Regulating private equity -
Overview of recent parliamentary hearings and legislatives initiatives

ANNEX

TUAC Labour/Management Seminar on
"Financialisation of the Economy: Regulating Private Equity"
12 November 2007
OECD, Room G

Extracts of parliamentary reports:

European Union

- Motion for a European Parliament Resolution on financial services policy (2005-2010), June 2007

Australia

- The Senate Standing Committee on Economics – Private equity investment in Australia, August 2007

United Kingdom

- House of Commons Treasury Committee – Report on Enquiry into the private equity industry, July 2007

United States

- Private Equity's Effects on Workers and Firms – Hearing Before the Committee on Financial Services US House of representatives - 110th Congress, May 16, 2007

EUROPEAN PARLIAMENT

2004 *2009*

Session document

FINAL
A6-0248/2007

27.6.2007

REPORT

on financial services policy (2005-2010) - White Paper
(2006/2270(INI))

Committee on Economic and Monetary Affairs

Rapporteur: Ieke van den Burg

interest of clearing and settlement security; welcomes the progress being made in implementing the Code of Conduct which will deliver those aims and which will also support Article 34 of MiFID, requiring stock exchanges to provide all their users with the option of designating the settlement system in which they want to settle their transactions in the event of cross-border share transactions; intends closely to scrutinise the developments surrounding the Code of Conduct as well as the TARGET2 Securities project in this context, emphasising the governance and supervision needed to cope with conflicts of interest; and calls the Council and the Commission to launch, without further delay, the initiatives required to remove completely the obstacles under the control of the public sector relating to the legal and fiscal barriers identified in the Giovannini Group's report and in the areas not covered by the Code of Conduct.;

12. Points to the increasing influence of proxy voting intermediaries and financial intermediaries holding consumers' tangible assets through indirect holding systems; asks the Commission to assess the potential risks of market dominance, market abuse and conflicts of interest by such intermediaries and to closely monitor the effects of the prospective directive on the exercise of voting rights by shareholders of companies;

13. Expresses its disquiet at the high proportion of financial service companies in the new Member States that are wholly or partly foreign owned, given, first, that this makes it difficult for the supervisory authorities in those countries to exercise effective supervision and control and, in addition, that the interests and needs of the new Member States' economies often play only a minor role in the strategies pursued by parent companies' foreign-based head offices;

14. Asks the Commission to assess facts about the functioning of the top level of the market of large merger and acquisition transactions and private equity deals and the accompanying underwriting and lending activities; strongly welcomes the increased vigilance of supervisors on plain cases of market manipulation, insider dealing or front-running; urges the Commission to cooperate with US regulators to check whether the necessary safeguards, such as internal codes of conduct and 'Chinese walls' are adequate to achieve an appropriate level of corporate governance and market transparency and to manage conflicts of interest;

15. Underlines the importance of ensuring the independence of financial analysts and financial market data providers through transparent funding structures; urges the Commission to address the issues unresolved by Commission Directive 2004/72/EC[1] (MAD) and MiFID with regard to the distinction between 'financial analysis' and 'other information';

Alternative investment vehicles

16. Is fully aware of the rapid rise of alternative investment vehicles (hedge funds and private equity); recognises that they provide liquidity and diversification in the market and create an opportunity to improve efficiency of corporate management, but also shares the concerns of some central banks and supervisors that they may give rise to systemic risk

[1] OJ L 162, 30.4.2004, p. 70.

and to high levels of exposure of other financial institutions;

17. Calls on the Commission to launch a debate on hedge funds so as to be prepared for international and European discussions;

18. Welcomes the Commission's recent studies on hedge funds and private equity, but regrets that these studies so far have focused only on barriers to growth of such funds, invites the Commission to monitor any potential policy gaps; emphasises the need for sector-specific work by regulators of such funds, including the CESR and IOSCO and competent authorities in markets where such funds are common taking it on board as part of the EU-US dialogue; asks for a broader and more critical approach with regard to the risks of market abuse; invites the Commission to review the differences in Member States' regimes for retail access to alternative investments, and in particular to determine the appropriate qualifications for distributors of such products to retail investors;

19. Urges the Commission to assess the quality of supervision in off-shore locations and to step up cooperation with the supervisors in these jurisdictions; intends to join forces with the US Congress Financial Services Committee of the House of Representatives in investigating, inter alia, tax measures to respond to the undesired flight of capital to tax havens;

20. Welcomes the updated report of the Financial Stability Forum of 19 May 2007 on the hedge fund industry; in particular welcomes the recommendations of the report aiming to address potential systemic risk and operational risks associated with the activities of hedge funds; calls for increased cooperation and exchange of information among supervisors of financial institutions in taking forward these recommendations and in spreading good practice in order to enhance resilience to systemic shocks; and furthermore urges the creditors, investors and authorities to remain vigilant and adequately to assess potential counterparty risks that hedge funds present;

Access to finance in the retail segment

21. Notes that cross-border integration of EU retail financial markets is less developed than in the wholesale area; notes that consumers still use physically present institutions more than virtual ones, and notes a predominantly domestic-oriented financing structure; but warns against simply overhauling the national consumer protection traditions and legal systems by one-size-fits-all harmonisation; takes the view that national consumer protection traditions must not be interpreted in such a way that new competitors are hindered on the domestic market; underlines the need for a well-functioning internal market for financial services; notes the importance of intermediaries in order to bring competition to Member States' domestic markets; stresses the benefits of open and pluralistic structures in the European banking market to meet the different and evolving needs of consumers;

22. Prefers a more focused approach directed at the concrete barriers which impact on mobile cross-border users; encourages the financial industry to develop pilot pan-European financial products such as pensions, mortgages, insurance products or consumer credit and invites the Commission to undertake the preparation of an appropriate and feasible

EXPLANATORY STATEMENT

The Financial Services Action Plan has contributed to delivering an integrated and well functioning European capital market that is taking the lead in the world not least because of the quality and solidity of its regulations. The question is now: who is profiting from this success? Are end users profiting to the same extent as the large multinational players that strengthened their international position in a consolidation that led to pretty dominant positions in the top of the financial markets?

Consolidation at the top of the market is strong, with 30 - 40 major cross border financial players and a high concentration in several member states. Merger and acquisition activity have been high and national markets in new member states are dominated by foreign players. The borders between the sectors are becoming increasingly blurred, with the aid of directives such as MIFID, which has led to initiatives such as project Turquoise in the area of alternative trading platforms, and the CRD and Solvency 2 which offer the possibility of convergence of banking and insurance activity through advanced risk management systems.

The high level of consolidation may lead to issues of competition law and market failure. Can a big listed company (listed on one of the bigger stock exchanges fully involved in such a consolidation process) survive without a rating of one or more of the 3 major rating agencies, without the services of top investment banks accompanying a major acquisition or merger, or without one of the 4 big audit firms for their financial statements?
What happens behind and between the Chinese walls of the City of London and other financial centres? Is there sufficient competition at the top end of the market? That is a first question raised in this report, leading up to suggestions for more in depth economic impact studies and DG Competition sector inquiries, where possible in cooperation with authorities in the US and elsewhere in the world.

Another important topical phenomenon is the rapid rise of the alternative investment business, often based in exotic places outside the EU. Do private equity firms and hedge funds bring the real economy the desired investments in innovation, in sustainable growth, in a higher quality of jobs and social cohesion? Or have they brought a much higher leverage on companies' debt burdens, degrading of their bonds' status, and higher complexity and interdependency of risks involved in complex financial products like credit risk derivatives? Are hedging techniques that diminish the risks for individual investors, also able to spread and diminish risks at the macro level or do they only lead to herd behaviour?

Commissioner McCreevy so far seems only to promote these alternative investors as providers of liquidity and as activist shareholders. His main concern is to take away barriers for private placement and he resists any discussion about further regulation. Prudential supervisors, Central Banks and the ECB, like their counterparts in the USA are becoming more aware of the financial stability and systemic risks involved. Some inquiries have started on market manipulation and insider dealing. The increasing leverage and debt ratios imposed on companies, the growing risks for underwriting banks, and the increasingly complex architecture of financial techniques meant to diversify and spread risks (such as credit risk derivatives) have led to warnings and investigations. The obverse of greater diversification and liquidity is a greater interdependency between investments and risks, which in case of a major default might lead to unforeseen domino effects in the whole global financial market. Besides individual screening and monitoring of the regulated parts of the system, and better registering and monitoring of the unregulated parts, an overall macro-prudential assessment of systemic and operational risks is what is needed in cooperation between all supervisors and political actors.

A third theme of the report is the much lower degree of integration in the retail financial markets. The answer to the persistent prevalence of traditional domestic structures of retail financing is not simply to open up the national markets by forcing acceptance of foreign products and sales methods on the basis of supervisory and consumer protection regimes of their country of origin. Traditions of consumer protection and conduct of business supervision are firmly rooted in the context of the different legal and social-economic systems and should not be simply overhauled into a one-size-fits-all harmonisation. Focus here should be more on the concrete cross border demands of mobile users than on ambitions to promote cross border shopping amongst domestic users to create more competition and more choice. The rapporteur rather likes to see financial industry developing pilots for pan-European financial products, such as pensions, mortgages or specific insurance products. An appropriate framework of supervision, contractual law and consumer protection should be developed for these products to be portable across borders within the EU, mutually recognised by all involved regulators.

The demand for micro credit from self employed and previously informal sector individuals that endeavour to start their own business is only recently acknowledged and reluctantly met by traditional credit providers. Your rapporteur suggests that, based on best practices in terms of legal and regulatory environment in and outside Europe, the Commission should present an action plan for micro financing.

In this chapter also the sustainable financing of further demographic imbalances via funded pension systems is mentioned. Besides first pillar pay-as-you-go income provision for pensioners, second pillar occupational pensions have a role to play. The big challenge is to make them accessible not just for the happy few. Particularly solidarity based 2nd pillar DB systems should be developed further and not counteracted and endangered by regulations or provisions that tend to lead to qualitatively deteriorated (DC) systems that put all the investment risks on the individual participant. For prudential supervision the specific IORP directive should be distinguished from the overall Solvency II approach.

Access to basic services is another major issue. A bank account, access to cash machines, card or other safe payment systems, the possibility to make financial transfers at low cost, to save or to borrow money, these are basic needs that should be available for every citizen. This is not evident everywhere though. A low income, previous registration of indebtedness, living in the wrong neighbourhood or even having the wrong name, is denying large numbers of European citizens' acceptance as a bank client and excluding them from the use of basic financial services. The Commission is asked to initiate a European study to assess the accessibility to basic financial services and to consider whether and in how far it is desirable and feasible to enforce universal service obligations on financial institutions to provide these basis services.

The Senate

Standing Committee on Economics

Private equity investment in Australia

August 2007

Senate Standing Committee on Economics

Members

Senator the Hon Michael Ronaldson, Chair	Victoria, LP
Senator Ursula Stephens, Deputy Chair	New South Wales, ALP
Senator Cory Bernardi	South Australia, LP
Senator Grant Chapman	South Australia, LP
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Conclusion

5.33 The committee does not consider that any convincing case has been made for any further regulation of private equity activity in Australia at this time. It recognises and endorses the ongoing watching brief maintained on this issue by the Treasury, the RBA, the ACCC, ASIC and the FIRB. The requirements of Chapter 6 of the Corporations Act, the conflict of interest rules, sector-specific legislation and the FIRB guidelines offer appropriate and adequate protection for Australian companies and the Australian public. The activities of both private and listed Australian companies will continue to be reported under the Corporations Act and through the international accounting standards set by the Australian Accounting Standards Board. Private equity consortiums will themselves be guided in their decision-making by prospects for economic success and growth.

5.34 The committee believes it is important to continue to attract foreign investment into Australia and does not accept the narrowly held view that some sectors of the national economy should be protected from private equity activity. The committee views private equity as an opportunity to reinvigorate underperforming public companies, which will subsequently benefit Australian consumers, shareholders and workers. It does not see the market imperative that drives foreign investors to buy out Australian companies as being inconsistent with the national interest and notes the protections already afforded under foreign investment policy and the *Foreign Acquisitions and Takeovers Act 1975*.

Senator the Hon. Michael Ronaldson
Chair

Private Equity – Labor Supplementary Report

Private equity has been an aspect of international and domestic markets for many years. Labor recognises the importance of private equity's role in the market and particularly the provision of venture capital to support emerging business opportunities. However, of some concern is the sector of the private equity market which makes highly leveraged acquisitions. Evidence to the Committee disclosed examples of gearing levels up to 200 per cent higher than the average company. The portion of the private equity market which related to leverage buyouts increased in 2006 compared to venture capital investment, although leveraged buyouts still only made up about 1 per cent of the Australian equity market.

Labor also notes that recent developments in global capital markets as a consequence of exposure to the non-conforming mortgage sector in the United States has resulted in a re-pricing of risk. Some market commentators have noted that this re-pricing of risk is likely to result in a downtrend in highly leveraged private equity buyout activity.

Although evidence to the committee indicates that investors in the private equity market, including leveraged buy outs, are largely sophisticated investors such as institutional investors, it is still essential that they are full informed of the risks involved in their investment.

There should also be clear guidelines to manage private equity proposals to deal with any conflict of interests issues. Labor welcomes the Takeovers Panel Guidance note 19: Insider Participation in Control Transactions provides a guide to setting up protocols to reduce the conflicts of interests for management involved in any takeover and seeks to address some issues relating to the protection of investors.

Labor agrees with the conclusion of the main committee's view that no further regulation is required for private equity activity at this time. In addition, Labor supports the main committee endorsement of an ongoing watching brief on this issue by the Treasury, the RBA, the ACCC, ASIC and the FIRB. The position that private equity holds in the market as well as any effects on the market should continue to be monitored and reviewed.

Labor members consider that monitoring by the relevant regulatory bodies should take into account:

- any increase of private equity leverage buyout activity in the Australian market as there was in 2006;
- the work of the Australian Taxation Office in terms of taxation implications and compliance as part of its large business program and compliance plan for 2007-08;
- any impact on revenue;

- any concentration of private equity leverage buyout activity in particular sectors and its effects, for example in the health and aged care sector; and
- any impact on employment as a result of private equity activity.

Senator Ursula Stephens
Deputy Chair

Senator Annette Hurley

Senator Ruth Webber

Senator Penny Wong
Participating Member

House of Commons
Treasury Committee

Private equity

Tenth Report of Session 2006–07

Volume I

Report, together with formal minutes

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration and policy of HM Treasury and its associated public bodies.

Current membership

Rt Hon John McFall MP (*Labour, West Dunbartonshire*) (Chairman)
Mr Graham Brady MP (*Conservative, Altrincham and Sale West)*
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)
Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)
Mr Philip Dunne *(Conservative, Ludlow)*
Angela Eagle MP (*Labour, Wallasey*)
Mr Michael Fallon MP (*Conservative, Sevenoaks*) (Chairman, Sub-Committee)
Ms Sally Keeble MP (*Labour, Northampton North*)
Mr Andrew Love MP (*Labour, Edmonton*)
Mr George Mudie MP (*Labour, Leeds East*)
Mr Siôn Simon MP, (*Labour, Birmingham, Erdington*)
John Thurso MP (*Liberal Democrat, Caithness, Sutherland and Easter Ross*)
Mr Mark Todd MP (*Labour, South Derbyshire*)
Peter Viggers MP (*Conservative, Gosport*)

The following members were also members of the Committee during the inquiry: Mr David Gauke MP (*Conservative, South West Hertfordshire*), Kerry McCarthy MP (*Labour, Bristol East*), and Mr Brooks Newmark MP (*Conservative, Braintree*)

Powers

The committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at www.parliament.uk/parliamentary_committees/treasury_committee/treasury_committee_reports.cfm.

A list of Reports of the Committee in the last Parliament is at the back of this volume.

Committee staff

The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk and Clerk of the Sub-Committee), Adam Wales, Jon Young, Harry Marin and Anna Leach (Committee Specialists), Lis McCracken (Committee Assistant), Michelle Edney (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

Contacts

All correspondence should be addressed to the Clerks of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk

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Report

Summary

Our inquiry was undertaken in response to the growing significance of the private equity industry in the UK (8% of the UK workforce is now employed in private equity-owned companies), and, in particular, to the rising number of takeovers of very large companies by private equity firms. We have concentrated on the highly-leveraged management buy-in and buy-out sector. Our report is an interim one.

We examine the respective advantages and disadvantages of private equity and public limited company (PLC) ownership, and conclude that there are benefits and potential problems associated with each, and that different forms of ownership may be appropriate for a company at different times in its history. There remains a debate in the case of some large-scale private equity takeovers about how much of the profit can be attributed to financial engineering compared with value extraction and creation.

Many of our witnesses highlighted the disadvantages of PLC status. We invite major corporate investors to re-examine why their requirements of PLCs and of private equity-owned companies are so different.

We note the need to ensure that company pension fund commitments are securely funded, especially when changes, such as an increase in leverage, are made to a company.

We note that, however extensive the due diligence conducted, higher levels of leverage are likely to create additional risk; that this becomes more significant the more important highly-leveraged firms become in the economy; and that the trend towards greater leverage has occurred during a period of economic growth and stability, which is not guaranteed to continue. We therefore urge the Bank of England to research the potential impact of an economic downturn, both on highly-leveraged firms and on the wider economy. We also recommend that the Financial Services Authority continues to seek assurance that the banking system has the appropriate structures and monitoring in place to handle the risk associated with banks' exposure to leveraged buy-outs.

We welcome Sir David Walker's proposals to increase transparency in the private equity industry, and would like to see more detailed guidance on some aspects of the information to be provided. We also suggest additional independent monitoring of the industry's conformity with the proposed code in order to provide greater assurance of compliance. In addition, we invite Sir David to consider whether more information could be made available on fees in order to make the private equity market more competitive.

Given the conflicting views expressed about whether the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) apply to takeovers, we ask the Government to clarify this.

We recommend that the Treasury and HM Revenue and Customs consider the tax treatment of carried interest as part of their current review of taxation in this area, and we request information about the purpose and current operation of the Memorandum of Understanding.

We recommend that, in addition to reviewing the tax treatment of debt in highly-leveraged management transactions, the Treasury and HM Revenue and Customs examine whether the tax system unduly favours debt as opposed to equity, thereby creating economic distortions. Whilst recognising that the issue is not exclusive to private equity, we also ask the Treasury to inform us of the progress on the 2003 review of the residence and domicile rules as they affect the taxation of individuals, and note that the Treasury and HM Revenue and Customs need to demonstrate a rigorous approach towards claims of non-domicile status.

The central issue remains what impact the current activities of the private equity industry, especially the larger private equity firms, are having on the UK economy as a whole. We will return to the matter in the autumn. It is clear that there are areas of concern which deserve continued attention from policy-makers.

Conclusions and recommendations

Private and public equity models compared

1. We accept that ensuring that company pension fund commitments are securely funded is a vitally important matter when major changes are made to the structure and financing of a company, especially when such changes include an increase in leverage and thus increased risk to pension funds, and we will return to this matter when we resume our inquiry into private equity. (Paragraph 32)

2. It is clear that there are benefits and potential problems associated both with private equity and public equity, and that different forms of ownership may be appropriate for a company at different times in its history and for different companies. We also accept that the central issue will usually be how effectively the company is being managed. There remains a debate in the case of some large-scale private equity takeovers about how much of the profit can be attributed to financial engineering compared with value extraction and creation. Also, we note that for some of the issues discussed in this chapter the available information, especially on the effects of management buy-ins, is patchy and these issues need further investigation. (Paragraph 33)

3. We invite major corporate investors to re-examine why their requirements of PLCs and of private equity-owned companies are so different, and we will take further evidence on this in the autumn. (Paragraph 34)

Economic Risk and Financial Stability

4. We welcome the work the FSA has carried out on the risks relating to market abuse and conflicts of interest in private equity markets, and its intention to carry out further work. We would be interested in receiving evidence on the incidence of market abuse or conflict of interest issues arising within private equity transactions or funds compared with public company transactions or investment funds. We will return to these issues as part of our work on the theme of transparency in financial markets. (Paragraph 40)

5. It is clear that the safeguards in place in respect of covenant-lite loans have yet to be tested. We urge the FSA and the Bank of England to continue to monitor the incidence and nature of covenant-lite loans, with a view to assessing the extent to which heavily-leveraged deals are consistent with the remits of the FSA and the Bank of England for financial and economic stability. (Paragraph 51)

6. We recommend that the FSA examine incentive structures relating to debt (Paragraph 57)

7. We note that, however extensive the due diligence conducted, higher levels of leverage are likely to create additional risk, and that this becomes more significant the more important highly-leveraged firms become in the economy. We also note that the recent increase in the number of highly-leveraged private equity-owned firms has occurred during a period of economic growth and stability, which is not guaranteed to continue. We therefore urge the Bank of England to examine the potential impact of an economic downturn, both on highly-leveraged firms and on the wider economy. We also urge the FSA to investigate the operation of due diligence in highly-leveraged firms. (Paragraph 61)

8. We strongly support the FSA's proposal to conduct "semi-annually" a survey of banks' exposures to leveraged buyouts to enable the identification of risk in a timely fashion. We recommend that both direct and indirect exposure is surveyed. We recommend that the FSA continue to work towards obtaining assurance that the banking system has the appropriate incentive structures and monitoring mechanisms in place to handle such risk. (Paragraph 65)

Transparency

9. We welcome Sir David Walker's proposals to increase transparency in the private equity industry. We would like the guidelines published in the autumn to be clear and specific in order to facilitate compliance by the industry. In particular, we would like to see more detailed guidance on the content of:

- Board statements by relevant portfolio companies setting out their approach to their stakeholders, together with information on their strategy for the company;
- Annual reviews by general partners, including the information on how value has been created;
- Reports on the level, structure and conditionality of debt.

We suggest that there be arrangements for additional independent monitoring of the industry's conformity with this code over and above the expected scrutiny by unions, politicians and the media, to provide greater assurance that compliance will not fall short of the desired level. We look forward to seeing the final details of Sir David Walker's guidelines for the private equity industry when they are published in the autumn. (Paragraph73)

10. Given the absence of comprehensive industry-wide data on the private equity industry, we look forward to seeing Sir David Walker's more detailed proposals for developing a respected capability for providing such data that commands confidence within the industry and externally when he publishes his final guidelines for the private equity industry in the autumn. (Paragraph 75)

11. We will certainly be willing to use our influence to help to ensure that any guidance drawn up by Sir David Walker is implemented. (Paragraph 76)

12. We note that the percentage fee paid by funds to general partners in the larger private equity firms has declined only to a small extent (apparently from 2% to 1.5% or 1.75%) despite the massive rise in the size of some funds. We invite Sir David Walker to consider whether more information could be made available on fees in order to make the private equity market more competitive in this respect. (Paragraph 80)

13. We ask the Government to clarify the application of TUPE to takeovers in time for the resumption of our inquiry. (Paragraph 81)

Taxation

14. We recommend that the Treasury and HM Revenue and Customs consider the tax treatment of carried interest as part of their review of the taxation of employment-related securities, and that they publish the results. (Paragraph 88)

15. We ask HM Revenue and Customs to write to us: (Paragraph 90)

- setting out the rationale behind the production of the Memorandum of Understanding in 1987 and the update to it in 2003;
- explaining the extent to which the Memorandum is used by the private equity industry;
- assessing whether the context in which the Memorandum is currently being used conforms with the original rationale; and
- stating whether the override provisions of the Memorandum have been exercised and what internal guidance on the exercise of the override has been prepared. (Paragraph 90)

16. The Treasury is already reviewing "one specific aspect of the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals"; the outcome of this review will be reported in the 2007 Pre-Budget Report. We recommend that, in addition to reviewing the tax treatment of debt in highly-leveraged transactions, the Treasury and HM Revenue and Customs examine whether the tax system unduly favours debt as opposed to equity, thereby creating economic distortions. (Paragraph 94)

17. Whilst recognising that this issue is not exclusive to private equity, we ask the Treasury to inform us of the progress on the 2003 review of the residence and domicile rules as they affect the taxation of individuals, setting out what evidence has been assembled, whether any external advice has been commissioned and the rationale behind any proposed changes. Given the apparently rising number of the non-domiciled, and a perception that monitoring of the status of non-domiciles is weak, it is essential that the Treasury and HM Revenue and Customs are able to demonstrate that they have a rigorous approach towards claims of non-domicile status. (Paragraph 95)

Formal minutes

The following Declarations of Interest were made:

12 June 2007

Mr Michael Fallon declared the following interest, as a director and a shareholder in company whose controlling shareholder is Alchemy Partners.

Mr Brooks Newmark declared the following interest: role as an industry practitioner in private equity for 14 years and role as a member of the Private Equity Institute at LBS.

Mr Peter Viggers declared the following interest, as Chairman of a pension fund which has various investments.

24 July 2007

Mr Philip Dunne declared the following interests: a remunerated directorship (non-executive) and a registrable shareholding in Baronsmead VCT-4-PLC, a venture capital trust; a former partner in a business with a development capital arm; and Chairman and founder of a company which used venture capital.

Tuesday 23 July 2007

Members present:

John McFall, in the Chair

Mr Graham Brady
Mr Colin Breed
Jim Cousins
Mr Philip Dunne
Mr Michael Fallon
Ms Sally Keeble
Mr Andrew Love
Mr George Mudie
Mr Siôn Simon
John Thurso
Mr Mark Todd
Peter Viggers

Private equity

Draft Report (*Private equity*), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 and 2 read and agreed to.

Paragraph 3 read, amended and agreed to.

Paragraph 4 read and agreed to.

PRIVATE EQUITY'S EFFECTS ON WORKERS AND FIRMS

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

MAY 16, 2007

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WITNESSES

Wednesday, May 16, 2007

APPENDIX

Additional Material Submitted for the Record

PRIVATE EQUITY'S EFFECTS ON WORKERS AND FIRMS

Wednesday, May 16, 2007

U.S. House of Representatives,
Committee on Financial Services,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Waters, Maloney, Watt, Meeks, Moore of Kansas, Hinojosa, Clay, McCarthy, Baca, Lynch, Scott, Cleaver, Moore of Wisconsin, Davis of Tennessee, Klein, Wilson, Perlmutter, Boren; Bachus, Baker, Pryce, Castle, Royce, Gillmor, Manzullo, Shays, Feeney, Hensarling, Barrett, Pearce, Neugebauer, Roskam, and Marchant.

The Chairman. This hearing of the Committee on Financial Services will come to order.

The subject of today's hearing is the question of private equity and specifically the effect that purchases of existing companies by private equity has on the workers and on the firms. There have been a number of concerns expressed about various new forms of activity in the economy, and this committee has had some hearings, and will have more, on the question of hedge funds.

Today, we are talking very specifically about private equity and one special area of concern. I will say, in general that I have not seen any argument that it is a matter for which public policy ought to be concerned as to whether people choose to own a company through a public shareholder method or privately. That seems to me to be a decision that ought to be left entirely up to the people who are making the investments, but we do have concerns about the impact on workers.

The committee, myself and many others, have been concerned for some time about increasing inequality in America. A year ago, we were debating the question about whether wages, real wages, were seriously lagging growth. We were debating inequality. That debate is largely over. There is general agreement that we have increasing inequality and that real wages have, in fact, lagged. There was a period earlier this year when they began to go up. That is now once again in jeopardy. I find the situation in which this country prospers overall, but the increased wealth is enjoyed by a relatively small number of people, to be troubling. It is morally wrong because it takes the efforts of most people to produce that wealth, and it should be shared fairly. No one is talking about equality. We are talking about degrees of inequality. I believe that the case for being concerned about this excessive inequality goes beyond moral considerations.

There is a big debate in this country now about immigration. There is a debate about trade. We are engaged in the question about how welcoming we should be to foreign investment, direct foreign investment. As more and more Americans have become convinced that economic growth, globalization, and technological change do them very little good, and in some cases, harm, you have seen increasing resistance to the kind of public policies that many in the business community believe are in the interest of economic growth, and until we are able to diminish this trend of increasing inequality, I believe that resistance will grow.

Now, with regard to private equity, I assume that the market is rational and that the private equity method increases value. I do not think people make deals in large numbers for no good reason. The question we have is does any of that increased value accrue to the people who work for the companies. Conversely, there is the fear that, to the extent that private equity is accompanied by significant increases in debt in some cases, this may have a negative effect on workers.

Now, what goes into some of the other concerns we have had in terms of compensation—and we are talking here not about compensation paid by shareholders, which is a matter we dealt with elsewhere, but the compensation that some individuals get when a small number of individuals benefit from a particular deal in the tens and sometimes hundreds of millions of dollars, and, concurrently, workers are laid off. We have a situation which seems, to me, wrong. Now the question then is, well, what are we going to do about it?

It is not clear. There may or may not be public policy implications, but to the extent that there are public policies that have an effect on the private equity situation, some of which would come before this committee, some which would deal with taxation which would come before other committees, and to the extent that we see gross imbalances, then we are going to have to act.

As an example of that, I would ask to put into the record the article from today's New York Times with the headline, "Unkind Cut For Janitors At Hilfiger," which says that one consequence of a $1.6 billion buyout of Tommy Hilfiger is that janitors making $19 an hour were fired to be replaced by janitors making $8 an hour. The Hilfiger Company was bought for $1.6 billion. Janitors show up to work, and they make $19 an hour, union wages. They are fired, and they are going to be replaced by people getting $8 an hour. Mr. Hilfiger got $66 million as the result of the sale and will get $14.5 million a year through 2010. Workers in their 40's and 50's have been laid off with 1 day's notice.

I do not know, as I said, whether public policy can do anything about that, but I do know that this is the sort of pattern that will make many of us determined to do something. So the point is a very simple one. If we have a situation, private equity, where enormous values are created, as apparently they are, and if only a few people get these large sums of money, and the workers are either no better off or worse off, then from a public policy standpoint that seems to me to be undesirable. Whether or not there are public policy remedies is the second question, but the first question I want to focus on today is whether there is such a pattern.

I must say, and let me say in closing, that in many of the areas of private equity, we are talking about hotel workers; we are talking about service employees in buildings; we are talking about janitors. These are not people who are competing with low-wage workers elsewhere. These are people serving in very low-wage capacities in a market that cannot move.

I think America can do better. Whether or not there should be a public policy response, we will find out, but we might find out with respect to policies involving unionization, taxation, and elsewhere. But the question remains, does the way in which private equity deals go forward exacerbate what is already an unfortunate trend in America for growth to go forward, for wealth to increase, but for inequality to increase even faster.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you, Chairman Frank, for holding this hearing.

This is the second hearing the committee has held on alternative investment vehicles, and, of course, this hearing is on private equity industry. Private equity is not a new phenomenon. It has been used, at least with some frequency, since the 1960's. More recently, the industry has drawn attention, you could say scrutiny, because of several blockbuster transactions: earlier this week, DaimlerChrysler; and earlier than that, Clear Channel, Sallie Mae, and Equity Office Products, just to name a few.

In 2006 alone, U.S. private equity transactions totaled $406 billion and accounted for 27 percent of all U.S. mergers and acquisition activity. One telling barometer of the growth of the industry is that, in 2001, private equity firms purchased 324 companies. By 2006, that number had more than tripled to over 1,000 acquisitions.

Several factors appear to be driving the explosive growth in private equity. Institutional investors, including public and union pension funds and university endowments and foundations, are turning more and more to private equity investments to generate higher returns for their stakeholders. In addition, publicly traded companies face an environment in which burdensome or overly burdensome regulations result in frivolous shareholder lawsuits and demands of activist shareholder groups, and all of those things have made going private an increasingly attractive alternative. And I think the executive compensation legislation that we considered just a few weeks ago may even accelerate this trend towards private financing if it empowers activist shareholders even more.

Private equity can be a valuable tool for providing capital and expertise to underperforming companies or to companies struggling to generate quarterly growth and meet Wall Street expectations. The overwhelming majority of publicly traded companies are single-mindedly focused on one thing right now, and that is June the 30th, or the end of the next quarter, which is most usually June the 30th, with the second quarter. Are they going to meet or beat estimates? Has the market already accounted for the company's possible growth?

Additionally, taking a struggling public company private gives its managers the opportunity to address strategic concerns free of day-to-day competitive pressures. To improve corporate performance, private equity firms typically recruit top managers often drawn from the ranks of senior management at publicly traded companies and directly tie their compensation to long-term performance and growth, not to short-term stock price gyrations. Indeed, our former Treasury Secretary, John Snow, verified this trend when he described his firm's acquisition of Chrysler as providing "management with the opportunity to focus on their long-term plans rather than pressures of short-term earnings expectations."

We must, I think, support the continued growth of private equity and other alternative investments in our marketplace. An overly proscriptive, rules-based approach to regulation of private pools of capital could stifle the industry and drive private equity firms and their capital offshore or to investments in other countries, potentially compromising the competitive standing of our capital markets.

Concerns have been expressed about the treatment of workers at companies that are taken private, as the chairman did earlier. While I intend to carefully listen to the testimony of today's hearing on this point, it is at least not clear to me at this point that privately managed companies act any differently with respect to worker retention or compensation than publicly traded companies.

To conclude, we have heard anecdotal accounts of differences in workers' wages in private versus public companies—the chairman read one this morning—but we have yet to see any definitive empirical evidence in this area.

Further, we should not automatically concede the premise that taking action to increase efficiencies in a privately held company is always unfair, unwarranted, or not in the best interest of the company. The actions of new management may, in fact, restore a company to competitive health, preserving most workers' jobs that would otherwise be lost, maintaining pensions and providing other benefits.

We must also not lose sight of the fact that, according to a recent study, private equity created 600,000 jobs in the United States from 2000 to 2003. Given the increasingly competitive nature of the global economy, our policy should be to ensure that American public and private companies can survive.

So, in closing, Mr. Chairman, I will look forward to hearing the testimony of the witnesses and to learning more about the ways in which this committee can play a constructive role or if there are ways of enhancing the competitiveness and vitality of our U.S. capital market.

The CHAIRMAN. The gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman, and thank you for holding this hearing.

First, I would like to say I am pleased to notice that a constituent of mine is here today to testify, Mr. Jon Luther of Dunkin' Brands, a Canton, Massachusetts-based company, who probably, I think, will offer a positive example of private equity involvement.

I am also very pleased that we are exploring the impact of the growth of private equity firms on the U.S. economy and financial system. I think it is important that this committee has a solid and accurate understanding of the modern workings of private equity funds given the recent concerns about fund executive compensation, the treatment of capital gains tax benefits on their profits, and also their ability to exploit the debt market to make those profits, sometimes to the detriment of companies and their employees.

I am going to be interested in a number of questions, but one of those is related to the modern-day private equity investment framework and how does it differ from the corporate raiders and leveraged buyouts of the 1980's given that the same big names are still involved.

Also, I think this committee, which recently held a hearing regarding hedge funds, would like to know what the difference in investment strategies is between the two. That is the private equity firms—a more long-term strategy or a more short-term, such as the hedge funds have exhibited. I think the common connector seems to be making a profit, and there seems to be a lot of industry overlap these days.

The second issue that I will raise regards the pensions and benefits of the workers at the companies that are acquired by private equity firms. Yesterday's Wall Street Journal said that Cerberus, which has announced its takeover of DaimlerChrysler, has pledged to work with the UAW, and I am a former employee of the General Motors Corporation at their plant in Framingham, Massachusetts, so I have a particular interest there; but they have assured the UAW that the $18 billion owed to autoworkers, my brothers and sisters, in benefits will still be honored, and they refer to this deal as a watershed moment for the private equity industry in global finance dealings. I would like to have confidence in that, and perhaps the panelists can sort of expand on that concept if they are able to.

My third issue that I would raise is regarding the pension funds that invest in private equity firms. Mr. Lowenstein mentioned in his testimony that millions of retirees are benefiting from private equity investments through their pension funds, and that pension funds have at least $111 billion invested in private equity. I would like to hear a description of the allure in private equity investments and what are the benefits specifically to pension funds and being involved.

Those are the issues that I would like to raise in a general sense, Mr. Chairman, and with that, I yield back.

The CHAIRMAN. The gentlewoman from Ohio is recognized for 3 minutes.

Ms. PRYCE. Thank you, Mr. Chairman.

Thank you to our panel for being here today.

Already this year, 33 U.S. companies worth $160 billion have made equity buyout deals. The Chrysler deal serves as an example that private equity can go anywhere, even buying the most symbolic of American brands. Hitting close to my home, Limited Brands, based in Columbus, Ohio, announced yesterday that they would sell off their Express line to a private equity firm, Golden Gate Capital.

The timing of this hearing could not be more appropriate. Thank you, Mr. Chairman, for holding it. The maintenance of our capital markets is paramount to our continued economic growth.

I want to thank our witnesses for helping us demystify a market that has become an increasingly important source of funds for public firms seeking privatization, for companies in financial distress, for start-up enterprises, and for companies looking to spin off parts of their operations. There are often short-term losers with job losses tied to the public companies that had, for perhaps too long, delayed badly needed restructuring, but long term, a healthy, growing private company is better than a stagnant, underperforming public one, for the investors, the employees, and the economy.

Mr. Chairman, I think we should be focusing some of our energy on what is making it advantageous for these companies to go private or, to put it another way, what is making it disadvantageous for companies to be public. Going private frees companies from the short-term pressures of the stock market, and as the U.S. Chamber and others have pointed out, quarterly earnings per-share statements are a centerpiece to this problem. Companies often sacrifice, creating long-term value if it means missing quarterly earnings' projections. Even if they believe that the cuts are destroying business value over the long term, they are not investing in things in which they should be investing. We should be focusing on decreasing the regulatory burden on public companies, not increasing the burden on private equity.

I want to thank the witnesses once again and the chairman for having this hearing, and I yield back.

The CHAIRMAN. The gentleman from Louisiana is recognized for 5 minutes.

Mr. BAKER. Thank you, Mr. Chairman. I appreciate the interest in the matter in calling the hearing.

Although there is really no clear definition of "private equity," there are some characteristics of funds which I think are important to point out. Although sophisticated investors, those with a net worth in excess of $1 million, are certainly participants, it is financial institutions, insurance companies, mutual funds, and pension funds that provide the overwhelming bulk of the financial resources deployed by private equity. So, when we are contemplating regulatory constraint, we need to realize it is not just millionaires we are going after in this case, it is the CalPERS pensioners—by the way, CalPERS holds direct investment in private equity funds—and millions of others who, either through mutual fund investment or pension funds, have a share in the profits of private equity.

I was surprised to learn that in households with average annual incomes of $35,000 or less, 18 percent are invested in mutual funds—who would imagine?—and that if those families want to improve their quality of life, it will come through the democratization of investment opportunity.

As an example, Power Shares lists this morning in SmartMoney.com that they, by fall, may be a new ETF that will allow individuals to buy shares in an index that follows a benchmark of 30 traded private equity companies, companies that invest in private equities. This is similar in operation, I understand, to hedge funds, which offer the same opportunity to individual investors.

So, in the search to help working people, we need to be very careful about how fat we make this regulatory book. It may fall right on top of them and deny them the opportunity to share in economic growth. Well, how big is this thing? Private equity investment in 2006 was just over $400 billion. That compares with $1.1 trillion to hedge funds in a single period. Although big, the two together are the source of enormous liquidity in a highly competitive international marketplace.

Hedge funds are going to act very quickly. They are going to see imbalances in the market, whether overpriced or underpriced. They are going to move, bring about market discipline, and get out. The churn rate for hedge funds is typically about 9 months. Where private equities are different is that they buy into the company and bring in management sometimes, and it can be there for 2 or 3 years. For them to turn their profit, it means the underlying economic value must be improved, and the company itself must grow and prosper. This is not just about squeezing just a little inefficiency out; this is about providing jobs that otherwise might disappear. So, in engaging about concerns over workers' fate, often it is better to have a healthy company grow over time than it is to let a staggering company fall under the weight of its failed economic model.

So what happens if the U.S. rulebook is unreasonably fattened? There is a high probability that money will go elsewhere. The view that we are an economic island from which there is no escape is a very limited view of the world. London, Bombay, and Hong Kong are experiencing extraordinary growth. I have heard many members of this committee concerned about London's passing New York as the primacy trading location for securities. The private equity firms in India enjoyed a 21 percent rate of return on equity last year. India passed China with $1 trillion, $239 million of private equity investments last year, and they, India and China, are modifying their rulebook to make their investment world all the more attractive to potential investors from the United States.

So we need to be very careful about how we act here. The Dow Jones Index of India, called CNX, is up 42 percent year over year. This is not an illiquid, overregulated market from which people are saying to outside investors, "Do not come." Instead, they are saying, "Come on down. Bring your money and your suitcases. We will make you a nice hotel room offer, and you can stay here for as long as you like."

How does that contrast with a market discussion where we are contemplating restricting the rules that enable smart people to deploy important resources to help grow our economy?

You know, we need to go slow. Maybe we need to go really slow, or maybe we do not need to go at all. Maybe we need to just watch for a while and make sure we understand market function before we unintentionally take it backwards in an enormous step.

Said another way, sometimes in Washington, people see a profit. So, first, they regulate it. If that does not stop it, then they tax it, and if that thing is still going, then they sue it. It is the three-step recovery plan to profit in America.

I think we need to get past that. I think we need to realize that working families, employed by companies, will change jobs, and new opportunities will come, but investing in the corporate growth for the long haul, not the next 10 minutes, is what grows value. That is what builds wealth in American families, and that is what American workers need.

The CHAIRMAN. The gentleman from California, for 4 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Chairman, I also want to thank you for holding this hearing to examine the effect that private equity has on the U.S. economy.

Recently a great deal of attention has been focused on private equity due to the increased role that it is playing in the capital markets, and I understand the committee's interest in exploring this topic. I am very concerned, though, that statutory exclusions from Congress are unwarranted. It could be very dangerous for the economy, and I think we have had some very cogent arguments from Congressman Baker. I am going to add a few additional points to this that I think we should be concerned about.

If the goal of our hearing today is for Congress to have a better understanding of this recent boom that we are seeing in private equity, then we should be asking ourselves and we should review some of the failings of our public equity markets.

For example, what is driving money out of the public into the private equity markets? One is the Sarbanes-Oxley legislation, frankly, coupled with abusive shareholders' lawsuits, and that has created a terrible operating environment for many firms in this country. Companies have become more risk-averse, resulting in less investments and new business ventures. Of course, this means fewer opportunities for employees and an inefficient capital structure for investors.

In my view, private equity is playing an important role in our financial system. As we have seen in recent years, private equity firms provide stagnant corporations with a viable alternative to public markets in a public market right now that is beset with enormous costs when associated with Sarbanes-Oxley. Private equity provides growth capital to these corporations, which frequently results in a properly capitalized corporation, which frequently means more investments in employees, and usually means the development of new business lines for that company.

In conclusion, I believe the presence of private equity is an important component of our financial system, and any attempt to regulate the industry will be harmful to our capital markets and to our economy as a whole.

Again, Mr. Chairman, I would like to thank you for exploring this issue today, and I look forward to hearing from our witnesses.

The CHAIRMAN. I thank the gentleman.

We will get to the witnesses, but I do want to ask one more question.

People may hear something that sounds like the gavel. It will be my cast inadvertently knocking against the wall. If you do not see the gavel, ignore the noise.

With that, we will begin with our witnesses. We will begin with Mr. Andrew Stern, president of the Service Employees International Union.