Feedback Statement

07/3

Financial Services Authority

Private equity: a discussion of risk and regulatory engagement

Feedback on DP06/6

June 2007

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Annex 1: List of non-confidential respondents to DP06/6

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This Feedback Statement reports on the main issues arising from Discussion Paper 06/06, *Private equity: a discussion of risk and regulatory engagement*.

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1 Overview

Introduction

1.1. In 2006 we conducted a wide ranging review of the UK private equity market, resulting in the publication of Discussion Paper 06/6 – 'Private equity: a discussion of risk and regulatory engagement' (the DP). We undertook this work in response to the private equity sector's growth, development and increasing influence within UK capital markets.

1.2 This publication has proved timely in setting out our thoughts and questions on an appropriate regulatory approach. Since then, private equity has generated significant comment in both a UK and global context which has increased the focus on the sector and the regulatory oversight it receives. Likewise, the growth and impact of private equity within the financial services sector has continued to increase. As an example, 2007 has already seen announcements of the largest ever leveraged buyout transactions in both the US (the $45bn acquisition agreement announced by TXU and a consortium led by Kohlberg, Kravis, Roberts & Co (KKR) and Texas Pacific Group (TPG)[1]) and the UK (the £11.1bn bid for Alliance Boots by a KKR led consortium which has been accepted by shareholders[2]). This follows on from the record levels of investment in private equity funds in 2005 and 2006 in which UK based funds raised over £31bn[3] each year. Over the same period, the global level of annual fund raising has more than doubled. The impact of private equity business is therefore being felt by an increasing number of stakeholders in private equity markets including: private equity firms; companies within their portfolios; and the firms with which they do business.

1.3 Within the UK, private equity has gained a high public profile and generated a wide ranging debate which incorporates the interests of a broad group of stakeholders. Our remit is only relevant to part of this debate and in Chapter 2 we clarify the scope of our regulatory responsibilities in this regard. However, other public organisations are addressing some of the wider aspects of private equity's growth within the UK. These include the current Treasury Select Committee inquiry and the Treasury's review of the taxation of certain types of corporate debt, typically associated with leveraged buyout transactions.

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1 Source: TXU press release

2 Source: Alliance Boots press releases

3 Source: Private Equity Intelligence

1.4 The industry has asked Sir David Walker to chair a high-level working group to assess the adequacy of disclosure arrangements and the clarity and consistency of valuations and returns employed by UK private equity firms. The intention is to establish a voluntary code of compliance in these areas.

1.5 At a global level, financial and securities regulators are working to address the risks posed by private equity. Debate and work in organisations such as the International Organisation of Securities Commissions (IOSCO) and the Financial Stability Forum is ongoing, alongside other efforts at national levels.

1.6 It is against this backdrop of heightened interest in the private equity market and its regulation, that we publish our Feedback Statement to the DP. This details the comments we received, our response and the steps we will be taking as a result.

Why are we publishing this feedback statement?

1.7 The DP was published following a wide ranging thematic review of private equity markets. This review sought to address the question 'what is the appropriate level and form of regulatory engagement with the private equity sector'? We therefore published the 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 measures to mitigate these risks that are already in place at both a domestic and global level;
- 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.

1.8 We are publishing this paper to highlight the views expressed in response to the questions raised in the DP, outline our response and confirm what actions we will be taking as a result.

Who should read this paper?

1.9 This paper is addressed to investment managers and advisers, leveraged finance providers, participants in the syndicated debt markets, wider market participants, commentators and analysts. It is also explicitly addressed to the Treasury, the Bank of England, the European Commission, Central Banks and other regulatory organisations around the world.

Executive summary of comments on the key risks and our regulatory response

1.10 We received a substantial response to the DP from a wide variety of stakeholders. The vast majority of responses confirmed that: we had identified an appropriate set of risks to our statutory objectives; we had assigned an appropriate significance to these risks; and our proposed regulatory approach was proportionate to the significance of these risks. Based on these responses we do not consider there to be any further issues regarding private equity markets, on which we should focus at the current time.

1.11 As outlined in the DP, we have created an alternative investments centre of expertise which is responsible for the relationship management of higher impact private equity and hedge fund managers. This has been generally well received by the firms concerned and we anticipate further benefits to our regulatory approach as the team becomes fully established.

1.12 The following table provides the brief summary of each of the seven risks, as identified and described in the executive summary of the DP, and the action we will be taking as a result of the comments received. The detailed responses are discussed further in Chapter 3.

Risk (from the executive summary of the DP)	Regulatory 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. Responses were supportive of the proposal to periodically repeat our 2006 survey of leveraged lending activity within the UK. We will rerun this survey semi-annually starting in the first quarter of 2008. This will allow us to better understand developments in the leverage and complexity of financing within leveraged buyout transactions, how exposures are distributed and the risks that this may present. We will liaise with participants before the next survey to refine the format so it is conducted in an effective manner.

Risk (from the executive summary of the DP)	Regulatory Response
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 buyout 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 (which may not be confirmed in a timely manner). 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.	Responses were supportive of our fact-finding exercise, as proposed in the DP, regarding the issues and risks that may arise in the event of financial distress and default within a heavily traded corporate entity. We are proceeding with this initiative including liaison with, and input from, trade associations, organisations specialising in corporate restructuring and authorised firms. We will report further on this work as appropriate in future. Several specific items were raised by respondents for our consideration during this exercise and we detail these in Chapter 3.
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.	Our statutory objectives mean we have no remit to promote, or favour, public or private ownership. We will therefore retain a watching brief on this issue, with respect to our Listing Rules, to ensure that they are proportionate and do not unduly influence firms to be either publicly or privately owned. Responses confirmed that this was an appropriate approach given the low impact of this risk to our statutory objectives relative to the other risks identified. We will therefore not be taking any other action in this area, at the current time.

Risk (from the executive summary of the DP)	Regulatory Response
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.	
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.	Responses confirmed that this was an important area of risk for us to consider, especially with respect to public-to-private transactions. This is in line with our statutory objective regarding the reduction of financial crime. We will therefore maintain our focus on market abuse in the context of private equity transactions, both through supervisory interaction with relationship managed firms, and ongoing work in our Markets Division. The implementation of our new transaction monitoring system in 2007 will further enhance our monitoring capabilities across the marketplace.
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.	Taking into account feedback received, we continue to perceive conflicts of interest as an area of significant risk within private equity markets. Conflicts management will therefore remain an area of supervisory focus for all authorised firms involved in private equity markets. We intend to carry out further thematic work in this area, within our alternative investments centre of expertise. This will focus on the management of conflicts within private equity firms.

Risk (from the executive summary of the DP)	Regulatory Response
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.	We acknowledge that indirect retail access to un-listed private equity firms, via institutional investment, is greater than we indicated in the DP, and that the very low level of direct retail access is appropriate given the risks involved. We will review the situation if demand for direct retail access increases. For listed firms, we continue to review our listing regime for investment entities. As communicated in April 2007, following earlier consultations, we intend to proceed on the basis of a single platform for all listed closed-ended investment funds irrespective of domicile. We will be publishing a consultation paper, outlining possible measures, in June 2007. Depending on the outcome of this consultation, we envisage that the single platform should be in place during the first quarter of 2008.
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. for 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 perceived in responses a lack of clarity about our remit with respect to transparency within private equity markets. We have set out a detailed explanation of this mandate within Chapter 2 as being to ensure appropriate disclosure to existing, and potential, investors in private equity firms. Feedback has confirmed that this transparency is extensive. Therefore, we do not propose to conduct further work in this area at the current time.

1.13 We outlined in the DP a significance level for each of these risks as being a combination of impact (the potential harm that could be caused) and probability (how likely the event is to occur). Feedback has confirmed our views that the provisional assessment of the significance of these risks to our statutory objectives is currently appropriate. We will continue to review this as both the impact of each risk and the probability of it crystallising evolves over time. The table below shows our current assessment of risk significance based on the feedback received.

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.

1.14 This paper focuses on risks to our regulatory objectives arising from private equity markets and the appropriate regulatory response. This should be considered alongside the potential benefits which private equity markets can deliver. As outlined in the DP, we believe that the private equity market is an increasingly important component of a dynamic and efficient capital market which 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 remains our view, having considered feedback received, and we are committed to work with stakeholders to ensure our regulatory approach remains effective, proportionate and adequately resourced.

Structure of this paper

1.15 In this paper we provide feedback on responses received to the DP. The paper is structured as follows:

- Chapter 2 gives an overview of responses and outlines our regulatory remit in the context of the wider market;
- Chapter 3 summarises detailed responses to the questions raised in DP 06/6; and
- Annex 1 provides a list of respondents to DP 06/6 excluding those who asked for their responses to remain confidential.

2 Summary of Responses

2.1 We received a substantial number of responses to the DP from a wide variety of stakeholders in private equity markets within the UK. Input from outside of the financial services sector was welcomed, and reflects the heightened interest that private equity has received since we published the DP.

2.2 The vast majority of respondents agreed that we had identified an appropriate range of risks for consideration, and that the regulatory approach we proposed was proportionate to the significance of the risks concerned. In Chapter 3 we outline our detailed response on each of the questions raised in the DP and the specific comments we received.

2.3 As we noted in the DP, our focus was devoted mainly to the mid and large cap private equity markets, where individual transactions are of a material size and complexity. We acknowledge, therefore, that several elements of the DP and this paper do not apply to the small cap and venture capital markets. However, respondents confirmed our view that it was appropriate and proportionate for us to focus on the area of the market presenting the most risk to our regulatory objectives. In any case, many of the issues and risks are applicable to all market participants. We will remain mindful of this in our future work, and assessing the impact of our actions on the market as a whole.

2.4 We outlined, in the DP, plans to establish an alternative investments centre of expertise. This is now in place and is responsible for the relationship management of higher impact private equity and hedge fund managers. This development has been generally well received by the firms concerned, and our supervisory team has already conducted several risk assessments under our revised ARROW 2 framework. We anticipate further benefits, in terms of the effectiveness of this regulatory approach, as the team becomes fully established.

2.5 There were, however, a number of recurrent themes arising from the responses received which we feel merit further comment and clarification from us in this statement. These relate to: whether private equity markets merit a distinct regulatory regime; the scope of the FSA's regulatory remit with respect to transparency in private equity markets; and the link between each of the seven risks we identified in the DP and our statutory objectives. We address these in turn in the rest of this chapter.

The FSA's regulatory regime with respect to private equity markets

2.6 Several interlocutors queried whether the fact that we had published a DP implied we were considering implementing a distinct regulatory regime for private equity markets than for other areas of the financial services industry within the UK. This is not the case. Our intention, throughout this review, has been to address the specific risks identified within our existing regulatory framework.

2.7 As we outlined in the DP, one of the key purposes of publishing the document was to clarify our current assessment of risks posed by private equity markets to our statutory objectives and consider what appropriate action could be taken in mitigation. We acknowledge that many firms interact, in some form, with private equity markets and therefore it is extremely difficult to define a specific set of private equity market participants. In fact neither the Regulated Activities Order (RAO), which sets out the UK regulatory perimeter, or our Handbook provide a specific definition for private equity. While we have a term defined as 'venture capital firm'[4], many firms have much broader permissions and so are not easily identifiable to us as private equity firms. Correspondingly, firms who conduct substantial investments in UK companies can have a minimal regulatory footprint. These would include organisational structures such as overseas domiciled and regulated fund managers whose funds purchase UK based companies based on input from an advisory subsidiary located within the UK. In this case it may only be the latter part of such a structure which we authorise and regulate.

2.8 We set out our rules and guidance in the FSA Handbook. All UK authorised private equity firms are subject to the relevant parts of this, as driven by their permissions and specific business activities. This approach is consistent across regulated firms, not just private equity markets, and we would expect all authorised persons to comply with the applicable sections of our Handbook. Particularly relevant are our Principles for Business[5]. Under these, we expect that any authorised firm or person should, among other things, conduct its business with integrity, due skill, care and diligence. The firm, or person, should also take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems for the type of business conducted.

The scope of the FSA's regulatory objective with respect to transparency in private equity markets

2.9 For stakeholders to have a realistic expectation of where we will make regulatory interventions, they must first have a clear understanding of the scope of our regulatory remit. As an example, a small number of respondents questioned whether the current method of taxation for debt in the UK was appropriate. This is an area of concern for the Treasury, and not an issue on which we have a mandate to comment.

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4 a firm whose permission includes a requirement that it must not conduct designated investment business other than venture capital business. (FSA Handbook)

5 http://fsahandbook.info/FSA/html/handbook/PRIN/2/1

2.10 Since we published the DP, debate about the appropriate level of disclosure by private equity firms, fund managers and investee companies has broadened significantly. It is a topic of great importance to a wide variety of stakeholders in private equity markets including investors, fund managers, finance providers and employees of both private equity firms and the portfolio companies they own. Responses to the DP indicated that there was a lack of clarity on our regulatory remit in this area compared with the scope of certain legislation and complementary initiatives. We therefore believe it is appropriate to outline the remit passed to us by legislation so that stakeholders can understand what to expect from us.

2.11 Under the Financial Services and Markets Act 2000 (FSMA) we are given four statutory objectives which govern the way we conduct our functions and provide political and public accountability. These are:

- market confidence: maintaining confidence in the financial system;
- public awareness: promoting public understanding of the financial system;
- consumer protection: securing the appropriate degree of protection for consumers; and
- the reduction of financial crime: reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

2.12 We summarise these objectives in our strategic aims under three broad headings. These form the foundation of our business plan:

- promoting efficient orderly and fair markets;
- helping retail consumers achieve a fair deal; and
- improving our business capability and effectiveness.

2.13 We outlined in the DP that we view private equity as a wholesale market to which there is no significant direct retail access. Responses have confirmed this to be the case. Our regulatory responsibility for transparency, including valuation disclosure, is concerned therefore with ensuring that private equity investors receive appropriate disclosure to aid informed and objective decision-making. This is outlined in the FSA Handbook under our Principles for Business (PRIN) and Conduct of Business (COB) sourcebooks[6]. As an example, the seventh Principle for Business is 'Communications with clients – A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading'[7]. If firms do not, this could be detrimental to the efficient, orderly and fair functioning of markets and our statutory objective with respect to market confidence.

2.14 As we explain in Chapter 3, DP responses have confirmed that transparency made to private equity investors is currently extensive, and we do not propose to take any further action on this risk at the current time. However, if retail access is sought by

6 The obligations of authorised firms, including private equity firms, under these sourcebooks will be dependent on the classification of their clients.

7 For clients classed as market counterparties, the only requirement under Principle 7 is that firms should communicate information to these types of clients in a way that is not misleading.

unlisted private equity firms, we may review the situation to ensure that our regulatory approach remains proportionate.

2.15 We also maintain the Listing, Prospectus and Disclosure Rules, within the FSA Handbook, which apply to issuers whose financial instruments are admitted to trading on a regulated market and certain other markets, within the UK. This would be pertinent to private equity firms who are either seeking their own listing, or looking to exit an investment by issuing equity in, or returning, an investee company to the public market. We have not considered these rules in this paper as they have been the subject of recent consultation on topics such as the Investment Entities Listing Review (IELR) and implementation of the Transparency Directive. As communicated in April 2007, the next steps in the IELR will involve a consultation paper on a single listing regime for all investment entities which will be published in June 2007. We expand further on this in Chapter 3.

2.16 The above paragraphs outline our various responsibilities regarding transparency within private equity markets. However, we do recognise that guidance with respect to disclosure, which is of relevance to stakeholders in private equity markets, is provided by a number of other regulatory bodies and legislation. For clarity, we highlight some of the most significant of these below. Readers should note that, typically, these apply to a broader range of firms and situations than solely private equity business.

2.17 The Companies Act provides a single company law regime applying to the whole of the UK incorporating both private and public companies. This includes certain disclosure and reporting requirements. Correspondingly, the Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting confidence in corporate reporting and governance The FRC's Accounting Standards Board is responsible for setting financial reporting standards for all UK companies not reporting under International Financial Reporting Standards (IFRS), including those in the private equity sector. When considering transparency requirements, stakeholders should understand that these areas are outside of our immediate concern.

2.18 One of the key areas which was repeatedly raised to us in feedback, is the requirement for disclosure during the process of a company being taken private. This falls within the remit of the Takeover Panel which has been designated as the supervisory authority to carry out certain regulatory functions in relation to takeovers pursuant to the Directive on Takeover Bids (2004/25/EC). The panel's main functions are to issue and administer the City Code on Takeovers and Mergers and to supervise and regulate takeovers and other matters to which the code applies.

2.19 As outlined in Chapter 1, from an industry perspective we welcome the announcement of a high-level working group, chaired by Sir David Walker, which intends to define a voluntary code of compliance for disclosure and valuation to be adopted by private equity firms. In terms of transparency, we understand that the group will assess disclosure to investors as well as areas outside of our regulatory remit including disclosure to the general public. We will stay abreast of the code's development and any regulatory implications that may result.

Link between the risks outlined and our statutory objectives

2.20 Several respondents questioned the link between the risks outlined in the DP and our regulatory remit. Others pointed out that certain risks would only apply to the larger end of the market, for example in leveraged buyout transactions, and were not necessarily applicable to venture capital business which accounts for a significant proportion of investment in private equity/venture capital funds. One example cited was the risk of excessive leverage; this would not apply to venture capital and small cap business which typically uses only equity financing.

2.21 We understand that some of the risks are indeed only applicable to the larger end of the private equity market, and outlined as such in the DP. We will therefore focus proportionately on this part of the market while remaining mindful of any impact our actions will have across the full range of firms. We would expect firms to consider carefully whether the risks we outlined are applicable to the business they conduct and therefore what systems and controls they should have in place to provide appropriate levels of mitigation.

2.22 With respect to the link between the risks outlined and our statutory objectives, we have attempted to provide greater clarity in the detailed responses in Chapter 3.

3 Responses to questions in DP06/6

3.1 We received a substantial number of responses to the questions set out in Annex 2 of our DP (reproduced below). This chapter summarises the comments received on each of those questions and outlines our response to them.

> 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.

3.2 Virtually all the responses we received commented on part, or all, of this question as it reflects the key findings of our review, namely the risks on which we should focus our regulatory attention and resources. Many respondents chose to combine their answers to Questions 1 and 3 into a single response. Therefore, under this question we will outline the responses to the seven risks we had identified in the DP, and under Question 3 we will discuss the other risks that respondents identified for our consideration.

3.3 As mentioned in Chapter 2, many respondents pointed out that the identified risks are applicable to other areas of financial markets, not just private equity. There was also a general call for us to link each risk more specifically to our statutory remit. This section therefore takes each risk in turn and addresses the feedback received and our response to it.

Our response: We acknowledge that responses confirm that the risks we had identified in the DP are the correct ones on which we should focus our regulatory attention. We discuss each risk in detail below.

Excessive Leverage

3.4 Many respondents queried our use of the word ‘excessive’ in conjunction with this risk. While accepting that leverage levels were increasing, as identified by our leveraged buyout survey, respondents pointed out that determining when this reached excessive levels depends on prevailing economic conditions, and could only be done at an individual deal level. Several respondents asked us to replace the word ‘excessive’ with an alternative such as ‘increasing’ or ‘high’.

3.5 A few respondents pointed out that increasing leverage was not necessarily indicative of finance providers performing less diligent credit and risk management analysis ahead of transactions, even if they were planning to hold a relatively low final exposure after distribution. The reputational risk of being associated with poor controls in this area was regularly cited as a key motivation for firms to demonstrate good practice. A small number of respondents reinforced this point by observing that typically all investors in the leveraged finance market are sophisticated and perform extensive due diligence of their own before participating in any financing facility. Therefore finance providers would find it very difficult to syndicate and distribute debt that had not been appropriately structured and priced.

3.6 One respondent commented that leverage levels in private equity transaction can naturally exceed those in public firms due to tax advantages of debt over equity finance.

Our response: We understand the comments made about the title of this risk; however, the DP highlighted that this was a description of a risk, not the current market situation. We maintain a risk exists that leverage in individual transactions increases to excessive levels making the financial viability of the underlying firms unsustainable. As we highlighted in the DP, this makes the default of a large private equity backed company or a cluster of private equity backed companies seem inevitable. This has potential to create market instability and presents risk to our statutory objective to promote market confidence. We therefore consider this risk to be appropriately titled.

We agree with the point that increasing leverage is not necessarily correlated with declining credit and risk management standards, or the final exposure to a deal that a lender is targeting to hold. However, the robustness of systems and controls will remain a focus for supervisors of leveraged finance providers. It is therefore important that we stay abreast of developments in the leveraged finance market so as to understand market developments and identify emerging risk at the earliest possible opportunity. We set out our proposals regarding the leveraged buyout survey under Question 5.

Unclear ownership of economic risk

3.7 A few respondents specifically commented on this risk under their answer to Question 1. Most chose to address this issue, in the context of the impact unclear ownership may have in the case of financial distress and the workout of a corporate default, under Question 6. So we address those responses under that question.

3.8 With respect to credit derivatives, several respondents commented on the work done to reduce confirmation backlogs as a good example of the industry working alongside regulators to mitigate risk.

3.9 One issue respondents raised was that the continued rapid growth in the cash market for leveraged loans could create operational resource constraints for the timely confirmation and settlement of transactions. This was particularly pertinent given the perceived lack of personnel with experience in leveraged loan markets available to participants.

Our response: We agree with respondents that ongoing work on derivatives backlogs has, so far, proved successful in reducing outstanding confirmations and enhancing operational controls. In our credit derivatives work, we have seen confirmations outstanding for over 30 days reduce by over 80% since September 2005. This has shown the value of close cooperation between regulators and the industry. However, continued vigilance is required to ensure the situation does not deteriorate as focus switches to backlogs in other asset classes and separate issues. Our supervisory teams will continue working closely with authorised firms and regulatory peers to monitor this situation.

We believe that any uncertainty as to the efficient operation of a financial market could create detriment to our statutory objective to promote market confidence, and responses have confirmed that this is a valid risk for us to consider in this context. Under Question 6 we set out our thoughts to the risks raised by unclear risk ownership in the context of financial distress and default of a corporate firm with publicly traded securities.

Reduction in overall capital market efficiency

3.10 We received a very limited response on this specific risk, reflecting our view that, while meriting consideration, this risk was currently of low significance to our statutory objectives. A few respondents argued that there was insufficient evidence to blame any decline in UK equity market capitalisation on private equity business. It was also pointed out that it was in the interest of private equity firms for there to be a liquid public market in the UK, as listing is a common exit route at the divestment stage.

3.11 One respondent raised a concern that the growth of private equity in the UK had forced listed companies to take a more short-term view focused on current value and not long-term growth.

Our response: Our statutory objectives mean we have no remit to promote, or favour, public or private ownership. This risk relates to the potential impact on market confidence, and our ability to ensure appropriate consumer protection, of a decline in the quality, size and depth of public markets. We had identified this risk as being of low significance to our objectives at the current time and the feedback we have received has confirmed our view. As outlined in the DP, while maintaining a watching brief on the ongoing appropriateness of our Listing Rules, we do not feel it is proportionate to take further action in respect of this risk at the current time.

We will also remain mindful of the impact that the growth in private equity markets could have on the conduct of issuers of listed securities, both in terms of their ongoing ability to meet the relevant Listing, Prospectus and Disclosure Rules and any other potential impacts to our statutory objectives. We will take further action in this area if appropriate.

Market Abuse

3.12 We received a substantial number of comments on the issue of market abuse. Most of these responses agreed that this should remain a key area of focus for us, both generally and with respect to private equity transactions. Commentators agreed with our assessment that ‘public-to-private’ transactions can present a significant area of risk where price sensitive information is potentially available to a large group of participants.

3.13 In reply, many respondents advocated that authorised firms, both financial intermediaries and private equity firms, had robust systems and controls in place to prevent the dissemination and misuse of price sensitive information. Reputational risk was presented as a strong motivation for firms to ensure the effectiveness of these controls. Accordingly, respondents commented that awareness and application of the Code of Market Conduct had increased markedly amongst private equity firms in recent years.

3.14 Several respondents pointed out that the Takeover Code places strict principles around disclosure if negotiations are extended beyond a 'very restricted number of people'. It was also noted that the code provides significant guidance on disclosure requirements for both public market and public to private transactions alike.

3.15 A substantial number of responses pointed to the 'Joint Statement Regarding the Communication of and Use of Material Nonpublic Information'[8]. This was jointly released by a number of trade associations in December 2006 and promotes good practice for preventing the inappropriate use of price sensitive information in securities and derivatives markets.

Our response: The thematic work on market abuse that we outlined in the DP has focused on the standard of systems and controls around preventing market abuse in private equity transactions. It is important that authorised firms demonstrate a clear understanding of their legal and regulatory obligations in this regard. We are also supportive of initiatives, such as the Joint Statement mentioned in the preceding paragraph, which highlight the industry's commitment to proactively ensuring appropriate mitigation. However, the risk of market abuse presents significant detriment to our statutory objectives with respect to the prevention of financial crime, consumer protection and, if not mitigated, overall market confidence. We will therefore maintain our focus on market abuse in the context of private equity transactions, both through supervisory interaction with relationship managed firms and ongoing work in our Markets Division.

The implementation of our new transaction monitoring system in 2007 will further enhance our monitoring capabilities across the marketplace.

Conflicts of Interest

3.16 Most respondents addressed this risk under Question 7. For consistency we will incorporate all comments on conflicts of interest under that section.

Market Access

3.17 Several respondents commented that greater access to private equity as part of a diversified portfolio should be encouraged for institutional investors, and opined that there currently exist a broad range of investment opportunities available despite recently heightened demand. Others commented that the involvement of pension funds in private equity investment was far greater than we had implied in the DP, with one estimate stating that pension funds now account for over 25% of funds raised in Europe[9].

8 Issued by 12 Trade Associations (December 2006)

9 EVCA Yearbook 2006

3.18 Respondents generally agreed that un-listed private equity funds were aimed almost exclusively at wholesale and institutional investors who have the sophistication and ability to conduct extensive due diligence before committing funds. Several respondents therefore indicated that any retail involvement in such investments should be focused on private equity investment trusts and venture capital trusts, where exposure is diversified across a broad range of funds.

3.19 Many of the responses on this topic focused on the listing requirements for private equity firms within the UK, building on previous responses to our Investment Entities Listing Review.

Our response: We identified this risk as it could present detriment to our objectives to promote market confidence and public awareness. This could occur if retail investors are unable to access an investment product which might form a beneficial component of a balanced investment portfolio. We accept that indirect access via, for example, pension funds is in fact greater than we had indicated. However, we note that private equity is at an earlier stage of the development cycle, in terms of institutional investment, than other forms of alternative investment such as hedge funds. As this investment develops we will continue monitoring to ensure our regulatory approach remains appropriate. We acknowledge the very low level of direct retail access in unlisted vehicles is what we might expect given the risks involved. If demand for direct retail access does increase, we may revisit this risk to review whether appropriate consumer protection exists.

We are, however, exploring opportunities to facilitate access to listing for private equity vehicles. A key objective of our Investment Entities Listing Review is to modernise the listing rules and produce a durable, principles-based regime which will facilitate the listing of entities with more modern investment strategies, such as private equity and hedge funds, while providing appropriate levels of investor protection. Throughout the review we have been conscious of our responsibility to protect investors while fulfilling our duty under the Financial Services and Markets Act when we make rules in our specfic capacity as the UK Listing Authority to have regard to the international character of capital markets and the desirability of maintaining the competitive position of the UK. We communicated to the market in early April that, following earlier consultations we intend to proceed on the basis of a single platform for all listed closed-ended investment funds, irrespective of domicile. We will be publishing a consultation paper, outlining possible implementation measures, in June 2007. This will include proposals for further deregulation which may aid the listing of some private equity and hedge funds. Depending on the outcome of the next round of consultation, we envisage that the single platform should be in place during the first quarter of 2008.

Market Opacity

3.20 Several respondents, including investor representatives, confirmed our views that transparency to existing and potential investors is extensive and made readily available by general partners. No respondents called for us to intervene in this respect.

3.21 One participant noted that the Takeover Code provides for disclosure requirements during the takeover process, both with respect to 'take private' and public acquisitions, and that these requirements are enforceable by law. Similarly the

Companies Act details the disclosure requirements of unlisted firms, and there should be no need for FSA action in this area.

Our response: We have outlined in Chapter 2 that our mandate with respect to transparency relates to the disclosure that private equity firms make to their investors. A clear risk to our statutory objectives to promote public awareness and market confidence would exist if investors did not receive sufficient disclosure to facilitate objective investment decision-making. Feedback we have received has confirmed that this is not currently the case. We also accept that there exists substantial take up of industry guidelines with respect to consistency of disclosure, such as the International Private Equity and Venture Capital Valuation Guidelines, which provide clarity to investors. Given this feedback, we do not propose to conduct further work in terms of investor transparency at the current time, but will review this should the situation change.

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

3.22 The vast majority of respondents to this question considered that the chapter provided an accurate description of current practices in the private equity market. No respondent fundamentally disagreed with our analysis, nor suggested that we had omitted any significant area. We received some useful non-material comments on specific detailed points.

Our response: We do not propose to re-publish Chapter 3 of the DP on the basis of the specific non-material comments received, but will factor them into future analysis. We acknowledge that this chapter provides a good description of current market practice. We will continue to monitor developments in market practices as the industry evolves to ensure our understanding of the market, and the risks it presents, remains up to date.

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?

3.23 There was a limited response to this question as the bulk of interlocutors chose to address the initial part of this query via a detailed response to Question 1. Therefore, any comments on the detailed description of the seven risks previously identified in the DP have been incorporated into the response to Question 1 above.

3.24 In terms of risks that had not been identified in the DP, a few respondents asked whether the debate should be widened to incorporate the economic impact of private equity markets within the UK. Specific topics raised included taxation, disclosure to wider stakeholders, employee rights, stakeholder protection and legislation.

3.25 One respondent asked us to consider a risk relating to ‘allegations of asset stripping’, the process of buying a firm and selling off its component parts for profit. The respondent did, however, note that this was not a common feature of the industry.

Our response: We note that the large majority of respondents to this question agreed we had identified the correct range of risks to our statutory objectives in the DP. Our response on each of these seven risks has been outlined under Question 1 above.

As outlined in Chapter 2, we necessarily focus our work on risks to our statutory objectives in order to determine the appropriate level and form of regulatory engagement with the private equity sector. In our view, none of the small number of additional issues raised pose specific risk to our statutory objectives and require further evaluation or mitigation work at the current time.

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?

3.26 Respondents were supportive of us collecting committed capital data from private equity firms and identified it as a key set of data. There was broad agreement that committed capital information was the most important indicator of a private equity firm's potential market impact.

3.27 The consensus view of respondents was that producing and reporting committed capital was unlikely to impose any significant additional costs on private equity firms as they typically hold this information in an easily reportable form.

Our response: We intend to move to collecting committed capital data from private equity firms, initially under the current reporting structure and then via our Integrated Regulatory Reporting (IRR) programme. This will not affect reporting for fees purposes. We will make firms aware of the necessary changes to their regulatory reporting requirements at the appropriate time.

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?

3.28 This question elicited strong support from respondents for the survey to be conducted regularly. It was generally agreed that exposures to leveraged buyouts represented an important dataset, and that the survey would improve our collaboration with industry in ensuring appropriate prudence and control in this area.

3.29 There were no explicit statements of the costs involved, but some participants suggested ways in which the original survey could be improved to make it less time-consuming.

3.30 Finally, two respondents said the output from the last survey suggested that participants might have interpreted certain areas inconsistently. There was a call for firmer guidance around the questions in order to standardise responses in the future.

Our response: We agree with respondents that a regular survey would be a valuable exercise, and in line with the perceived importance of the data set we propose to conduct the survey semi-annually. We will communicate further information to participants before the next survey, which we currently plan to take place in the first quarter of 2008.

We welcome the offers a number of firms made to help ensure the survey is structured in the most efficient way, and to address the issue of firmer guidance. We will work with participants to refine the next survey and outline the list of required data in a timely manner to enable firms to plan accordingly.

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?

3.31 Approximately half of all respondents commented on this specific question; most of whom supported us conducting a fact-finding initiative in this area. We also incorporate relevant responses to Question 1 under this section. Three relevant risks were highlighted by respondents for our consideration:

- Covenants – Several respondents highlighted the relative weakening of covenant protection on recent issuance. Covenant breaches alert investors that a company is potentially entering financial distress and can trigger refinancing negotiations. Specific mention was given to the advent of 'covenant-lite' packages in the leveraged loan market as an example of the lowering of investor protection. It was widely commented that excess liquidity in recent times has driven market participants to increasingly accept lower levels of protection on their investments.
- Unclear ownership of economic risk – Many respondents commented on the increased diversity of debt ownership within the market. Much of the comment reiterated the structure of this risk, as outlined in the DP. Diverse ownership was seen as a positive factor in reducing individual exposure to default, and hence systemic risk. However, it was noted that a negative impact would be the increased complexity of managing a corporate restructuring, or default workout, involving a large number and variety of investors. Indeed, several respondents saw the difficulty in identifying who the true investors are, in order to involve them in a restructuring process, as a key risk. Some respondents also noted that the changing profile of investors, from traditional lending banks to newer participants such as hedge and distressed debt funds, created additional risk. Respondents questioned whether these types of investors, who were less motivated to manage long-term relationships with issuers, would be incentivised to successfully rescue a corporate firm. It was expressed that such investors may be motivated to push for a short-term strategy which would maximise their returns but act against the long-term sustainability of the underlying firm. This was seen, by several respondents, as an issue for the ownership of the company concerned, and not necessarily the FSA. In light of these issues, a small number of respondents called for us to specifically review the 'London Approach' to

verify its applicability in the current market. Some also called for us to consider acting as a facilitator in restructuring negotiations by performing a similar role to that of the Bank of England in previous years. These respondents felt an independent facilitator would help ensure an appropriate and fair process.

- The impact of credit derivatives – A few respondents commented that the increased volume of credit derivatives trading, including on leveraged loans, creates risk to the restructuring and workout process. Firstly, risk associated with settlement was mentioned. Often derivatives volumes can far outstrip that of the underlying assets, and concerns were raised that this would prevent an efficient and orderly settlement of credit derivatives positions. Secondly, respondents questioned whether owners of credit derivatives hedges, who are not required to declare these positions in a credit committee, would be incentivised to push an otherwise viable company into default.

Our response: During early 2007, we conducted initial fact-finding through meetings with Trade Associations and other organisations experienced in corporate restructuring and workout scenarios. This has highlighted a number of areas on which we will be conducting further analysis and evaluation work to determine whether further regulatory focus is warranted. We will report further on this work in the future, as appropriate.

In terms of the specific risks respondents raised:

- Covenants – The terms of covenant protection result from negotiation between investors and issuers, and are driven by market forces including investor demand, associated competition for investment opportunities and the supply of new issuance available. Currently, we do not propose to take further action in this area, outside of our current supervisory process, though we remain focused on the due diligence and risk management controls employed by lending institutions within debt markets. We believe that ongoing industry initiatives to provide greater understanding of common wording for covenants will prove useful in facilitating the effective flow of information between investors and issuers to the benefit of both.

- Unclear ownership of economic risk – We acknowledged in the DP that opacity as to the true ownership of economic exposure could create complexity and difficulty with respect to corporate restructuring and default workout. We note, however, the work done by the industry in disseminating good practice for such situations. INSOL International's 'Statement of principles for a global approach to multi-creditor workouts'[10] outlines a process which updates the Bank of England's 'London Rules' for the 21st century and provides a comprehensive summary of issues for market participants to consider in corporate restructuring negotiations. However, market developments may continue to challenge the ongoing suitability of this process in the future. We will remain mindful of these issues in the case of corporate distress and assessing whether regulatory action is appropriate in the future. We note that certain respondents asked us to consider acting as a facilitator in specific restructuring negotiations. However, this did not receive widespread support from respondents.

10 http://www.insol.org/statement.htm

- The impact of credit derivatives – We acknowledge the risks raised concerning the implications of the growth in credit derivative volumes on workout and default scenarios. We believe that the industry has already taken significant steps to address these risks, of which market participants should be made aware. In terms of derivatives settlement, we have noted the success of ISDA's cash settlement protocol in providing an effective process for cash settling credit derivative positions in the case of recent US defaults. This was supported by the vast majority of market participants, who signed up to the protocols. We believe that the protocol's application in the European market will provide effective mitigation against the potential mismatch in volumes of derivative contracts versus underlying assets as settlement is made in cash form thus negating the need for a physical transfer of the reference assets. We will watch the development of the leveraged loan credit derivatives market with interest, to observe if similar issues may emerge if volumes grow significantly. We note that ISDA has indicated that its intention is to extend the cash settlement mechanism to loan CDS in the short term. With respect to the complexity that credit derivatives add to a corporate restructuring, INSOL International's booklet entitled 'Credit derivatives in restructuring'[11] provides a comprehensive outline of the relevant issues for participants to consider. We consider both of these initiatives to provide substantive mitigation to the risks raised by respondents.

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?

3.32 As the bulk of responses on the conflicts of interest risk were received under this question, we have combined relevant responses to Q1 and Q7 here.

3.33 Respondents acknowledged the potential for conflicts of interest, but generally considered them to be well recognised within the industry with the risk mitigated by the structure and systems that market participants had in place.

3.34 With regard to conflicts of interest in investment banks and leveraged finance providers, a significant number of responses highlighted our previous work in this area as providing effective mitigation of conflicts risk. This included our thematic review leading to the Dear CEO letter of November 2005[12], the supervisory follow up, and proactive ongoing regulatory oversight.

3.35 Focusing on conflicts in private equity fund structures, respondents raised the effectiveness of contractual agreements in protecting against potential conflicts of interest between the fund manager and investors or between different investors. It was widely countered that relationships were governed by extensive contractual documentation such as Limited Partnership Agreements which provided detailed mechanisms for fully disclosing and resolving such conflicts. Respondents were adamant that this provided for effective mitigation against any conflicts which can arise. They also noted investors were not passive and proactively monitor controls in this regard.

11 http://www.insol.org/derivatives.htm

12 http://www.fsa.gov.uk/pubs/ceo/conflicts_18nov05.pdf

3.36 Some respondents highlighted potential conflicts between general partners and limited partners, particularly around fee structuring. These can arise in the case of fees paid by a private equity firm to its own subsidiary for providing services (e.g. advisory) during a purchase or disinvestment. In these cases, a private equity firm faces a conflict between achieving the best price for these services for the limited partners and maximising the revenues of the firm's advisory arm.

3.37 Other respondents pointed to conflicts which can exist during a management buyout (MBO) where a firm is purchased by its existing management, in many cases with financial backing from a private equity fund. In such cases, the management involved potentially face a conflict between their incentive to purchase the firm at the lowest possible price, and their obligations to achieve the best result for the firm's existing investors or shareholders. These conflicts were, however, acknowledged as a matter for the management of the target company and not the private equity firm. Respondents registered particular concern where the MBO involved a listed firm being taken private as public investors could be impacted.

Our response: We note that respondents believe that conflicts of interest risks are well recognised within the industry, that many of these have been covered by previous thematic work and are generally considered to be effectively mitigated by firm's structures and systems, legal contracts and proactive ongoing supervision work.

Having taken account of the above we nevertheless continue to perceive conflicts of interest as an area of significant risk in the industry, specifically to our objective of market confidence, where vigilance must be maintained. This will remain an area of supervisory focus for all authorised firms involved in private equity markets. We intend to carry out further thematic analysis work in this area, within our alternative investments centre of expertise, focusing on the management of conflicts within private equity firms.

List of non-confidential respondents to DP06/6

Association of British Insurers

Association of Corporate Treasurers

Association of Investment Companies

Bank of England

Blaiklock Associates

British Bankers' Association

British Private Equity and Venture Capital Association

Centre for Management Buy-Out Research

European Private Equity and Venture Capital Association

Ian Clark

Initiative for Private Equity Investment Trusts

Institute of Chartered Accountants in England and Wales

Intermediate Capital Group

Investment Management Association

International Swaps and Derivatives Association

London Investment Banking Association

Mizuho Corporate Bank, Ltd.

MMS Regulatory Solutions

Private Equity Investors Association

SJ Berwin LLP

Transport and General Workers' Union

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