Disclosure and Transparency in Private Equity

Consultation Document July 2007

CONTENTS

PREFACE

1. I was asked at the end of February by the British Venture Capital Association and a group of major private equity firms to undertake a review of the adequacy of disclosure and transparency in private equity with a view to recommending a set of guidelines for conformity by the industry on a voluntary basis. I have been assisted in my work by an advisory group comprising:

Adrian Beecroft	Apax Partners
David Blitzer	Blackstone
Anne Glover	Amadeus
Robin Hall	Cinven
Baroness Hogg	3i Group
Lord Hollick	KKR
William Jackson	Bridgepoint
Dwight Poler	Bain Capital
Sir Mike Rake	KPMG
Rod Selkirk	Hermes

   I have also benefited from contact with a wide range of groups from both within the private equity industry and from other interested parties: a list of these contacts, which will be greatly enlarged during the consultative process, is at Annex A.

2. This is a consultative document that sets out the principles underlying my intended approach to setting guidelines later in the year in the light of responses to this consultative process. An executive summary of main elements is immediately below. Key questions to be addressed are included in the executive summary: further questions are set out in each Section of the review. **The consultation period runs until 9th October and responses should be sent by that date to the secretariat, details of which may be found on the website: www.walkerworkinggroup.com.**

3. Private equity needs to become more open. This review seeks to promote materially greater visibility of private equity, but without eroding its capacity to act as a positive agent of economic change and as a contributor to the UK economy through the concentration of significant cross-border private equity activity in London. The importance of private equity has been recognised and supported by successive governments in the UK. But it has been inadequately explained, and its role and the ingredients in its success are not well understood. This is partly the result of the understandable tendency of many in the industry, who chose not to be in the public eye of the listed sector, to say that "private means private" and to be attentive to confidentiality to the point of secretiveness. It is also the result of very rapid recent growth in a highly competitive industry, which has left many of the main industry participants focussing on winning deals and implementing business strategies in the companies they acquire with little attention to the wider context. Some of this recent growth has been driven by exceptional credit conditions which are at least partly cyclical in nature. Major secular influences are, however, also at work, and it seems

realistic to expect that the industry will continue to grow in both relative and absolute significance both as a key feature of the UK economy but also as a major cross-border business phenomenon.

4. This underscores the importance of measures to reduce the palpable visibility gap and the wider public suspicion of private equity that has come to be associated with it. Private equity enjoys rights of ownership which, in particular given their massive scale, must now be complemented by matching obligations. Unless this challenge is appropriately and urgently addressed, it will impair the significant capacity of private equity to contribute to the UK economy in future. As Paul Myners puts it in his written evidence to the Treasury Select Committee, "private equity is more likely to prosper if the industry has a positive image which will encourage others to invest and deal with it and will not cause alarm to employees, trade unions, suppliers, customers, regulators or legislators".

5. Reference was made at the launch of this review to the importance of proportionality in the guidelines, underscoring that the dramatic growth of private equity and concerns associated with it relate principally to medium and large-scale buyout transactions which are the focus of the analysis and recommendations of this report. The guidelines that flow from it may have some relevance for, but were not specifically designed for, the venture and growth capital parts of private equity business, which are widely respected as a significant source and support for new and growing enterprises and have given rise to little or no public controversy.

6. This review does not encompass tax policy. As far as disclosure and transparency are concerned, this consultative paper envisages material enhancements in particular on the part of larger private equity firms and their portfolio companies, and invites comments. In considering options, it has drawn on many current examples of what may be seen as best practice. The problem is that while best practice in some areas has been achieved by a few firms, many others fall far short. So the need is to reduce this dispersion in performance and to secure wider commitment to best practice standards. The object throughout has been to develop a code and set of guidelines for voluntary compliance, partly as a matter of enlightened self-interest, in particular for larger firms in the industry, but importantly also to meet the interests of a wider group of stakeholders that have been inadequately addressed hitherto. Conformity with the guidelines to be proposed should be on a comply or explain basis, with explanation as a fully available option, carrying no connotation of lack of conformity or failure, where compliance in particular circumstances is judged to be inappropriate.

7. This review does not see the need for and does not recommend any change in existing regulatory or legislative provisions on disclosure in the UK. The guidelines framework approach as described here is particularly apt for an industry whose evolution has involved, and seems likely to continue to involve, relatively rapid change. There will accordingly be a recommendation for a robust review process to ensure that the guidelines are adapted as necessary over time so that they remain effective and relevant in the light of changing conditions and experience.

8. Two other specific areas for reference at the outset are leverage and the position, in terms of their wider accountability and transparency, of at least larger private companies whose ownership does not involve private equity. In respect of leverage, a concern that is widely expressed is that private equity ownership usually entails substantially higher ratios of debt to equity than is found in most listed companies. This report reviews how the level and structure of leverage might be appropriately described and accounted for in the reports and financial statements of companies owned by private equity. The report does not, however, review processes of credit assessment, disclosure and other issues in respect of the initial provision of credit and its subsequent distribution through the capital markets, which are matters for the FSA and other financial supervisors. Nor does the review address reporting by other private companies that are not owned by private equity. But as and when the guidelines for enhanced reporting by private equity portfolio companies come to be adopted, they may increasingly come to be seen and commended as appropriate for adoption more widely by other large private companies.

9. In preparing this consultative document I have benefited very greatly throughout from the help of members of the advisory group, but ultimate responsibility for the approach and conclusions set out here, and also for any inaccuracies, is mine.

David Walker

17th July 2007

A. EXECUTIVE SUMMARY

1. This executive summary describes the broad approach that is envisaged: detailed guidelines will follow after the consultation process is complete. The focus of the review is on the need for greater openness in respect of buyout activity. The guidelines that will emerge from it are not addressed to the venture and growth capital parts of private equity business, which are widely respected as important sources and support for new enterprise and have given rise to neither the visibility gap nor critical concern that have come to be associated with buyouts.

2. A private equity fund with a focus on medium to large-scale acquisition might typically have some 150 limited partners, in sharp contrast with the average of some 150,000 shareholders for a FTSE 100 company in the UK. Reporting by listed companies is aimed principally at the interests of shareholders, a large group holding stock that is traded in public markets. In contrast, the interests of the very much smaller group of ultimate owners in private equity, who hold an illiquid stake in a fund that cannot be traded on a public market, do not in themselves call for public disclosure. This review finds that reporting arrangements between private equity firms (general partners) and investors (limited partners) in private equity funds are generally satisfactory, and few changes are proposed.

3. But reporting by listed companies is also the channel for addressing the legitimate interests in their policies and performance of stakeholder groups such as employees, suppliers and customers, as well as the public interest more widely. These interests have been inadequately informed by the buyout end of private equity. In particular, its rapid recent growth in scale and economic significance has outstripped its recognition of implicit contractual obligations to these constituencies, over and above its explicit contractual relationships. As a result, the industry has come to be seen as needlessly secretive, feeding suspicion and, in some quarters, close to hostility. Much of the concern is exaggerated and risks obscuring the significantly positive economic contribution made by private equity.

4. There is thus a major transparency and accountability gap to be filled. The need is to identify the areas and reporting channels through which this can be done. But this does not call for the full array of obligations now imposed on listed companies, resistance to the burden of which appears to be a material influence in the growth of public to private buyout activity.

5. This need for greater openness and explanation cannot be met through any one channel, but calls for initiative and adaptation by three separate but related groups, namely:

   - **private equity portfolio companies**
   - **the general partners who manage private equity funds**
   - **the representative industry association.**

6. The approach envisaged for conformity with the **voluntary guidelines** is on a **comply or explain** basis in the expectation that buyout firms and portfolio

companies will generally conform, with the added discipline, especially in the present environment, of external scrutiny by unions, politicians and the media, all of which can be confidently expected to play a part in seeking and smoking out explanation for any divergence from the guidelines. No other monitoring process is therefore proposed.

7. It is proposed that **portfolio companies** that were: formerly listed as FTSE 250 companies or where the equity consideration on acquisition exceeded £300 million or where the company has more than 1000 employees and an enterprise value in excess of £500 million should report to an enhanced standard beyond that required in the 2006 companies legislation.

   Views are invited as to whether these are the appropriate thresholds for enhanced reporting by portfolio companies.

   The main ingredients of such enhanced reporting would be:

   - filing of the annual report and financial statements on a company website within 4 months of the year-end as against the 9 months currently provided in companies legislation
   - the report to provide detail on the composition of the board, indicating separately executives of the company, board members who are executives of the general partner or fund and directors brought in from outside to add relevant industry or other experience
   - the narrative in the statements by the Chairman or CEO and in the board's operating review to refer to the company's values and approach to its reputation, with specific reference to employees, customers and suppliers and, as appropriate, the company's role in the wider community
   - financial reporting to cover balance sheet management, including links to the financial statements to describe the level, structure and conditionality of debt
   - there should be a short interim statement not more than 2 months after the mid-year, but no requirement is envisaged for publication of quarterly earnings statements.

   Views are invited as to whether these are the appropriate ingredients in enhanced reporting by portfolio companies.

8. Such enhanced reporting is intended to apply to operating companies owned by private equity: standards for reporting by other private companies are outside the scope of this review, but the approach developed here may increasingly be seen as at least a benchmark for other large private companies.

   Does the prospective imbalance in reporting obligations as between private equity portfolio companies and other large private companies give rise to public policy or other concern? And, if so, how should this be addressed?

9. The guidelines will include a provision as to the approach that should be taken by the general partners or fund in a situation in which a portfolio company encounters severe business difficulty that threatens its survival. Generalisation is difficult because the circumstances of such (hopefully rare) situations will differ. But the proposal is for commitment by general partners that they would see it as their responsibility to assist in the transition to management by a creditor group as smoothly as possible along the lines provided in the Statement of Principles of INSOL (International Federation of Insolvency Professionals) on multi-creditor workouts.

10. **General partners** should publish an annual review, accessible on their website, which should become an important channel of communication on the values that inform their approach to business and the governance of their portfolio companies. This general communication should include:

    - an indication of the leadership team of the management company, identifying the most senior members of the general partner team or general partner advisory group
    - a commitment to conform to the proposed guidelines on a comply or explain basis
    - under the rubric of the values of the private equity firm and the general partners, the philosophy of their approach to employees and the working environment in their portfolio companies, to the handling of conflicts of interest that may arise, and to corporate social responsibility
    - a broad indication of the performance record of their funds, with an attribution analysis to indicate how much of the value enhancement achieved on realisation and in the unrealised portfolio flows from financial structuring, from growth in the earnings multiple in the market in the industry sector, and from their strategic and operational management of the business.
    - a categorisation of the limited partners in their funds, indicating separately UK and overseas sources to include pension funds, insurance companies, corporate investors, funds of funds, banks, government agencies, endowments of academic and other institutions, private individuals and others.

11. Alongside communication through such annual reviews, private equity firms will be expected to be more accessible to specific enquiries from the media and more widely. Confidentiality concerns will constrain responses that can be given in some situations, but the line between openness and secretiveness should be drawn with much greater flexibility than hitherto, especially in respect of large transactions which, in the listed sector, would attract very full public presentation.

    Views are invited as to whether these should be the recommended elements for an annual review and for greater openness on the part of general partners.

12. **Industry-wide initiative and communication:** alongside enhanced reporting by portfolio companies, there is a major role for data collection, aggregation and dissemination on an authoritative industry-wide basis broadly to cover:

- scale of funds raised
- categorisation of limited partners by type and geography
- scale of existing private equity portfolios and of recent buyout activity
- leverage levels and debt structures, indicating the relative significance of covenants (or their absence)
- estimates of levels and changes in employment and new capital investment by portfolio companies
- aggregate performance measures for portfolio companies, including revenue and profit growth
- estimates of aggregate performance measures for funds
- estimates of aggregate fee payments by private equity management companies and by portfolio companies to other financial institutions and for legal, accounting, audit and other advisory services.

All of this calls for substantial amounts of data but not all of it is clearly additive, and judgement will be required to make qualitative overall assessments in some areas, for example in providing an assessment of the overall performance of funds on an aggregate basis and, in another area, given the wide array of definitions of leverage ratios and types of covenant used in the industry. Hence the importance of investing resource in developing an authoritative and respected capability that avoids misleading aggregation of apples and pears and commands confidence within the industry as well as externally.

Views are invited on the coverage of this data agenda and proposal for evidence-based analysis, keeping in mind the need to avoid undue reporting burdens on the industry.

13. The data should be drawn on in high quality evidence-based economic assessment, to be effectively and pro-actively deployed. The overall objective should be to create a centre of excellence for the private equity industry that should come to be seen and respected as such and, would thus make a major contribution to filling the void that currently exists in terms of credibility and authority. This will take time to build, but it is a high priority for the process to start now.

14. Beyond more effective communication, there will be need for the industry's representative body to institute arrangements to keep the proposed guidelines under review so that they can be adapted as priorities and changing circumstances require: a small group of trustees chaired by an independent outsider is envisaged for this purpose.

    Views are sought on the appropriate model for review of the guidelines on a timely, effective and authoritative basis.

15. Given the cross-border nature of private equity, there is a need for pro-active engagement with industry bodies beyond the UK, in particular in Continental Europe and North America, to promote the guidelines put in place in the UK as at least a reference benchmark.

16. All of this will require commitment of substantially increased resource to the industry's representative association, in particular from buyout firms.

17. This report is a consultative document with key issues and questions on which responses are particularly sought summarised here with further questions set out in each Section. **Responses should be addressed to the review website: www.walkerworkinggroup.com. The consultation period will continue until October 9th.**

B. PRIVATE EQUITY: BACKGROUND AND CONTEXT

1. Private equity is the name loosely given to an industry which draws capital into specific funds, managed by management groups, which may be quoted or unquoted. Hitherto, quoted funds or management groups have been rare, but there have been several in the UK, and some US groups have recently sought to list. Private equity groups take stakes, often involving control or full ownership, in companies across a wide array of industries. The industry can be sub-divided into "venture capital", typically invested in technology companies at an early stage of development (and where a group of investors may each take a relatively small stake); "growth capital", typically invested in companies at critical points of expansion (and where an investor may take a stake of perhaps 20% of the equity); and "buyouts", the largest and most high-profile part of the industry (where private equity funds take stakes, commonly involving control or full ownership, in companies whose size has recently increased substantially). The industry has developed on the basis of contractual arrangements between professional investors, the limited partners, and management groups, who are contracted to advise and manage the funds in which they are typically also investors. There is substantial variety in structure, organisation and areas of focus, but private equity firms in buyout business, the principal focus of this review, typically follow a relatively straightforward strategy of investing in, buying, improving and selling companies.

2. The UK is the largest market for private equity outside the United States, with some 200 private equity management companies directly authorised by the FSA and a significant numbers of others who are part of other authorised firms such as investment banks. A private equity firm generally requires FSA authorisation if it conducts a regulated activity (as defined in financial services legislation) in or from the UK, for example the management of investment for a private equity fund. But lines of demarcation based on geography are of limited relevance. Reflecting the cross-border nature of private equity business run from the UK, in the sense that the "mind" of the management in respect of their business in the UK and Continental Europe is UK-based, employment in private equity firms is typically from a wide spread of nationalities. Most of the funding of the largest UK-based private equity firms is raised from limited partners based outside the UK, and a significant share of the investments of such funds is abroad. Of the 20 largest private equity groups in the UK, 79% of new funding in the period 2004-2006 came from outside the UK and only 38% of their investment was in the UK. This means that the evolution of guidelines and standards for the industry has a potentially significant international dimension, to be reviewed later in this report.

3. The core concept and model of private equity originated in the United States and took root in the UK in the late 1970s. The early focus in the UK, and subsequently in Continental Europe, was on investment in new ventures and the provision of growth capital, which is still the principal activity of many of private equity management companies in the UK. But in terms of the scale of transactions, buyout activity, which involves a change in ownership of the target company, is now the largest part of the industry. Most of that activity in terms of the number of transactions involves smaller

and medium-sized companies, but deals involving large companies have recently come to much greater prominence, with some large private equity groups now substantially or wholly disengaged from venture and growth capital activity and mid-market buyouts. The main focus of this review is on these larger transactions and the private equity funds that undertake them, sometimes working in co-operation with other private equity funds in "club" deals.

4. The principal sources of capital for private equity funds are institutional investors, accounting for well over half of total investment in private equity funds, sovereign government funds, endowments and wealthy individuals, often through family offices or investment vehicles for whom investment in private equity complements their allocation to listed equity and other asset classes, and whose participation in a fund is as limited partner. Limited partners share in the risk and benefits of the performance of companies in which the fund invests, but have no active day-to-day involvement in the management of the partnership once their capital is committed to a chosen fund managed by the general partner. They are attracted to private equity by the prospect of risk-adjusted returns that are typically, though not invariably, substantially in excess of those in listed equity markets. The formulation and execution of strategy for a fund is the responsibility of the general partner, for which the general partner receives an annual management fee, commonly 1.5 – 2.5 per cent (tending to vary inversely with the size of the fund) of funds committed, and a share or "carry", commonly 20 per cent, of profits made by the fund as a whole, subject to achievement of a minimum hurdle level of return, commonly of around 8 per cent. General partners are themselves invariably investors in their own new funds through "co-investment", though their proportionate share will typically be small.

5. A private equity fund with a focus on medium to large-scale acquisitions might typically have some 150 limited partners, in sharp contrast with the average of some 150,000 shareholders for a FTSE 100 company in the UK. All UK companies are required under companies legislation to file reports and accounts at Companies House, but required content and detail is less for private companies (including private companies that are not owned by private equity groups) than for those that are listed. Listed companies must also report more frequently and within a shorter timeframe than private companies. The key ingredient in reporting by private equity portfolio companies is that by the general partner to the limited partners. Such reporting is governed by contractual relationship, set in place at the time of the limited partners' commitment to a fund, and normally involves, on a confidential basis, whatever content and frequency of information flow the limited partners may require. The limited partners hold an illiquid asset, their stake in the fund, and since neither it nor the fund's holding in a portfolio company is publicly traded, there need be no inhibition on the information flow to limited partners in respect of which they are "natural" insiders. There is some secondary market activity in limited partner stakes, but it is limited in scale and does not materially detract from the contrast with listed company reporting. The latter is necessarily public, to all shareholders simultaneously, given that their stock is liquid and tradeable in public markets, and is thus subject to substantial regulatory prescription as to both content and timing.

6. Not all private equity investment involves acquisition; it may involve taking a minority stake. Where acquisition is involved, it is through the four main channels of conversion of a listed into a private company; purchase of a subsidiary from another company which might be listed or private; purchase of a private company, possibly from its founders or a family; or a secondary transaction involving purchase from another private equity firm. The fund itself is the source of the equity element in the acquisition of portfolio companies, with the balance of financing, commonly involving substantial leverage, provided through banks and the debt market. A common pattern is for the credit exposure in initial bank participation in the provision of facilities to be substantially distributed to other market participants within a relatively short period after completion of an acquisition.

7. Listed companies typically have much less debt in their balance sheets, but comparisons between listed and private companies based on levels of debt are potentially misleading without analysis of the structure of debt. In the current market environment, leverage in private equity portfolio companies normally involves several layers below senior debt (debt that takes priority over all other debt sold by the issuer) and mezzanine debt (debt that is subordinate to senior debt), with the most subordinated debt involving few if any covenants, and thus higher risk for the lender. The precise composition of the capital structures used by private equity for the companies that they acquire is evolving over time, reflecting changing market conditions and financial innovation. A significant recent development in the structuring of larger transactions is the increasingly common use of non-amortising bullet debt, where no capital repayments will be made for a pre-agreed period, often around 8 years, after which a large payment falls due. Such 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 repayments.

8. There are substantial differences in style, practice and performance among private equity firms and in the characteristics of individual portfolio companies. But there are also important common features. Private equity funds are typically raised with an expected life of around 10 years, a term that is established in the partnership agreement at the outset and thus involves long-term investment commitment to the fund by the limited partners. The limited life of the fund means that the general partner might typically invest the capital committed during the first 5 years, allowing sufficient time to improve the performance of the portfolio companies and to arrange for their divestment before the end of the fund's normal life span. So the expected hold period for an individual portfolio company is normally well below 10 years, and most commonly in the range of 3 to 5 years before the general partner exits, by means of an initial public offering, sale to another private equity firm or to a strategic buyer. The larger private equity firms normally commit substantial resource to buyside research, often involving long periods of focussed research on particular prospects before any acquisition initiative is taken, with research typically concentrated in a limited number of sectors in which they have built industry specialism and expertise. Although the basis for comparison is at best imperfect, and is of only limited public policy interest, it is a relevant contrast with the partial or mistaken view that the

private equity time horizon is invariably short that the average holding period by investors in FTSE 100 stocks is substantially less than 1 year.

9. Successful business selection and financial structuring are typically material elements in the value added for their limited partners by private equity firms, with a combination of favourable stock market conditions (relevant for exit prices) and abundant credit availability giving a significant boost to these elements in private equity performance in the recent past. But a large, and frequently the largest, element has been achieved through introduction of strong management teams to implement a focussed strategy and improved operating efficiency in portfolio companies. A key differentiating feature of private equity is the direct alignment and short chain of communication between the general partner and the executive of the operating company, facilitating proactive and real-time convergence between shareholder interests and management. This contrasts with the attenuation and potential impairment of the agency relationship between owner and manager as a result of the formal structures that have been imposed in listed companies as the means of assuring appropriate accountability to a large group of public shareholders.

10. Despite the significant cross-border dimension, both the scale and the recent growth in private equity activity focussed on UK companies has been very substantial. The data and estimates below are drawn from the BVCA and the Centre for Management Buyout Research (CMBOR) at the University of Nottingham. In the 3-year period 2004-2006, employment in the UK in portfolio companies controlled or wholly owned by private equity rose to 1.2 million, 8% of UK private sector employment; buyouts of UK listed companies, from corporates and secondary transactions (that is, buyouts from other private equity firms) totalled £26 billion in 2006; total private equity investment in the UK totalled £43 billion over the period 2004-2006 and associated leverage might double or treble this equity investment in terms of total enterprise value; and IPOs and strategic sales of portfolio companies acquired earlier totalled £26 billion in this period.

11. This recent growth in private equity involves major features that are still comparatively novel in the UK environment. These include taking listed companies private, leading to a diminution in reporting and governance obligations, as well as the introduction of substantial leverage into the balance sheet of acquired portfolio companies. But the preoccupation of the main private equity firms with identifying opportunities and executing business in a fast-developing and attractive environment has not been matched by comparable attention to the wider public interests and concerns to which these developments have given rise. The questions raised in this report focus on the appropriate weight to be attached to these interests and concerns and how they might be addressed in particular:

    - in enhanced reporting by portfolio companies;
    - in fuller communication by major private equity firms;
    - and through more substantive reporting, interpretation and analysis by and on behalf of the whole private equity industry.

C. REPORTING BY PORTFOLIO COMPANIES

1. All UK companies, listed and private, are required under companies legislation to file financial accounts at Companies House, which can be done electronically, and to make narrative disclosures in their annual reports.* In the case of listed companies, the FSA's listing rules specify that reports and accounts need to be filed no later than 4 months after the company year-end whereas for unlisted companies the provision under companies legislation allows up to 9 months.

2. The 2006 Act specifies matters to which the directors of all companies need to be attentive (Section 172) and specifies a business review (Section 417) (both Sections are reproduced in Annex B) whose purpose is to report to members how the directors have performed their duty to promote the success of the company. Private companies, as well as listed companies, are accordingly required to prepare a review of their business and a description of the principal risks and uncertainties that they face. Consistently with the size and complexity of the company, the review should be a balanced and comprehensive analysis of the development and performance of the company's business during the financial year and its position at the end of that year. These provisions apply to both listed companies and large private companies, but do so with much greater specificity in respect of listed companies. Substantial flexibility remains for large private companies to determine precisely how to conform. The particular provisions in Section 417 that relate exclusively to listed companies call for inclusion in the business review of information about "trends and factors likely to affect the future performance of the company's business", about environmental matters, and the company's employees and social and community issues, to include "information about any policies of the company in relation to those matters and the effectiveness of these policies". How far should provisions such as these be applied to at least the larger private equity portfolio companies? It is for consideration in the context of this review, having regard to the interests of the wider groups to which the legislation refers, whether there is an appropriate intermediate position for private equity portfolio companies that would involve less narrative disclosure than that for listed companies but would go beyond the minimum standard specified for all companies.

3. To be clear and for the avoidance of doubt, these questions (and this Section) do not relate to the interests of limited partners in appropriate disclosure and reporting (see Section E). But the principal reason for this enquiry is that a position that such disclosures and reporting to limited partners, the ultimate owners, is alone sufficient is no longer politically and otherwise sustainable, at least in respect of the largest portfolio companies. At the opposite end of the spectrum – what might be termed the stakeholder position – there is the view that the large portfolio company is a social institution with obligations to all who are affected by its activities. The definition of stakeholder is sometimes drawn narrowly to emphasise those who have contractual relationships with the company (employees, suppliers, customers) but is frequently expanded to embrace local or wider communities in which the company operates. In extreme form, composition of this latter group might include parties that have no commercial involvement with the company at all, though those concerned may have views as to what the company should do and how it should be organised.

* For the purposes of this report, references to companies legislation in the UK are to the requirements under the Companies Act 2006, which comes into force in stages by October 2008.

4. Neither the view that reporting and disclosure in private equity should be to limited partners only nor the extreme stakeholder position would appear to be tenable. The questions accordingly become what are the persuasive arguments for a realistic and moderate version of the stakeholder position and what measures might be appropriate in response. The relevance of these questions has been underscored recently by the increasing diversity in patterns of ownership of large businesses. In the UK in the 1980s and 1990s it appeared that the listed company would soon become essentially the only form of large-scale business organisation as statutory corporations, mutuals and partnerships converted to listed status. But the trend has been reversed latterly, above all by private equity. It is also relevant to signal here that, although the immediate focus of this review is on private equity in the UK, there are important differences of at least nuance between American and European approaches to matters of law and regulation. An American perspective tends to adopt what may be characterised as a unilateral concept, whereas the European approach tends to be more sympathetic to the notion that ownership entails obligations as well as rights. These different assumptions and characteristics in relation to the nature of ownership are associated with different approaches to dispute resolution, with an American disposition to resolve contested issues by reference to texts and documents, and with readiness to litigate, and a European inclination to place greater emphasis on the social context of behaviour or transactions. Firms that operate cross-border, as all of the larger UK-based private equity management companies do, need to be sensitive to these differences.

5. The following four criteria would seem to be the most apt for assessment of the weight to be attached to stakeholder interests beyond those of the limited partner as principal – legitimacy, integrity, other contractual relationships and wider external factors.

6. Under **legitimacy**, in a modern economy business leadership represents the largest concentration of power that is not derived from or accountable to an elected body. In Europe, the social democratic view has historically been that the authority of business leaders needs to be legitimated politically through regulation and direct state control of the most important business activities. One characterisation of European experience in the past two decades is that social democracy in the business sense has been forced into retreat as it became apparent that its preferred business model was inefficient at providing the goods and services that consumer and society wanted. The legitimacy of business authority, in short, has been established by its success in meeting the economic needs of stakeholders, particularly those of consumers. If this analysis is correct, then the source of business legitimacy is economic success, and the means of maintaining the undisturbed authority of business and business leaders is by clear and continuous demonstration of that success. On this approach, the legitimacy of authority, importantly including that of the leaders of private equity, is likely to be easiest to defend in a competitive market – where commercial success and the authority and rewards that go with it are the direct result of demonstrable superiority in meeting consumer needs. In contrast, the defence of such legitimacy is

more difficult where competition is limited or effectively non-existent, which provides the justification for appropriate economic regulation of utilities and of firms that control natural monopolies in the field of infrastructure.

7. The **integrity** of the conduct of business controlled by private equity is, in the first instance, the responsibility of the principals, and especially for those who are actively engaged in management. The relevant question here is whether combination of the contracts and the general law are sufficient to ensure that general partner management companies and portfolio companies are run by people of decency and integrity. Two factors suggest that greater assurance might be needed. First, what is meant by decency and integrity is more substantive than conformity with contractual provision or the law: it relates to a set of principles and values that cannot be encapsulated in a detailed set of rules. Second, standards of conduct are contagious, and malpractice in a particular business situation can have a powerful negative effect on general expectations of what is and what is not normal business conduct and weaken the legitimacy of corporate structures as a whole. On the positive side, the promotion and demonstrable achievement of high standards of behaviour in all portfolio companies, extending beyond compliance with the law, should be powerfully supportive of private equity as a whole.

8. Apart from the contract between general partner and the limited partners, the private equity industry has, directly and indirectly, a wide array of **other contractual relationships**. Those with employees and suppliers are clearly partly explicit, for example, the contracts of employment or contractual terms of trade credit maintained by a portfolio company. But there are also important implicit contractual relationships, for example with employees who believe that the company is a good one in which to work, and with suppliers who value the continuity and depth of their relationship with the company. Such contractual relationships are implicit partly because explicit contracts cannot be sufficiently wide-ranging or anticipate every possible relevant contingency, and because the nature of the behaviour and relationships expected is often defined by the context rather than by the contract. It follows that the effective mechanism of enforcement of such implicit contracts is not legal process, but the requirements of the parties to go on doing business together. Of special importance in this context is that the increase in leverage commonly involved in a public to private transaction is likely to involve some increase in risk for wider stakeholder groups, above all employees and suppliers, which underscores the importance of attentiveness to the implicit social contracts between a portfolio company and these groups. This does not of course mean that implicit contracts are merely what all stakeholders would like them to be. For example, the existence of implicit contractual commitments does not mean that jobs cannot be cut where this is necessary to continuing viability of a business. But it does mean that reasonable expectations as to behaviour in matters such as appropriate communication, including its style and timeliness, should not be disappointed. Part of the concern that gave rise to this review is a sense, rightly or wrongly, that some private equity portfolio companies may have acted in relation to employees in violation of such

implicit contracts which, despite being implicit, are nonetheless regarded as real and substantive, with reliance reasonably placed upon them.

9. Under the rubric of **wider external factors**, other relationships for general partners and portfolio companies do not involve either explicit or implicit contracts in the sense discussed above. Those that relate to matters such as health, safety and pollution are extensively covered by regulation. But the wider agenda of what may be loosely defined as external effects is now generally characterised as corporate social responsibility (CSR). The CSR agenda has in some cases become the focus for critics of business whose interest in the commercial performance of a firm maybe less than a political agenda. But CSR has been adopted by many corporates, both listed and private equity portfolio companies partly for perceived business advantage, for example in improving the perception of brand by customers and motivation of employees.

   Does analysis of underlying principles on these lines provide the right approach? What other principles or criteria might be proposed as relevant?

10. If analysis of underlying principles on broadly these lines is accepted, what are the implications for reporting and disclosure by private equity portfolio companies? The widespread and justified perception that private equity is insufficiently transparent feeds suspicion that its success is not of a kind that gives it legitimacy in the sense described above. There are also associated doubts about some aspects of its integrity, for example in the perception of "asset stripping" to the detriment of employees, suppliers and potentially other stakeholders, and that private equity is insensitive to the implicit contractual obligations that are seen to be more fully and dependably observed by listed companies – though this is probably not invariably the case in practice. In broad terms, the response would appear to lie in more effective display of the business activity and performance that gives it legitimacy, in emphasis on the integrity of the business and of those responsible for directing it, and in underscoring the board's attentiveness to the conventions embodied in implicit contracts as described above and to matters of social responsibility.

11. As a point of reference, it should be noted that, over and above the formal and explicit reporting obligations of listed companies, a set of associated reporting obligations has evolved over the last decade in the UK in some degree as an unintended consequence of reporting to address the core objectives of investor interest and the fair and efficient functioning of the market. These obligations are generally implicit and non-contractual but, nonetheless, have become an important part of the generally accepted public accountability of listed companies. They relate to stakeholder interests as discussed above, prominently including employees, customers and suppliers. The fact that these interests are non-contractual and implicit, does not mean that they are not real, and they are indeed now to some degree formalised under the 2006 companies legislation. This growing stakeholder attentiveness to the way in which companies do business, including their approach to environmental issues and the way that they engage with employees, is extending to private equity portfolio companies and seems bound to grow further. But as indicated earlier, the

legislation still leaves substantial flexibility for non-listed companies, and the approach should thus be to identify appropriate enhancements in reporting requirements on the voluntary guidelines basis envisaged in this review.

12. Two important markers relate to executive remuneration and to timing issues. On remuneration, despite frequently intense media and political interest in remuneration policies and practices, in respect of both general partners and the executive board in portfolio companies, these are substantially matters for the investors, that is, limited partners. Remuneration policy issues relate to the balance between ensuring appropriate incentivisation of management and ensuring that owners are not disadvantaged through the installation of excessive remuneration arrangements. Provision for ensuring such balance and reporting on it is built into contractual arrangements between general partners and limited partners under the formulae for the management fee and the "carry" percentage. None of the stakeholder interests in private equity discussed above would to appear to warrant the institution of public reporting obligations on remuneration as in listed companies, for whom full disclosure is the only effective means of communicating with their shareholders and of providing them with reassurance that remuneration structures for the managements of the companies in which they are invested are appropriate. Put in other terms, it is important to differentiate between the information needs of investors (in private equity, the limited partners) who require information on remuneration and other matters to exercise their ownership function and those of stakeholders, who need information for general or some other particular interest – for example, in a values statement or broad indication of a company's future plans. These information thresholds are altogether different.

13. On timing issues, it would seem appropriate to shorten the period for filing of annual reports and accounts of large private equity portfolio companies from the 9 months currently permitted under the new companies legislation for private companies to the same period of 4 months required for listed companies. For a portfolio company that was previously listed, this will entail no additional scheduling pressure on reporting at the time of transition of ownership, and this reporting timetable will in any event apply in due course where the chosen exit strategy for a portfolio company is by means of an IPO. But, still under the rubric of timing, while the practice of quarterly reporting of earnings is widely seen as necessary to keep both investors and the market in listed companies adequately informed on a regular basis, it is also regarded as impairing, on occasion, the ability of boards to focus undistracted on the improvement of business performance and strategy. Given that limited partners are in a position to stay abreast, through regular exchange with general partners, of developments in their portfolio companies, there is no ownership interest reason to impose quarterly reporting obligations on a public basis on private equity portfolio companies. As indicated, keeping the equity market informed is the concern that underpins quarterly reporting by listed companies: but this consideration plainly does not apply (except in respect of any market reporting obligations on publicly-held debt) in the case of private companies. Accordingly, this report makes no proposal for

quarterly reporting by private equity portfolio companies. This would be an incubus that need not and should not be imposed on private equity.

14. The interests of limited partners in their portfolio companies are met under the reporting obligations established contractually at the outset with the general partner. But employees and other stakeholders such as suppliers, without access to any other regular information on the business, have a continuing and reasonable interest in the state of the business which would be satisfied by some form of interim report on development of the company in which they are engaged. Meeting such reasonable interest would not call for the degree of detail normal in listed company interim statements, but could be a vehicle for reporting on key elements in development of the business in particular in respect of growth, employment and investment. As envisaged here, such interim reports would not need to include detailed financial information nor to be audited, but might take the form of a basically narrative statement by the chairman, CEO or board made available on the company website and possibly also in hard copy form as part of regular internal communication with employees.

15. As indicated in the previous section, the principal focus of this review is on large buyout transactions and the private equity funds that undertake them. For the purposes of the enhanced reporting guidelines for portfolio companies as broadly described below, some arbitrariness as to the qualifying threshold is inevitable. Views will be sought in the context of this consultation but, as a broad indication, it is envisaged that enhanced reporting would be applicable to any portfolio company that was previously a FTSE-250 listed company, or where the equity injection by the general partner (or by several private equity funds together) exceeds £300 million or where the company has more than 1,000 employees and an enterprise value in excess of £500 million. Given the emergence of private equity as an increasingly significant asset class for the professional investment community, it would seem appropriate for conformity with these guidelines to be encouraged even in buyout situations where these fall somewhat below the threshold levels envisaged here. The comply or explain approach would enable a board in any such situation to explain if full compliance appeared inappropriate or disproportionate in terms of cost.

    Views are invited as to whether these are the appropriate thresholds for enhanced reporting by portfolio companies.

16. Within the broad framework outlined above, guidelines for annual reporting by portfolio companies would include the following ingredients, already achieved by some portfolio companies, implying a need to promote wider observance of existing good or best practice rather than to create wholly novel new obligations. In what follows, much more weight is placed on enhanced narrative reporting than on financial reporting, save in respect of debt and debt structure, and could be presented either as a short-form annual review or contained within the company's annual report and accounts as filed at Companies House. None of these suggested enhancements is intended to set a bar for reporting or for detail in financial statements going beyond that for listed companies:

- The report to give detail on the composition of the board, identifying separately executives of the company, directors who are executives of the general partner or fund and directors bought in from outside to add relevant industry or other experience
- Chairman's and CEO's statements to include reference to company values, embracing reputation and brand and specifically covering the company's attentiveness to the interests of employees, including a commitment to effective communication, as also to customers, suppliers and, as appropriate, the company's role in the wider community
- Chairman's and CEO's statements covering performance and, within commercial confidentiality constraints, strategy including investment plans and innovation
- A CEO or CFO report to cover balance sheet management including the level, structure, restrictions and conditionality of debt – with links to appropriate detail in the footnotes to the balance sheet and cash flow section of the financial statements
- Audited reports and accounts filed at Companies House within 4 months of the year-end and either the full report and accounts or a short-term report to be made freely available simultaneously on the company's website, any short-form report to include appropriate reference to the scale and structure of leverage.
- An interim statement to be published on the company's website to report in largely narrative format on main elements in first-half performance within 2 months of mid-year, possibly also made available to employees in hard copy format.

Views are invited as to whether these are the appropriate ingredients in enhanced reporting by portfolio companies.

17. Currently portfolio company boards have unequivocally clear accountability to the general partner as advisor to or manager of the fund that is their shareholder and an obligation to file their reports and financial statements in accordance with the requirements of companies legislation. The previous discussion envisages that, as the signal of their acceptance of implicit but, nonetheless, substantive obligations in respect of a broader group of constituencies, portfolio company boards should commit to fuller narrative reporting and financial statements. Some private equity portfolio companies already report in line with this higher standard but, for others, conformity with the guidelines that are envisaged will involve some material enhancement in their reporting. But the ability of private equity to continue to concentrate effectively on its core purposes and deliver superior returns on a sustainable basis will be increased rather than diminished if the industry can demonstrate and command confidence that, in the way it conducts its business, it is sensitive and attentive to these other legitimate interests. Fuller reporting in a chairman's statement, in the directors' report and in financial statements will provide a major and, probably in some cases, the principal ingredient.

18. External confidence in the conduct of the business could also be materially boosted by awareness that a portfolio company board has some explicit process not only for the purpose of signing off appropriate narrative in the report and accounts but also to ensure that these wider responsibilities are balanced (as indeed the new companies legislation requires them to be) on a continuing real-time basis alongside the continuing accountability to the general partner to deliver value; and that composition of the board demonstrates experience and capability in this respect. This has special relevance at a time of significant change, for example when a portfolio company is rolling out a new strategic initiative which could involve downsizing or expansion, when proactive and effective communication with employees and others will be more important than ever. Recent experience has been variable but it would seem that some cases have involved communication on timing and content to an inadequate standard. The guidelines will call for improvement in this respect so that high standards are achieved across the board.

D. AGENCY AND THE ALIGNMENT OF INTERESTS

1. The agency problem relates to the challenge of ensuring that the interests of the owner are effectively aligned with the interests of the manager of the business. As indicated above, alignment is achieved in private equity through control exercised by the general partner over the appointment of the executive and in setting and overseeing implementation of the strategy of a portfolio company. Lines of communication are short and direct, with effectively no layers to insulate or dilute conductivity between the general partner and the portfolio company executive team. An important element in giving force to such alignment is incentivisation of the executive team to promote the objectives of the general partner in turning a company round or accomplishing some other strategic objective. This direct alignment between shareholder and executive minimises, and may substantially eliminate, agency tension in private equity.

2. The position of the listed company is in sharp contrast. A combination of the provisions of companies legislation, listing requirements and the combined code in respect of corporate governance sets a complex set of obligations with which the listed company has to conform. These requirements for listed companies are geared principally to two major public policy objectives: investor protection and the integrity and efficiency of the listed equity market. The first of these is not directly relevant for private equity, where the obligation of the general partner is governed by contractual agreement with a group of professional investors, that is, the limited partners. Considerations as to the integrity and efficiency of the listed market become directly and specifically relevant for private equity only as the exit strategy evolves, and where creation of a board structure akin to that of a listed company will be an important element in preparation for an IPO where that is the chosen exit. Alongside and partly reflecting the main differences described above in the weight and priority of public policy objectives between listed and unlisted companies (including "other" private companies alongside private equity-owned private companies), the burden of the governance obligations specified for listed companies, to meet these objectives, appears to be an important element in the private equity case for conversion from listed to private status. Concerns expressed are that the sheer complexity, weight of detail and perceived inflexibility of governance and related requirements for listed companies, despite the comply or explain approach of the combined code, impair the capacity of the board, including the executive team, to focus on the running and strategic direction of a company with the speed and adaptability that many areas of business currently require. Combination of the priority attached to these governance requirements and the instruments adopted to achieve them involve sizeable opportunity cost for listed companies that private equity is able to avoid. It is able to do so by virtue of the clear and direct alignment of interest between general partner and the portfolio company executive team, uncluttered by governance layers and reporting structures. This freedom is one of the most distinctive characteristics and strengths of private equity.

3. In their decision to invest in a private equity fund, the limited partners have deliberately chosen to go for the model of direct and undiluted alignment from general partner to the portfolio company executive team. They do not seek, and indeed implicitly reject, the insulation for shareholder interests that is provided through all the appurtenances of the listed company. This highlights the difference from the listed company situation and, in particular, that the required corporate governance structure, prominently including the independence of non-executive directors, is not only unnecessary in private equity but could risk impeding precisely the direct effectiveness in accountability to the shareholder that private equity seeks to achieve. To reiterate, the main driver of reforms in corporate governance of listed companies has been to re-emphasise the role of the board as guardian of shareholder interests. But the private equity model has no material deficiency in this respect and, as seen above, the reforms in corporate governance seen to be appropriate for listed companies have in some respects boosted the attractiveness of private equity.

4. It is thus clear that an important secular influence in the recent development of private equity is the preference of talented executives to work in a business environment without many of the formal constraints of the listed sector. At one level, this might be seen as a form of regulatory arbitrage, but it would be mistaken to conclude from this that private equity generates economic outcomes that are inferior to or sub-optimal compared with those in listed companies. Balance sheet structuring is a topical example. While critical focus tends to be on high levels of leverage in private equity, a balanced overall assessment would not necessarily take the much lower levels of leverage in the listed sector as an appropriate benchmark. This lower leverage and, as an additional example, the apparent readiness of boards of listed companies to recommend cash bids from private equity, might instead be regarded as demonstrating a greater degree of risk aversion among managers of listed companies and their boards than that of their owners, many of whom are limited partners in private equity. Any such difference between the risk appetite of investors and that of the boards and managers in listed corporates would be an important manifestation of the agency problem. But neither the listed company model nor the private equity model has any intrinsic overall superiority and in a flexible enterprise economy they should constructively co-exist.

5. In private equity, general partners are able to take a view on the potential contribution of an outside board member untrammelled by any statutory or regulatory obligation as to board composition. Specifically it is for the general partner, with input from the portfolio company executive team, to decide how far the efficient development of the business might be boosted by or, indeed, depend critically on, input from an experienced "outside" board participant. He (or she) might typically be a chairman, who, though not formally part of the general partner or portfolio company executive team, is able to participate and prospectively benefit from in the alignment of interest in enhanced performance described earlier. Such appointments appear to be increasingly common (though by no means standard) in larger portfolio companies. They do not however involve "independence" in the sense of the combined code, in

particular because an "outside" director on a private equity portfolio company board will normally participate in a remuneration structure related to performance and will be directly representative, alongside the executive team, of the major or sole shareholder. Put in other terms, whereas reforms in the listed company model emphasise the independence of the non-executive director, the private equity model underscores the full engagement of the "outside" director with the general partner's strategy and its execution and his (or her) core role is thus dependent on that strategy. In what follows, the term "outside" director is used exclusively to mean a board member who, though not part of the executive board team of a portfolio company, is appointed by the general partner and is fully engaged in and committed to the strategy put in place by the general partner.

6. Although the alignment challenge is much less for private equity than for the board of at any rate most listed companies, boards of private companies are not absolved from the wider accountabilities described in the company law review process (before the 2006 legislation reached the statute book) as "enlightened shareholder value". It should be noted in particular that, under the 2006 companies legislation, all directors, of listed and private companies alike, are called upon to act with reasonable care, skill and diligence, to avoid conflicts of interest, and to promote the success of the company for the benefit of its members as a whole. In discharging this latter duty, the law requires the director to have regard (among other matters) to:

   - the likely consequences of any decision in the long term;
   - the interests of the company's employees;
   - the need to foster the company's business relationships with suppliers, customers and others;
   - the impact of the company's operations on the community and the environment;
   - the desirability of the company maintaining a reputation for high standards of business conduct;
   - the need to act fairly as between the members of the company.

   If a company reaches a point where it has no reasonable prospect of avoiding an insolvent liquidation, and the director is aware (or should be aware), then the director is subject to an overriding duty to take steps to minimise the potential loss to the company's creditors.

7. Neither conformity with the enhanced reporting framework as described in the previous Section nor attentiveness to the wider stakeholder interests now described in companies legislation require any particular board composition or governance structure in a private equity portfolio company. A board exclusively comprised of executives and employees of the general partner could plainly comply, and some private equity portfolio companies are already achieving standards at or close to them. But the sum total of the responsibilities of a director of any UK company is now very substantial. In addition to the requirements under companies legislation, specific duties and obligations are imposed on a director under a wide array of other statutes

and regulations, some of which involve personal liability as in respect of health and safety, the environment and creditor protection. Given this array of responsibilities and the judgment that is needed to achieve balance in respect of many of them, a suitably experienced outside board member will potentially be in a position to make an important contribution, both substantively and in enhancing the external credibility of the board process.

8. One specific role to which an outside board member may be particularly appropriate is that of chairmanship of the audit committee which, alongside the statutory audit, encapsulates the board's oversight of internal controls and the risk assessment and management process. Effective board level oversight of these functions is plainly in the interest of the general partner as a means of minimising risk that its company might be knocked off course by avoidable internal or external shock. Where the audit committee is chaired by an experienced outsider with, inevitably, a greater degree of detachment from day to day operations than can be available to an executive board member, his (or her) ability to question or challenge the executive team may create a useful discipline and, potentially, constructive tension for the board. Wider stakeholder groups plainly also have an interest in effective management in the areas in which the audit committee has oversight, reinforcing to some degree the case for a degree of detachment in chairmanship of such a committee. An outside contribution might also be of special relevance in a business situation, for example in an infrastructure company, where substantial value could be added by appointment of a senior board member or chairman with solid experience of interface with government or an economic regulator.

9. Appraisal of the potential business value of an outside director's contribution is ultimately for determination by the general partner, with specific reference to operational and strategic objectives. There may and desirably should commonly be congruence between these and the wider stakeholder interests discussed above. This appears to be reflected in the increasing practice of general partners in appointing outsiders with substantial boardroom experience as chairmen of their portfolio companies. Ideally, the qualities for such an outsider should include, alongside experience elsewhere, a reputation for integrity that he (or she) will be concerned to safeguard and which will command respect externally, even though it is expected or known that, as a matter of private equity convention, the individual participates in an incentive structure related to performance.

10. The challenge will, however, often be the difficulty of identifying suitable individuals for such a role. Little purpose would be achieved by nominal appointments to a portfolio company board (in box-ticking compliance) where the individual concerned is unlikely to be able to make an effective contribution and could indeed be a source of unconstructive tension. In this situation, this review does not envisage any specific prescription as to board composition in private equity portfolio companies, and leaves flexibility for general partners to determine how to balance the interests of owners with appropriate attentiveness on the part of the board to the interests of the wider group of stakeholders in a portfolio company. The critical need is for clear indication

by both general partners and portfolio company boards as to how they address the need to be attentive to these wider concerns. Hence the proposal in Section C above that reports and accounts of large portfolio companies should not only incorporate substantially enhanced narrative reporting but also detail on the background and capabilities of the board, identifying separately executives of the company, directors who are executives of the general partner and directors brought in from the outside to add relevant industry or other experience.

Views are sought on the conclusion here that it would be inappropriate to set any blueprint for the composition of boards of portfolio companies, but that it will be important for annual reports to describe the experience and capabilities of the board, in particular in respect of its responsibilities to wider stakeholder groups.

E. REPORTING TO LIMITED PARTNERS

1. Limited partners are professional investors investing in private equity on the basis of partnership agreements with the general partners of private equity funds. The limited partner's interest is in the performance of the fund, and the partnership agreement invariably includes provision for regular reporting on the performance of the fund portfolio, in particular of operating companies within it in which the fund is the shareholder. The extent and frequency of such reporting is a matter for negotiation between limited partner and general partner in the context of the initial partnership agreement, but often includes provision for more continuous information flow or ad hoc briefing of limited partners if they seek it. The substantive content and frequency of communication between general partner and limited partner is typically much greater than that between a listed company and its shareholders, in large part because limited partners are committed as insiders and there is no public market for trading in the illiquid asset which is the share of the fund held by the limited partner.

2. When raising a new fund, a general partner will prepare a marketing document that sets out the performance of previous funds and proposals for the new fund. Limited partners are professional investors, some with fiduciary responsibilities to, for example, members of a pension fund, and typically conduct extensive due diligence ahead of any investment commitment to a new fund. Given that private equity funds typically have a life of 10 years, with only very limited opportunity for exit by a limited partner within the life of the fund, settlement on the terms of the limited partnership agreement is of critical importance at the outset and includes, in particular, specific provision in respect of information flow, the entitlement of the general partner through the management fee and carry provision and arrangements for consultation with limited partners in respect of any conflict of interest. As a minimum, contractual reporting provisions comprise annual audited fund accounts and commonly, but not invariably, quarterly reporting on the value of the portfolio. In practice, as indicated above, the communication from general partner to limited partner often goes far beyond the conventional minimum where the limited partner seeks a more continuous flow of intelligence. Guidelines on reporting form, content and frequency have been published by the European Venture Capital Association (EVCA) and are now widely observed: it is proposed that observance of these guidelines as a minimum standard should be a specific recommendation of this review. For those interested, these guidelines are accessible through the review website.

3. In discussions in the context of this review and an informal survey of a large number of the principal investors in private equity, the clear sense is that, in practice, limited partners are generally satisfied with overall information flow. Indeed, if this were not so they are likely to be in a position to seek adjustment to meet their needs more fully. In general, limited partners are much better informed about the position and performance of companies in the portfolio of funds in which they have invested than most investors in companies that are listed. The normal pattern is for limited partner agreements to include provision for an advisory committee of limited partners which provides a forum for consultation between the general partner and limited partners on, for example, any conflict of interest issue and, more widely, to convey views to the

general partner on other issues if these give rise to general concern among the limited partner group. These advisory arrangements appear to work well as an informal buttress, available in the event of need, to the close bilateral relationships that normally exist between limited partners an the general partner.

Views are sought from limited partners as to whether timeliness and content of information made available to them by general partners is sufficient, and to identify any deficiencies.

4. There are, however, three areas in the relationship between general partner and limited partner that call for special focus, relating to confidentiality, related party transactions and valuation. The stake of the limited partner is directly in the fund, and the general partner has substantial obligations of accountability to the limited partners. Whereas there are substantial wider stakeholder interests in the portfolio companies of a fund, with reporting standards and guidelines appropriate to them as described and proposed earlier, there is no comparable wider stakeholder interest (except possibly in the identity of its major limited partners, see below) in a fund which, in particular, does not have employees or suppliers in any way comparable to those in an operating company in which it is the sole or a major shareholder. In this situation, there seems no reason to disturb the confidentiality which generally governs the relationship and information flow between general partner and limited partner. Indeed, where this has been disturbed, as under freedom of information provisions in the USA and UK which may create access to information held by public sector bodies (such as public sector pension funds) that may have invested in private equity, an unintended consequence has been some restriction in the otherwise open relationship between general and limited partner. Such restrictiveness might apply to information that could be made available to a limited partner on a confidential basis but which, if it were in the public domain, might impair the competitive position of a portfolio company and would not therefore be made available to limited partners from the public sector. There have reportedly been instances in the United States where general partners have declined to accept participation in a new fund by public sector pension funds to which freedom of information provisions relate.

5. Limited partners have a clear interest in the financial entitlements of the general partner because the cost is effectively deducted from the return that accrues to them, and provision in this respect is invariably a key ingredient in the limited partnership agreement. It is for the limited partner to reach a view on the appropriateness of any particular provision for carry and for compensation of the general partner, set alongside the business dynamic of the enthusiasm of the general partner to raise a fund and of the limited partner to participate in it. These are effectively the terms of trade of private equity between principals, and the recurrent public curiosity about these arrangements does not appear to warrant or validate disturbance of their confidentiality if the principals involved wish to keep them private. Similar considerations would seem to apply in relation to reporting to limited partners on the performance of the individual funds in which they are invested. General partners may wish, as a business matter, to refer to the returns that they have realised through successful exits in the context of their generic communication but, in particular given

the extent of enhanced reporting and disclosure envisaged here on the part of their portfolio companies, there seems no clear basis for setting detailed public disclosure here of individual fund performance as a guideline requirement on public interest or similar grounds. How limited partners report on the private equity performance that they have achieved is a matter for their accountability to their own constituents, in particular pension fund beneficiaries, but not a matter for the general partners of the funds in which they have invested. There is, however, clearly wider interest in the overall performance of private equity in terms of returns that are generated on an aggregate basis, and fuller provision for disclosure in this respect is reviewed in Section G.

6. Another area in which the question of confidentiality arises relates to the identity of limited partners in a fund. One view is that the wider stakeholder interest in a private equity portfolio company extends beyond the strategy set by the general partner, its execution by the board and the performance of the company, to interest in its ultimate ownership by limited partners in the investing fund. On this view, it would be appropriate and helpful for the public to know who, indirectly but ultimately, invests in and owns the assets that are acquired by in particular private equity groups. These investors are generally not "asset strippers" (however precisely defined) but long-term institutions, managing assets for millions of savers many of whom, through pension funds, are employees. This might lead to a proposal that the identity of limited partners in any new fund should be made publicly available, with provision for such disclosure incorporated into all new limited partner agreements as a matter of best practice. There are, however, other considerations:

    - While there is public policy interest in the identity of limited partners from the standpoint of anti-money laundering provisions and the financial robustness of entities such as hedge funds that may choose to invest in private equity, these are matters for the FSA, and do not in themselves call for public disclosure of the identity of limited partners.
    - The decision to participate in a particular private equity fund by a limited partner such as a sovereign patrimonial fund, a university endowment or a pension fund is a matter for its own accountability, within the framework of its own asset allocation process, to its constituents or beneficiaries on its own terms and timetable.
    - Shareholding disclosure requirements in respect of listed stocks exist to provide market-relevant information in respect of traded instruments, plainly not the situation for private equity, and this market disclosure obligation in any event applies to the holder of a listed stock, which might be an investment fund, but does not apply to an institutional investor in such a fund unless the fund is itself listed.
    - The limited partner in private equity invests in a fund, not in the operational companies in which the fund is the shareholder, and in respect of which the general partner has clear and unfettered responsibility for business strategy: any impression, to which disclosure of the identity of limited partners might give

credence, that the limited partners are involved in the business direction of an individual portfolio company, would be altogether misleading.

- The majority of funds managed from the UK are structured as English limited partnerships, and the law already requires that, within 7 days of becoming a limited partner, the name of the limited partner must be registered at Companies House. But this is not a comprehensive source for the identity of beneficial owners, many of whom use nominee names (in most cases as a matter of convenience, as in the case of shareholdings in listed companies, rather than as a matter of deliberate concealment). And some funds use non-English partnerships or other structures as their fund vehicles, and not all countries have similar registration requirements under their equivalent local law.

7. It follows that the case for automatic and full disclosure of the identity of limited partners is not compelling. The resolution envisaged here would involve a detailed categorisation of limited partner constituencies and their proportionate share in their funds in regular generic communication by general partners and on an aggregate basis for the whole industry (see later Sections). The categorisation envisaged would indicate, separately, UK and overseas sources of funds to include pension funds, insurance companies, corporate investors, funds of funds, banks, government agencies, endowments of academic institutions, private individuals and other. A compromise approach on these lines would usefully inform and promote understanding of private equity overall but without requiring disclosure of the indentity of Limited Partner on an individual basis.

   Views are sought on the proposal that, while disclosure of the identity of individual limited partners should not be required, general partners should provide a full categorisation of the limited partners in their funds, indicating the proportionate stakes of each category.

8. It is common for general partners to charge their portfolio companies a range of fees including deal fees (to cover costs associated with the preparation and completion of an acquisition or exit), monitoring fees (in respect of ongoing oversight of strategy and is implementation in a portfolio company), financing fees (relating to the arrangement of financing or debt rescheduling for a portfolio company) and, in a few cases, corporate advisory fees (in respect of corporate finance advice from the advisory capability within the group of which the general partner is a part), all under the accounting rubric of related party transactions. While the EVCA guidelines on reporting to limited partners provide for disclosure as to the proportion of such fees to be attributed to the general partner or an entity related to the general partner, the contractual arrangements embodied in limited partner agreements should invariably specify what fee attribution is proposed in respect of such services so that limited partners are aware and in agreement from the outset, especially if circumstances are envisaged in which some or all of the fees are retained by the general partner rather than flowing in to the fund. This review accordingly envisages a guideline calling for specific provision and explanation of such fee arrangements to be incorporated in limited partner agreements when new funds are being established.

9. In measuring and reporting the valuation of a fund's investment portfolio, general partners adopt either a cost or a fair value approach. Cost has the obviously important merit of being factual but, in contrast to fair value, does not capture the evolution in value of a portfolio company which, even over a relatively short-term, may be substantial as a result of market developments and of initiatives put in place in a portfolio company by the general partner. Estimation of fair value inevitably depends on assumptions and judgement as to prospective as well as past performance, with potential for wide differences of view. Relevant here is that the arrangements for carried interest entitlement that are built into limited partner agreements are triggered only at the point of exit from a portfolio company holding. This means that, in making valuation judgements in respect of an existing portfolio, general partners are under no incentive to give an exaggerated view of performance, and it seems that their fair value assessments often err in a conservative direction. This situation and the preference of many limited partners, given their own constraints and methods of operation, has led to a widely (though not yet universally) - held view in private equity that valuations of portfolio companies for purposes of ongoing reporting should be on the fair value approach.

10. Against this background, substantial progress has been achieved by the industry and the accounting profession toward standardizing valuation approaches. The EVCA and BVCA have developed approaches which, with the support of ASIC, the French private equity trade association, were consolidated in 2005 into the International Private Equity and Venture Capital valuation guidelines. These are currently adopted by 32 private equity trade associations outside the USA, where guidelines developed by the Private Equity Industry Guidelines Group ('PEIGG') are used. Although some differences remain, the two sets of guidelines are substantially aligned, are widely held in both the industry and the accounting profession to be representative of best practice and are both endorsed by the International Limited Partners Association ('ILPA'). There seems no reason in the context of this review to adopt any different approach and it is accordingly proposed to recommend provision for conformity with these guidelines in all new funds and, as far as possible, a similar move to fair value reporting in respect of the portfolio companies of existing funds.

11. But whereas guidelines are now effectively in place with respect to valuation of portfolio companies, no comparably accepted guidance is in place for reporting of track records of investment performance of the investment manager. This lacuna is of limited relevance in relation to ongoing reporting, where the principal focus is on the performance of individual portfolio companies, but has much greater relevance in the assembly and method of presentation of track record data to support a new fund-raising. Where different companies in a portfolio have shown substantially different performance, the at least theoretical opportunity for cherry-picking by a general partner, through excluding poorly performing investments, giving greater weight to the stronger performing companies in the portfolio or giving lesser weight to unfavourable past performance, may mean that the overall assessment of fund performance is on occasion skewed and presents an unduly favourable picture. In

practice, the scope for such distortion will be seriously constrained by the ability of limited partners to check fund performance reports against both their own assessments of value based on regular reporting on the companies that remain in the portfolio and on the values that were achieved on exits.

12. The need is nonetheless for a methodology to assure limited partners and potential new investors not only that fund performance information is complete and fairly presented but that it also provides a basis for comparison of the performance of different funds managed by different general partners. Perfect comparability is unlikely to be attainable and for this reason, and given also the diversity of practices currently established in the industry, further discussion and assessment will be needed in the consultation process to determine whether there is a single approach to fund performance reporting that could be commended in the guidelines. One possible approach is provided by the Global Investment Performance Standards (GIPS), prepared under the auspices of the CFA Institute in respect of performance measurement for all categories of portfolio investment, and which includes guidelines for private equity funds. Given that the main comparability concern is in the description of past performance in the context of a new fund-raising, the GIPS requirements for annual fund reporting and for recommended independent verification on an annual basis, go beyond what may be required as a recommended outcome of this review. Either or both of these requirements could be met if limited partners, as a result of discussion in their advisory committee, determined that they wished to have it. Depending on the preferences revealed by limited partners in the consultation process, this is an area where a guideline, possibly providing for broad conformity with the GIPS standards, might become more specific at a later stage.

    Given the substantial progress made toward harmonization of approaches to valuation, what priority should now be given to efforts to promote greater comparability in fund performance reporting? Do the GIPS standards offer the most practical approach?

F. GENERIC COMMUNICATION

1. The private equity industry has not kept communication about its activities abreast of its development. The innate concern of many general partners to keep the industry private, in the sense of protecting confidentiality to the fullest possible extent, is explicable in a historic context. But it is no longer compatible with the position that the industry, through its energy and initiative and in a benign market environment, has come to occupy in the economy and in society more widely as a result of its acquisition of large companies. The industry has to adjust to this reality, and the recommendations to follow from this review will enable it to do so.

2. This identified need for greater openness and explanation cannot be met through any one channel, but calls for appropriate initiative in several areas of interface between private equity and the wider array of constituencies described above. The term "generic" is used here to describe communication by the general partners (or their management company) to an array of constituencies including government, politicians, the business community and the media. This will be an important ingredient in the deliberate shift to fuller disclosure and transparency on the part of private equity, to include also enhanced portfolio company reporting (as reviewed in Section C) and on an aggregate industry-wide basis (see next Section). Generic communication has a purpose different from that of reporting to limited partners and, as envisaged here, does not necessarily entail specific reporting on individual portfolio companies. Nor is it envisaged as the channel for reporting on private equity performance to those for whom the limited partners act, for example the members of a pension fund that invests in private equity. The form, content and frequency of such reporting to their members is a matter for the trustees of the pension fund.

3. But generic communication could and should become an important prime source for information, education and guidance on the approach by general partners, and thus by the operating companies in their portfolios, and to the wider constituencies and implicit contracts described earlier. Much of what might be envisaged here is already available on the websites of some general partners. The need is to generalise the practice among private equity groups (engaged in buyout activity) and for greater proactivity in making the wider stakeholder community aware of what is available. Such generic communication could also provide commercial opportunity for the general partners. It would have special importance in providing assurance to employees and other stakeholders in a company at a time of transition in ownership and at the time of the raising of a new fund. Whether such statements should include details of aggregate performance of individual funds is a matter between general partners and their current or prospective limited partners, not necessarily calling for publication more widely. In practice, the reports prepared by some general partners and management companies for their limited partners already set a starting point or template for such generic reporting, though it is not part of the generic reporting proposition that confidential detail appropriate for limited partners only be included.

4. The focus is on general partners of larger funds, but the growing importance of private equity as an asset class points to the desirability of conformity with these communication guidelines as far as possible by all general partners in the buyout business – with, as in respect of portfolio company reporting, the flexibility to explain if full compliance were reasonably judged to be inappropriate, for example because of the small size of a fund.

5. This generic communication should be in the form of an annual review, readily accessible on the website, focussing more on narrative than on financial numbers, attentive to wider stakeholder interests in an aggregate, top-down manner rather than in the more detailed way in which the portfolio companies themselves, conforming to the approach described earlier, will be reporting. As to content:

   - this should indicate the leadership of the management company, identifying the most senior members of the general partner team or general partner advisory group;
   - it should prominently include a statement by general partners of their commitment to conform (on a comply or explain basis) to the guidelines to be promulgated by this review and of the values that inform their approach to business and the governance of their operating companies;
   - it should include an attribution analysis (particularly important as a communication and education tool) across the operating companies in a general partner portfolio, of how value growth is achieved. The three key ingredients are:
     - balance sheet management (that is, the impact of financial leverage in improving returns on equity)
     - improved operational performance (through application of the management techniques that are put in place)
     - and the rise in the earnings multiple that is attributable to the rise in the market in the industry sector (that is, separately from the multiple growth associated with management-generated improvements in operating performance)
   - where appropriate, the communication might include an indication of how portfolio companies have performed after being sold back into the public markets
   - the communication should also seek to counterbalance, with supporting evidence as appropriate, the widely-held notions that private equity behaviour is characterised by asset-stripping and that its time horizons are invariably short.

6. On the latter, such communication would be the channel for categorisation of the limited partners in funds (as proposed in the previous Section), not least to emphasise that, typically, they are institutions with medium to long-term time horizons and are frequently repeat investors in successive new funds of the same general partners, with whom long-term relationships are built. This would also provide general partners with opportunity to describe the industry sectors in which they have built specialism and capability, the substantial and often lengthy research process which is typically a

prerequisite for any acquisition initiative and, after a portfolio company has been acquired, the intensity of continuing attention to effective management and performance. In the latter context, the annual review should include a description of the approach of the general partner to corporate governance and board composition in its operating companies, with particular attention to the way in which the wider responsibilities of their boards are discharged as discussed in Section D.

7. Four areas of special importance under the rubric of the values of the private equity firm and general partner are the philosophy of their approach:

   - to employees and their working environment in portfolio companies
   - to the handling of conflicts of interest that may arise
   - to corporate social responsibility
   - as a contingent commitment and to their continued engagement in the unfortunate event that a portfolio company encountered severe business difficulty that threatened its ability to continue trading.

   The guidelines envisaged here will call for general partners to describe in their generic communication their approach in the first three of these areas, but will not be prescriptive in any other sense. The commentary in the following paragraphs is intended to be indicative only of how the ground might be covered in a way that, as well as addressing external interests, would yield benefits for the general partner, for example in terms of enhanced brand awareness and reputation. Although the overall guidelines that are envisaged will include description of an approach and process in the event that a portfolio company encounters severe financial difficulty, the contingency is not one that a general partner would wish to anticipate, and it is not proposed that reference to it should necessarily be included in generic communication. The commitment itself is, however, intended to be substantive and real, and should in any event be made indirectly through a general partner's overall statement of intention to conform to the guidelines as a whole.

8. In respect of employees, the statement will provide opportunity to describe the general partner's approach to employment policies in the funds operating companies and how they take into account the needs and interests of their employees as a critical ingredient in delivering the business success that they seek to achieve. It would be a vehicle for the general partner to describe the approach that a portfolio company would be encouraged to follow on employment practices including, in particular, provision for effective and timely communication with employees, for appropriate training and development programmes and possibly in respect of employee standards elsewhere in the supply chain if outsourcing becomes significant. The statement should also include a description of the general partner's approach to the management of conflicts and a confirmation that related party and any other transactions with implications for the limited partners in a fund are in all cases fully disclosed and explained within the contractual framework for reporting to limited partners.

9. In respect of corporate social responsibility, the 2006 companies legislation requires (in S.172) the director of any company (including a private company) to have regard (amongst other matters) to "the impact of the company's operations on the community and the environment". But the legislation does not specify any particular method of reporting on how this responsibility is discharged and the provision (in Section 417) that calls for the business review to cover"social and community issues" extends only to quoted companies. In this situation, it is for general partners and the boards of their portfolio companies to determine how fully to describe their "attentiveness" to the impact of the company "on the community and the environment". The proposal here is that some reference should be made in the general partner's annual review as a matter of enlightened self-interest.

10. In the event that a portfolio company encounters severe business difficulty and that the efforts of the general partner and board to retrieve the situation have proved unsuccessful, little or no value may then remain for the providers of equity. The question then arises as to the appropriate stance of the general partners. Generalisation is difficult because individual problem situations will have different features. But the fact that leverage is likely to be high means that, in a critical situation, the operational transition from ownership and control by the general partner to control and at least substantial ownership by what may be a large group of capital market participants could superimpose serious disruption on an enfeebled company unless the handover is sensitively and professionally managed. Where the equity providers have effectively lost the capital committed to a portfolio company, the general partner will be left with no direct financial interest to protect and could, if such interest were the sole criterion, feel little compunction about walking away from further engagement in a situation which by its nature, risks being messy and resource-intensive. But the rights of ownership should be seen to be complemented by a degree of obligation that would exclude abdication of responsibility by the general partners in the hopefully rare critical situation as described here. The specific features of any such situation will differ, above all in respect of the covenants and rights built into the debt structure of the company. But they would appear to call for commitment as a matter of principle that, if one of their companies encountered such problems, the general partners would see it as their responsibility to commit to assist in husbanding a transition to management by a creditor group as smoothly as possible.

11. Guidance for the calling together and functioning of such a creditor group is provided in the Statement of Principles of INSOL (International Federation of Insolvency Professionals) on multi-creditor workouts. It is not proposed here that general partners should anticipate or refer to the problem of corporate failure in this sense in their generic communication. But they would be expected to commit in this communication to conform to all of the guidelines to be enunciated as the outcome of this review, and these will include specific guidance on a general partner's interface with the creditor process to be established in a potential insolvency situation, along the lines of the INSOL Statement of Principles.

12. Production of such generic reports annually as envisaged here would inevitably involve a degree of repetition – for example, broad policies toward employment or the structure of the balance sheets of portfolio companies may not change with much frequency – and "values" in the integrity sense would obviously not be expected to change. But it would seem the better course, given the industry's current communication deficit as described above, to err on the side of over-exposure. This is a necessary part of the repositioning of the industry in public perception and, if done well, could do much to change attitudes that are misinformed and, on occasion, unjustifiably and damagingly critical. In addition to generic statements, accessible on websites as described here, it would also seem essential for general partners to be readier than hitherto to respond to specific enquiries from the media and more widely and to take the initiative in communication, in particular when significant transactions are taking place involving portfolio companies. Confidentiality concerns will no doubt constrain how much can be said publicly in many situations, but the line between openness and secretiveness could and should be drawn with much greater flexibility than hitherto.

    Views are invited as to whether these should be the recommended elements for an annual review and for greater openness on the part of general partners.

G. INDUSTRY-WIDE INITIATIVE AND COMMUNICATION

1. No single approach will to be sufficient to give the necessary boost to the transparency of the industry. Alongside enhanced reporting by portfolio companies and generic reporting by general partners, there is a major role for data collection, aggregation and dissemination on an authoritative industry-wide basis with the data drawn on in high quality evidence-based economic assessments, to be effectively and pro-actively deployed. Beyond effective communication there will be need for the industry's representative body to instal arrangements to keep the proposed guidelines under review so that they can be adapted as circumstances change; and, given the cross border nature of private equity, a need for engagement with industry bodies beyond the UK, in particular in Continental Europe and North America, to promote the guidelines to be put in place in the UK as at least a reference benchmark.

2. In respect of the data function, a key element here is that, in providing input within the framework of such an aggregate process, general partners are able to protect the confidentiality of information that they might not be ready to release publicly – for example, on their internal rates of return, or where particular disclosure might compromise the confidentiality of the relationship with a limited partner or provide material useful to the competition of a portfolio company. The BVCA currently collects and publishes substantial amounts of data, with the scope broadened recently to reflect the rapid growth of leveraged buyouts of large portfolio companies. But the orientation of much of the data continues to be toward venture and growth capital, reflecting historically the first stage in the development of private equity in the UK. Reporting on venture and growth capital developments, which have given rise to little or no public controversy, should continue as now. But in relation to larger funds and leveraged investments in large portfolio companies, fuller industry reporting should be organised on a regular basis broadly (and subject to further refinement) to cover:

   - scale of funds raised
   - categorisation of limited partners by type and geography
   - scale of existing private equity portfolios and of recent buyout activity
   - leverage levels and debt structures, indicating the relative significance of covenants (or their absence)
   - estimates of levels and changes in employment and new capital investment by portfolio companies
   - aggregate performance measures for portfolio companies, including revenue and profit growth
   - estimates of aggregate performance measures for funds
   - estimates of aggregate fee payments by private equity management companies and by portfolio companies to other financial institutions and for legal, accounting, audit and other advisory services.

   Although considerable reference is made here to the need for data, not all of it is clearly quantitative, and judgement will be required to make qualitative overall assessments in some areas, for example in providing an assessment of the overall performance of funds on an aggregate basis and, in another area, given the wide array of definitions of leverage ratios and types of covenant used in the industry. Hence the importance of investing resource in developing an authoritative and respected capability that avoids misleading aggregation of apples and pears and commands confidence within the industry as well as externally.

3. The proposal is that all private equity firms engaged in buyout activity involving enterprise value in excess of £250 million should commit to provide data in a timely manner as reasonably required for the purpose of such enhanced aggregate reporting and economic impact analysis. Responsibility for the collection, and assembly of data might be delegated to an accounting firm or research group to which, provided protection of confidentiality is assured, the relevant input would be transmitted. But verification and quality control in the whole process will be of critical importance in ensuring that the output comes to be respected and widely used as credible and authoritative.

4. Beyond the collection and dissemination of authoritative industry data, there is the task of setting this in an economic context, drawing on the data and industry developments to present a regularly updated assessment of the industry and its economic impact. The main focus of such economic assessment would, at the outset, be UK-centric in respect of portfolio companies but, given the cross-border dimensions of the industry, the economic assessment capability should be extended into the performance of UK-based funds through their portfolio investments in and exits from operating companies in other countries. Important ingredients in such economic assessments would be evidence-based analysis of the extent to which and how private equity impacts operating company performance, and the impact of private equity, through the experience of their companies, on aggregate employment, investment and innovation. There could also be occasional special assessments of the impact of the industry on particular sectors in which buyout activity has been concentrated such as media, distribution and real estate, and the capability to commission research assessments on topical public policy issues. And although the focus of this review and associated industry-wide reporting and analysis is on larger buyout activity, overall assessment of the private equity industry should extend also to growth and venture capital.

5. These assessments, presented on a regular basis would be available to be drawn in presentation and projection of the industry's position in interface with government, politicians, the media, unions, consumer groups and other stakeholders. Development of an authoritative and high quality capability of this kind will require substantial additional resource at industry level and more explicit and positive engagement from major private equity firms than has been committed to such activity hitherto. The overall objective should be to create a centre of excellence for the private equity industry that would come to be seen and respected as such and, would thus make a major contribution to filling the void that currently exists in terms of credibility and authority. This will take time to build but it is a high priority for the process to start now.

Views are invited on the coverage of this data agenda and proposal for evidence-based analysis, keeping in mind the need to avoid undue reporting burdens on the industry.

6. A substantial advantage of the recommended guidelines approach envisaged in this review is that, in a dynamic and fast-moving industry environment, the guidelines can be adapted to meet changing needs and priorities much more readily and flexibly than would be possible under formal regulation. As a consequence, there will be need to institute provision for regular review and, as necessary, updating of the guidelines. For this purpose, the proposal envisaged is for creation of a group of trustees of the guidelines, on the analogy of the Takeover Panel Code Committee, with a mandate to review their continuing fitness for purpose on a regular basis and to make changes as and when necessary with the industry expected to conform to them on the comply or explain basis committed from the outset. This trustee function should be led by an independent experienced business figure with participation by a small but representative group from the buyout end of private equity.

   Views are sought on the appropriate model for review of the guidelines on a timely, effective and authoritative basis.

7. The question naturally arises how conformity with the guidelines will be monitored or indeed, in the words of some, enforced. But the fact that this whole review process, and the guidelines that are its intended outcome, reflects industry initiative on a voluntary basis does not mean that conformity with the proposed comply or explain approach will be lax or taken less than seriously. Industry leaders indicated at the time of launch of this review that their intention would be to conform to the guidelines to emerge as its result and, in this situation, no special provision for monitoring, still less enforcement, is envisaged here. Alongside what seems a reasonable expectation that the private equity industry will wish to adhere to the guidelines that will be proposed, the background to and circumstances within which the review process has taken place means that intense trade union, political and, perhaps above all, media interest is set to continue. It seems realistic to expect that any non-conformity with the guidelines, in particular those relating to reporting by portfolio companies and generic communication by general partners, will attract keen and critical external interest and publicity. It is doubtful whether any monitoring or enforcement process that might be instituted bureaucratically would be more effective in promoting conformity.

8. A major element in industry-wide communication should be a continuing evidence-based demonstration of the cross-border dimension of UK-based private equity business and its significance as a contributor to the UK economy, quite apart from its impact through ownership of portfolio companies in the UK. Beyond this, there is need for proactive engagement with private equity industry groups outside the UK, in particular in elsewhere in Europe and in North America, to promote as far as practicable convergence around the approach to disclosure and transparency being developed in the UK environment. In relation to valuation, substantial progress toward convergence has already been accomplished within Europe and dialogue is in train with relevant industry groups in the United States. In all this, there remains

more to be done, but the limited partner community appears to be both broadly content with the progress that has been made, in particular in the more or less universal move to fair value for valuation purposes, but is in any event well placed to continue to push for further progress toward harmonisation of standards, in particular to facilitate greater comparability in fund performance presentations.

9. Despite the substantial progress made toward cross-border harmonisation in what might loosely be termed accounting and valuation conventions, of critical relevance for the interests of limited partners as ultimate owners, there has so far been little international discussion of disclosure and transparency issues for private equity in relation to the wider constituencies addressed in this review beyond that of ownership. The expectations and weight to be attached to the interests of these different constituencies are, and may continue to be, significantly different in the different countries, even within Europe, in which private equity firms do business. But given that the UK is the base for the most significant grouping of private equity business outside the United States and that wider concerns as to accountability already exist or seem likely to develop elsewhere as the role of private equity investment becomes more significant in other countries, there would appear to be a key role for the main industry body in the UK to seek to influence policy development elsewhere and, as appropriate, to proselytise the UK approach to greater transparency and disclosure on the basis of the guidelines envisaged here.

   Views are sought on the areas for international initiative and the priority to be given to this (potentially resource-intensive) effort.

10. These proposed responsibilities for:

   - industry-wide data collection, processing and dissemination on an authoritative basis
   - development of a high quality economic assessment capability, to be projected pro-actively
   - creation of a trustee procedure to ensure that the proposed guidelines are kept under review and are adapted as necessary and
   - an active role in promoting and engaging in industry dialogue on a cross-border basis to promote convergence as far as practicable

   amount to a major opportunity for private equity's industry association in the UK. It will only be met with an increase in the resource committed to this collaborative activity by private equity firms, an additional commitment which should be seen as wholly in line with the great increase in the significance of this industry in the UK and international business environment.

ANNEX A - ORGANISATIONS CONSULTED IN THE COURSE OF THE REVIEW TO DATE

1. **Members of the working group**

Bain Capital	Amadeus
KPMG	Cinven
Apax Partners	3i Group
Blackstone Group	KKR & Co.
Bridgepoint	Hermes Private Equity

2. **Other private equity firms and investors**

Permira	Alchemy Partners
Carlyle	Pathway Capital Management
TPG	SVG Capital
Candover	CVC
Cognetas	Enterprise Ventures
Barclays Private Equity	Langholm Capital
Parallel Private Equity	Phoenix Equity Partners
Star Capital	August Equity
CalSTRS	CalPERS

An informal consultation by email of over 50 major Limited Partners is currently in train.

3. **Other bodies**

BVCA	KPMG
CBI	SJ Berwin
Financial Services Authority	TUC
Financial Reporting Council	PEIA
CalSTRS	LMA
Ernst and Young	

ANNEX B - PROVISIONS OF COMPANIES ACT 2006 RELATING TO DIRECTORS' DUTIES AND THE BUSINESS REVIEW

Section 172 Duty to promote the success of the company

1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to —

   a. the likely consequences of any decision in the long term,
   b. the interests of the company's employees,
   c. the need to foster the company's business relationships with suppliers, customers and others,
   d. the impact of the company's operations on the community and the environment,
   e. the desirability of the company maintaining a reputation for high standards of business conduct, and
   f. the need to act fairly as between members of the company.

2. Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

3. The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

Section 417 Contents of directors' report: business review

1. Unless the company is subject to the small companies' regime, the directors' report must contain a business review.

2. The purpose of the business review is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).

3. The business review must contain —

   a. a fair review of the company's business, and

   b. a description of the principal risks and uncertainties facing the company.

4. The review required is a balanced and comprehensive analysis of —

   a. the development and performance of the company's business during the financial year, and
   b. the position of the company's business at the end of that year, consistent with the size and complexity of the business.

5. In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include —

   a. the main trends and factors likely to affect the future development, performance and position of the company's business; and
   b. information about —
      (i) environmental matters (including the impact of the company's business on the environment),
      (ii) the company's employees, and
      (iii) social and community issues, including information about any policies of the company in relation to those matters and the effectiveness of those policies; and
   c. subject to subsection (11), information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.

   If the review does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii) and (c), it must state which of those kinds of information it does not contain.

6. The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include —

   a. analysis using financial key performance indicators, and
   b. where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

   "Key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.

7. Where a company qualifies as medium-sized in relation to a financial year (see sections 465 to 467), the directors' report for the year need not comply with the requirements of subsection (6) so far as they relate to non-financial information.

8. The review must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.

9. In relation to a group directors' report this section has effect as if the references to the company were references to the undertakings included in the consolidation.

10. Nothing in this section requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

11. Nothing in subsection (5)(c) requires the disclosure of information about a person if the disclosure would, in the opinion of the directors, be seriously prejudicial to that person and contrary to the public interest.

3 Clements Inn
London, WC2A 2AZ

Tel: 020 7025 2971
Web: www.walkerworkinggroup.com

Produced by Jeffrey Pellin Consultancy www.pellin.co.uk