquisition due diligence.

3.96 Sometimes the transformation can involve professionalising the company. For example, ensuring management structures and reporting lines are put on a firm footing, proper internal reporting mechanisms are established, systems and controls are put in place to govern operations effectively, and financial control expertise is augmented to a level able to cope with the revised financial structure etc. This type of transformation is most typical in early stage companies or where transferring a company from an individual/family owner managed operation to a professional corporation. It can also occur where an entity is being separated out from a conglomerate and therefore there may be a need for new independent systems and controls, management etc.

3.97 Sometimes expansion capital is required to facilitate organic growth e.g. acquiring new premises/equipment, increasing headcount etc. to take a company to the next level in their market. This cannot be easily achieved without expertise on how to handle a significantly larger operation.

3.98 In other circumstances expansion capital is required to enable a company to acquire other businesses in similar/adjacent markets, facilitating non-organic growth. This needs to be backed up with expertise in identifying suitable opportunities, achieving the deals, bringing about integration without detracting from the core business etc.

3.99 Sometimes the company may need help to maximise operational potential by improving management of working capital including stocks, creditors and debtors to maximise operating margins, to redeploy resources more effectively and to cut overheads.

3.100 In other circumstances the changes can be more fundamental, perhaps involving restructuring the company, selling off non-core business units, refocusing the company's strategy, facilitating a move into new markets or the acquisition of new clients etc.

3.101 Generally speaking the riskiest stage in the transformation process is the first 12 months following the completion of the deal. This is where any major strategic, management or operational flaws typically become apparent. If the company survives this stage it is more likely to survive in the long term. The proportion of defaults occurring in the first 12 months is greater than later in the life of a private equity ownership. Equally, the greatest returns on investment have been shown to be those where the private equity fund manager devotes a particularly significant amount of time and resource to the company in the early months of its ownership.

3.102 Private equity fund managers do not typically take over the running of the company on a day-to-day basis, rather they are providing direction, advice and technical support – acting essentially as a concerned and proactive investor. Private equity fund managers will bring new staff into such companies where necessary or beneficial, but typically these individuals are not members of their own staff (except sometimes temporarily where a caretaker manager is required). Instead they will introduce known industry experts, either individuals or teams. Some of these people may have been kept on a retainer by the private equity fund manager before being introduced to the firm.

3.103 Clearly any transformation work in a private equity owned company may be undertaken outside of the public gaze. This has advantages as the management are able to focus all of their time and attention on improving the business rather than being distracted by obligations to deal with a large shareholder base, analysts, journalists etc. This may be essential where the changes are radical in nature and require a considerable amount of careful handling. Carrying out such activities privately has disadvantages in that the public at large are unable to easily monitor developments in the company and hold the executives accountable – something that may be relevant where, for example, considerable redundancies are envisaged (although clearly labour law etc still applies).

3.104 Private equity fund managers are careful to ensure that the capital structure they implement for the investee company provides effective incentives for the executives of the company to work with them in transforming the company. They will often purchase (sometimes with the help of loans provided by the private equity fund

managers) a material share of the equity of the company and so will get a material share of the profit created from the company's transformation. With the interests of the company management so clearly aligned with that of the private equity fund manager, the process of transformation is usually a collaborative team effort, even where some difficult decisions have to be taken. Both sides are seeking to increase the enterprise value of the company by the maximum possible amount.

3.105 It has been shown that the more input a private equity fund manager offers in the early days of a transaction and at key stages in the company's subsequent development, the greater the likely rewards. This indicates that fund managers can add real value by bringing their expertise and insight to a firm. Typically company executives will be aware of this and will seek to cooperate accordingly.

3.106 One area where interests can diverge is on the time horizon of the private equity fund manager's investment. Private equity fund managers have typically positioned themselves as long term investors, focusing on long term capital growth. Increasingly this position is being called into question. The average hold period of a private equity investment has declined recently as fund managers have been able to exit more quickly, still at a significant profit, thanks to a strong M&A market and the growing secondary market in private equity. This means that an individual fund manager may exit before the value added private equity ownership can bring has been exhausted. This is perceived as sub-optimal by the management team of the company as they have to deal with new owners, new strategies etc. However, they are typically experiencing a similar type of owner as the new private equity fund manager will also want to support the company's growth. This increasingly short termist ownership approach may be nothing more than a cyclical issue as market indicators suggest that fund managers will have to work harder and for longer in the future to make a profit.

The hedge fund approach

3.107 Hedge fund managers tend not to be as involved as traditional private equity fund managers in the application of control within the firm transformation process. They tend to 'back a man with a plan' rather than having a specific strategic/transformational vision themselves. Having said that, hedge fund managers may take a seat on the board of the target company, giving their opinion on developments, including with respect to potential re-financings or exits.

3.108 Despite the short-termist tag frequently applied to hedge fund managers, it is worth noting that their hold period for private equity investments has the potential to exceed that of private equity fund managers. This is because hedge funds have an evergreen/open-ended structure i.e. they do not have a finite lifespan, so there is no risk of them being forced to disinvest because the fund has reached a stage in its life cycle which requires that. Furthermore, the traditional risk that they might be forced to dis-invest due to redemption requests from their investors is being addressed by the introduction of illiquid side pockets. Although few hedge fund managers have yet taken an equity stake in private equity transactions, some of those that have are able to point to holdings of significantly longer duration than some private equity fund managers. They are also often able to point to a number of fundamental investment

positions they hold in public equity that they have held for a significant period, noting that this long term approach could easily be carried over into any private investments they are able to make in the future.

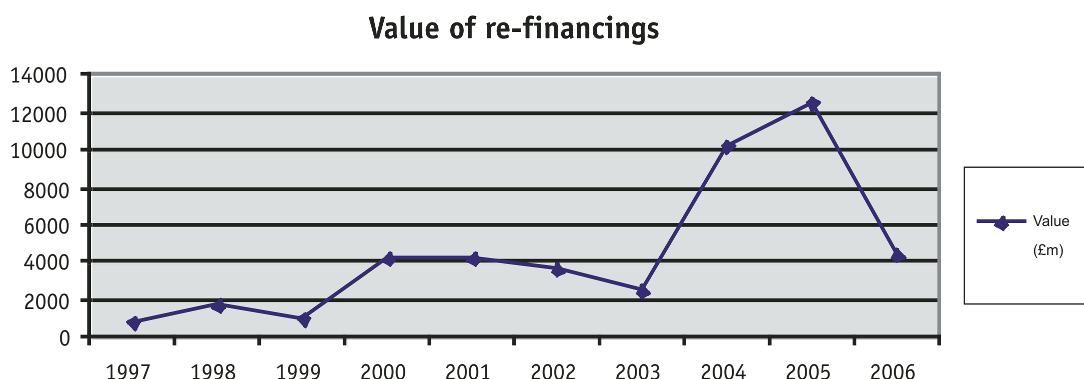
Re-financing

3.109 Where a privately owned company has been performing well a private equity fund manager may choose to re-finance the transaction. This can allow the company to have a lower cost of capital. For example, the deal may originally have been financed with lots of expensive non-amortizing bullet debt because the firm initially did not have enough spare cash flow to make interest payments. If its performance has since improved and it is now able to pay interest, then the expensive bullet debt could be replaced with cheaper, amortizing debt.

3.110 Re-financing can also be used to further gear up the private company. If the private equity fund manager believes that the company's capital structure would be more efficient with a greater amount of debt than was included when it initially took ownership of the company (or is left in the company if some has been paid down) then it may refinance it. This might be necessary if lenders were initially reluctant to lend the company as much money as the private equity fund manager considered optimal but, having seen a track record of performance since the initial transaction, are now willing to lend more.

3.111 Re-financing can also allow a private equity fund manager to withdraw some of its commitment to the firm and return some capital to its investors. This is typically achieved by injecting more debt into the company and paying out a dividend to the equity holders. If a company has done well, private equity fund managers frequently withdraw as much or more than they initially invested. This means that although they still own the equity they can never have negative investment performance and indeed have already locked in a certain amount of profit. This may explain why the market in recapitalisations has been growing so strongly over the last few years. £12.6bn of refinancing was undertaken in the UK in 2005, a new record. The average time period between acquisition and a refinancing being undertaken has been dropping. The re-financing trend may have run its course (see chart below) now that the interest rate cycle appears to have turned – only time will tell.

Value of re-financings



Source: CMBOR – Year 2006 figures are for first 6 months only.

3.112 There are some concerns that the lack of downside risk for private equity fund managers in a refinanced company could remove the incentive for them to ensure that the capital structure is sustainable, i.e. that lending is prudent, and that efforts to transform the company are adequate and being sufficiently well implemented. It could also reduce their incentive to put additional capital at risk in order to try to save the company if it got into difficulties. Rating agencies have observed that default rates following recapitalisations are higher than for non-recapitalised companies. It is, however, worth noting that the private equity fund managers do still share in the potential upside and so will still want to ensure that the company demonstrates enterprise value growth.

Involuntary re-financing

3.113 Levels of corporate default in the UK are currently very low which might suggest that companies have not been excessively geared. However, anecdotal evidence suggests that companies are currently being re-financed when they would historically have been considered on the verge of insolvency. This could potentially distort the perceived state of the UK economic cycle[19].

3.114 If a company goes into default, the equity holders stand to lose some or all of their investment. Clearly this is unacceptable to them and they will do everything[20] they can, including sometimes injecting new equity capital, to keep the company as a going concern in the hope that eventually their impaired equity capital will be repaired. They will typically work with any other investors who also stand to lose money, such as mezzanine investors, to persuade the senior lenders that a re-financing is in their interest (perhaps by offering them an increased yield or a higher potential recovery rate). As there is plentiful demand for high yield investment products, such as those used in a distressed re-financing (new distressed debt funds are being set up every month – including by private equity houses), this is generally relatively easy to achieve.

3.115 However, the institutionalisation of the debt market means that it is no longer a small and well known group of bankers working with the private equity firm to agree on a re-financing. Instead, the investor base is broad and diverse. The interests of the holders of different parts of the capital structure frequently diverge substantially so experienced distressed re-financing mediators are required to help resolve disputes. The London Rules, the method developed in London for handling insolvency arrangements, is generally considered to be ‘dead’. This is because of this new broader ownership base for corporate debt and the fact that behaviours may be affected where counterparties may own the debt but not the risks as a result of the increasing use of sub-participation and derivative hedging. Outside the UK, investors in private equity backed companies (the equity and debt components) are also facing a step change in work out complexity and a shift in the balance of power between interested parties. The different insolvency regimes in these countries may mean, however, that their experience will be substantially different to that of investors in UK companies.

19 The definitions of a default used by rating agencies usually do not include re-financing as a default event.

20 Assuming their incentives are not distorted by a previous re-financing – see section on re-financing.

3.116 The real question about this phenomenon is: are companies surviving that shouldn't, storing up trouble for the future, or has the market become more efficient with companies with viable long term businesses being saved that would traditionally have been lost? There certainly seems to be some potential for a significant future rise in insolvency levels once these re-financings have had time to run their course. Certainly the market appears to be lending credence to the idea that the number of distressed companies will rise, as many players are setting up distressed investment funds.

3.117 Only time will tell if excessive re-financing has been undertaken. We think it is logical to monitor covenant waivers, amendments and re-financings more closely, in addition to formal default levels. However, even this may not give the full picture, as the weaker covenant packages prevailing in the market today mean that the likelihood of credit events happening without a warning coming from preceding covenant breaches is increasing. In light of this, additional monitoring of credit spreads may be prudent.

Deal exit

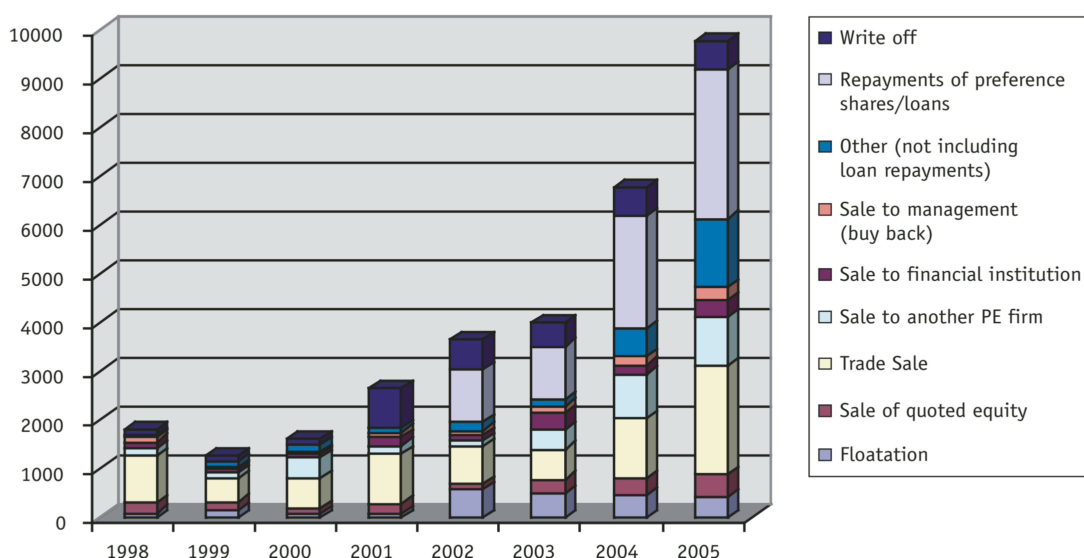
3.118 Deal exit is a critical element of the private equity business model. It is something that will typically be planned for, in considerable detail, before the deal is even entered into.

3.119 Exits can take a number of forms. The three core exit options include:

- initial public offerings – the flotation of the company on a stock market;
- trade sales – sales to corporate bodies whose existing business model would be expanded/complemented/suitably diversified by the acquisition of the company; and
- secondary sales - sales to other private equity funds.

3.120 Other forms of divestment include sales of already quoted shares, write offs, repayment of loans, sale to management, sale to other financial institutions and selling non-core segments/assets of the business.

Amounts divested by types of exit since 1998 (£m)



Source BVCA

3.121 The choice of which of these options to pursue is complex and depends on a number of factors. These factors include:

- The development stage of the company – is the company mature enough, with sufficiently professional management to survive in the public arena or does it need further development either by a trade buyer or another private equity firm.
- Whether the mechanism would deliver an immediate and total exit or leave the vendor with a continuing exposure. Private equity funds floating a company are typically required by the underwriter to hold on to a material portion of the stock for a pre-determined period of time - so only a partial exit from the investment is possible on flotation date. By contrast, a trade buyer or another private equity fund may take over the entire exposure immediately.
- Whether the mechanism exposes the vendor to market movements – any risk or uncertainty is a negative factor in any assessment of an exit mechanism. IPOs are most vulnerable to stock market movements, but there are sensitivities in secondary transactions too i.e. changes in average purchase price multiples can affect the achievable price. Trade sales are vulnerable to a variety of different factors including the performance of the sector in which the buyer operates, the movement of the buyer's share price (especially if shares are to be used in addition to a cash offer) and other macroeconomic factors such as interest rates.
- The cost of completing the transaction – total costs including management time and legal, advisory, regulatory and other fees. Large fees are incurred for all types of exit. However, anecdotal evidence suggests that management time and fees for a public flotation are significantly higher as there is a need to prepare detailed information on the company including public offer and reporting documents.
- The views of the company's management team – operating in the public arena is very different from operating in the private markets. Public market participation tends to involve far greater demands on executives, public scrutiny of their salaries, regular information dissemination to the market, media and analyst scrutiny etc. Some managers believe that they can be more productive in a private equity environment.
- The maximum achievable valuation of the company – maximising the total sale price, net of other costs, is the most significant factor in determining the exit mechanism. This allows the private equity fund manager to return the largest possible amount of capital to its investors (as well as delivering the highest possible fee income for the fund manager).

3.122 Rather than simply selecting one option and pursuing this, vendors now typically run at least a twin track process, exploring two or more options to see which would deliver the highest valuation. The decision as to which option actually will be executed may be taken right at the last moment.

Valuation

3.123 While a standardised method of valuation (whose use is widespread) has yet to be established, progress has been made. In March 2005, the British Venture Capital Association (BVCA), the European Venture Capital Association (EVCA) and France's Association Francaise des Investisseurs en Capital (AFIC) jointly issued one set of valuation standards for the industry, known as the International Private Equity and Venture Capital Valuation Guidelines.

3.124 In a joint statement the three groups said 'the International Private Equity and Venture Capital Valuation Guidelines were developed ... to reflect the need for greater comparability for both investors and investment managers across the industry internationally and for consistency with IFRS and US-GAAP.' These guidelines have since been adopted by over 25 countries and endorsed by the Institutional Limited Partners Association (ILPA).

3.125 There has also been progress in the US. The set of revised guidelines published in 2004 by the Private Equity Industry Guidelines Group (PEIGG) were later officially endorsed by the Institutional Limited Partners Association (ILPA). The two sets of guidelines seem not to be too far apart.

3.126 There is, however, a significant amount of flexibility contained within these guidelines. Globally, opinions remain divided amongst fund managers over whether investments should be valued: (i) at cost, unless there is an event which justifies either a boost in the valuation or triggers a write down or (ii) at 'fair value', the 'amount for which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction'. Both perspectives on prudence / conservatism on the one hand and realism on the other have their merits. However, the performance of funds with different valuation methodologies cannot be compared before full realisation.

3.127 Also, the valuation of private equity investments and private equity funds is difficult to understand during their life cycle as they experience what is commonly referred to as 'the J curve effect':

- The J curve effect in private equity investments arises from the need to incur capital expenditure in order to facilitate the transformation of the company, allow that to take effect, and then demonstrate a return. Fair value accounting could therefore show a dip in the valuation of the company in the early days of private equity ownership followed by a rise as the effects of the investment becomes evident. Cost accounting would show a flatline valuation followed by a vertical lift at the point of revaluation.

- The J curve effect in private equity fund valuations arises from the J curve effect applied to the investments owned by the fund, exacerbated by the impact of fees. As noted earlier, fees are incurred from the launch of the fund on the total value of the committed capital even though much of this will yet to have been deployed. The value of the fund therefore starts diminishing on day one, in line with the fees, and only moves back up again once investment performance can be demonstrated.

3.128 Investors cashing out early from private equity investments need to understand the J curve effect in order to ensure that a fair valuation is achieved.

3.129 Under the present arrangements fund managers are not obliged to adhere to either set of valuation guidelines, although increasingly Limited Partners will try to ensure compliance by negotiating a contractual requirement in the LP agreement. Many general partners remain unconvinced that a mechanistic, formulaic, objective single standard will be helpful. Instead they believe that a more subjective, judgemental, qualitative approach will produce more reliable valuations and that if the methodology and calculations are disclosed this will allow sophisticated investors to form their own view. It seems that if further progress is to be made towards a single global set of valuation guidelines the drive must come from limited partners, audit firms and/or regulatory bodies.

3.130 The introduction of International Financial Reporting Standards (IFRS) for listed entities occurred in January 2005. Work is now being done on the implementation of IFRS for non-listed companies. IFRS has extended 'mark-to-market' or 'fair value' accounting into investment securities. This has knock on implications for the private equity market as institutional investors have difficulty explaining why private equity investments should be exempt from accounting rules applied to other illiquid instruments.

3.131 In reviewing IAS 27 (Consolidation and separate financial statements) IFRS has also raised the prospect of investee companies having to be consolidated into the accounts of private equity fund managers (despite the fact that the fund rather than the fund manager is the actual owner of the company) saying that 'consolidated accounts should be prepared if an entity controls another entity' and defining control as 'the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities'. The industry is arguing for a 'carve-out' for venture capital/private equity but this issue has yet to be resolved.

Performance reporting

3.132 The valuation issues described above need to be considered in the broader context of performance reporting. The complexities of private equity make performance reporting difficult to standardise. As private equity investors are generally sophisticated, issues of methodology and information requirements are governed by contract in the Limited Partnership Agreement.

3.133 We have observed that reporting of performance by general partners to their limited partner investors appears to be extremely comprehensive. Both the quantity of information provided and the level of detail are far greater than that afforded to an investor in an equivalent publicly quoted company. Similarly, the reporting of historical performance, which is an important part of the fund raising process, also appears to be detailed and generally conducted in a diligent manner.

3.134 A global standard for reporting investment performance does exist (GIPS: the Global Investment Performance Standards). However, the guidelines for private equity have not been widely adopted as they are not generally considered to (yet) adequately reflect the specific characteristics of the market.

3.135 In fact, the methodology for the reporting of performance to investors is not standardised and comparable performance data across the asset class as a whole is not available. Indeed, we have identified a strong reluctance to providing such information. Some believe that this is allowing poor performance to be masked.

3.136 The problem with not having agreed standards on performance reporting is that performance is reported in a variety of ways. Internal rates of return can be calculated on a variety of assumptions but the assumptions made make a material difference to the results. It is rare for two firms to calculate IRR (the Internal Rate of Return) in exactly the same way. There are also potential confusions about reporting on the performance of the fund as opposed to investment performance.

3.137 The IRR calculations are not determined by reference to actual cash flows but according to a cash flow model which is derived from a set of approximating assumptions applied to the actual cash flows. One such assumption is the choice of 'rest stops' which can be weekly, monthly or quarterly. Cash flows are averaged over the period between the rest stops and can then be applied either at the beginning of the period or at the end. Auditors typically insist that their clients make their choice consistent and transparent but the particular methodology utilised may vary according to which delivers the most favourable IRR result for a particular fund.

3.138 Another performance reporting issue relates to whether costs such as dividends and interest receipts should be included or excluded for the IRR calculation. In addition, there appears to be some confusion amongst new investors to private equity between the fund performance and the investment performance. The two are not the same. For example, an introduction fee (for introducing advisers to a transaction) may be charged by the managers to the fund, this reduces fund performance but not investment performance.

Staff remuneration

3.139 The partners and senior employees of private equity fund managers generally invest substantially in the fund, both as a mechanism for demonstrating the alignment of their interests with those of the fund's investors and as a mechanism for personal gain. The executives' investment in the fund can bring real rewards. However, like the third party investors in the fund, their investments are by necessity long term in nature and highly illiquid.

3.140 To boost staff returns and further align the interests of staff and the funds, some private equity fund managers contribute leverage to staff investment vehicles, increasing the potential upside (without increasing their downside risk which is limited to the staff's initial investments).

3.141 Staff will also often receive performance-related pay on top of their basic salary, with strong links evident to the performance of investments they have worked on.

3.142 Finally, staff can be rewarded by being granted partnership status in the fund manager itself. This is a far longer-term reward and locks staff in even further to the company but it can be very lucrative. The one difficulty with this approach is the difficulty of exit. To extract all of the value of this status the partners would have to float the company or sell on their interest to other partners. This is something that may affect

future access for investors to private equity related investments as the flotation of such companies would create an additional route to gaining private equity related exposure.

The hedge fund approach

3.143 As noted above, hedge fund fee structures do not typically involve hurdles i.e. both the management and performance fees must be paid in full from year one. This allows earlier reward payments to staff. There is also typically far more liquidity in a hedge fund meaning that staff investments can be withdrawn more quickly. These factors may offer hedge fund managers a competitive advantage in attracting and retaining staff relative to private equity fund managers.

3.144 It is worth noting that as the hedge fund industry matures, we are starting to see some partnership status hedge fund managers consider floating their companies. This typically occurs where the founders are approaching retirement and wish to extract all, or a significant proportion, of their invested capital. This is a phenomenon that we may also see emerge in the private equity space.

Taxation's influence

3.145 Taken together, low rates of tax, a range of tax incentive schemes to address market failures, and structural flexibility, all contribute to a tax environment for UK private equity that is highly competitive. The European Venture Capital Association's 2004 benchmarking report rated the UK tax and legal environment for private equity as the most favourable in Europe. However, Bunn & Young's Bank of England Working Paper No 226 and McKinsey's 'Making capital structure support strategy' both indicated that there is little evidence to suggest that the UK tax system is particularly influential in driving the PE market.

Accounting influence

3.146 There is a programme of convergence between UK Accounting Standards (UK GAAP) with International Financial Reporting Standards (IFRS) which has raised concerns in the industry. At this point in time, IFRS does not extend to private equity firms but only to the consolidated accounts of listed entities. Since listed private equity vehicles (VCTs and PEITs) do not generally have any subsidiaries, they do not prepare consolidated accounts and are like to continue to report in UK GAAP. However, the ongoing convergence rather than a direct application of IFRS to unlisted entities is causing some concern. The focus of some of these concerns is set out below.

Fair value

3.147 Fair value is a logical measure to apply to liquid assets but difficulties arise in the more illiquid assets where determination of the 'market' price is less easy to obtain. Private equity, by its very nature, invests in 'illiquid' or at least 'unquoted' investments and therefore has the difficulty of valuing the assets on its balance sheet. However, industry guidance has been published and valuation techniques including basing the value on a recent transaction of a similar asset and comparison to a

similar asset can be used. It would therefore be difficult to argue that a value for an investment cannot be reasonably obtained.

3.148 Also, given that the nature of private equity business is to increase the value of investee companies during the period for which they are held, reporting investments at cost would not enable users to assess the performance of fund managers from one financial period to the next.

Consolidation

3.149 If the convergence between UK GAAP and IFRS continues, it is possible that non-listed companies will have to consolidate accounts under IAS 27 – this would apply to any private equity and venture capital firms that had subsidiaries. Also, if the current prohibition in the listing rules relating to exercise of control of investees is lifted, listed private equity firms may be required to adopt IFRS and prepare consolidated accounts to include investee companies controlled by them. This would be a major change in the way these entities are accounted for.

3.150 IAS 27, although broadly similar to the UK standard FRS2 (Accounting for Subsidiary Undertakings), has a number of differences. The main one, in respect of private equity, is the definition of a subsidiary where IAS 27 focuses on the power (of the parent) to control another entity.

3.151 The definition of control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. As a general rule, control is presumed to exist when an investor owns more than 50% of the voting power of an entity. Under this definition a private equity fund manager would be seen to control its portfolio companies.

3.152 As private equity houses operate through partnerships (including LLPs) that manage the relationship between the fund manager, the investors and the portfolio companies, they feel that consolidation produces a distorted view of the financial statements under IFRS. However, IAS 27 relies on the control element and even where an investment manager holds significant equity interest in the capital and income of a fund, and cannot be removed by other investors, the investment manager is regarded as the parent of the fund.

Regulatory remit

3.153 The Financial Reporting Council (FRC) is the UK's regulator for corporate reporting and governance, which encompasses financial reporting, auditing and corporate governance, and is thus the regulator on matters relating to accounting standards. The FSA, on the other hand, is the UK's financial services regulator and has interests for example with respect to markets, conduct of business and prudential matters. We participate in European and global committees such as IOSCO and CESR which seek to influence the IASB. Our remit is therefore complementary to that of the FRC but, ultimately, has a different range of interests.

> Q2: Is the description of private equity market practice as set out in Chapter 3 accurate? Have any key features or practices been omitted?

4 Issues and risks arising in the private equity market

Risks to the private equity sector

4.1 Given the ever increasing importance of the private equity market to the UK and global economies, it is important to consider what factors could threaten its smooth operation. The risk factors we set out below have been raised by private equity market participants as potentially material concerns.

4.2 There are a number of risks to the performance of privately owned companies. Such entities are, like all companies, vulnerable to macroeconomic shocks such as deep recessions, to sector cycles, to poor strategy, to weak management etc. All of these factors can obviously damage a company's trading performance and profitability. The leveraged nature of private equity backed companies means that they have less of a cushion should costs rise or revenues fall.

4.3 By far the most significant perceived risk for private equity owned companies is, however, a sudden increase in the cost or decrease in the availability of debt capital, particularly if this comes against a backdrop of a rapid economic downturn. This could be triggered by a sudden and unexpected material increase in interest rates or a dislocation in the debt market. Such events could cause significant losses for companies and investors alike. The potential impact of such risks is discussed further in the section on 'risks within the private equity sector'.

4.4 In terms of risks to the private equity fund managers, the failure of a large well known privately owned company or the failure of a cluster of large privately owned companies could obviously weaken the performance of the funds that had invested in these entities. As fund performance weakened, so could the ability of the private equity fund managers to raise new funds. Even if fund performance were still good despite a credit event, it is possible that investors could still (irrationally or not) become concerned and reduce their exposures. Related to this, private equity fund managers are concerned about the reputational risk arising from another fund manager making a significant mistake in an investment or behaving inappropriately and tarnishing the sector and therefore the reputation of the firm's competitors.

4.5 A sudden (unanticipated) stock market crash, similar to the bursting of the tech bubble, could also cause equity capital to dry up. Immediately after the tech market

crisis fund inflows were substantially reduced. It is, however, worth noting that private equity fund managers have a certain degree of cyclical immunity. When they cannot engage successfully in fund-raising they can concentrate on other aspects of their business such as investment - a falling stock market creates buying opportunities as valuations are low and public market capital is hard to raise. Private equity fund managers may be able to successfully deploy the capital that has already been committed to their funds in such a market environment, acquiring assets at bargain prices with positive consequences for the outlook of fund performance.

4.6 Exchange rate fluctuations could undermine the purchasing power of a fund or the value of its assets. Private equity fund managers' use of currency hedging is de minimis given the high cost of such protection, therefore their exposure to this risk can be significant, especially where funds are raised in a currency that is not used in the geographical location of the majority of their investments and/or their investors.

4.7 The private equity industry is vulnerable to political intervention, particularly with respect to the potential takeover of 'national champions'. Not all public authorities around the globe follow the open market approach favoured by the UK. Concerns have been expressed in the past in some jurisdictions about the conduct of private equity fund managers and their suitability to take control of major corporations. Any national initiatives to deter private equity investment could cause damage to the industry as a whole and, potentially, wider economic damage.

4.8 The UK tax environment's competitive advantage is comparatively stable, but tax changes in the UK or overseas have the potential to influence the preferred location of private equity firms, funds, managers and investments. As the UK tax environment is currently seen as highly competitive within Europe, any change carries the risk of reducing that competitive advantage and causing a negative impact on the market in the short term, although in the medium to long term such effects could be mitigated by the relocation of private equity activity (firms, funds, managers and/or investments) into jurisdictions with a competitive tax advantage.

4.9 In venture capital investment there are concerns that excessive company (non-financial services) regulation (e.g. health and safety requirements, the minimum wage, flexible working etc), could cause undue burdens on companies. This could limit the scope for venture capital investing by limiting the profitability of potential target companies. It is suggested that the relatively small size of the companies backed by venture capital funds means that the regulatory burden on them is felt disproportionately compared to their larger, better resourced, peers.

4.10 Interestingly, financial services regulation (including changes to the regulatory regime driven by European Directives) was not cited as a major risk factor until we prompted industry participants to consider the concept. It appears that regulation is currently not particularly high on the radar screen of some of the participants in the private equity market. Regulated firms do, however, need to actively consider their evolving obligations, particularly in light of the various changes to the UK regulatory regime that are being made due to the implementation of various European Directives. To help with this, we discuss the nature of the current regulatory regime and potential future changes to it in Chapter 5.

4.11 All of the risk factors outlined above to which the private equity market is exposed are starting to lead to market comment about a potential substantial downturn in the next 12 months. Some commentators are suggesting that people moving into the private equity market now are coming in at the peak and will be particularly vulnerable to the downturn. Discussion is becoming more common of a significant rise in opportunities and commitment of resources in the vulture fund and distressed debt space. However, it is worth noting that other commentators take a more optimistic view and believe a downturn will be more gradual, reflecting normal market cyclicality.

4.12 Clearly any crystallisation of these risks would not affect all market participants in equal proportions. Some stronger or better positioned entities may not only survive a crisis but also emerge from it stronger. Others may be forced to withdraw from the market entirely or substantially scale back their participation. It is worth noting in this context that we do not operate a zero failure regime and cannot therefore be expected to intervene where, for example, a private equity fund or fund manager finds itself in difficulties.

Risks within the private equity sector

4.12 There are a number of risks arising within the private equity market as a consequence of specific market practices, structures or products. The risks we have identified so far are outlined below.

Excessive leverage

4.13 The amount of credit that lenders are willing to extend on private equity transactions has risen substantially. Lending limits are increasing, multiples are rising, transaction structures are being extended and covenants are weakening.

4.14 We identified two different schools of thought prevailing in the private equity market on the leverage levels currently being employed, in particular with respect to the larger transactions. These are:

- *Positive:* Leverage levels in UK firms, particularly in public companies, are inefficiently low. Private equity fund managers are simply transforming the companies they back into capital efficient operations that can make the most of the generous tax treatment and flexible financing options associated with debt capital.

  The reason why leverage levels in private equity backed companies are increasing relative to historical levels is because larger companies are being invested in today. These larger companies are generally considered to be inherently more stable, better able to withstand a downturn, better able to defend their market share, and therefore their medium/long term ability to pay interest/capital on debt finance should be stronger. They are frequently cash generative, asset rich companies (such as infrastructure companies). Interest rates are low so these companies currently have enhanced ability to service large amounts of debt and at least 50% of their interest rate exposure will typically be hedged (for around three years). This means the impact of potential future rate rises is mitigated. Even if companies do get into trouble, the stable interest rate and wider economic environment means that it should be possible to re-finance them at competitive rates.

Although the short term exposures of the bank underwriters may be increasing as they finance larger transactions, their medium and long term exposures may be decreasing or becoming increasingly diverse as the debt becomes more widely distributable. Should a company default, the risk is spread so broadly given the extent of syndication and risk transfer that no one party should bear catastrophic losses.

- *Negative:* Banks face increasing competition in their bids to win the mandate to provide the debt finance for private equity transactions. Such finance provision (particularly in relation to the top tier of private equity transactions i.e. the largest deals) is now generally the subject of a competitive auction. The private equity fund manager frequently takes the most advantageous elements of individual banks' bids (i.e. the most debt finance offered on the cheapest and most flexible terms) and combines them into one highly leveraged package, asking the banks to accept those terms or lose the mandate. Winning a mandate can be highly lucrative in terms of both transaction fees and other fee-earning ancillary services the banks may be invited to provide, so there are strong incentives for banks to participate in these auctions. As private equity firms frequently re-use the same banks for consecutive deals, the banks are reluctant to impair their relationship with the private equity fund manager by rejecting a particular transaction, potentially losing the right to provide lucrative debt finance packages for future deals.

  Leverage levels are being competed upwards because of this process and increasingly appear to approach the limits of prudence. Banks accept these leverage levels as they are increasingly able to distribute the debt (including bridge finance) as a consequence of the recent substantial growth and innovation in the institutional debt market. An increasing number of banks now target minimal or even zero final holds. Credit terms are therefore increasingly of secondary importance in the lending decision to the appetite of the institutional debt market for the credit. Some lenders may no longer be prioritising strict risk-return criteria based on the credit quality, transaction value and interest rate when deciding how much to lend. Rather, they may be focusing on ensuring that any distribution will be successful, with the fees they generate from the process being maximised and the duration and extent of their exposure minimised. Purchasers of this debt may be either unaware of, or under-pricing, the inherent risk.

  On the assumption that a re-financing on more favourable terms will be possible, private equity owned companies are increasingly being initially financed with a capital structure that is unsustainable[1] in the long term. An inability to re-finance on competitive terms could push the company into default. Re-financing may not be as easy as expected as the credit cycle may deteriorate and/or the appetite of institutional investors for debt may dry up. There are a number of factors which could cause illiquidity, or dislocation in the leveraged finance market. If institutional investors such as CLOs, CDOs and hedge funds were in financial trouble, then the availability of debt capital could deteriorate and its cost could increase. This could

1 The structure may for example involve substantial portions of non-amortizing debt with the implication that although the company may be able to meet its short term obligations, it may have negative cash flow forecasts for the points where capital repayments fall due.

be triggered by a number of factors either related or completely unrelated to the private equity market itself. For example, if the institutional debt market participants had made significant losses on the debt elements of private equity transactions then clearly this could reduce their appetite for taking on new private equity related risk. If they had made losses on investments in other asset classes and were forced sellers in order to meet redemption requests this could require the disposal of some LBO related assets and also trigger a reduction in their appetite for taking on new risk – this is a risk we have observed crystallising recently.

Even if a re-financing does not appear necessary from the outset, private equity backed companies are highly vulnerable to interest rate rises wherever they are carrying a significant debt burden. Interest rate hedging is far from perfect (and is less comprehensive than was observed historically) so capital structures that once looked sustainable may become unsustainable over time. Transactions with capital structures that were designed before the trend towards using non-amortizing debt and before the interest rate cycle turn was anticipated may be particularly vulnerable to a continued deterioration in the credit cycle. This is because their short term exposures may be significant, which means they could get into difficulties more rapidly.

Due to the increase in debt financing, the credit quality of private equity backed companies/leveraged finance instruments is declining rapidly. There have been a number of significant and rapid downgrades. The market is also experiencing a rise in covenant waivers and amendments as firms become unable to meet their commitments or come close to that. Effective defaults where companies are starting to have difficulty meeting their commitments are being masked by 'involuntary re-financings' which are being undertaken when a default is imminent.

4.15 Which of these two schools of thought, positive or negative, is correct is not certain, although the number of market participants expressing concerns over current leverage levels is high and rising. There are also signs that firms have begun preparing for the possibility of a market downturn, for example by increasing resources in their distressed debt and restructuring teams. If those who support the negative view of private equity transaction leverage are correct, it is not clear whether we will see a gradual adjustment or a sharp correction. A gradual adjustment could take the form of lower returns leading to reduced capital inflows and hence less competition for deals. A sharp correction could involve a major transaction or cluster of transactions failing suddenly. Some market participants feel that the market is still supported by sound fundamentals and is well placed to bear a shock. They point to the efficiency with which the market dealt with recent events including significant downgrades, where, after some turbulence, new liquidity emerged and the market found its level. Other participants believe a 'hard landing' in the near future is more likely as multiples contract towards long-term averages and risk is re-priced. Some such market participants are speculating that a correction might come about in the next 12 months, although others feel the market will continue to test its boundaries in 2007 with the correction coming after that.

4.16 Given the real possibility of a correction occurring, it is sensible to consider in more detail what the implications of such a correction might be. Equity investors bear the first loss of any failure and so there is potential for a credit event to reduce private equity fund returns and even cause fund losses (particularly if multiple companies fail, more than one of which may be backed by a single fund). Investors' losses may be more significant in the context of club deals as attempts by the investors to diversify their risk may be countered by different funds investing in the same deal. Losses may also be high where the institutional debt market collapses while bridge finance is in place on a transaction. Although the private equity fund is not directly exposed to the debt, it can have knock on implications. Deals may be structured assuming the replacement of bridges at a lower cost – if this proves unfeasible the company may be faced with a higher debt repayment burden than was expected.

4.17 However, it is worth noting that the potential scale of losses in a private equity fund is capped. A fund can never lose on an investment more than the capital it committed as they do not employ derivatives, or short selling – investment techniques associated with other forms of alternative investment.

4.18 It is also worth highlighting that the ramifications of equity losses are not as great as they might first appear. Private equity funds are not vulnerable to one of the more acute risks faced by other alternative asset managers, such as hedge fund managers, namely liquidity mis-match risk. Liquidity mis-match risk is the fund management equivalent of a bank run and involves a fund manager being forced to rapidly liquidate fund assets in order to meet redemption requests from investors. As private equity funds do not offer liquidity to their investors this risk does not arise.

4.19 Clearly there is also potential for losses to be made on private equity related lending. If the finance providers are unlucky and the transaction becomes distressed in the period before an expected syndication, their losses may be particularly high. Some lenders may face losses on multiple transactions as different deals may be vulnerable to some of the same triggers and therefore may become distressed at the same time. There is also potential for losses to be made post syndication by investors in the debt tranches of private equity backed companies. If these investors have built up material exposures, perhaps buying into multiple private equity investments or committing heavily to individual transactions (perhaps on a leveraged basis) then losses could be material. Recovery rates on distressed debt vary considerably so it may be some time before the scale of any losses is known (unless the debt holders trade out of their positions – the ability to do this will be linked to the scale of their exposures and the circumstances of the default). Rating agencies are increasingly trying to produce loss given default probability distributions to help market participants understand and manage this risk.

4.20 The distress of specific private equity backed companies and the related debt will clearly have implications for the market in such debt. We could see a period of instability and corrections triggered by corporate distress/default. Capital markets are increasingly inter-related. What happens in the leveraged loan market could have knock on effects in the markets for other asset classes. The transmission mechanisms to other markets are not always as clear as they might be as they involve a complex set of variables, however, there is evidence of correlation in price movements, albeit often with a time lag. We

could therefore see instability in the leveraged loan market having consequential effects in the wider debt markets and indeed the markets in other asset classes such as equity. The impact could be greater if private equity transaction related losses lead investors to consider risk to be under priced more generally. This could lead to a broad retreat from certain types of asset, in particular high yield assets. Such a development is more likely to occur if investors in private equity related debt are forced into large scale sell-offs of other assets. They might, for example, do this to meet redemption requests from investors nervous about private equity related losses or to reduce overall capital at risk if risk managers/limits set in fund documentation require it.

4.21 Market turbulence and substantial losses amongst private equity investors and finance providers have the potential to create a financial stability level event. This is more likely if risk holdings are concentrated and/or leveraged, particularly where there is uncertainty about actual net exposures, leading to liquidity withdrawal and an inability to trade out of positions. The appetite for the riskiest tranches of leveraged finance debt is reported to be concentrated amongst a relatively small community of fund/structured product managers employing leverage. Where the provisions of the funds/vehicles holding these assets contain restrictions upon the types of assets that may be held e.g. they must be investment grade, or of a certain credit rating, these funds could become forced sellers. This is something frequently seen in CLO structures. A financial stability level event is also more likely if a high profile transaction fails or if multiple transactions fail that have no clear link between them other than their private equity ownership/high leverage levels as this could undermine confidence in the asset class as a whole.

4.22 The private equity industry is praised for creating jobs – 19%[2] of the private sector workforce is employed by companies that have received private equity backing. As the situation of these companies becomes less stable due to their over-leveraged status, so these jobs start to look increasingly precarious. The impact of a private equity market downturn on the UK economy could therefore be felt not just through the transmission mechanism of capital markets but also more directly via the unemployment rate. Equally, as these corporations pay tax (albeit at a reduced level due to their debt shields) the government's tax revenue could fall in the event of a crisis.

Unclear ownership of economic risk

4.23 There is potential for debt markets to become disorderly in the immediate aftermath of a leveraged buyout related credit event. The leveraged loan market is well known for its time consuming and arcane processes in terms of transaction confirmation and settlement, particularly with respect to the use of sub-participation and assignment as techniques for transferring risk. This fact could create uncertainty for investors in the debt of private equity backed companies about quite how much risk, and of what type, they are exposed to at a single point in time.

4.24 This situation could, perversely, be exacerbated by the development of more efficient risk management in the form of hedging via LCDS, which may themselves be unconfirmed, and could further complicate the picture of who owns the risk. The added complications caused by credit derivatives do not just relate to the confirmation status. Issues also arise

2 Source: BVCA Economic impact of private equity 2005.

from the fact that increasingly, trading volume in credit derivatives far outweighs that in the underlying and it may be that firms find themselves unable to obtain the underlying in order to physically settle a transaction. In a number of cases industry bodies have facilitated a cash settled work out, but these arrangements have yet to be truly tested as the defaulting companies have not yet included entities whose securities and risk were particularly heavily traded. Neither have they really tested the complex array of insolvency regimes found across the EU, with their very different levels and forms of creditor protection. Also, there may be complexities based on different understandings about the precise terms of the derivative, what actually constitutes a credit event, what securities might be deliverable against it and what the implications would be of any delay in delivery. A further complication arises from the fact that, for reasons of prevention of market abuse, individual departments of a bank may be completely unaware of exposures of other departments as Chinese walls may exist between them.

4.25 As firms devote substantial front, middle and back office resources in an attempt to quantify and limit their exposures to a credit event (and meet their contractual obligations) they may withdraw from the market for a period. This could reduce market liquidity and increase market volatility. The period of time during which individual parties are unsure as to the extent of their own exposures and whether trades will be honoured by their counterparties on the terms they expect (in the absence of a confirmation/clear legal position) could be quite lengthy.

4.26 The situation will be further complicated by the general opacity surrounding the transfer of leveraged loans and their related risk. There is no general market-wide transparency surrounding loan risk transfer. Risk transfer mechanisms allow lenders of record to have a materially different level of net exposure than their lender of record position may suggest. Lenders are unlikely to be under any legal or contractual obligation to disclose their true position, even if they form part of a work out committee. Even the debtor company and its private equity backer may be unaware of the true extent of the net exposure of the lenders of record so the chance of a counterparty possessing all of the relevant facts is extremely slim.

4.27 This opacity as to counterparties' true exposures can create significant difficulties. Risk transfer mechanisms may distort incentives in any credit event negotiation, leading parties to act in ways that are unpredictable to, and potentially to the detriment of, their fellow debt holders. It is no longer the case that those who appear to have an exposure to a particular debt security will want to maximise the recovery rate for that security as they may have an off-setting position and will be focused on maximising their overall recovery rate. Those who retain or purchase material debt exposures are most vulnerable to this risk. They could find themselves extremely distracted by complex work outs in the wake of credit events, possibly leading to enhanced losses. They could also find themselves with material losses if the complexity of a particular work out causes it to fail. Market participants need to be aware of these risks and build them into their risk management and operational arrangements.

4.28 Various industry bodies are alive to these risks and are taking steps to forewarn market participants and even help facilitate work outs. However, as the complexity and opacity of LBO risk ownership grows so their ability to help mitigate this risk may diminish.

Reduction in overall capital market efficiency

4.29 Managers of larger private equity funds have effectively chosen to focus their activities predominantly on public to private transactions and large-scale carve outs of entities or business units of listed companies, supplemented by a number of very large purely private transactions. If a firm raises a €5bn fund and has the resources (such as headcount) to undertake 20 deals within the fund's lifetime (which could be seen as quite a generous assessment of many firms deal making capability), then the average deal needs to be valued at between €1.25bn and €1.5bn (if you assume that debt will be four to five times the level of the equity commitment). It is easier to identify public to private transactions of this size than purely private deals. Some fund managers are now raising funds of well over €10bn, suggesting that their average deals size could be even higher – the circa €15bn funds raised recently would have an average deal size of €3.75bn to €4.5bn under these assumptions. As large deals can be harder and more time consuming/resource intensive to complete we may see the number of transactions undertaken by big buyout funds drop. If they only completed ten deals, each deal would have to be worth around €7.5bn to €9bn, further cementing their focus on public companies.

4.30 The number of public to private bids globally is currently high and has the potential to rise further. Speculation is rife about potential bid targets, including constituents of the FTSE 100 index. Some of this debate may be wishful thinking either on the part of shareholders in public companies or on the part of the private equity fund managers, but there does appear to be a significant deal pipeline. Announced transactions such as the $33bn envisaged takeover of US hospital group HCA make it appear as though such deals are a reality. Market commentary suggests that there is no limitation on the ability to complete additional deals of this size. As more and more large cap deals are completed, so the market capitalisation of the public markets will decrease (assuming there is no equivalent value of IPOs/returns to the market by previous public to private companies). Particularly in smaller markets, this trend could be meaningful and have a significant impact on the size and depth of markets.

4.31 The UK equity market shrank by a net £46.9bn[3] in the first half of 2006, considerably more than it fell in the whole of 2005 (£42bn). The UK equity market has not grown since the last quarter of 2004. These figures come despite significant new public market fund-raising activity and reflect, in addition to public to private transactions, the widespread de-equitisation of companies who are engaging in share buy backs and special dividends. Given the overall size and depth of UK markets, these developments have not yet had a particularly significant impact. To date, both public and private markets in the UK appear to be deep, liquid and encompass high growth potential companies. It is not clear whether these trends will continue.

4.32 In recent times there has been considerable debate about the amount of profit made by private equity funds. If they are able to extract so much additional value from a company, is it because they underpaid on the initial transaction and therefore were the public shareholders who sold their stock ill advised by the board who recommended the sale? Private equity certainly appears to facilitate more accurate valuation of companies, factoring in their growth and restructuring potential as well as current balance sheet,

3 Source: Citigroup.

profit and loss account and cash flow fundamentals. In response to this development, the boards of public companies appear to be behaving increasingly cautiously with respect to recommending a bid, demanding far higher premia to the prevailing share price. They are increasingly rejecting initial and subsequent bids in an attempt to ensure (and be seen to ensure) shareholder value. Firms that do not believe a private equity bid is in their interest are typically returning cash to shareholders and gearing up the company's balance sheet to make it a less attractive target for private equity bids. This process may actually increase the efficiency of the capital markets by addressing concerns of under leverage in the public market. Where these developments are supplemented by the implementation of private equity style management incentives these benefits could be further augmented[4]. Even so, a material proportion of potential public to private transactions have failed recently. In many ways this may be a good thing – indicating that private equity fund managers truly understand the real value of the companies and are unwilling to gamble on the potential upside effect of their proposed transformational improvements to the company. Private equity firms that are currently pulling out of potential transactions because the price is too high may, however, given the pressure on them to invest capital and the significant due diligence costs that they will already have incurred, begin to consider completing deals that they would not normally have undertaken.

4.33 Some fund managers may also currently be forced to pull out of these deals if they become hostile as their investment mandates may not allow them to complete hostile deals. Private equity bids are usually non-hostile. The fund managers work with the incumbent management to structure a deal which is of benefit to both them and their shareholders. Some private equity funds are, however, now being established with provisions that do not prevent them from undertaking hostile transactions. Hedge fund managers are also usually exempt from such restrictions. It is therefore possible that we will see more and more hostile private equity bids as the fund managers search for investment opportunities.

4.34 It would also be unwise to ignore the potential influence of pension fund trustees on the capacity of private equity fund managers to complete public to private transactions. There have been a number of examples of potential transactions where negotiations stalled because the trustees of the target company's pension scheme sought substantial contributions from the private equity purchaser to the pension fund – usually to help remedy a pension fund deficit. For as long as market conditions mean that public company pension schemes may be stressed, this risk to deal completion will remain.

4.35 Some market leading private equity fund managers are developing innovative ways of addressing shareholder and company management concerns. Transaction structures are being designed that would leave the company public, with the private equity bidders taking a significant (controlling) stake in the target with a view to applying private equity techniques in the public markets. This allows shareholders to participate in the growth potential the private equity firm sees in the company. Such an approach might involve shareholders accepting a cash payment in exchange for a dilution of the capital base (with the private equity firms buying the new shares). This process would be financed by new debt which would increase the gearing of the target company to levels

4 It is, however, worth noting that the share prices of a number of companies that have successfully rebuffed private equity bids have demonstrated negative performance recently, calling into question the wisdom of the decision to reject the private equity offer.

common in the private market but not typically seen in the public markets. The private equity fund manager would be able to exert significant control over the company still via its large share block, albeit there would still be theoretical potential for other shareholders to block developments if they all worked together. It is not yet clear whether these 'public-private equity' transaction structures will prove successful.

4.36 Some executives of public companies are themselves employing private equity investment techniques to their own companies without having recourse to actual private equity investment. They recognise the benefits of the private equity business model and want to secure all of the potential returns from such activity for their existing shareholders. However, it remains to be seen whether such executives will overcome the difficulties of the short term mindset and diverse interests that typify a public shareholder base and therefore be able to bring private equity style corporate improvements to fruition.

4.37 Not all companies' management teams are against private equity bids. Some executives of large public companies are increasingly enthusiastic about their company being taken private because it removes a number of constraints on them and can increase their rewards. Executives of public companies have to deal with a diverse ownership base and a focus on short-term performance rather than long-term growth (even though public markets are meant to provide a permanent rather than short term source of capital). They must also deal with constant media coverage, extensive corporate governance requirements including the transparency of executive pay etc. Although going private is not without risk, it can allow them:

- the freedom to focus their resources on the day-to-day management and development of the company;
- to deal with just a small number of informed shareholders whose interests are aligned with their own;
- to increase leverage to more efficient levels with greater certainty that if the company did encounter difficulties the concentrated ownership base could facilitate new equity injections where rational;
- to undertake capital expenditure for growth purposes even where it would diminish short term profitability;
- to avoid onerous corporate governance requirements in the public sector; and
- to receive higher remuneration, including more performance related remuneration as they will frequently increase their ownership share of the company while it is in private hands.

4.38 For many of these same reasons managers of companies that are currently privately owned are increasingly reluctant to float. They prefer to continue to operate in the private arena even as their business expands to the point where public market ownership would historically have been the norm. This fact, combined with the growing demand from private equity fund managers for investments and the related development of the secondary market in private equity is leading to a reduction in the number of flotations[5].

5 Although overall new issuance in the UK public markets is growing, much of this has its origins overseas with foreign companies seeking a new or dual listing in the UK.

4.39 Many of those companies formerly owned by private equity fund managers that have been floated on the stock market recently have underperformed the market, bearing out fears that private equity will only sell off assets from which all of the growth potential has already been stripped. Concerns exist that the private equity market will expand to the point where publicly traded companies will be either very mature, stable, cash generative but slow growth companies or highly volatile, perhaps politically sensitive, companies that private equity funds would not consider backing. All (stable) high growth potential companies would be privately owned. This would be a direct consequence of fewer entries to the public market and fewer returns of companies previously taken private. The probability of this occurring appears very low in the short term. It appears more likely that the market will eventually find its level with private equity investors only acquiring companies where they can prove that they can add real value that could not be achieved in the public markets, and therefore that a material proportion of growth companies will remain public. All participants seem to believe that private equity will be a material element of capital markets going forward, what is at issue therefore is the relative scale of this market to public markets.

4.40 If public equity markets do ultimately become low growth environments this would (unless structured/leveraged equity based products were created with obvious implications for the risk return trade off) diminish public market investment returns. Institutional investors could obviously divert their capital to the private equity market in the pursuit of yield. Retail investors, however, have limited access to the private equity market therefore they may be discouraged from saving by the lower return investment products that they could access. One might also expect to see a bidding up of prices for the few private equity instruments they could access e.g. PEITs could routinely trade above par.

4.41 The overall impact of these developments on capital market efficiency, and indeed the UK economy, savings and investment is as yet unclear. The balance between public and private will eventually find its equilibrium but it is not yet clear where this will be.

4.42 Public bodies may need to consider if the incentives to participate in the public or private markets are calibrated effectively. The regulatory, corporate governance, taxation and competition regimes applicable to both markets may need to be reconsidered if there is evidence that private equity is either:

- substantially increasing economic growth and/or the efficiency of capital markets; or
- damaging to market confidence, consumer savings or the economy as a whole.

There currently appears to be insufficient evidence of market failure for significant regulatory intervention, although we think there does seem to be merit in continuing to monitor developments.

Market abuse

4.43 We have reviewed anti-market abuse controls in firms active in the private equity market on a number of separate occasions including, but not limited to, the broad thematic review of the private equity market which led to this Discussion Paper and a number of follow up interviews by our market conduct specialists to private equity

fund managers, hedge fund managers and banks to understand further, and to raise awareness of, the scope for market abuse in private equity business.

4.44 In some private equity market participants, most notably the larger firms that are frequently active in the public as well as private markets, standards are generally quite high. Smaller firms, some of whom only interact rarely with public markets, may have less developed control environments. The COMC (Code Of Market Conduct) does, however, still apply to them and they need, in particular, to be aware of their obligation to update their policies and procedures to reflect the implementation into UK law of the Market Abuse Directive.

4.45 In terms of the detailed market conduct related risks faced by private equity market participants, there are a number of areas where information, that may be relevant to those active in securities markets, may be generated in relation to private equity transactions. This is particularly the case in the context of public to private transactions. The correct handling of any such material information is essential for the preservation of market integrity.

4.46 Discussions with firms by our market conduct specialists indicated that leaks of price sensitive information could be the result of either deliberate or innocent comments but were more likely to be deliberate. The short-term and long-term economic interests of the various participants in the deals were recognised as the drivers for such leaks. Dissemination of information to other firms has the potential to result in inappropriate trading, while dissemination of information to the press has the potential to disrupt the deal. Both of these have potential to constitute market abuse and to compromise the integrity of the market.

4.47 One of the main causes of the increased potential for leakage of information in the private equity market is the number of institutions/people involved in private equity deals, which appears to be larger than in most other types of business. For example:

- When considering a bid for a public company, a private equity fund manager may approach the executives of the target company, seeking their cooperation in its efforts to conduct due diligence on the company. There is a risk that this information could be used inappropriately with individuals seeking to profit from the share and debt price movements typically seen as a consequence of the announcement of a private equity bid.
- Likewise the advisers of the company up for sale may approach a number of different private equity fund managers to ascertain their interest, resulting in dissemination of information about the potential sale.
- More significantly, in preparing a bid for a company each private equity fund manager participating in the auction will test the availability of debt to finance the bid, asking potential finance providers to submit competitive tenders. Fund managers often go into the first round of an auction for a company with five or six ‘commitments in principal’ from different leverage finance providers, combining the best elements of them in subsequent auction rounds. The rationale for involving so many parties has its origins incomes from the very large and very complex leveraged finance packages currently associated with private equity

transactions (particularly where public to private transactions are involved). The broader expertise and enhanced competition help ensure the best possible package is available. Each of these finance providers may themselves increase the number of parties holding price sensitive information by road testing potential elements of the potential capital structure with their trading desks or key clients. This widening of knowledge may be advertent, where parties are formally brought inside, or inadvertent where, when gauging appetite by talking about sector, geography, tenor, price etc, they give away enough information to allow parties to guess the price sensitive information. Clearly, the more parties involved in putting together the finance, the more potential there is for leakage and misuse of price sensitive information. Typically several hundred individuals will be aware of a deal, rising to over a thousand in the case of larger deals.

4.48 The potential for leaks is exacerbated in cases where deals take longer to come to fruition. While the market uses Confidentiality Agreements which are reasonably uniform, it is apparent that the greater the number of parties involved in transactions and the longer the deal is running, the greater the potentiality for leaks. All the firms interviewed have systems in place to manage information flows and some give consideration to the number of individuals with access to price sensitive information. It is apparent that there is a tension, which firms need to manage, between the commercial necessity to involve a number of different parties in deals and the potential for information to leak.

4.49 There is a general perception amongst market participants that the pressure points for the leakage of price sensitive information are when participants walk away from a deal or are not selected to proceed with a deal e.g. a bank is not selected after the auction process. Participants need to be aware of their obligations under relevant Confidentiality Agreements, to ensure that information remains confidential within the relevant time restrictions, and the Code of Market Conduct in such circumstances.

4.50 A number of private equity firms indicated that they receive ‘ad hoc’ enquiries from various sources about their interest in potential deals and the progress of live deals. Private equity firms commented that such ‘fishing trips’ were a common practice. However, firms consider the calls unhelpful, and we agree with this assessment. Firms recognised the importance of having appropriate procedures in place to deal with such calls.

4.51 In addition to the need to reduce the potential for external misuse of information, private equity market participants need to have policies in place to reduce the potential for information to be mis-used internally. Private equity market participants usually have robust personal account dealing policies in place, restricting staff from purchasing or disposing of traded instruments. In some private equity firms these extend to an absolute ban on trading. Others allow trading but only with prior approval from senior management, and then only in limited circumstances where it can be shown that the firm had no inside information relevant to that security. Firms also typically try to contain, to the extent possible, access to price sensitive information although some private equity fund managers operate a firm wide restricted list rather than establishing separate teams behind Chinese walls.

4.52 Private equity firms are beginning to participate in the public equity markets, not just as part of an entry or exit but rather as a core investment strategy. Private equity fund managers can gain significant sectoral expertise via their due diligence on potential transactions which they can employ profitably in public markets. They are beginning to act as fundamental investors, applying private equity techniques to public companies without any intention of taking that company private. This can be achieved either by raising a fund with a flexible investment strategy or setting up an in-house hedge fund. The fund purchases a significant share of the public equity and then the fund manager behaves as an activist investor, providing advice to the company management on strategy and structure.

4.53 There is an inherent tension in companies that both trade themselves and participate in private equity business. They need to be careful not to trade on any inside information they may have gained through their traditional private equity investing. It may, however, be in the commercial interest of the trading arm of such firms to restrict trading in the smallest possible number of securities and for the shortest possible period of time. While there are inconsistencies in the market, those firms we spoke to generally applied trading restrictions quite broadly: they restricted trading in debt and derivative instruments as well as in the equity and looked for causal links between companies. We expect firms to apply restrictions broadly and document their decisions.

4.54 Private equity fund managers are also beginning to use their leveraged buyout expertise to run in-house hedge funds and CLOs concentrating on LBO debt. There is a significant potential for intra-group transmission and therefore potentially misuse of inside information relating to individual LBO transactions. This information flow is potentially sensitive both ways. The private equity fund manager could transmit to its hedge fund/CLO fund manager information about the likely credit quality of a company it is buying (including whether or not any re-financing is likely). The hedge fund/CLO manager could transmit information to the private equity fund manager about other rival private equity fund managers' bids for a company, allowing the private equity fund manager to adjust its bid accordingly.

4.54 An alternative style of public market investing that may be employed by private equity specialists is to invest in PIPEs – private investments in public equity. There has been a difficult evolution for this investment technique as a number of cases of market abuse (specifically insider dealing in securities of the company receiving finance via the PIPE) were identified internationally. If this investment technique becomes more mainstream in the UK, users and regulators will have to be aware of its potential misuse.

4.55 It is not just at the time a private equity transaction is arranged that access to inside information is an issue. Participation in the debt components of a leveraged finance structure can give access to significant amounts of data about the ongoing performance of the company – potentially including price sensitive information. Trading in any related instruments (where there is a listing) or participation by holders of this debt in subsequent rounds of public market fund-raising e.g. the public offer of high yield securities replacing the bridge finance could make them vulnerable to committing market abuse if price sensitive information forms the basis of the decision to trade. This risk has been raised by market participants as being particularly acute in the context of the emerging market in LCDS.

4.56 Interestingly, firms attempts to avoid committing market abuse may actually also be increasing risk in other areas – there are suggestions that sellers of credit protection on leveraged loans are doing so without seeing the loan documents because they want to avoid being brought inside. The question has to be asked about whether they truly understand the risk they are taking on in this context and whether there is an appropriate mechanism for resolving this problem.

4.57 The implications for market confidence of this enhanced market integrity risk in the context of private equity are significant and merit ongoing scrutiny from regulators and enhanced vigilance and preventative action from market participants. Fears that markets may not be clean can damage market efficiency by discouraging trading.

The hedge fund approach

4.58 Hedge fund managers face many of the same market integrity risks as private equity fund managers, although sometimes the risks may be more acute in a hedge fund model. Hedge fund managers, frequently participate in both public and private markets, they are frequently holders of company debt and therefore may be passed price sensitive information and they also frequently take an activist approach to investing. In Discussion Paper 05/4 'Hedge funds: A discussion of risk and regulatory engagement' we noted that some hedge fund managers were testing the boundaries of acceptable practice. Despite enhancements made to the systems and controls in many hedge fund managers since that paper was published, hedge fund managers following good practice continue to be worried about the reputational risk arising from inappropriate conduct in other hedge fund management operations. This risk is perceived to be rising in an increasingly competitive and complex trading environment.

Conflicts of interest

4.59 Conflicts of interest may arise in the business models of any of the participants in the private equity market. There are, however, some particularly clear examples of where these conflicts can arise in fund managers and in leveraged finance providers. Some of these examples are outlined below.

4.60 Fund managers:

- A key element of the marketing conducted by the majority of private equity fund managers during a fund-raising cycle is to highlight the fact that key investment staff will commit their own capital to the pool of funds under management. This ensures that their interests are aligned with the interests of the fund investors. This alignment of interests may break down, however, if staff investment is not fully aligned with that of the investors e.g. if staff are able to under or over commit to specific transactions – effectively cherry picking. Co-investment vehicles are common in the private equity sector. These vehicles allow for certain investors to make an additional investment over and above that made by the fund. Sometimes the fund manager selects investments that may be the subject of a co-investment and it (or its staff) has the option to co-invest. This creates a risk that they could unfairly steer potentially more lucrative deals into these structures to enhance the weighting of these companies in their personal portfolios.

- Conflicts of interest do not just arise between the fund manager and the fund investors; they can also arise between different investors. In particular conflicts can arise between investors in separate funds that may be run concurrently by the same manager. These funds may be at different stages in their investment cycle, for example one may have been recently raised and another may be in its divestment stage. Where both of these funds have an investment in the same underlying company, in the best interests of which fund should the manager act? For example, if the value of the company co-owned by the funds has been increased and therefore it could be sold at a profit, but continued ownership has the potential to further increase this profit, should the fund manager sell it or retain it? Selling it is to the advantage of the investors in the more mature fund who may now want their money back but retaining it benefits the investors in the younger fund who want to extract the maximum possible profit from the investment.

- Conflicts can arise if a private equity fund manager is also managing hedge funds or CLOs, particularly where these funds may purchase assets related to companies owned by the private equity fund. For example, there is a risk that these vehicles could be used to warehouse debt from a private equity transaction that other market participants were unable or unwilling to take on. This might be in the interests of the private equity fund investors but would not be beneficial for the hedge fund/CLO investors.

- Where an employee/partner of the fund manager is also acting as a director/has a seat on the board of a company owned by the fund, conflict may arise between their personal responsibility to the company and their responsibility to the fund investors/the fund manager. The alignment of the interests of the fund manager, the fund investors and the company is most likely to break down where:

  – The fund invests in many different companies and the resources of the individual are shared between different companies owned by the fund. This limits the time that they are available to an individual company and raises the potential for conflict because the interests of the different companies for which the individual is a director diverge. This is particularly likely if the companies for which the individual has a responsibility are in the same sector.

  – The fund's capital and profit has been extracted in a re-financing and the private equity manager/employee sees greater upside potential in allocating its finite management team resources to other companies in its portfolio. Once a refinancing has occurred, a fund manager has often extracted all of its initial investment and an amount of profit. The only risk to which it is exposed in respect of that company is therefore that it may not maximise the additional potential profit it could extract (which may be harder extract than the first profits of a company). As the fund manager's resources could be more profitably deployed elsewhere, they may therefore devote insufficient resources, from the company's perspective, to continuing to improve the company.

  – The fund manager is taking a portfolio approach to its investments and something that is in the best interests of its overall portfolio is not in the best interests of an individual company it owns/other shareholders in that

company. For example, if fund profit can be maximised by securing the takeover of one company it owns by another of the fund owned companies, but that this may cause job losses at the company taken over or the value of that company's shares to be capped.

- Loans are provided (by the fund manager or its partners) to the management teams (e.g. the directors) of companies backed by the fund. These loans help the directors buy an equity stake in the leveraged buy out. These loans could create a conflict between the interests of the fund manager, the fund and the company. Clearly the fund manager has the power to call a loan made to the director of a company (which can be highly material e.g. of an order of £1 million) so, potentially, the fund manager could exert significant power over the director. This might cause that director to act in the interests of the fund manager or the fund rather than the company they direct.

- An investee company makes payments to the private equity fund manager or its staff which do not go through the fund even though the fund manager only gets to appoint directors because the fund it manages owns the company. For example, if the company gives options to its directors, which includes employees of the fund manager, the benefits may not be passed on to the fund. This can put the fund manager/its staff into conflict with the fund investors. The fund manager/its staff could for example cause the company to make significant payments to its directors. This would reduce the value of the company (and therefore the value of the fund which owns it) but increase the profit to the fund manager and /or its staff. If the value was transferred to the fund, the fund manager would only be entitled to a percentage of this whereas if it is transferred directly to the manager or its staff then all of the value is theirs.

4.61 Leveraged finance providers:

- Private equity provides a material source of income for banks. According to our LBO survey, one bank earned almost €900mn from its private equity related activities in the 12 months to June 2006 and another bank was shown to generate over 50% of its income from private equity. The reliance of banks on this revenue stream may cause them to consider actions that they would normally discount.
- Banks with long-term relationships with corporate clients may find themselves conflicted where that client is the subject of a potential private equity bid. On the one hand, the bank may be asked to help the company defend itself against the bid (which may be hostile) while on the other hand the bank's private equity customers may be seeking the bank's help to successfully conclude the acquisition. This risk becomes particularly acute where one of the potential bidders is the bank's in-house private equity fund (especially where this includes proprietary as well as third party investments).
- The banks may also face conflicts when they have multiple private equity clients, each of which might be interested in a particular acquisition target. The bank must determine which clients to approach with the potential transaction and in what order. It may be tempted to present first to those clients most likely, not

only to complete the transaction and therefore pay fees to the bank, but also use the bank for other services e.g. related to the transaction, to the transformation of the target company or future acquisitions/disposals. Again, these conflicts may be heightened where one of the potential private equity clients is in-house.

- Where a bank advises multiple clients on the same transaction it must determine which resources to allocate to each deal team. For example, it may have staff with particular expertise and knowledge of the target company, and it must determine which client to allocate these individuals to. Banks need to ensure this process is fair.
- Where a bank is asked by a vendor or potential private equity target to facilitate a sale, it will often be asked to provide a stapled finance package. This involves offering to potential acquirers a financial package that could supplement an equity investment and thereby facilitate an acquisition. These packages are often used to establish expectations as to the likely acquisition cost. The bank may find itself conflicted because after making its initial offering it may then start working on slightly amended packages for individual bidders and therefore it will have teams of internal staff competing against each other to help their client win an auction (and therefore help get that team's finance package accepted). As it is possible for some packages to be far more lucrative for the bank than others, there may be incentives to influence the outcome of this process. For example, the bank might give biased advice to the vendor about which is the best bid or allow the price expectations of the seller to leak to the relevant team. Again, it is possible that one of the bidders could be in-house, further aggravating the conflicts.
- If a bank is providing third party fund management services, it faces conflicts in its decision-making process about to which fund(s) an investment should be allocated. A single investment opportunity might fall within the investment management mandate for a number of different funds. The bank needs to ensure that its allocation process between funds is fair (particularly where this may include allocation decisions between funds involving third party money and funds involving in-house money). The same is true for investment decisions where multiple funds are involved in a single investment.
- We have already identified market practice surrounding competitive Initial Public Offerings (IPOs), in the publication in November 2005 of a List! article, as an area where acute conflicts of interest can arise. Competitive IPOs are frequently used in the context of an exit by a private equity fund from an investment as it gives the fund manager greater leverage over the firms involved in the IPO process. In a standard IPO the lead manager and other brokers are appointed at a very early stage, whereas under competitive IPOs the syndicate members, their roles and remuneration are not defined until late in the process. This maintains competitive pressure on the potential syndicate members and may therefore enhance conflicts of interest, particularly around the preparation of research and pre-marketing activity. For example, if the vendor of a company asks banks bidding for the IPO mandate for examples of their research, the firms may feel under pressure to produce research that is favourable or which justifies a higher valuation range in order to improve their chances of winning the mandate. The firms need, however, to ensure that their research is not held out in a way that could be misleading. It would be misleading for

a connected firm to label their research about an issuer as being 'objective', 'impartial' or 'independent'. It is also worth noting that it is inappropriate for issuers or vendors to exert pressure on firms to act inconsistently with their responsibilities.

- Where a bank accepts more than one mandate on a transaction, it will need to consider whether this precludes it from acting as Sponsor (for the purposes of ensuring compliance with the Listing Rules). This is because, under the Listing Rules, it may be unable to demonstrate the independence from the company and the transaction which is required. This question of independence is in addition to any other conflicts of interest which may arise as a result of the bank acting as Sponsor.
- It is frequently observed that the price of a company's shares rises and the price of its debt (particularly debt without change of control covenants) falls when a private equity bid is announced. The banks may therefore be conflicted where their trading desks/investment advisers have exposures to securities related to a potential private equity target. This is because their actions in supporting or making a private equity bid could have a detrimental effect on their trading desk positions or the positions of funds they manage/customers they advise.

Market access constraints

4.62 At the moment, retail investors have only limited direct access to the private equity market via venture capital trusts – which arguably offer access to one of the riskier parts of this market – and a small number of private equity trusts. Indirect access is also limited as few UK pension funds or insurance companies have yet committed significant capital to private equity. Pension fund managers have noted that they find the structure of most private equity funds burdensome. This is because they need to frequently negotiate new Limited Partnership Agreements and there is an inability to invest all the capital straight away, instead having to wait for it to be drawn down. Pension fund managers indicated to us that they would prefer to access the market by investing in liquid listed entities. UK pension funds also suggested that they experience access difficulties as they are generally late entrants to the market and are finding that the fund managers with the best track records are closed to new investment as they are able to raise sufficient capital for their new funds from their existing investor base. This means that pension funds trying to commit capital to the private equity market are restricted in their choice of fund managers and rely heavily on fund of funds (with layered fees) and second tier investments, with potentially negative performance connotations.

4.63 A risk therefore arises that retail consumers are not getting sufficient access to investment products which might form a beneficial component of a balanced investment portfolio. Many long standing investors in private equity have enjoyed strong investment performance, albeit reflecting illiquidity and volatility premia. The potential for private equity to demonstrate good performance (which may have the advantage of being less than perfectly correlated to the performance of other asset classes) set against the backdrop of a low yield environment and weak performance of other asset classes raises questions about whether retail investors are able to build efficient investment portfolios that will demonstrate sufficient and stable returns as to incentivise continued saving and investment. As public authorities are increasingly

aware of the importance of retail saving and investment, consideration needs to be given as to whether this situation should be rectified and, if so, whether it is an issue for the industry or the public sector.

4.64 Similar questions may be raised about the limited access of UK pension funds to private equity and whether this is an issue and, if so, whether this is a matter for the industry or the public sector. The case for public sector intervention is inevitably going to be less robust where professional (as opposed to retail) investors are involved. Furthermore, it must be noted that some UK and many US pension funds have overcome the barriers to investment, either by investing in funds of funds, or devoting the necessary time and resources to develop their own in-house relationships and expertise.

4.65 This risk of insufficient access to private equity is, however, counterbalanced against the risk that any enhancement of access to private equity potentially exposes investors to an asset class and risk return environment that they may not be able to fully understand. This is particularly likely to be true for retail consumers although some pension fund trustees may share some or all of the same difficulties. They may also have difficulties understanding the different forms and distribution channels of the different private equity related products, resulting in mis-buying or mis-selling. These risks may be difficult to correct via transparency and disclosure in this relatively complex and opaque asset class.

4.66 If, as is commonly believed by market participants, the private equity market is currently nearing its peak, new entrants to the market may be particularly vulnerable to a market correction, in particular if they do not intend to view such an investment as a long-term asset. Past performance cannot be seen as a good indicator of future performance so no reliance may be placed on historical returns in assessing appropriate access levels.

Market opacity

4.67 Despite real efforts by relevant trade associations, the methodologies for disclosure, valuation and performance reporting used in practice in the private equity market are far from standardised. Transparency to non-investors is extremely limited and comparable data across the asset class as a whole is not readily available. Those investors that do have access to fund data are often faced with a large volume of complex and non-standardised information. There are clearly issues and risks arising from this.

4.68 Constraining investors to making investment decisions without access to concise information and without an ability to easily compare and contrast the performance of an individual fund manager relative to its peers (and other alternative investment opportunities) poses a threat. The threat is that less experienced and less well resourced investors will make ill-informed and therefore potentially unwise decisions including both not investing or investing in the wrong fund.

4.69 Once invested, an inability to effectively monitor performance and make comparisons to alternative potential investors means capital may be deployed inefficiently if there are better alternatives elsewhere. Investors may also fail to exert the appropriate influence over the manager of their money to ensure that they continue to act in their best interest.

4.70 Finally, the absence of market level transparency renders beneficial research, analysis and commentary extremely difficult, potentially allowing poor performers to persist in the market, and preventing the sharing of best practice.

4.71 This is, however, predominantly a wholesale market. Professional investors should have the appropriate resources and skill to assess information given to them by managers in which they plan to invest or are invested – even if this information is complex. Once an investment is a realistic prospect they are generally given enough information to understand the investment strategy and experience of the fund managers. Private equity fund investors frequently receive far more extensive and detailed disclosures than investors in public companies. Assuming they have the appropriate skills, investors should therefore be able to make a decision about the optimality of investing with them in their own right, even without information on alternative investment options.

4.72 If retail access is enhanced then clearly further questions would arise about the opacity of this asset class. This could give rise to difficulties as private equity fund managers are frequently strongly opposed to offering additional transparency, particularly if it is at a portfolio rather than fund level. Listed PEITs have, however, managed to overcome these difficulties so it is clear that a workable solution is possible.

4.73 There are also obviously transparency issues with respect to the debt components of private equity transactions – these are discussed in the section on 'unclear ownership of economic risk'.

Q3: Is the detailed description of the risks associated with the private equity market set out in Chapter 4 accurate? Have we mis-represented or omitted any material risks?

5 Regulatory approach to the private equity market

UK regime for private equity firms

5.1 The UK regulatory perimeter is set by the Regulated Activities Order (RAO). A private equity firm will generally need authorisation from us if it carries on regulated activities in or from the UK.

5.2 Neither 'private equity' nor 'private equity fund manager' are defined within the RAO or our Handbook. We have defined the term 'venture capital firm', which is a firm whose permission[1] includes a requirement that it must not conduct designated investment business other than 'venture capital business'.[2] The definition captures the activities typically undertaken by many (but not all) private equity fund managers. Where all of a firm's activities fall within the definition of venture capital business they may currently benefit from relatively light touch regulation.

5.3 The venture capital definition allows us to identify some firms active in the private equity market but other firms undertaking activity which goes beyond 'venture capital business' have broader permissions and are therefore not easily identifiable as private equity market participants.

5.4 Relevant regulated activities that private equity firms may conduct include:

- establishing and operating collective investment schemes;
- managing investments;
- arranging deals in investments; and
- advising on transactions in investments.

5.5 In addition to permissions to undertake the activities outlined above, many private equity firms also have permission to undertake dealing activities in connection with their fund management and operation.

5.6 Some private equity firms appear to have broader permissions than their operations require. In the N2 cutover we gave private equity firms a variety of different limitations on their activities which did not always relate directly to the activities they are carrying on – there appears to be a certain amount of inconsistency. All firms should ensure that

1 'Permission' is, in broad terms a technical expression of the regulated activities a particular firm authorised by us may perform.

2 This term is something of a misnomer as it is not in any way restricted to just early stage private equity activity.

their permissions are appropriate to the business that they undertake. Supervisors intend to remind firms, through generic risk mitigation programmes which will be issued shortly, to review their permissions. We believe that the implementation of MiFID and the CRD[3] will also cause firms to review their permissions to assess potential changes in capital requirements and that this may help reduce inconsistencies.

Current FSA Handbook requirements

5.7 The FSA Handbook sets out our rules and guidance made under FSMA. As an authorised firm, a private equity firm will be subject to the relevant parts of our Handbook, including the High Level Standards, Prudential Standards and Business Standards. The requirements on individual firms will be driven by the nature of the firm's business model and the specific activities the firm undertakes or the permissions the firm has.

Current High-Level Standards

5.8 The High-Level Standards include the Principles for Businesses Sourcebook (PRIN) and the Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) together with other material.

5.9 PRIN sets out the fundamental obligations of all firms under the regulatory system. The 11 Principles serve as the foundation stone for rules and guidance elsewhere in the Handbook; as well as setting standards in their own right.

5.10 SYSC sets out our rules and guidance on high-level systems and controls and the firm's apportionment of responsibility. For example, SYSC requires authorised firms to take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities between directors and senior managers, and to establish and maintain such systems and controls as are appropriate to their business.

5.11 There are no specific exemptions or concessions from SYSC for private equity firms, but the nature of the systems and controls a firm will need to maintain depends on a number of factors. This includes the nature, scale and complexity of its business; the diversity of its operations; the volume and size of its transactions; and the degree of risk associated with each area of its operation. For example, we do not necessarily expect smaller firms to have separate compliance, risk assessment or internal audit functions, or to have an audit committee.

Current Prudential Standards

5.12 The prudential treatment of a private equity firm within the regulatory scope of the FSA is determined primarily by whether its activities bring it within the scope of the Investment Services Directive[4] (ISD). If it is, for example because it carries out portfolio management or the reception and transmission of orders, then it will be subject to the Capital Adequacy Directive[5] (CAD) which specifies certain minimum capital requirements, depending on the activities of the firm.

3 See section on 'Impact of MiFID and the CRD' for further discussion of these Directives.

4 Directive 93/22/EC on investment services in the securities field.

5 Directive 93/6/EC on the capital adequacy of investment firms and credit institutions.

5.13 The ISD, however, provides for a number of exemptions from its scope, for example for firms that manage (i.e. act as operators of) collective investment undertakings[6]. A significant number of private equity firms fall outside the ISD because of these exemptions. We have the discretion to set out the capital requirements for such firms. For the most part, these requirements are relatively low, set at an own funds level of £5,000 if the firm does not deal with private customers.

5.14 A firm that is within the scope of the ISD, most likely because it arranges or manages investment transactions that are not restricted to its operation of collective investment undertakings, will at present be subject to requirements at least equivalent to the CAD. In summary, the firm needs to have a minimum level of own funds that exceeds the higher of a prescribed amount and the sum of an expenditure based requirement and risk based capital requirements which are related to the firm's exposure to market and credit risks. A firm may also be subject to consolidated supervision under CAD if it is a member of a group. This will depend on whether the firm and its group meet the criteria to be exempt from consolidated supervision and have notified us accordingly.

5.15 These capital requirements are included in the interim prudential sourcebook for investment firms (IPRU (INV)), which operates on a sectoral basis. The policy in it is basically the policy that the legacy regulator responsible for the relevant sector applied before we assumed our regulatory powers in December 2001.

Current Business Standards

Current anti-money laundering requirements

5.16 Private equity firms, as firms engaged in 'relevant business', must comply with the obligations contained in the Money Laundering Regulations 2003, including the establishment of identification, record-keeping and internal reporting procedures, and organisational requirements and training obligations.

5.17 We substantially revised our own rules on anti-money laundering procedures in January this year, replacing the Money Laundering Sourcebook in the FSA Handbook with high level provisions in SYSC. We intend the changes (amongst other things) to promote a comprehensive, flexible approach to anti-money laundering controls and to fit better with existing legal obligations, since our earlier Money Laundering Sourcebook in places provided for matters covered by the Proceeds of Crime Act 2002 and the Money Laundering Regulations 2003. For further details on these new rules, please refer to Policy Statement 06/1: Reviewing our Money Laundering regime.

Current training and competence requirements

5.18 Private equity firms are currently required to comply with our training and competence regime. Under the current rules in the Training and Competence (T&C) Sourcebook, in order to be assessed as competent to carry out the activities of managing or advising on investments in relation to venture capital, employees of private equity firms need to have passed an 'appropriate examination'. It is up to firms to determine what is an appropriate examination for the roles of their relevant employees, although they can

6 Article 2(2) (h) of the ISD. The same exemption is replicated in MiFID.

select the exam from an examination list maintained by the Financial Services Skills Council (FSSC). Choosing an appropriate examination from the FSSC's list will provide firms with a safe harbour, as long as they can justify the exam is appropriate.

5.19 Concerns expressed by the industry regarding the T&C examination requirements appear to be based on a misconception that a firm in effect has to choose inappropriate exams from the FSSC list. This is not the case. The requirement is for the employee to have passed an 'appropriate' examination, which can be selected from the FSSC's list, rather than having to pass a potentially irrelevant exam from a prescribed list. However, the firm may be able to obtain a waiver from the examination requirement, if the employee has sufficient up-to-date relevant experience for his role.

5.20 We indicated in March 2006 that we intend to limit the scope of the detailed T&C rules to activities carried on by firms with private customers[7], following consultation in CP 05/10 in July 2005[8]. This will remove the requirement for many private equity firms to comply with the T&C rules (including the examination requirements), as most do not deal with private customers. These changes are due to come into force on 1 November 2007. We are currently carrying out a wider review of the T&C Sourcebook, which is focusing on the retail side. We plan to consult on the review and propose to make any changes to the sourcebook on 1 November 2007.

Current conduct of business (COB) requirements

5.21 As most clients of private equity firms will be classed as intermediate customers or market counterparties, COB regulation of their activities is generally light.

5.22 General COB requirements include provisions on such matters as: client classification, providing information to clients, suitability, best execution and conflicts of interest management.

5.23 In addition, private equity firms who operate collective investment schemes can take advantage of the concessionary regime in COB 10. A limited set of the rules in COB applies to activities performed by the operator of a fund in relation to that operation and there are relevant modifications for some other activities. There are also special provisions in COB 10 regarding content of the scheme documents and statements which need to be supplied to fund investors, although these provisions are generally relevant only for funds containing investors classed as private customers.

Impact of MiFID and the CRD

5.24 The ISD will be replaced shortly by the Markets in Financial Instruments Directive[9] (MiFID) and the CAD by the Capital Requirements Directive (CRD)[10]. Those private equity firms currently classified as ISD investment firms are likely to be considered MiFID investment firms.

7 FS06/1, *Reviewing our Training and Competence regime: Feedback on Chapter 4 of CP05/10*, http://www.fsa.gov.uk/pubs/cp/fs06_01.pdf

8 CP05/10 *Reviewing the FSA Handbook*, http://www.fsa.gov.uk/pubs/cp/cp05_10.pdf

9 Directive 2004/39/EC on markets in financial instruments.

10 Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast).

5.25 The UK is required to implement MiFID by 1 November 2007. Like the ISD, it contains a number of exemptions which are likely to be relevant for many private equity firms. In CP06/9[11] we included draft perimeter guidance which is intended to help a firm consider whether and how it is affected by the MiFID and the CRD. This guidance uses a question and answer format supplemented by flow charts and tables.

5.26 One important difference for private equity firms between the scope of MiFID and the scope of the ISD is that MiFID includes investment advice as a core investment service, whereas under the ISD it is a non-core service. Private equity firms who act as advisers to funds without operating them, or advise third party funds or persons as well as operating their own funds, may be brought within the scope of MiFID, even if not within the ISD. It is therefore possible that more private equity firms will fall within MiFID than currently fall within the ISD. Such firms will fall within the CRD so that the capital and other prudential requirements to which they are subject will also change.

5.27 MiFID contains detailed conduct of business and organisational requirements which we will have to apply to MiFID investment firms. We intend to implement MiFID primarily through changes to COB and SYSC – with most of the organisational provisions being placed in SYSC.

5.28 On 31 October 2006 we published two consultation papers[12] on the implementation of MIFID's conduct of business requirements and our proposals more generally for reforming our conduct of business regime and making it more principles based. These consultations are important milestones in our move towards a more principles-based approach to our regulation and away from detailed prescriptive rules. Our proposed approach to implementation in these CPs is 'intelligent' copy-out of the MiFID provisions. We are carrying forward some of our existing additional Handbook rules but only where justified robustly by market failure and cost-benefit analysis and the conditions within MIFID itself allowing Member States to make additional requirements[13]. There are also resultant changes to the prudential requirements for firms obliged to comply with MiFID/CRD.

Revised conduct of business requirements

5.29 MiFID will bring wide-ranging changes to our current conduct of business requirements, including:

- client categorisation;
- providing information to and reporting to clients;
- the suitability of advice and discretionary portfolio management business and appropriateness of non-advised services;
- best execution; and

11 CP06/9 Organisational systems and controls – common platform for firms – issued in May 2006.

12 CP06/19 Reforming Conduct of Business Regulation and CP 06/20 Financial promotion and other communications. Consultation closes on 28 November 2006 on the elements required for MIFID transposition and by 23 February 2007 for other elements of the consultations.

13 As set out in the MIFID Level 2 Implementing Directive 2006/73/EC.

- controls over inducements.

Revised systems and controls requirements

5.30 Because the CRD and MiFID impose broadly similar high-level requirements on firms for management oversight and internal systems and controls, we proposed in CP06/9 a 'common platform' – a single set of rules for CRD and MiFID firms – to be located in SYSC. Following consultation, we propose to make these rules in November 2006. Of particular relevance to private equity firms may be the revised framework for the management of conflicts of interest. This will require firms within the scope of the rules to maintain a policy for identification and management of conflicts of interest, with a lesser role than now for disclosure as a means of managing conflicts.

Revised prudential requirements

5.31 If a firm is within the scope of the MiFID then, from 1 November 2007, it will be subject to the CRD, which replaces the existing CAD with effect from 1 January 2007[14]. A firm within the MiFID's scope but whose non-exempt investment business is restricted to receiving and transmitting orders and/or providing investment advice, and which does not hold client assets is subject to a lower prudential requirement which allows it to hold either own funds of €50,000 or a prescribed minimum level of professional indemnity insurance cover[15] or a mixture of the two that provides equivalent coverage. We propose to implement these requirements in a new Chapter 9 of IPRU (INV) and are consulting on the necessary rules in CP06/14[16].

5.32 Any other firm within the MiFID's scope will, from 1 January 2007[17], be subject to the requirements of the Prudential Sourcebook for banks, building societies and investment firms (BIPRU), which incorporates the requirements of the CRD. We consulted on the BIPRU text in CP06/3[18] and issued a Policy Statement, in response to consultation comments we received, in July 2006. We expect that many private equity firms subject to BIPRU will be limited licence firms[19], and subject to capital requirements that are similar to those currently faced in IPRU (INV) by a firm within the scope of the ISD.

5.33 The CRD has retained the ability in CAD for a firm that is a member of a group to exempt that group from consolidated supervision under CAD, but the criteria have been amended. A firm seeking to exempt a group must now ensure that the top financial holding company in a Member State has own funds in excess of the sum of capital resources requirement of each financial entity in the group. The capital resources requirement of each entity must be calculated using the same method for calculating capital resources requirements that applies to the firm under CAD. There is more

14 For the period from 1 January 2007 to 31 October 2007 the ISD will determine whether a firm will be subject to the requirements of the recast CAD.

15 The minimum level is at least €1,000,000 applying to each claim and 1,500,000 per year in aggregate applying to all claims.

16 CP06/14 Implementing MiFID for firms and markets – issued in July 2006.

17 There are some firms within the scope of MiFID that are not currently within the scope of ISD e.g. commodity firms and they will not be subject to BIPRU until 1 November 2007

18 CP06/03 Strengthening Capital Standards 2 – issued in February 2006.

19 This is basically a recast CAD scope firm that does not deal as principal.

guidance in BIPRU 8. We expect the effects of this requirement for private equity firms are that it may impact on the internal funding structures use for groups and the amount of capital that the groups are required to hold to be able qualify for the exemption. The changes made by the CRD mean that notifications under the existing regime will not be valid after 1 January 2007 and firms that wish to continue the exemption from consolidated supervision will need to apply to us for a waiver before 1 January 2007.

5.34 Firms outside the scope of the MiFID will remain subject to the requirements of IPRU (INV). At this stage we have no specific plans to review this policy in the near future.

5.35 We have also reviewed the regulatory reporting requirements for investment firms within the scope of BIPRU and other investment firms undertaking non- retail business and we consulted on new integrated requirements in CP06/11[20].

Additional Handbook revisions for private equity firms/activities not within MiFID

5.36 In the light of MIFID implementation, we shall be considering during 2007 what conduct of business rules should apply to firms that are not within the scope of the Directive, including relevant private equity firms. Our policy formulation will be influenced by our desire for a more principles-based approach and our commitment to evidenced-based regulatory processes. Competition analysis between in scope and non-scope areas will be a factor here.

5.37 Similarly, we will be considering the extension of the SYSC 'common platform' to firms outside the scope of MIFID/CRD.

Listing regime

5.38 Currently relatively few private equity firms or funds – for example venture capital trusts and private equity investment trusts – are listed. Funds or firms that wish to list apply as investment entities and are required to comply with specific rules requiring a spread of investment risk. The current listing rules for primary listed investment entities also contain a number of provisions which are sometimes perceived to be barriers to the listing of private equity funds. In particular, they prohibit primary listed investment entities of any kind from exercising control of investees (something which private equity firms may do for commercial reasons) and require the boards of directors of listed investment entities to be independent of any external investment manager. A private equity applicant will also have to comply with disclosure and other continuing obligations.

Code of Market Conduct

5.39 The Code of Market Conduct outlines behaviour which may, and may not, amount to market abuse. This Code applies to participants within private equity business who should pay particular attention to their dealing activities and the dissemination of information to ensure compliance. Participants should note that the Code not only

20 CP06/11 Integrated Regulatory Reporting: Credit institutions and certain investment firms – issued in May 2006.

applies in respect of instruments trading on particular markets but also to products that are closely related to such instruments. You can find the full code on our website at: http://fsahandbook.info/FSA/html/handbook/MAR/1

UK regime for debt capital and service providers in the private equity market

5.40 The full range of regulatory requirements applicable to debt capital providers and service providers in the private equity market are not discussed in detail here as they are generally more extensive and apply to a far wider scope than the private equity market. A number of specific examples of requirements that affect their private equity market activity and relate specifically to the mitigation of risks identified in this Discussion Paper are, however, set out in the rest of this chapter.

Our current efficient and proportionate regulation of the private equity market

5.41 Regulation extends in practice beyond the mere existence of rules. We implement a risk-based framework, applying additional regulatory tools and resources according to our assessment of the risks that an individual firm or sub-sector poses to our statutory objectives. Our, recently revised, risk-based framework, ARROW II, allows us to calibrate the degree of intensity of our supervision according to the impact and probability of the risks that are apparent within a particular firm, based on defined criteria.

5.42 Generally speaking, the vast majority of private equity firms have been assessed as Low Impact using a standardised impact scoring mechanism. This score is derived from an assessment of two main constituents; a calculation of the firm's size/impact within the market and therefore overall risk to our objectives, and the application of a private equity sub-sector weighting which is based on an over-arching assessment of the risks inherent within the private equity industry as a whole.

5.43 We relationship manage firms where this impact score breaches certain thresholds (largely relevant to captives of investment banks and a small number of firms within private equity groups). The firm becomes subject to on-site individual risk (probability) assessments with ongoing risk mitigation programmes, as required. For those firms which do not meet these criteria, we maintain a risk-based approach towards crystallised events, such as rule breaches and firm specific issues, which feed into thematic reviews of the private sub-sector.

Enhancements we are making to our organisational structure and supervisory framework in order to respond more effectively to private equity market developments

5.44 We believe that our long-standing regulation of the private equity market is both proportionate and effective. We are, however, making some enhancements to our organisational structure and supervisory framework in order to allow us to respond more efficiently to private equity market developments.

5.45 We are in the process of creating an alternative investments centre of expertise via the integration of private equity firms and relevant supervisory staff into the existing hedge funds centre of expertise. The alternative investments team will carry out relationship management of all higher impact hedge and private equity fund managers/advisers and carry out relevant thematic work. While there are a number of significant differences in the risk profile of private equity and hedge fund managers, there is evidence of some convergence between these sub-sectors and a number of common risks have been identified such as market abuse and mis-valuation. Creating a single centre of expertise on both hedge fund and private equity business models should increase the efficiency and effectiveness of our regulatory response to these sub sectors. We believe that this enhanced centre of expertise will allow us to offer a first class, informed, timely and proportionate regulatory approach to the alternative investment sector.

5.46 However, we do recognise that the risk profile of individual private equity fund managers appears to be generally less significant than that of many hedge fund managers. For example, private equity fund managers typically follow a single, relatively straightforward strategy of buying, improving and selling companies whereas some hedge fund managers engage in a highly diverse array of investment activities involving complex products and investment techniques, such as short selling and using derivatives for investment purposes. Despite this, as a collective private equity fund managers are able to exert an important impact upon overall capital market efficiency. This is especially true in a very small number of firms (including captives of investment banks), who are managing or advising extremely large funds and therefore have the potential to influence/drive the balance of public and private markets within the UK.

5.47 We plan to support the work of this restructured team by creating two discrete but coherent sub-sectors under the revised ARROW 2 model. This approach will facilitate the development by these supervisors of coherent Risk Mitigation Programmes for the relationship managed firms. Supervisors will be able to draw on the risks identified in this Discussion Paper and the previous Discussion Paper on hedge funds, but adapt them to meet the specific circumstances of the individual firms. It is also, primarily, the supervisors from this centre of expertise who will engage in any thematic reviews affecting private equity market participants (such as the proposed conflicts of interest management review) of all types.

5.48 We have also recently enhanced our monitoring capabilities with respect to the credit markets. These capabilities will be further enhanced by the implementation of a new transaction monitoring system which is currently under development. In addition, we have recently undertaken a number of visits to private equity firms to discuss the potential for market abuse. These discussions indicated that there is considerable potential for market abuse within the private equity market and we will be mindful of the issues raised in its future monitoring work.

Potential additional enhancements to our regulatory approach

5.49 In accordance with our statutory objectives, we aim to respond in an efficient and effective manner to identified risks. The following paragraphs describe how, from a practical perspective, our regime addresses the specific risks arising in the private

equity market that we have identified in this paper and highlight various potential enhancements that could be made (none of which require rule changes). Before we discuss these risk-specific enhancements, we note one potential enhancement that is not related to a specific risk but rather represents an improvement to our general data collection and impact assessment – the enhancement therefore relates to our overall targeting of regulatory resource at where the most significant risks arise. We would welcome comments on all of these potential enhancements.

5.50 *Data collection:* The regulation of the private equity market in the UK is currently light touch relative to the rest of the asset management industry within the UK. Given the risk profile of the majority of private equity fund managers/advisers, there appears to be no reason for increasing the regulatory burden on these firms. However, it is recognised that there remains potential to enhance the efficiency and effectiveness of our regulatory approach towards these firms and to enhance our ability to monitor developments in this increasingly important market. One of the ways this could be achieved is by re-configuring the current firm financial reporting requirements to better identify the specific risk profile of private equity market participants. This new key data, could in turn, be used as the basis on which revised impact metric are calculated potentially, at the margins, adjusting which firms are relationship managed.

5.51 Currently, our financial reporting requirements for private equity fund managers/advisers, which we use to drive impact assessments and the allocation of resources, are based on the conventional asset management industry. Impact metrics are calculated by reference to the higher resulting score of total funds under management and advisory fee income, while factoring in whether the firm is permitted to hold client money.

5.52 Taking into account the differences in which the private equity markets operate against more conventional asset management sectors, there are a number of ways in which these key data requirements could be extended. These might include, for example, the maturity profile of the funds under management or the volume and value of deals done during the period, separating out public to private transactions and re-financings. However, we recognise that the production of this information on an ongoing basis may prove to be unduly onerous on firms given their risk profile, and therefore, we have doubts that it would pass a cost benefit analysis.

5.53 Although one particular area where the current reporting requirements may be improved has been identified in relation to the reporting of funds under management. Currently private equity firms are required to report total funds under management based on total drawn down funds plus any debt leveraging within fund(s). However, given the speed with which the industry is evolving and the ever increasing size of the funds being raised, it now appears that we should look to capture total funds under management by reference to both committed and drawn down funds. This view is in recognition that private equity firms typically derive fees (and their clients are contractually obligated) based on total committed funds. It also recognises that fact that the market impact of a firm managing say, £10bn fund is significantly greater than that of a firm managing a £1bn fund, even if only £500k of that £10bn has been drawn down. This approach would enable us to monitor and anticipate where a significant increase in funds under

management dramatically changes the risks that a particular firm poses to our objectives and therefore the way we should supervise the firm. Given the cyclic nature of the private equity firms and the correlation between committed funds and drawn down funds, this is particularly important given the high percentage of private equity firms which are non-ISD and therefore submit financial returns on an annual basis. We believe that firms already produce this information as part of their internal accounting procedures and therefore anticipate that reporting it to us should not be unduly burdensome.

> Q4: Recognising that we take into account the costs and benefits of additional data collection, do you have any suggestions about the optimal data set to be collected from private equity fund managers and could you indicate the likely costs involved in its production? In particular, could you comment upon the specific proposal to collect information on committed capital in addition to the existing requirement to report drawn down capital?

5.54 *Excessive leverage:* Supervision of the major UK banks and the investment banks has included reviews of firms' management of their credit, market and underwriting risks in the area of private equity (as with other significant business lines) for many years. This takes place in the context of close and continuous meetings with supervisory relationship management teams as well as in periodic cross-firm reviews. For example, over the last two years we have taken a closer interest in the major UK banks' exposures to private equity deals as leverage multiples have increased. We have discussed with firms their approach to deal origination, reviewed the limits and controls around these exposures and the process by which firms monitor and sell down underwritten exposures to final hold levels. Similarly, the survey conducted as part of the research which led to this paper considered the exposures of the banks over time to private equity deals and how the risks are hedged or laid off to other counterparties.

5.55 Given the risks identified in Chapter 4 with respect to leveraged lending, this area will remain a focus for supervisory discussions in the near future. We will continue to emphasise the fact that regular senior management scrutiny of the progress of material exposures is an essential part of the risk management process to identify early warnings of changing market sentiment.

5.56 We are also considering repeating the recent leveraged buyout survey (perhaps on a regular basis e.g. every six months) in order to better understand the impact on this market of the evolving credit cycle. We would welcome comments on the costs inherent in this exercise for affected firms in order to be able to perform effective cost benefit analysis on this proposal. We would also welcome suggestions for the refinement of this questionnaire. We plan to discuss this with key trade associations and market participants, but we would also welcome suggestions in responses to this Discussion Paper.

> Q5: Should we repeat (on a regular basis) our survey of banks' exposures to leveraged buyouts? What are the costs and benefits inherent in such an exercise?

5.57 *Unclear ownership of economic risk:* We communicated our concerns about the development of backlogs in the confirmation of credit derivatives in a Dear CEO letter sent to all financial institutions active in the credit derivatives market in February 2005. This letter highlighted firms' obligations with respect to operational processes and effective risk management Since the publication of that letter we have worked proactively with industry bodies and other regulatory organisations to ensure that steps are taken to address these backlogs. We are continuing this work, observing standards not only in the credit derivative markets but also in the markets for other classes of asset e.g. equity and commodity derivatives.

5.58 We have highlighted[21] various issues and questions facing firms when managing credit events. We plan to supplement our existing knowledge by undertaking some fact-finding work in order to better understand firms and trade associations' preparations for managing work outs. We will particularly focus on the complexities that may arise in the context of different types of market participants holding different types of exposures (e.g. derivatives and different tranches of the underlying) across different business lines and via different types of products. We believe that this is an increasingly important area for firms and one that has yet to be truly tested. We intend to begin this exercise by discussing the issues and risks with the Capital Markets Sector Trade Association Co-ordination Committee and Senior Practitioners Committee. However, we believe that it will be necessary to broaden the scope of participation in these committees for the purposes of this exercise in order to ensure that all relevant categories of market participants, such as hedge fund managers and CLO managers, are represented. Further information may be found about these committees via the following link: http://www.fsa.gov.uk/Pages/About/Teams/Capital/liaison/index.shtml. One of the key questions we will consider as part of this exercise is whether there would be merit in the development of an industry code of practice in this area.

> Q6: What are the main issues, risks, documents and practices we should consider in our fact-finding initiative with respect to the issues and risks that may arise in the event of the default of a heavily traded corporate or multiple concurrent defaults?

5.59 *Reduction in overall capital market efficiency:* Our activities are driven by our need to meet our statutory objectives. These objectives, including our market confidence objective, are in no way limited to the public markets. They do not differentiate at all between public and private markets and therefore neither do we.

5.60 In addition to the impact of our rules, the relative situation of public and private markets is driven by a number of factors outside of our control. We therefore see our responsibility as twofold:

- to promote understanding of both market segments in order to help other public policy makers ensure that any requirements they impose do not have unintended consequences due to a lack of awareness of the specific characteristics of both public and private markets; and
- most significantly, to ensure that the impact of our regulation to both public and private markets is effective and proportionate.

21 http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0512_th.shtml

5.61 We continue therefore to review our Listing Regime to ensure that all of the requirements are proportionate and respond to an identified risk and therefore that there are no regulatory requirements which unduly influence firms to be either publicly or privately owned. We are also monitoring proposals to grant us powers to ensure that Recognised Investment Exchanges and Recognised Clearing Houses do not impose rules which are disproportionate.

5.62 We also intend to maintain a watching brief on market quality with respect to both the public and private markets and will continue to ensure that the characteristics of both markets are fully taken into account when we are considering any regulatory changes.

5.63 Furthermore, we intend to engage proactively with other public bodies to discuss the issues and risks arising from developments in the private equity market that go beyond our statutory objectives, helping them to take an informed view on their optimal response.

5.64 *Market abuse:* As mentioned earlier we have recently enhanced our monitoring capabilities with respect to the credit markets. These capabilities will be further enhanced by the implementation of a new transaction monitoring system which is currently under development.

5.65 In addition, we have recently undertaken a number of visits to private equity firms to discuss the potential for market abuse. These discussions indicated that there is considerable potential for market abuse within the private equity market and we will be mindful of the issues raised in its future monitoring work.

5.66 *Conflicts of interest:* Investment banks face the same challenges of managing conflicts of interest in their private equity business as they do across the full range of their other activities. The need to manage conflicts of interest effectively has increasingly been recognised as a critical objective by investment banks and regulators alike. It has featured prominently on the regulatory agenda in recent years, culminating most recently in the Dear CEO letter of November 2005 and the subsequent self-assessment by firms against these identified good practices. As noted earlier, implementation of MIFID/CRD will also bring new requirements. In November 2005 we also published an article in List! – the UK Listing Authority's newsletter – highlighting the potential for enhanced conflicts of interest in competitive IPOs.

5.67 The management of conflicts across particular business lines including private equity has consequently taken prominence in some firms' recent supervisory risk mitigation programmes. Supervisors will, for example, ask certain firms how they manage the multiple roles they may take in particular transactions (e.g. as lender to buyer, adviser to seller etc). They will also ask about the control of information between these roles (e.g. acting as a potential rival buyer against a client who is also a potential buyer) and the mitigants in place to address the conflicts arising.

5.68 The (restructured) alternative investments team undertakes thematic reviews in addition to its relationship management of higher impact firms. Conflict of interest management is one area that may be the subject of a thematic exercise in the 2006/2007 business plan for this team. Conflicts management will also feature highly in the list of issues private equity firm supervisors will consider including in firms' risk mitigation programmes.

Q7: Are there specific areas of conflict of interest that give rise to especially significant risks and which therefore merit particular focus in any thematic work?

5.69 *Market access constraints:* At the moment retail investors have only limited direct access to the private equity market (which is predominantly to the riskiest part of the market, venture capital) and limited indirect access as few UK pension funds have yet committed significant capital to private equity. Pension fund managers and advisers have indicated that they find current mechanisms for accessing private equity market to be cumbersome and off putting. Listing is one potential mechanism for facilitating market access.

5.70 In March 2006, we issued CP06/4 which proposed changes intended to modernise the listing regime for investment entities. Some of the proposals in the CP might, if implemented, facilitate the listing of private equity vehicles in future. However, the CP did not propose any change to our board independence requirements, nor did it advocate any relaxation of the ban on exercising control. Having evaluated the feedback received and market issues that have surfaced since the CP was published, we have decided to publish a further consultation paper in December 2006.

5.71 The December CP will propose removing the prohibition in the Listing Rules on primary listed investment entities taking control of the companies in which they invest.

5.72 We have reflected both on the recent appearance of substantial closed-ended investment funds targetting an international investor base in other European jurisdictions operating directive-minimum listing regimes and on our duty to have regard to the international attractiveness of UK markets, we have concluded it is not appropriate to prevent overseas investment companies from taking up the directive minimum regime currently embodied in the secondary listing requirements in Chapter 14 of the Listing Rules. We will not therefore take forward proposals made in CP06/4 to prohibit the use of Chapter 14 by investment companies.

5.73 No change to the rules is necessary to admit overseas investment companies under Chapter 14, so this route is thus already available to, for example, companies specialising in private equity investments. Investors will need to satisfy themselves as to the rights of the securities and the responsibilities of the issuer and our revised proposals will include measures to ensure the distinctions between the different obligations applicable to different types of listed issuers are clearer. Unlike primary-listed investment companies, a company with a directive-minimum listing will have no obligation under the UK Listing Rules to spread investment risk or maintain a board of directors that is independent of its manager. Given that many new investment companies are incorporated overseas (often in Guernsey or Jersey) the consultation will also consider the wider implications that a growth in directive minimum listings, if such a growth occurs, may have for our markets, including for the primary listing regime.

5.74 *Market opacity:* Our standard approach is, wherever possible, only acting where there is both an identified market failure and cost benefit analysis justifies it. In line with this, we plan to take no action at this time with respect to market opacity other than to maintain a watching brief on this issue, observing the progress of industry initiatives to raise standards. We welcome developments that improve market practice and obviate the need for regulatory intervention. Industry participants may

wish to proactively consider if there are further steps that they could take to improve market practice, for example by adopting common standards/implementing the recommendations of relevant trade bodies where possible.

5.75 Clearly the appropriate level and form of transparency is linked to the nature of the investor base. We could therefore reconsider our position in the light of any enhanced retail access to private equity.

International context

5.76 We are fully aware that these initiatives need to be viewed in the context of wider international developments. There are very different approaches to the regulation of private equity market participants around the globe (and within the EU). The scope, nature and intensity of the regulatory approach, as well as the applicable rules and regulations, vary considerably. Indeed, private equity fund managers fall outside the scope of regulation completely in a number of major financial centres (including in jurisdictions where the private equity market is highly developed). These facts raise issues of market standards. They also raise questions about level playing fields and international competitiveness. Any disproportionate regulatory requirements (either too little or too much) imposed by a regulator could damage the competitive position of their domestic capital markets. Too much regulation could cause the private equity industry to migrate to more lightly regulated jurisdictions; too little regulation could raise issues of market confidence. We are aware of this issue and endeavours to ensure that its regulation is informed, proportionate and adds value.

5.77 Regulators and public policy makers are increasingly focusing on the private equity market and considering whether or not to make changes to the relevant regulatory requirements.

5.78 The European Commission sponsored industry expert group published a report in July 2006, potentially covering issues such as difficulties in fund structuring, marketing and distribution in a cross border context. Furthermore, MiFiD appears to require Member States to regulate some (but not all) private equity fund managers. As they consider MiFiD implementation, some regulators may consider the appropriate regulation of the industry as a whole.

5.79 Private equity is also being actively considered, particularly from the perspective of risks to financial stability, by a task force on private equity that brings together European regulators and central banks and is co-ordinated by the European Central Bank. A report on this topic is anticipated to be published in the Spring of 2007. Furthermore, private equity is increasingly appearing on the agenda of international regulatory bodies e.g. IOSCO and the Financial Stability Forum.

5.80 We will contribute to these initiatives and/or respond proactively to them and hope that in so doing we will continue to maintain the competitive position of the UK private equity market.

6 Conclusions and next steps

6.1 Private equity plays an important role in the UK's efficient and dynamic capital markets as well as in the UK economy more generally. Against this backdrop, we have sought to identify specific risks and appropriate risk mitigation actions.

6.2 A number of initiatives are already in place, both domestically and internationally, to quantify and mitigate private equity related risks. We have outlined a very limited number of additional steps we believe merit consideration. These potential actions are consistent with our risk-based approach to supervision and would not require extensive changes to our rules.

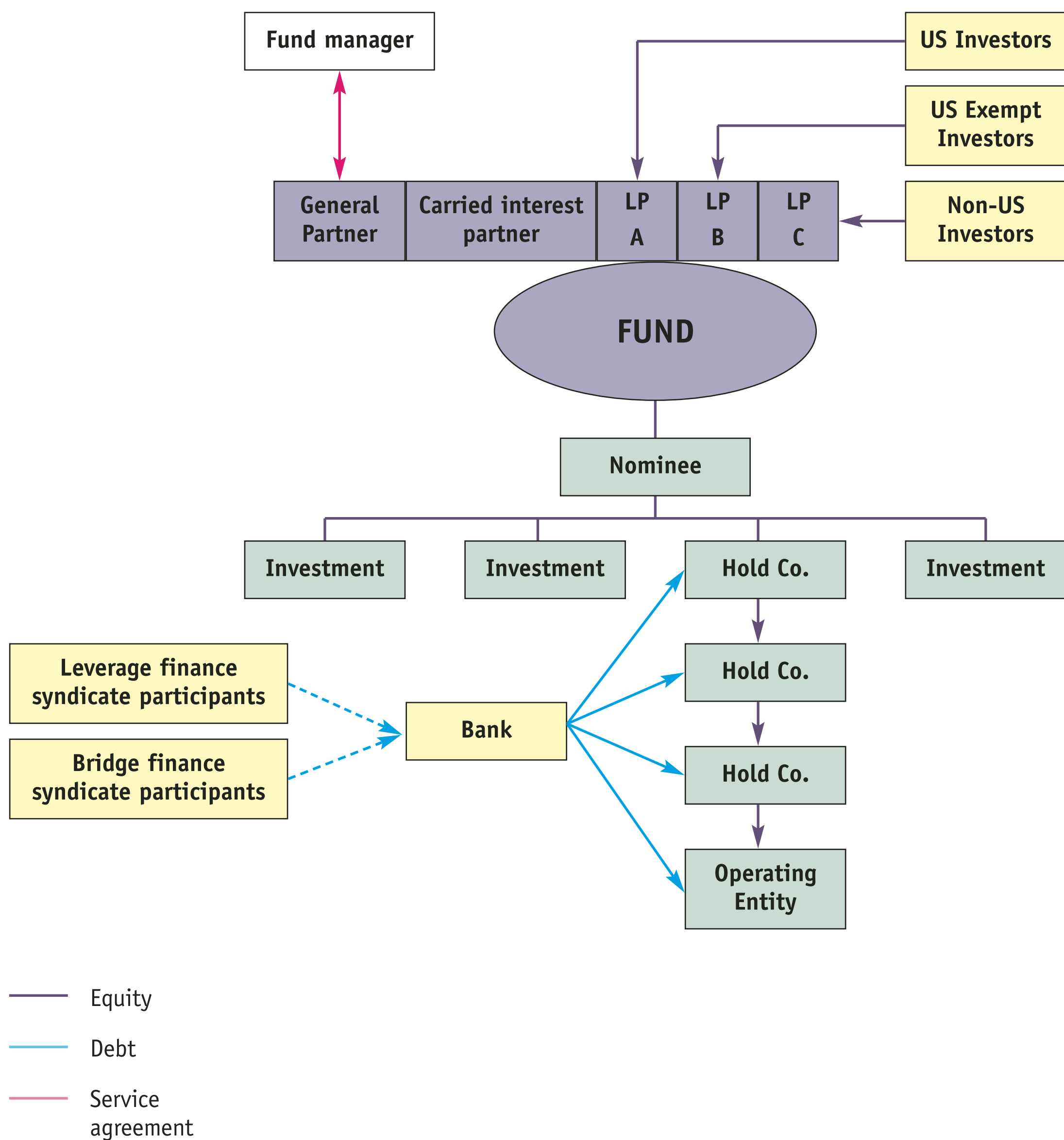
6.3 We recognise the highly mobile and international nature of the private equity sector and are conscious that it would not be beneficial if regulatory action caused the private equity industry to move to more lightly regulated jurisdictions. Consequently, we are giving due care to proportionality requirements and the need to have regard to the competitiveness of the UK.

6.4 We are now embarking on a period of consultation during which we invite views from interested parties that will help us to reach a conclusion on:

- whether we have correctly identified the risks; and
- which of the potential risk mitigation actions merit further analysis.

6.5 We would like to receive comments by 6 March 2007 – a four month consultation period. We intend to review these comments and issue a Feedback Statement in the summer of 2007.

A typical private equity structure diagram



Summary of questions

Q1: Are the risks to our statutory objectives outlined in this paper the correct ones? These risks include excessive leverage, unclear ownership of economic risk, reduction in overall capital market efficiency, market abuse, conflicts of interest, market access constraints and market opacity.

Q2: Is the description of private equity market practice as set out in Chapter 3 accurate? Have any key features or practices been omitted?

Q3: Is the detailed description of the risks associated with the private equity market set out in Chapter 4 accurate? Have we mis-represented or omitted any material risks?

Q4: Recognising that we take into account the costs and benefits of additional data collection, do you have any suggestions about the optimal data set to be collected from private equity fund managers and could you indicate the likely costs involved in its production? In particular, could you comment upon the specific proposal to collect information on committed capital in addition to the existing requirement to report drawn down capital?

Q5: Should we repeat (on a regular basis) our survey of banks' exposures to leveraged buyouts? What are the costs and benefits inherent in such an exercise?

Q6: What are the main issues, risks, documents and practices we should consider in our fact-finding initiative with respect to the issues and risks that may arise in the event of the default of a heavily traded corporate or multiple concurrent defaults?

Q7: Are there specific areas of conflict of interest that give rise to especially significant risks and which therefore merit particular focus in any thematic work?

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