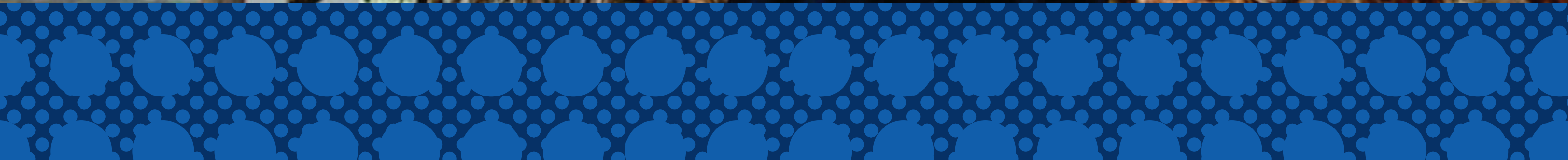
Caveat Venditor: Towards a Conceptual Framework for Buyer Selection in Responsible Microfinance Exits

Sam Mendelson & Daniel Rozas

April 2018



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Date: 19 April 2018

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ABSTRACT

As microfinance equity sales grow, so does the importance of selecting a suitable buyer - the obligation on the seller to exit 'responsibly'. This research project involved consultation with various equity investors, to ascertain what is current industry practice on buyer selection processes, and the priority that investors give to different criteria in selecting a buyer. We find a consensus around a process which first excludes clearly unqualified buyers but, beyond that, gives primacy to the financial offer. A minority view places more importance on protecting the social mission of the MFI, and ensuring the new buyer provides the necessary strategic value for the MFI to grow congruent with its social mission. We have developed a conceptual framework for buyer selection that imports elements of both approaches, and can guide investors and their advisors in future exits.

INTRODUCTION

With the growing maturity of the microfinance industry, a question that has come into sharper focus is how social investors committed to advancing responsible finance practices should "exit responsibly" from the microfinance institutions (MFIs) – and, increasingly, the broader category of financial service providers (FSPs) and other companies working in financial inclusion – in which they have invested.

Leveraging an industry consultation process, we have consolidated investors' own emerging principles and procedures in assessing potential buyers, and used the findings to produce a Conceptual Framework for Buyer Selection in financial inclusion equity exits. This framework serves as a resource for investors embarking on an equity sale, providing them with a concrete, industry-recognized framework to evaluate an exit. Additionally, it can:

- Guide investor discussions with external organizations that assist them in exit trajectories (investment banks, advisory firms, etc.);
- Assist new categories of impact investors that have little experience in exits; and
- Serve as a guide to potential buyers to help understand selection criteria and prevent interested (but unsuitable) buyers from spending time on a futile due diligence process.

During the course of our research, a majority practice and opinion emerged (what we call the First, ***Do No Harm* consensus**), alongside dissenting voices that argue for an inversion (what we call, continuing the medical analogy, the ***Best Interests* approach**) of some of the processes and presumptions of this majority perspective. As a result, we have moved beyond just reporting what existing industry practice *is*, to incorporate in the output of this paper - the Conceptual Framework for Buyer Section – not only what is commonplace, but also what industry practice *could* – and perhaps *should* – look like.

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BACKGROUND AND SCOPE

Equity exits by social investors are relatively recent. While equity investment in microfinance dates to the 1990s, the first big wave of Microfinance Investment Vehicles (MIVs) were created in the mid-2000s. Many were ten-year closed-end funds, which began to mature around 2013-16. That experience was the impetus for the 2014 CGAP/CFI paper *The Art of the Responsible Exit in Microfinance Equity Sales*[1], that looked at 'responsible' exits in microfinance equity, and which outlined four broad issues – **when**, **to whom**, **how** and **at what price** – that investors should consider in a proposed exit.

> *"To what extent can – or should – investors seek to ensure that the sale of their stakes in MFIs will result in ongoing responsible behavior by their (former) partners and new owners and even contribute to healthy development of the overall market?"*
> – The Art of the Responsible Exit in Microfinance Equity Sales

Our research was informed by some of the questions raised in previous work on the subject, including:

1. What does it mean to exit 'responsibly'?
2. In a financial inclusion equity exit, what (if any) responsibility does the seller have to select a buyer that will maintain the investee's social impact?
3. How is any responsibility to ensure enduring social impact in buyer selection compatible with a divestor's fiduciary obligations?
4. What are the potential consequences of an irresponsible exit – prioritizing the financial offer without other considerations, or selling to a buyer whose objectives don't align with those of the MFI and the best interests of its clients?

The thinking has continued to evolve. More recently, the Global Impact Investing Network (GIIN) observed in their January 2018 Issue Brief *Lasting Impact: The Need for Responsible Exits*[2]: "Even for investments where the impact is thought to be 'baked in' or occurring as a natural by-product of a given business model, there are risks of shifts in that business model that can be mitigated by a thoughtful exit plan."

All of this leads to significant questions for the investor: What weight should be given to the needs of the investee and the investor? How does one enshrine the mission and maintain good governance post-sale? How can exiting investors balance social and commercial returns? And perhaps most importantly: who is a suitable buyer?

1 Daniel Rozas et al., *The Art of the Responsible Exit in Microfinance Equity Sales*, CGAP and CFI, April 2014
2 Global Impact Investing Network (GIIN), *Lasting Impact: The Need for Responsible Exits (pdf)*, Jan 2018

WHY DO INVESTORS NEED TO SELL?

Investors may exit for a number of factors, including, according to Silva and Riecke[3]:

1. For the social investor that views its role as midwifing the MFI to sustainability, interest by commercial investors implicitly signifies 'job done'
2. A change in investment strategy of the seller
3. A need for funds to meet capital requirements or make other investments
4. Changes in market context, including need to mitigate risk.

In addition to these factors, an investor may either be compelled to sell (for example in a closed-end fund approaching maturity) or there may be compelling economic and opportunistic reasons (if another minority shareholder is selling, and there would be greater appetite among buyers for a larger stake).

Executing a responsible exit is a complex undertaking, encompassing considerations of timing, identifying buyers that share the values of the exiting investor, the capacity of a buyer to not just pay the asking price, but provide other support to the financial institution, and above all, the risks to reputation from getting it wrong.

Back in 2014, *The Art of the Responsible Exit*... took a broad view of the challenges of responsible exits. Several of these issues are, by now, relatively well understood and embedded in practice. But for many investors, **responsibly selecting a buyer** continues to pose the most challenging questions.

EMERGING FINDINGS AND CONCEPTS

> *"Better to make sure beforehand (during the selection process) that the buyer is aligned with the social mission of the MFI."*

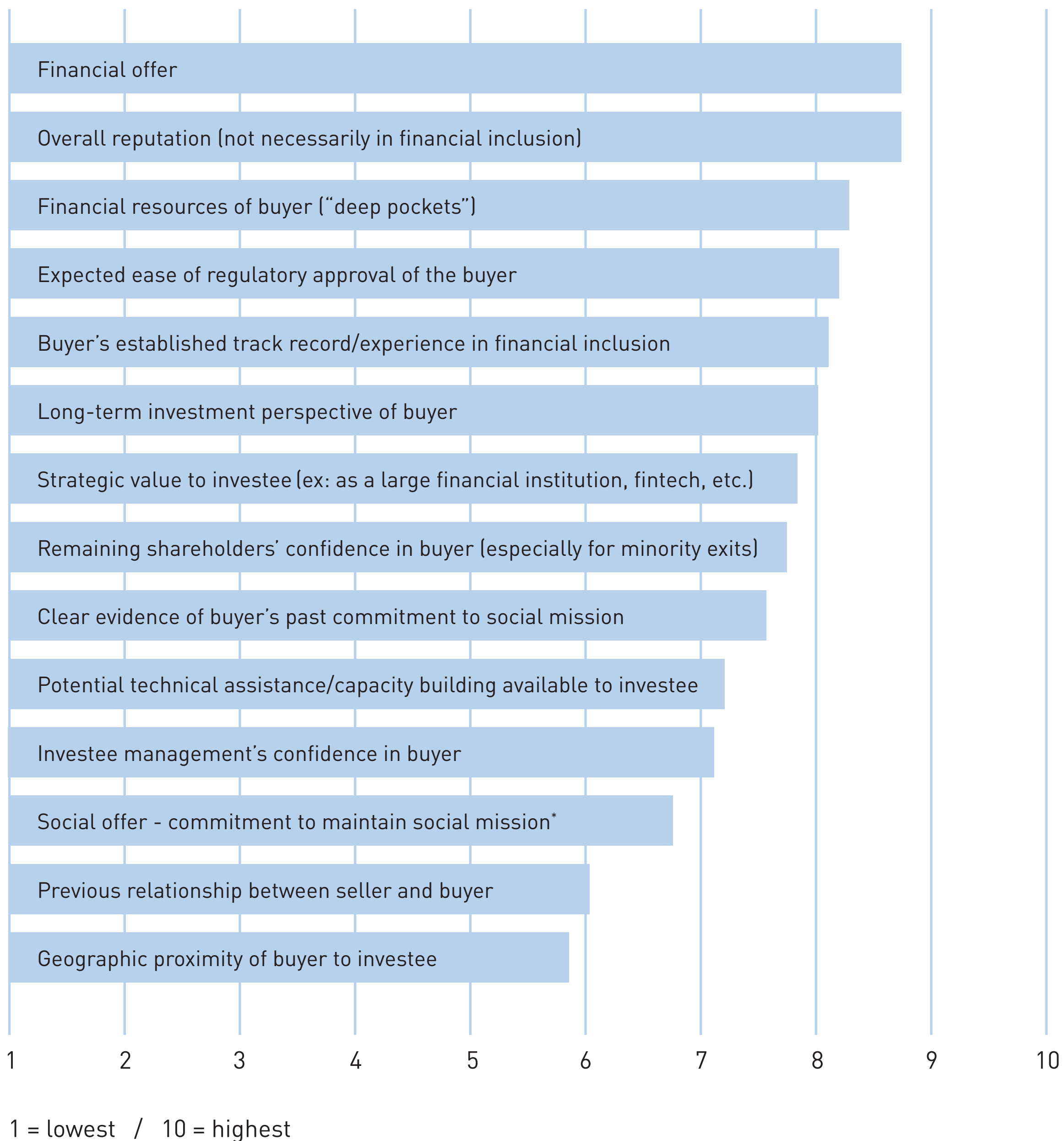
To answer these challenges, we reached out to some of the key MIVs that have experienced equity sales, via an online survey of investors, several interviews, and two consultation sessions. From this, we sought to distil their experience into a conceptual framework that would offer investors a systematic way for thinking through and evaluating potential buyers in future exits to come.

Figure 1 shows the importance of 14 criteria, according to respondents to the online survey[4], in which financial offer and the overall reputation of the potential buyer dominate.

3 Alex Silva & Jeffrey Riecke; *What's Responsible about Impact Investing Exits?*, CFI, 2017

4 The survey included: Preliminary questions – Name, org, title, confidentiality, number of exits; Part I: (Dis)agreement with nine statements (*strongly disagree* to *strongly agree* – plus open-ended comments); Part II: Rating of fourteen buyer selection criteria in importance (1-10, plus open-ended comments); and Part III: Open-ended questions on due diligence, past examples of buyer rejection based on due diligence, preference with respect to category of buyers, due diligence resources, and internal decision-making processes. 16 investors responded to the survey.

Figure 1: Investors' Ratings of Buyer Selection Criteria



* (e.g. 'letter of comfort', statement of principles in shareholder's agreement, or similar covenant)

Figure 2 shows investors' agreement with nine different statements concerning buyer selection.

Figure 2: Investors' Agreement with Buyer Selection Statements

The open-ended comments and rankings illustrated the importance investors place on **financial offer** and **buyer reputation**, and the various ways this reputation can be verified using public and private resources - from "industry gossip" and "specialized databases" to "Google News".

> *"Typically, we know the buyer's reputation and individuals at the buyer. If we do not, we research independent sources and seek meetings with the buyer to understand better their mission and their ambitions with the investee."*

> *"A big issue is selling to a consumer lender, turning a decent MFI [into] a payday lender; you then kill what you have built, and you don't want to be associated with it."*

Another key consideration was a matter more from the perspective of strategic fit rather than social mission - the **financial resources of the buyer** ('deep pockets'), which includes not just capacity to invest in the MFI post-acquisition, but, crucially, the willingness to do so - perhaps providing a debt facility, providing additional equity to spur growth, or paying for technical assistance support.

Divestors place more emphasis on the past actions of a buyer revealed by their due diligence than on the words or other non-binding commitments (such as 'letters of comfort') made by potential buyers. A past relationship between the seller and buyer is less important than what the seller can learn about the buyer. Divestors also place considerable weight on the input of the current MFI management, as well as the willingness of a prospective investor to retain that staff and management after the sale. And while a track record in financial inclusion is not critical, it is valued. Geographical proximity of the buyer to the institution being bought is, however, not important at all, at least for the large majority of investors.

> *"Though one would hope that a new investor would retain the staff and management, one has to be realistic and acknowledge that a new investor would most likely want to bring its own people to the company. Yet, on equal terms, a buyer willing to retain the staff and management would definitely increase the odds of being chosen."*

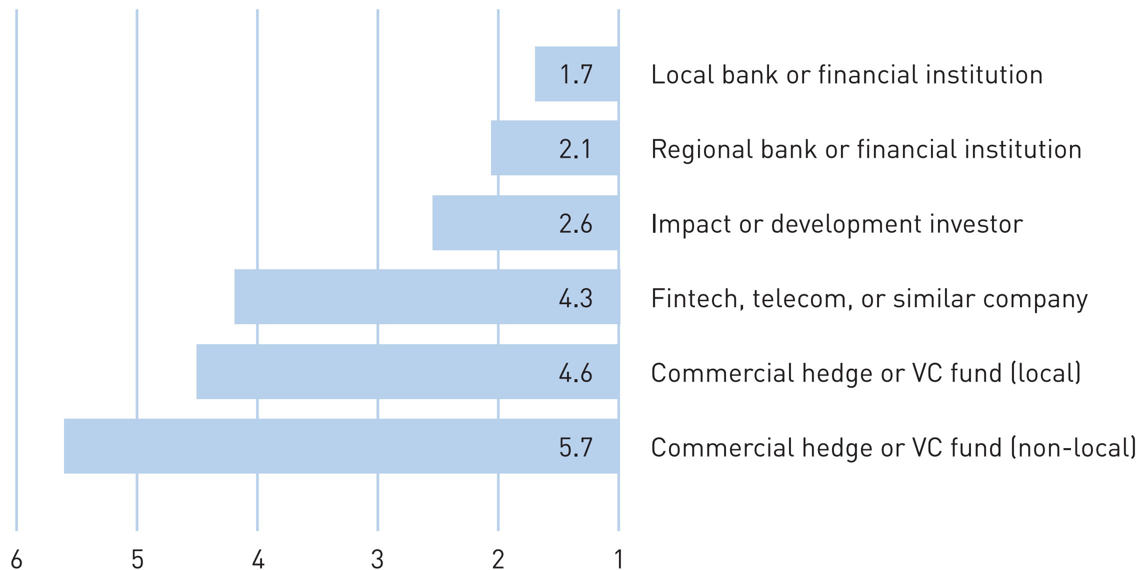
The regional proximity of the buyer may be of low importance, but buyer type is not. Figure 3 shows that there was indeed a strong preference for local or regional, banks or other financial institutions, with middling support for impact/development investors or FinTech companies. Commercial hedge or venture capital funds were the least preferred category of buyer.

Despite this, there was consensus in the interviews, survey and consultation session that FinTech companies may often require special attention as a category, with their lack of previous financial inclusion experience and incentives that may not align with those of the social investor. There is a resulting need "to look into [the] intentions, strategy, and if there is a commitment to the [MFI's] purpose, or if they are just looking to buy a client base..."

> *"[A] new fintech company would require additional verification that the commitment to the social impact was maintained."*

Figure 3: Investors' Reported Preference on Buyer Categories

Please rank, with any other knowledge, the following categories of potential buyer in terms of favorability to you:



1 = best / 6 = worst

The proliferation and evolution of Social Performance Management (SPM) frameworks in the financial inclusion industry may be thought to affect the due diligence required of a prospective buyer (a SMART-certified MFI may have more social 'mission' to lose, but on the other hand, may be more protected by other investors from abandoning that mission after a strategic sale), but generally, respondents reported low relevance of the SPM accreditation of the MFI in terms of its effect on buyer selection (i.e. the level of accreditation or social ratings does not affect the process of evaluating buyers). However a few investors did observe the value it has in **self-selection**: the perception that no buyer looking to profit-maximize or replace prudent microfinance loan appraisal with usurious payday lending is going to want to do so via a socially-focused MFI.

> *"It depends what you sell: if you sell a minority position, it has less impact than if you sell control and proportionate level of impact. To preserve the institution they should be kind of self-selection on the buyer's side, who needs to be integrally committed to the social mission."*

> *"It is better [if] the mission is 'hardwired' in the corporate structure, culture, and foundation documents. Then buyers can self-select."*

FIRST, DO NO HARM: AN INDUSTRY CONSENSUS...

Overall, the consensus is that - subject to clearing certain reputational hurdles (outlined in more detail in the Conceptual Framework for Buyer Selection) - the financial offer is the dominant criterion in buyer selection. The industry consensus is therefore Hippocratic in nature: First, Do No Harm - which in this context means excluding egregiously unsuitable candidates whose purchase, particularly of a majority stake, would imperil the social mission of the MFI. After this (usually modest) threshold is cleared (and in practice such candidates would seldom make it as far as a shortlist of buyers after a Call for Expressions of Interest), the financial offer dominates in the ultimate selection. This is the dominant practice reported by equity investors throughout this research.

In fact, investors did cite cases of withdrawal of interest in a prospective buyer after due diligence. This happens as a result of negative references; others' negative experience with the buyer in other transactions; doubts on origins of funds; inadequate knowledge of or experience in financial sector; poor sustainability credentials; links to undesirable groups; or the fear that they would turn the MFI "into a salary [payroll] lender." Or as one investor put it, "once you get past the clearly disreputable buyers, [including via] self-selection, you have to take the best offer."

'Reputation' does matter of course, but the cited importance of reputation is as much about the reputational risk to the seller as the protection of the MFI from the buyer whose reputation is at stake. Reputation is often just naked self-protection:

> *"The first thing I would consider as a seller is: how does it affect me? Is my reputation being affected? Second, [how does it affect] the [end-]client? Third is the effect on staff. In that order."*

Put simply, the consensus approach establishes a minimum threshold for social or strategic criteria, and a maximizing approach with respect to the financial offer.

BEST INTERESTS: AN ALTERNATIVE BUYER SELECTION MODEL...

There is another position too, which holds that 'First, Do No Harm' exclusionary criteria based on negative obligations placed on the seller fails to recognize:

1. The deleterious effect on staff morale, leading to high turnover and adverse effects on clients, if a new investor dilutes the mission of a socially-focused institution;
2. The particular vulnerability of microfinance clients and the need to ensure that they are not only protected from bad practices, but that they are also well-served by the mission-driven institution being sold; and, perhaps most significantly ...
3. ... the implied intention of the asset owners that the social mission of the asset should be maintained - and that this is a positive obligation - i.e. the obligation to do something, rather than to merely not let something else happen.

> *"The wish to go for positive impact and not just prevent negative impact is a debate [that's] very much at play on [Environmental and Social] topics; e.g. [should we] only apply exclusion lists (negative screening) or look at positive impact (of investments) on E&S? I can see the need for the industry to go the extra mile."*

This position reverses the prevailing view, arguing instead that the financial offer should serve as the initial threshold, and once the investor's target return is met, other aspects of the buyer - its strategic value to the investee and its ability to carry the baton of the MFI's social mission into the future - should dominate.

In this sense, there is a minimum threshold for the financial offer, and a maximizing approach with respect to social and strategic criteria.

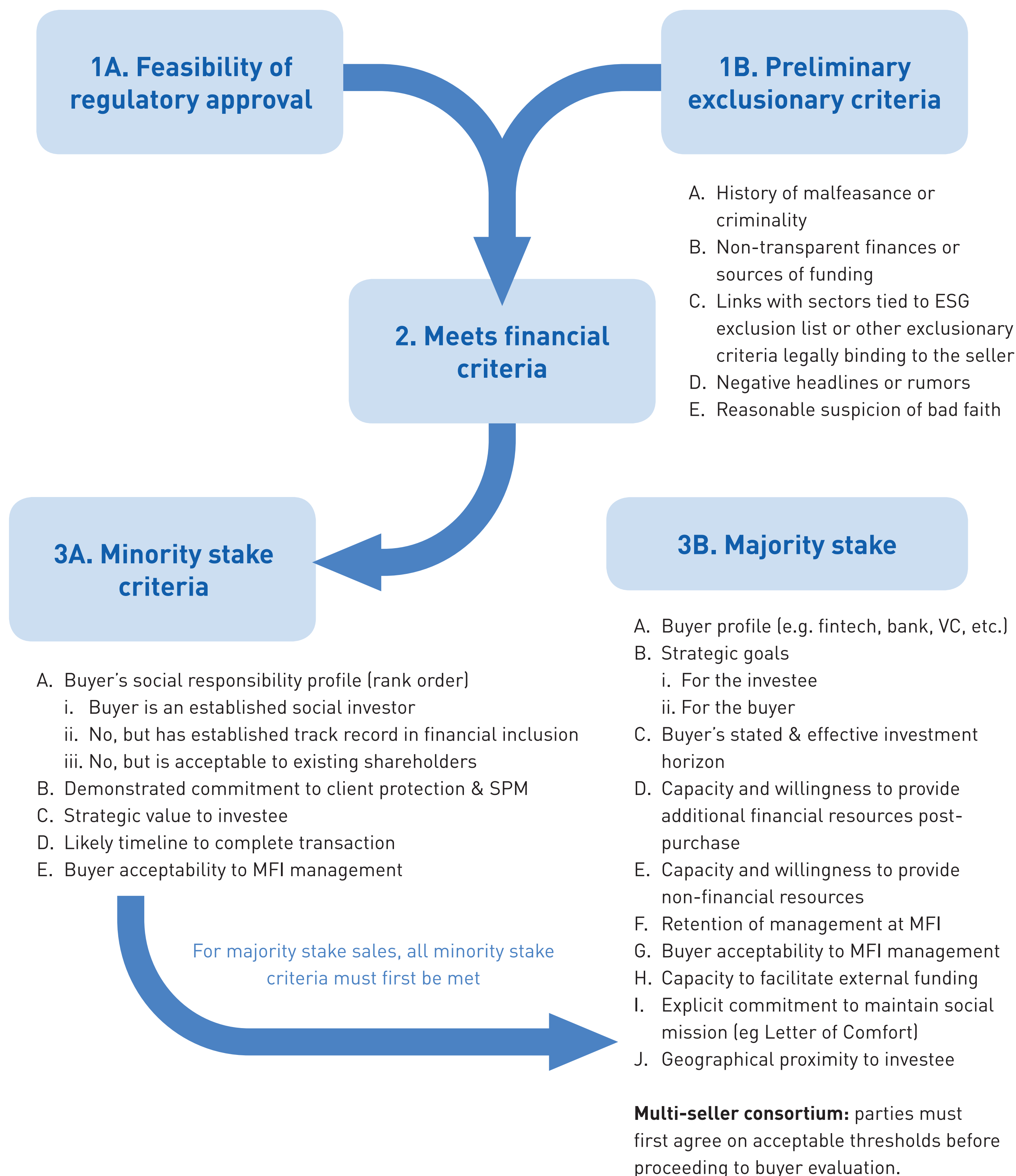
We believe that this approach, with its positive obligation on the seller(s), is better aligned with pursuing a social mission while delivering a reasonable financial return - which is at the core of the social investment value proposition.

> *"Impact investment only makes sense if we track social performance with the same rigour as financial performance...so if your claim is to be an impact investor, you should have a framework around why it is a responsible exit. SPM is not subjective, there are internationally recognized best practices. Likewise, for exits in private equity...we still need to strive to think about what is responsible and what is not, and document the decision process, or we will be accused of 'impact washing', and the impact we claim will go away and will cease to be able to place money and create impact."*

Many of these concepts are affected by the key issue of whether the stake being sold is a **minority** or **majority** share - and, relatedly, if the selling investor is selling in a consortium alongside other investors. As the Conceptual Framework for Buyer Selection illustrates, first, regulatory approval must be feasible. Second, there are basic exclusionary criteria to be considered to exclude manifestly unsuitable candidates. Third, if a minority stake is being sold, there is a checklist of factors to consider. Fourth, if a majority stake is on the table, the importance of due diligence on these existing criteria increases (because of the added consequences of selling to a bad buyer), and further selection criteria become relevant.

> *"Sometimes [reputation] is driven by other sellers in the same transaction if we are not the ones driving the sale...if we are selling our stake together with several others, including locals, and the shares are being sold to another local entity, then the burden of "reputation proof" gets somewhat shifted to the local actor in the consortium."*

A CONCEPTUAL FRAMEWORK FOR BUYER SELECTION



Within each category, the indicators are ranked by importance, but different contexts may result in different ranking order.

Designed to help exiting investors to think through the types of questions they need to consider when evaluating buyer suitability, this Conceptual Framework for Buyer Selection brings together the practices of different investors, drawn out from interviews, survey and consultation, and also advocates an evaluation process which moves beyond *First, Do No Harm* towards *Best Interests*. It is structured so that questions are organized based on the type of transaction being contemplated: a minority or majority stake being sold, as part of a consortium of shareholders, or by a single investor.

> *"An investor [buyer] with vast experience and knowledge can add value and contribute significantly more than a less experienced investor operating within the same region/ country."*

The framework of concepts should be illustrative, but it is not designed - nor could it - to be one-size-fits-all: each exit is dependent on the investee's mission and the context in which operates, as well as the seller's own objectives. While the framework is illustrative in terms of **rankings** - the criteria are provided in broadly descending order of significance based on the survey responses and interviews - the rankings should not be seen as inflexible, nor are **weightings** attached to different criteria. This is deliberate: the relative weight of these will depend on the timing, urgency and objectives of the seller, as well as the regulatory and market context, and sellers may include additional criteria not contemplated by the framework. The framework should be thought of as providing a rubric that each seller can expand upon themselves.

Moreover, the framework here is presented not as a conventional decision tree or chronological guide, because the stages will overlap, and the criteria considered in step 3A - cases where a single seller or consortium are selling a minority stake - are not distinct from step 3B - cases where a majority stake is being sold. These steps must be considered as one, with supplementary criteria added for the latter, and with certain criteria - for example, Buyer Acceptability to MFI Management - part of both, but of increased importance in cases of a majority versus a minority sale.

This framework may be thought of as a **three-stage process**:

1. Are there **exclusionary factors** which mean the potential buyer is manifestly unsuitable; and, if not, is there any reason to believe that regulatory approval for the purchase would be difficult or unlikely?
2. If not, is the initial, **indicative financial offer** within a predefined range[5] that is acceptable to the seller(s) based on the overall double-bottom line objectives of the Fund?
3. If so, how does the proposed buyer, and its strategic objectives for the MFI, align with the social mission and the other **best interests** of the MFI?

> *"A seller should start with setting up a preferred profile for a buyer, as part of the process of determining a predefined price range. That will bring focus in the search for buyers, be it a search done by sellers themselves or through an advisor."*

5 The predefined pricing range reduces the temptation to change the price target based on the bids received, which would serve to steer the buyer selection back towards the financial offer and away from the best interests of the MFI and its clients.

EXPLANATORY NOTES 1/3

CATEGORY	#	DESCRIPTION
1A. Initial likelihood of regulatory approval		Is there reason to believe that the regulator in the MFI's market may reject or otherwise have cause to look unfavorably upon the buyer?
1B. Absence of Preliminary Exclusionary Criteria	A	**History of malfeasance or criminality**. Does the buyer have any formal record or a sufficiently pervasive reputation for criminal activities, such as corruption, fraud, money laundering, or illegal or unethical labor practices?
	B	**Non-transparent finances or sources of funding**. Can the provenance of buyer's funding be reasonably traced in order to determine legality or ties to illicit or otherwise unacceptable activities?
	C	**Links with sectors tied to ESG exclusion list or other exclusionary criteria that are legally binding to the seller**. Does the buyer have investments in assets or sectors that fall under ESG or other exclusions that prohibit the seller from selling to that entity? This is a standard concern for direct or indirect investments by public entities and DFIs.
	D	**Negative headlines or rumors**. Does the buyer have significant amount of negative press coverage or is subject to concerning rumors among individuals active in the buyer's area of operations.
	E	**Reasonable suspicion of bad faith**. Does the seller have reasonable suspicion that the buyer has a history of acting in bad faith, or does the buyer and the proposed acquisition not 'smell right'?
2. Financial Criteria		**Meets financial criteria**. Does the buyer's offer meet the target price defined by the seller(s) prior to soliciting bids? The target price should be guided by the fund's *overall* financial return objectives and reflect realistic evaluation of what the asset may be worth. Defining the target price in advance reduces the temptation to change the target based on the bids received, which would serve to steer the buyer selection back towards the financial offer (and *do no harm*) and away from the *best interests* objective.

EXPLANATORY NOTES 2/3

CATEGORY	#	DESCRIPTION
3A. Minority Stake Criteria	**A**	**Buyer's social responsibility profile.** Is the buyer an established social investor, of a similar profile to the seller? If not, does the buyer nevertheless have a track record of investing in the financial inclusion sector? If not, does the buyer nevertheless demonstrate sufficient social bona fides to be acceptable to the seller and other investors?
	B	**Demonstrated commitment to client protection and SPM.** does the buyer have a demonstrable track record that indicates support for client protection or other SPM initiatives, including investing in other financial inclusion entities that have a continued commitment to client protection? If not, are there any other activities, partnerships, or statements that positively indicate such a commitment?
	C	**Strategic value to investee.** Is the buyer able and willing to offer value to the investee, for example partnerships that provide access to digital finance platforms?
	D	**Likely timeline to complete transaction.** Is the reasonable timescale for completion reasonably expedient and convenient for the seller, buyer and investee?
	E	**Buyer acceptability to MFI management.** Does the MFI's management see the buyer as a good fit for the organization and its mission?
3B. Majority Stake Criteria	**A**	**Buyer profile.** Does the buyer have a profile that warrants additional due diligence? Investors have expressed that buyers such as fintech and venture capital companies typically require additional due diligence to establish their strategic goals and likelihood to sustain the investee's social mission.
	B	**Strategic goals (i - for the investee).** How does the buyer envision the strategy of the investee post-purchase? Is this strategy in line with the overall social mission of the investee and the intentions of the seller? **Strategic goals (ii - for the buyer).** What role does the purchase of the investee play in the buyer's overall business strategy (e.g. expansion into a new region or segment, portfolio diversification, growth & capital appreciation)?
	C	**Buyer's stated and effective time horizon.** What is the time horizon of the buyer's strategy for the investment (i.e. what are its own exit plans, if any)? Is this time horizon consistent with the buyer's legal/financial structure (e.g. a venture capital fund would not typically be able to sustain a long-term horizon)

EXPLANATORY NOTES 3/3

CATEGORY	#	DESCRIPTION
3B. Majority Stake Criteria	D	**Capacity and willingness to provide additional financial resources post-purchase**. Does the buyer have "deep pockets," i.e. additional capital that can be made available either to fund investee's future growth or to inject equity to support the investee during a market downturn. Is the buyer willing to make such additional equity investments?
	E	**Capacity and willingness to provide non-financial resources**. Does the buyer have non-financial capabilities, such as operating a digital finance platform or an agent network, expertise in new products (savings, insurance), access to new market segments or geographic areas, or other capabilities that would be valuable in furthering the investee's mission? Is the buyer committed to making these capabilities available to the investee in an effective manner?
	F	**Retention of management at MFI**. Does the buyer intend to retain a significant proportion of senior staff and management at the MFI after purchase of a controlling stake (for example, by signing employment contracts as part of the sale agreement)?
	G	**Buyer acceptability to MFI management**. Does the MFI's management see the buyer as a good fit for the organization and its mission? Note that for majority sales, this question should typically receive considerably more weight than for minority sales.
	H	**Capacity to facilitate external funding**. Is the buyer of a controlling stake in the investee able and willing to assist the company in accessing debt finance through capital markets, especially at competitive rates in local currency?
	I	**Explicit commitment to maintain social mission (e.g. 'Letter of Comfort')**. Has the buyer made a written (although non-binding) commitment or covenant to maintain a particular social focus within the investee, such as limits on interest rates, outreach to low-income segments, or commitments with respect to reaching client protection certification milestones?
	J	**Geographical proximity to the investee**. Is the buyer located in the same country/region as the investee, and with convenient transportation routes?

MOVING FORWARD

Each of the MIVs interviewed during this research already have some type of internal process used to assess potential buyers for suitability. They share some elements in common, and there are others that reflect more specific institutional concerns. And yet, they all feel that there is more to be done. From the start, this effort was guided by the goal of giving back something actionable, a framework that could pull together examples from different funds and provide a more holistic approach to this most fraught part of the exit: evaluating whether the buyer is suitable or not.

The framework isn't meant to be a checklist, but an illustrative guide to the web of competing concepts and criteria that inform an exit. It can be adapted to reflect the needs of different investors. But it's also more than just a sum of the individual parts. We encourage investors, who feel strongly about their social missions and put extensive efforts in selecting and monitoring their investee institutions, to put equal rigor into divesting their stakes.

Some investors interviewed during this research have used the analogy of 'letting children move out into the adult world' as a way to express that there is little they can do about the social mission of their investees once they've exited. But this analogy doesn't fully pass muster. Young adults can make up their own minds and pursue their own goals. But the investees aren't 'set free'; they are sold to other investors who, especially in cases of a majority sale, will assume control. To go back to the children analogy, rather than setting their investees 'free', investors are transferring responsibility to another guardian.

We believe that the responsibility of finding the right buyer lies very much with those doing the selling. And if the sale means handing over control - a majority stake - this creates an even greater burden. A buyer selection practice which gives primacy to the financial offer and considers social mission and strategic value to the investee - the investee's *best interests* - only in order to reject egregiously unsuitable buyers, fails to keep in mind that the best interests of the MFI and its clients is, for the investors who put funds into the MIV, arguably the primary reason for investing in the financial inclusion sector in the first place.

We hope that the Conceptual Framework for Buyer Selection this research has produced will spur discussion and encourage investors to wrestle with the challenges of strengthening the sector's focus on sustainable and profitable social mission. We hope too that it will inspire further work on an issue which, as equity sales continue to grow, will only increase in importance.