

Disclosure and Transparency in Private Equity

A Consultation Document from the Walker Working Group

A response by

The National Association of Pension Funds

October 2007

Introduction

The Consultation Document proposes a sensible approach to achieving greater disclosure and transparency in the private equity industry and there should be significant benefits to investors, the industry itself and other “stakeholders” from implementing its recommendations. We have noted a few areas for greater disclosure and these are set out in our detailed answers below.

However, at a higher level we have concerns that the interests of limited partners (including our members) have not been taken sufficiently into account in drafting the proposals. We question the quality of information provided to LPs. Most are supplied with sufficient quantity, but it can be hard to analyse, particularly for a pension fund with limited resources in-house. There is also some confusion around the issue of fees and their disclosure. It appears that standards may vary between providers and the industry would benefit from establishing an agreed standard for fee disclosure and any related conflicts of interest. In addition the Review does not address the reputational risk issues faced by pension funds when investing in private equity funds.

We also have some doubts about the ability of a “comply or explain” regime to deliver changes in behaviour when there is no apparent sanction for non-compliance. It works in the public market because there is extensive dialogue between investors and companies and because the AGM gives investors the ability to call management to account. Appropriate accountability is required in the private equity industry. We acknowledge that this may be achieved in part through use of advisory boards.

Specific Consultation Issues: NAPF Answers

1. Reporting by Portfolio Companies

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

NAPF Answer

We agree that there should be enhanced reporting standards for larger companies and the suggested cut off points seem reasonable as they equate to companies in the lower half of the FTSE Small Cap Index. We would expect companies to exercise discretion in applying these guidelines, with for example, those who fall just below the cut off adopting enhanced reporting or being required to continue with enhanced reporting in the absence of a compelling reason for stopping.

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

NAPF Answer

In our view these are the key criteria which should be of interest and concern to limited partners such as pension funds as well as other stakeholders.

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

NAPF Answer

While the above provides the bulk of the information which is needed in a comprehensive report on a business, we believe that it would also be helpful to report directors' holdings in the company and any changes to them. In the same vein we believe that there should be disclosure of the proportion of pay (in aggregate) which is linked to performance and a statement of the main performance measures used. This is not data which would necessarily be part of the periodic reporting to limited partners, but it is important that they can see that there is clear link between pay and performance. Finally, we recommend that private equity-owned companies be encouraged to report against the Turnbull Guidance on internal controls, which have been widely adopted by companies in the UK.

d) *“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?”*

NAPF Answer

This is a legitimate concern and we can see no good reason why all large private companies should not comply with these guidelines.

2. Agency and the Alignment of Interests

a) *“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.”*

NAPF Answer

While the public company model of recruiting independent directors is attractive it is felt that in private equity more flexibility is appropriate. Boards should seek to recruit the skills seen as necessary and, as suggested, report appropriately in the annual report.

3. Reporting by General Partners

a. To Limited Partners

i) *“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.”*

NAPF Answer

Generally NAPF members who have positions as limited partners are satisfied with the timeliness and content of information provided. General partners should ensure that the information is also complete and presented in such a way as to give a readily understood picture of the progress of investee companies and the fund as a whole.

ii) *“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.”*

NAPF Answer

NAPF members are divided on the merits of disclosure of their investment in a partnership. While it is consistent with the growing disclosure of investment activity to members of pension schemes, some are concerned that the information could be used to target a pension fund or its sponsor where a private equity company has attracted controversy. We therefore agree that this should not be mandatory.

iii) *“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?”*

NAPF Answer

The NAPF is a co-sponsor of the UK Investment Performance Committee which itself is the UK country sponsor of GIPS. We believe that there is much to be gained from private equity incorporating GIPS into their reporting guidelines. The benefits would be to both the funds themselves and their investors, well outweighing the costs, and we encourage the industry to move to this standard.

b. Generic Communication

“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.”

NAPF Answer

This is an important element of any reporting to institutional investors, such as pension funds, as it seeks to address issues of resources, philosophy and process which are key to understanding the investments made on their behalf. The outline is in our view deficient two important aspects: firstly, the management company should address what steps it has taken or plans to take to manage the growth in its business; and secondly, there is little or no mention of the specific risks which apply in private equity and what they have done to mitigate them. Examples might be the risk of rising interest rates, or problems with the management of an investee company, including succession planning.

4. Industry-wide initiative and communication

a) *“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.”*

NAPF Answer

We agree that there is a need to provide authoritative data along the lines suggested. We do however question whether that data can have real authority when it is being produced by the industry itself. The additional costs of independent verification, or even perhaps collection, would be worthwhile.

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

NAPF Answer

The approach seems sensible. We would suggest that a review is conducted annually in the initial years to assess compliance and relevance in practice.

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

NAPF Answer

UK investors should seek similar standards of disclosure and transparency when investing overseas. Likewise the UK-based managers of international funds should aim to provide that disclosure. The suggested guidelines are widely drawn and do not in our view impose a burden which is either too expensive or commercially inhibiting.

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