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Private Equity - The Role of the FSA

The UK Financial Services Authority (FSA) has issued a feedback statement on its Discussion Paper (DP) 06/6, entitled "Private equity: a discussion of risk and regulatory engagement".

Importantly, these papers do represent just that, namely a "discussion". The industry does not face radical policy proposals or imminent threats. In fact, the influence of the FSA with respect to private equity is, perhaps more than in any other sector of the financial services industry that it regulates, diluted by shared responsibility with others. Although the FSA regulates private equity advisors and the banks that finance their deals, in the spit and sawdust of the public debate, the emotive issues, such as beneficial tax treatment on carried interest and leveraged deals, as well as employment sensitivities with respect to companies that are the subject of highly leveraged deals, have attracted most of the flak. Tax is the responsibility of the Treasury and the role of private equity in the economy is a political concern. In addition, as the FSA states, at a global level, regulators such as the International Organisation of Securities Commissions (IOSCO) and the Financial Stability Forum are working to address the risks posed by private equity.

So what does the FSA have to say in its feedback statement? Essentially, it reiterates the risks identified in the DP, including:

- excessive leverage,
- reduction in overall capital markets efficiency,
- market abuse,
- conflicts of interest,
- market access constraints, and
- market opacity.

These risks are assessed and analysed in the context of the FSA's statutory obligation to prevent financial crime and maintain overall market confidence. The FSA identifies market abuse and conflicts of interest as presenting the highest risks.

In terms of market abuse, the FSA has assessed that public-to-private transactions can present a significant area of risk where price-sensitive information is potentially available to a large group of participants. Given the risk that market abuse presents, the FSA states its willingness to maintain its focus in the context of private equity transactions. There is a parallel here with the FSA's closer monitoring of the largest hedge fund managers and, evidently, market abuse is an area it continues to watch closely.

In the context of market access constraints, the FSA, in its guise as the UK Listing Authority, notes its pending consultation paper on the listing regime for closed-ended investment as a means to broaden the investor base for private equity funds.

Some of the responses to the DP, have suggested the creation of a separate regulatory regime for private equity advisors. No definition of private equity exists in either the legislation or the FSA's Handbook, although the FSA does define "venture capital firm". It is implied that the FSA sees no need for a separate regime and, if there were such a regime, it might run counter to the general flexibility of UK financial services legislation.

Clearly, the regulators are watching the private equity industry closely, but the development of the FSA's approach will be influenced by the Treasury and the continuing political manoeuvrings. Depending upon which way the government decides to proceed, the FSA may revisit its relatively hands-off stance.

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