Pension Fund Investments in Private Equity: Implications for the Stewardship of Workers' Capital

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Executive summary

(i.) This paper investigates the regulatory, financial and governance issues associated with pension funds' investments in private equity funds. The relationships between pension funds and private equity houses date back to the origin of the industry in the 1980s in the US and have cemented over the years. The recent boom in the private equity business in 2003-2006 was accompanied by regular reports in the media about such investments benefiting from "superior" returns than traditional asset classes. Despite the media visibility however, the real performance of such funds has lately become a hotly debated issue. Recent academic work has tended to contradict the rosy picture presented by the industry. And indeed, the performance of the private equity industry does not follow a classic risk distribution pattern between the most performing and the least performing funds. Standard risk management techniques are not valid to monitor investments in private equity investments, which require ad hoc procedures. This in turn leads to additional, burdensome back-office and hence requires enhanced in-house expertise.

(ii). The success of private equity takes place in a broader process of risk diversification. Pension funds across the OECD have moved away from traditional bond and equity portfolio to a more diversified composition. This diversifying frenzy has come at the cost of an increasing complexity of the funds' asset risk management, as well as of the monitoring procedures by supervisors. In other words, we are now witnessing an "arms race" between the funds and their regulators; the recent tendency to invest in private equity is the latest manifestation thereof.

(iii). Modern trade union policy with regard to pension funds' investments recognises the need to ensure "stewardship of workers' capital" which draws on the broader move toward "shareholder activism", with the specific purpose of defending worker's rights and trade union values. While in principle applying the concept of stewardship of workers' capital to private equity represents an opportunity, there is little doubt that it might, concomitantly, generate important complications, notably because of the un-regulated nature of the private funds. Workers' capital strategies were designed for listed equity, in particular in the case of large multinational enterprises with relatively diluted ownership structures, and not for the weak regulation of private equity funds, and their un-listed portfolio companies. In particular, the Limited Partnership (LP) agreements that rule the private equity funds run counter to the reforms and changing practices adopted in the past decade to ensure more responsible and active investors. Compared with shareholder activism in listed equity annual general meeting of shareholders (AGM), the private equity LP is a return to the stone age of governance.

(iv). Efforts are underway to promote trustee education and awareness about private equity investments. However, recent parliamentary debates have shown that there are limits to what can be achieved on a voluntary basis. Re-regulation of private equity is needed. It is yet too

early to draw definitive conclusions on the sudden deepening of the financial crisis on 15 September 2008. In principle, 100% ownership of a company can only play in favour of effective stewardship of workers' capital. It is clear however that without the creation of a new agenda on financial regulation, the transactions costs of applying stewardship of workers' capital to private equity funds, and to other lightly regulated investment funds, will remain high, if not prohibitive.

Table of contents

Tables and charts

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www.boeckler.de

"Investors [in private equity] can be quite lethargic… [we] should ask why they invest in private equity with its association with aggressive capital structures, high incentives for management and a minimalist approach to governance … while adopting an entirely different approach when investing in public equity".

Paul Myners, House of Commons, Hearings on private equity, June 2007, UK

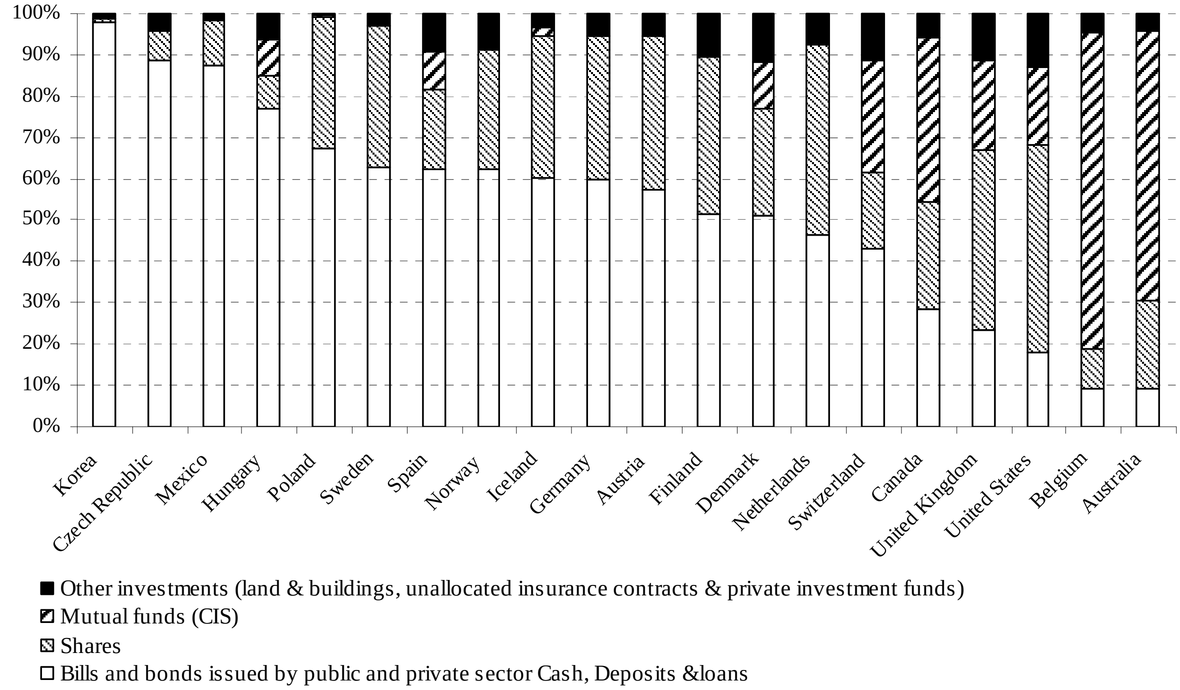
I. The Landscape

1. Compared to traditional asset classes – bonds and equity – very little reliable and comprehensive data exists on institutional investors' investments in alternative assets: private equity funds, hedge funds, other private funds specialised in commodity markets, infrastructure, and real estate. Such lack of data is due to the fact that "alternative investments", as they are called, use un-regulated or lightly regulated investment entities: compared to regulated investors, such as mutual funds, their reporting requirements, by law, are singularly poor. In fact, private funds are very often not required to provide any form of reporting at all to national regulators and supervisors… who consequently have no data on these industries. Other than academia, the main source of information is provided by country- and sometimes region-wide sample surveys, which are either financed by the industry itself, or by service providers, such as the investment banking industry and the business consultancies and auditing. According to these sources, in mature markets (the US, the UK, Canada, Netherlands, Nordic countries and Japan), pension funds ensure between a quarter and a third of total funding of private equity funds.

2. Data collection is a problem that bedevils the allocation of pension fund assets as well. Pension funds are required by law to disclose the composition of their portfolio annually, but seldom to disaggregate the portfolio into specific asset classes such as private equity. Official OECD data on pension fund allocation does not disaggregate to that level: private equity and hedge funds are lumped together with "land and building" and with "unallocated insurance contracts", as shown in the enclosed graph. According to ad hoc surveys, allocation to private equity is specific to large pension schemes, more frequent among Defined Benefit (DB) schemes than among Defined Contribution (DC) schemes; it typically represents 3-5% of total assets under management (AUM)[1]. This share may reach 8-10% in some cases, notably in the US public sector pension funds and the Swedish occupational pension funds. Both the US and Sweden have a long history in developing private equity funds.

[1] According to a Nov 2007 JP Morgan Survey, the allocations of institutional investors' to private equity stand at 3% or less in all European markets, and 8% in Nordic countries (JP Morgan 2007)

Asset portfolio composition of pension funds across the OECD



Source: OECD 2007b

The boom in 2002-2006

3. Pension fund investment in private equity dates back to the origin of the industry, when large public sector pension schemes in the US partnered with the two investment firms that pioneered the industry: KKR and Forstmann Little. This historical relationship between pension funds and private equity houses cemented over the years, particularly during the 2002-06 cycle of economic growth. At the time, cheap money flowed into private investment funds, as a result of low interest rates globally and a flush of liquidity from the surpluses of emerging economies (China in particular). The boom in the private equity business was accompanied by regular reports in the media about such investments benefiting from "superior" returns than traditional asset classes. The US $250bn CalPERS – the largest pension fund in the world, with the longest experience in private equity among US public pension funds, together with OregonPERS – reported earning 33% more with its private equity programme than with listed equity during the 16 previous years. Even after the subprime financial crisis erupted in August 2007, reports of exceptional private equity performance has continued to feed the pension industry media. In 2007, the €217bn Dutch scheme ABP had a +29.4% return on its private equity programme, compared to an overall 3.8% all asset classes included. PensionDanmark reported a +19.4% on a similar programme, compared with an overall 2.6%. The Finnish €6.1bn worth scheme Fennia reported a +42.4% return (!) on its investments in private equity funds (compared with +4% overall), which generated a net increase of €400m of its AUM[2]. At the end of 2007, several pension funds announced their intention to increase their investments in private equity in the future, including CalPERS and the British €43bn Universities Superannuation Scheme (USS). The

[2] IPE.com 17 March 2008

latter will actually hire new experts and analysts for its in-house "private equity and infrastructure team", and intends to multiply by four the share of its allocation to alternative products from currently 5% to 20% in the medium-term. It is worth noting that all the above mentioned pension schemes are governed by a board which includes a substantial representation of trade union-appointed trustees.

4. The promotion of private equity funds in the pension industry has not been limited to occupational pension funds. Though less visible, the move of state-owned pension funds towards alternatives is equally noteworthy. For example, early 2008, the €31bn French state-owned reserve fund, the FRR, announced that it would raise its investment in alternatives, including private equity, from a current 0.8% to 10%[3]. In a move to diversify its asset allocations of the state reserve fund[4], the South Korean government has decided that the €140bn National Pension Service would increase its allocations to private equity from a current 1.9% to 10%, as part of a broader reform of the governance of such funds. In Sweden, the four public 'buffer' funds of the national pension scheme, the APs 1 to 4, with a combined AUM of €90bn, have advocated loosening the restrictions on their investments in alternatives – currently limited at 5% of the total AUM[5].

Assessing and comparing performances

5. Despite the media visibility of anecdotal private equity's "excess returns", the real performance of such funds has lately become a hotly debated issue. Recent academic work has tended to contradict the rosy picture presented by the industry. Indeed a genuine assessment is made difficult by the scarcity of data and the fact that it does not compare easily with traditional asset classes. The latter's performance can be objectively evaluated, as these are marketable products: their trading is hence regulated and supervised by public authorities, securities and exchange authorities, central banks, and other financial supervisors. Thus, the exposure of an investor to these traditional classes is relatively simple to measure, because their market valuation cannot be contested.

6. None of this applies to private equity funds for which several performance measurements can be used. A first indicator is the calculation of an investor's current investments, or "remaining value", in a private fund. This is akin to a standard measurement of an investor's holding in listed equity: one simply looks at the current investment in the asset class, and compares it to its previous years or months. Unlike listed equity however, the valuation of the investor's stake is determined by the private equity firm that runs the fund, and not by any sort of regulated market (which by definition does not and cannot exist for private equity). Another (and perhaps more accurate) measurement of private equity performance evaluates the "exposure" of the investor to the invested fund. Exposure consists in the addition of the above mentioned remaining value and the future contributions that the investor has legally committed to the fund: the "un-funded capital commitments". These two indicators, "remaining value" and "exposure", can lead to very different results. As is shown in the table below, at end-2007 CalPERS's remaining value in private equity funds was valued at $20bn by the respective private equity managers, while its exposure was $43.2bn. Calculating

[3] IPE.com 13 February 2008
[4] South Korea shakes up pensions governance, FT.com, Nov 05, 2007
[5] Swedish diversification on the cards, Financial Times, 8 Oct. 2007

exposure, rather than the remaining value, is important for pension schemes that have reached maturity, and are hence entirely dependent on incomes generated by the portfolio – as is the case of CalPERS[6].

CalPERS' private equity programme since 1990

Valuation at end-2007, USD Bn

Total capital commitments	(legal obligation to the private equity fund over several years)	**52.8**
- Capital contributed (Cash in)	(effective contributions to the fund, including management fees)	**29.6**
= Un-funded capital commitments	(remaining contributions legally due to the fund)	**23.2**
+ Remaining Value	(as reported by the General Partner)	**20**
= Total Exposure	(un-funded commitments + remaining value)	**43.2**
Cash Out	(proceeds distributed back to the investors)	**22.5**
Investment Multiple	(cash out + remaining value) / cash in	**143%**

Source: CalPERS 2007b

7. As noted above, key to private equity performance assessment and comparison is the valuation of the remaining value of the fund, as made by the fund's general partner. Whether such a process of valuation – inherently difficult in the absence of market pricing – can be achieved without raising conflicts of interest is an open question, all the more so when the contracts ruling the governance of the fund are not made publicly available. A research paper published in April 2007, and widely commented in the international financial media, provides evidence that recent research and surveys on private equity often use overstated industry benchmarks. In particular, the paper points to problems of valuation of non-exited investments in the case of mature funds. The authors show that such non-exited investments "mostly represent living dead investments". Having corrected the data for sample bias and overstated accounting values, they find that average private equity funds underperformed the S&P 500 – the US listed equity index – by 3% per year in the past decade (PHALIPPOU et al 2007).

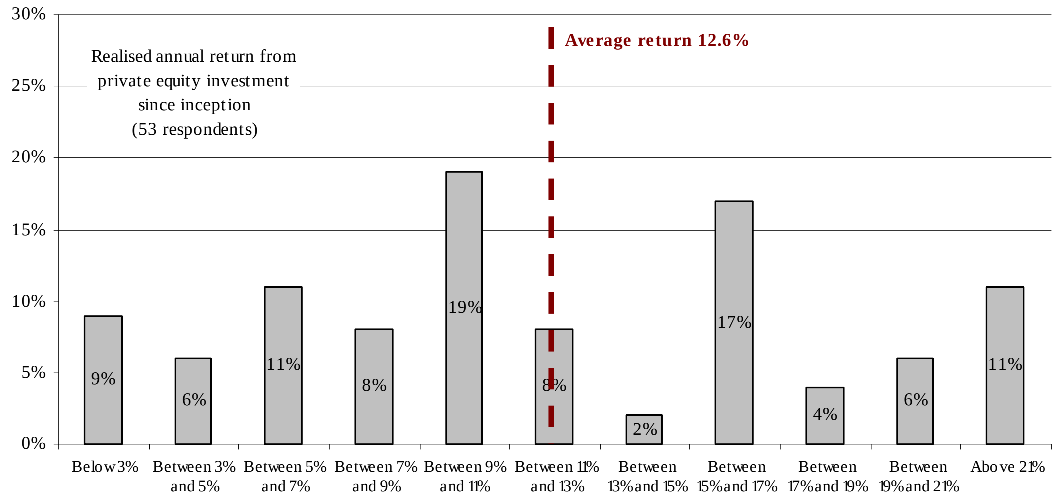
8. When considering effective performance of the fund, the only valid indicator is the calculation of performance at the end of the life of the fund (typically, about ten years). The private equity firm issues annual performance reports, which reflect the temporary performance of the fund. These annual evaluations are reviewed in the light of future performances, and may be corrected upward – or downward – as the fund nears closing and liquidation.[7]

9. The risk distribution characteristic of the private equity industry provides another key to the gap between the few existing industry-wide surveys, which all point to a very measured performance, and the "superior returns" that are reported in the media. As argued by Michel Aglietta, among others, the performance of the private equity industry does not follow a classic risk distribution pattern between the most performing and the least performing funds (AGLIETTA 2008). While a normal distribution follows a bell curve (the majority of funds being located close to the average or median performance of the sample), the private equity industry has a much more dispersed distribution, and a high standard deviation from the mean.

[6] In 2007, CalPERS retirement benefit payments – $10.1bn – exceeded the contributions by active members (workers and employers) - $9.7bn. The growth in asset management was entirely due to investment incomes generated by the portfolio, that is +$40,7bn (CALPERS 2007)

[7] This system is not exempt from conflict of interest. E.g., a private equity manager can continue fund raising after the fund has been launched, adopting aggressive strategies that artificially boost returns during the early years of the fund in order to maximise fund raising.

Sample distribution of performance of the Industry as reported by European investors



Source: JP Morgan 2007

10. Abnormal distribution of risk has two consequences for investors. First, unlike what happens with traditional assets, the gap between the top performers and the rest of the industry makes the choice of the private equity house eminently delicate. Second, standard risk management techniques are not valid to monitor investments in private equity, as private equity requires ad hoc procedures; this in turn leads to additional, burdensome back-office and hence requires in-house expertise.

11. Doubts about performance have been further fuelled by the macro-economic context between 2002 and 2006, as it heavily favoured the modus operandi of private equity funds, the leveraged buy-out. The cost of borrowed money was extremely cheap: it allowed private equity funds to considerably lower the cost of capital needed for buy-outs, and hence to increase the internal rate of return of their investment. Funds would take over larger companies or pay higher prices, without necessarily impacting their business plans and expected future returns. In November 2006, Citibank produced a research showing that listed equity in the US could have achieved the same returns than private equity funds, had they engaged the same level of leverage. The so-called return enhancer function of private equity could well evaporate with the prolonged global economic slowdown and the tightening of lending standards, while the rise of inflationary pressures could have dramatic consequences for the companies currently under private equity regime. According to some analysts, private equity in the post-subprime financial crisis is a “disaster in the making”[8]. Citing the above report by Citibank, Michael Gordon, head of investment at the mutual fund Fidelity International, wrote in March 2008 that the recent boom in private equity was “nothing more than a trick of financial engineering and a clumsy one at that”[9].

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[8] IPE.com 11 April 2008
[9] “Private equity boom was nothing more than a clumsy trick”, Michael Gordon, FT column, March 31 2008

Freeing up the investment policy

12. The debate around the success of investment into private equity is particularly important at a moment where pension fund investment policies tend to open up the spectrum of potential assets, thus making private equity account for a much larger figure in pension funds investments. Understanding the patterns of pension fund investment regulation is therefore crucial in this present discussion. On that, trade union oriented literature on the World Bank- and OECD-inspired pension reforms (which took place in the 1990s and early 2000s) has overwhelmingly focussed on the impact of reforms on workers' pension benefit levels, including: increasing pension eligibility age, increasing the supply of older workers on the labour market, moving from final pay to career average in fixing benefit levels, moving from wage- to price-indexation, and, last but not least, shifting from defined benefit (DB) to defined contribution (DC) schemes (or developing incentives for the latter).

13. All these measures have had dire consequences, across OECD countries, on workers' final pension entitlements, be it in terms of net replacement rates or of total pension wealth (OECD 2007a). On the other hand, the impact of reforms of pension fund investment regulation on workers have attracted comparatively less attention, despite momentous changes in the field across OECD countries, first in the common law countries in the 1970-1980s, and, since the late 1990s, across the rest of the OECD. Essentially, these reforms consisted in a liberalisation of the policies regulating pension funds investments. Such disinterest is rather unfortunate: investment-side pension reforms have been a key factor in the development of the "shareholder value" model of corporate governance, with its association with financial short-termist behaviours.

14. The liberalisation of the investment policies (adopted by a majority of OECD jurisdictions, as shown in the table below) has freed up the asset allocation strategy, by loosening, or even removing altogether, the existing quantitative restrictions on certain asset classes. Pension funds are now increasingly ruled by a general requirement imposed on the governing body – the *trustees* under common law regime – to adopt principle-based "prudent person" standards. Roughly, these de-regulatory measures have aimed at:

- removing barriers to investment in bonds and listed equity,
- easing restrictions to private funds, and
- broadening the investment universe by enhancing access to foreign assets.

15. In Europe, the EU Directive on Institutions for Occupations Retirement Provision (the "Pension Fund" Directive) paved the way for investments in alternatives, as it forced many jurisdictions to liberalise access to asset management within the EU, and to apply a prudential framework rather than quantitative limits. Interestingly, the transposition of the Directive into the many national pension laws that co-exist across the EU have led to a variety of interpretations. In 2006, a report prepared by a group of representatives of the European private equity industry and commissioned by the European Commissioner Charlie Mc Greevy concluded that "institutional investors should not be faced with arbitrary or outdated quantitative restrictions" and that there is "a growing need for a "prudent person" concept to be applied to institutional investors across the EU". It went on to regret that such concept was "still inconsistently implemented through national implementation of the IORP Directive" (EC 2006).

Removal or loosening of quantitative restrictions on pension fund investment policies 2002-2007

	Bonds, listed equity	Alternatives	Foreign assets
Austria	√		
Canada			√
Czech Rep.		√	
Denmark	√		
Estonia		√	
Finland			√
Germany			√
Hungary	√		√
Iceland	√	√	√
Korea	√		√
Luxembourg	√	√	√
Mexico	√		√
Portugal	√	√	
Slovak Rep.	√	√	√
Spain		√	
Turkey	√		√

Countries where no change in occupational pension investment regulation has been observed in 2002-2007: US, UK, Sweden, Japan, Italy, Switzerland, Poland. Source: OECD 2008a

16. Yet investment restrictions are still widespread. According to a 2008 OECD survey, 20 OECD countries apply some form of restriction on loans, 18 on private un-regulated funds including hedge funds and private equity, 17 on foreign assets, 17 on ownership concentration, 16 on real estate, 15 on retail (ie. regulated) funds, 14 on listed equity, 10 on bonds and 10 on bank deposits (OECD 2008a). Of all assets open to pension funds hedge funds and private equity funds are those whose access is most restricted by regulators across the OECD, apart from loans. While this is generally true across the OECD, a closer look at national jurisdictions and at the size of the national pension industry allows us to categorise OECD countries into three groups:

- The Anglo-Dutch-Japanese group includes countries that have very large and mature pension industries, whose total AUM represent between 25 and 130% of the national GDP, and whose jurisdictions impose no, or very few quantitative restrictions. Pension funds are ruled by the prudent person principle;

- Similarly, the Nordic group (Scandinavia, Finland and Iceland) enjoys an important industry (AUM between 30 and 130% of GDP), but quantitative restrictions remain substantial. Investments in private equity (and hedge funds) are typically limited to 10% of the total AUM – be it through explicit restrictions on those classes, or through consequences of restrictions on other forms of transaction;

- The rest of the OECD (Continental Europe and Korea) has a comparatively small industry (AUM between 1 and 13% of GDP). The jurisdictions are diverse: some apply quantitative restrictions, some do not. Investment in private funds is prohibited in the Slovak Republic, Poland, Mexico, while Korea, Hungary, Portugal, Spain, Germany, Italy, and Austria apply quantitative limits ranging from 5 to 30% of the total AUM; the Czech Republic and Belgium impose no restriction at all.

17. Some quantitative restrictions may indirectly affect private equity. For example, restrictions on foreign assets often hinge on OECD membership, and, *in specie,* on a commitment to the OECD Code of Liberalisation of Current Invisible Operations. Funds that are resident in offshore centres are hence discriminated against in several OECD jurisdictions. Within the EU, many national jurisdictions also discriminate among investment funds by imposing specific restrictions on investment entities not covered by the EU Directive 85/611/EEC on Undertakings for Collective Investment in Transferable Securities, the UCITS Directive. The Directive ensures mutual recognition, cross border mobility and a ‘harmonised’ framework for mutual funds and other regulated collective investment schemes, to which private equity and hedge funds typically do not belong. In Spain, e.g., the new regulation enforced in January 2008 [10] allows pension funds to invest up to 20% in harmonised (UCITS directive) funds, and 5% in non-harmonised funds. In Portugal, the ceiling on non-harmonised funds was raised from 5 to 10% in 2007[11].

II. The Arms Race

18. Pension funds across the OECD have moved away from traditional bond and equity portfolio to a more diversified composition, which includes alternative products such as real estate and land building, private equity, hedge funds or lightly regulated investment vehicles. Such a drive toward diversification of assets, and therefore of markets risks, has in turn stimulated financial innovation with the development of complex ‘structured products” that separate economic ownership of an asset from its credit risk. This diversifying frenzy has also come at the cost of an increasing complexity of the funds’ asset risk management, as well as of the monitoring procedures by supervisors. In other words, we are now witnessing an “arms race” between the funds and their regulators; the recent tendency to invest in private equity is the latest manifestation thereof.

Risk-based allocation and regulation

19. The drive to liberalise pension fund investment policies has been motivated, among other things, by the need to diversify and hence mitigate the funds’ exposure to market risks. Since the previous growth cycle which ended with the burst of the IT bubble in 2001-2002, during which pension funds invested heavily in listed equity, some significant changes have taken place in the asset allocation structure.

20. Investors traditionally use strategic allocations, designed to ensure diversification across broad asset classes and to access generic “beta” returns (i.e., correlated to general trends of the markets); but the novelty is that they increasingly rely on “tactical allocations”, in order to extract “alpha” returns, i.e. those which are supposed to “unlock excess returns”. Excess returns are not correlated to generic market moves, but are specific both to the asset class and

[10] *Reglamento de Planes y Fondos de Pensiones*
[11] *Norma Regulamentar N.º 9/2007-R*

to the level of sophistication of the asset management. The success of "alpha return" products stems from the search for higher yields in a context of low interest rates. Clearly, such a "search" appears far more serious for DB plans than for DC plans. For the latter, asset allocation follows a relatively straightforward plan: access the highest possible returns for a given level of risk. For DB funds however, given their additional longevity risk, the imperious objective of matching assets with liabilities represents more of a challenge.

21. While the private equity industry appears to emerge as a winner of the current wave of liberalisation of pension funds' investment, no general rule seems to prevail when assessing individual pension funds' decisions to allocate or not to private equity. Several factors are at play:

- the type of investment strategy,
- the nature of the strategy management (in-house, or outsourced), and
- the structure of the liabilities over the medium and long term.

22. Importantly, the added value of private equity may vary. Two advantages are generally put forward: (i) private equity is a return enhancer and (ii) private equity is a risk diversifier. The distinction is central in understanding private equity. A return enhancer approach to private equity would validate the view that the industry does indeed extract "absolute return" above generic market trends. On the other hand, if private equity is considered for the purpose of diversification, its comparative advantage would rest not on the performance value per se, but on the fact that it is uncorrelated to traditional core holdings and in particular to listed equity. Whether the assertion that private equity is a genuine asset class on its own remains an open question: as noted above, some research findings show that, once we remove the leverage effect, private equity funds do not appear to perform any better than listed equity.

23. Decision to allocate to private equity also depends on less obvious characteristics, such as the quality of the employer's covenant, the internal governance and in-house expertise of the fund, the "risk tolerance" of the Board, the role of outside advisers, etc. Asked about the role of external advisers in the development of pension funds' investment in alternatives in the UK, an asset manager responded: "It was probably the consultants that introduced the trustees to alternatives rather than vice versa in many cases"[12]. Similarly, the role of asset management outsourcing would also need to be investigated more fully. Outsourcing used to be limited to specific mandates – for example a European pension fund outsourcing management of its ownership in US listed equity. It now appears to take a much broader dimension with the appearance in the UK of "fiduciary mandates", whereby the quasi-totality of the mandate of the pension fund governing board is delegated to professional teams.

24. The move to alternative assets has come at the cost of greater exposure to market risks, either because the invested asset classes are inherently risky, or because they are lightly regulated. Supervisor authorities have had to change funding rules (which aim at matching assets and pension long term liabilities) and supervisory procedures in order to adapt to this new reality.

25. Some countries have introduced measures leading to "risk-based" funding regulation. Funding levels are traditionally measured by biometric risks: calculating the present value of the accrued benefits that the fund has committed to its members essentially requires (i) a reliable mortality rate and (ii) a valid discount rate. In addition to biometric risk, new risk-

[12] "Shifting to alternatives", IPE.com, 6 December 2007

based funding factors the ‘riskiness’ of the investment portfolio in determining the regulated funding level. Not only should a pension fund’s AUM account for the long term liability, it should have the quality and security necessary to meet any short term (one to two year distant) solvency crisis (OECD 2008c). A higher equity allocation or higher exposure to alternatives would call for a higher funding level to protect against the potentially larger funding gaps that could emerge as a result of the exposure to market risks.

26. Few countries have introduced risk-based regulation: Denmark, the Netherlands, and Sweden. Denmark and Sweden have implemented a “traffic light” system whereby the supervisory authority can undertake risk evaluation on individual pension funds whose funding appears not to be in a position to meet the liabilities[13]. The issue has come to the fore in Europe with the on-going discussions at the Committee of European Insurance and Occupational Pensions Supervisors; the issue revolves around the applicability of the EU prudential framework for insurance companies, Solvency II, to pension funds. Concerns have been raised that, as is the case with insurance companies, the implementation of Solvency II to pension funds would severely restrict investments in alternative products because of the high capital charge and funding levels that would be required to meet the market risks associated with such assets[14].

Monitoring the general partner (and the fees)

27. The abnormal distribution of risks that one observes in the private equity industry has implications in terms of risk management by pension funds. According to the above-cited survey by JP Morgan, together with the fees paid to the general partners, the “selecti[on] & monitoring [of] the general partners” of the private equity fund is considered to be the “most challenging aspect” of investing in private equity. The same survey further indicates that the barriers to access the industry are high: while 50% of investors currently investing in private equity said they would increase their exposure in the future, only 9% of those not currently investing in private equity said they would do so (JP Morgan 2007). Investors’ unease with risk management seems to extend to the private equity firms’ own risk management procedures. According to a survey by PWC, while 72% of responding investors chose performance as the prime criteria in selecting a private equity fund, in the following phase (in which an investor has to decide whether to stay in, or to exit, a fund), the quality of the general partners’ own risk management came first – i.e., ahead of performance (PWC 2008).

28. The barriers to entry faced by institutional investors when considering private equity investments are linked to the complexity and burden of the risk management procedures. Unlike traditional asset classes, investors need to conduct extensive due diligence procedures, in order to commit to funds which in turn may well put the investor’s own institutional capacity at a test. For example, early 2008, the Danish ATP pension fund admitted that it had exercised only about half of the initial commitments it had allocated to private equity because of the “unexpectedly high volume of due diligence work” it had had to engage and the “onerous procedures” to select and monitor the general partners[15]. Specific risk management

[13] See for example Memorandum by the Swedish pension & insurance supervisor, *Finansinspektionen*: “FI will introduce a new version of the traffic-light model” 1 March 6, 2007 http://www.fi.se/upload/90_English/90_Reporting/traffic/070306/9_introduction_newversion.pdf
[14] “Solvency rules may cramp insurers” FT Fund Management, Jul 30, 2007 & EDHEC 2007
[15] “Size and diligence slow ATP’s private equity shift”, IPE.com 12 March 2008

tools and procedures hence are essential for pension funds considering investing in private equity. This is turn requires robust governance structures and in-house expertise to understand and monitor its own private equity programme – which is not necessarily within reach for small and medium pension funds. Even large pension funds may face problems with regards to institutional capacity.

29. Other than risk management, the fees paid by pension funds to the private equity firms appear to be an on-going concern. According to the UK employer group the National Association of Pension Funds, fund management fees paid by British pension funds have risen by 105% between 2005 and 2007 (NAPF 2008). The explanation lies partly in the growing shares of alternative assets. Unlike traditional asset management, which may take up to 0,5% in fee commission, private equity managers, like hedge funds managers, charge a full 2% on commitments made to the fund every year, to which is added another 20% performance fee on realised gains, also called 'carried interest'. These figures are net of all "operational expenses" that the private equity firms have engaged in running the fund. While the NAPF seems to be satisfied with the fees that its employer members pay to the industry[16], others are not. Danish ATP for example has expressed public concern about private equity fees that have "increased tenfold" in the past decade, and has called for investors to pool their money and collectively negotiate down General partners' fee in the future[17]. In the US, even the most ardent supporters of private equity within the pension industry, such as OregonPERS and CalSTRS reacted strongly when private equity partners suggested that a raise in the US capital gain tax from a current 15% to 35% (as envisaged by the US Congress at the end of 2007) would be passed on to investors via higher fees[18].

Single fund, fund-of-funds, strategic partnership or co-investments?

30. Various options can be envisaged to deal with the specific risk management required by private equity. One popular option consists in channelling private equity allocations via a fund-of-funds (FoF), i.e. a private fund which in turn invests in other individual private equity funds. FoFs have become popular with 'beginners' and first timers who lack the expertise to engage directly with a private equity firm. They have also become attractive due to their capacity to access the most performing funds on the market place and/or to access highly specialised funds, be it in terms of geographic location (for example non-OECD mid-cap emerging markets), or in terms of the type of transaction (e.g., truly "venture capital" and seeds capital). Naturally, investing via funds-of-funds comes at a cost: to the already high fees charged by the private equity firms (2% on management, 20% on capital gains), the fund-of-funds typically charge up to 1% fee on management and 10% on capital gains[19].

31. When investing directly in a private equity fund, the key is to access favourable terms with the private equity managers over issues such as the fees, the distribution of the proceeds and opt-out options. As developed below, the governance underpinning of the private funds, namely the limited partnership (LP) agreement, is a pure contractual product (at least in key

[16] See letter to the editor by Chris Hitchin, chairman of the British NAPF: "Pension funds will pay for private equity experts" Financial Times, 3 July 2007
[17] "ATP to push private equity fees", IPE.com 10 April 2008
[18] Pension funds in threat over private equity fees, Financial Times, 7 January, 2008
[19] For a broader discussion on the merits of FoF, read for example "Diverse or direct investment?" IPE.com 14 November 2007

jurisdictions such as the US and the UK). No industry-wide or statutory rules apply to these agreements and much of the investors' basic rights can be obtained and exercised only via ad hoc negotiations and deals between individual investors and the private equity managers.

32. The ad hoc nature of the investor–private equity manager relationship explains why so many pension funds seek to establish long term partnership with certain private equity groups, or to create their own dedicated private equity branch, or to team up with other institutional investors to create international 'consortiums'. OregonPERS and KKR, for example, have close investment relations that date back to the creation of KKR in 1981, and of the LBO business as a whole. OregonPERS committed $1.3bn to private equity funds run by KKR in 2007; in early 2008, it announced an additional $3bn commitment in an investment vehicle set up by KKR to invest in fixed-income products[20]. In Europe, the Swedish state-owned pension fund AP4 has a "long and positive business relationship" with the leader of the industry in Sweden, EQT, the private equity arm of the powerful Wallenberg family[21].

33. Another option might simply consist in buying stakes in a private equity firm: CalPERS for instance is a shareholder of Carlyle, Silver Lake and Apollo; the New Jersey Investment Council has similar plans[22]. Some pension schemes have pooled together and created joint private equity branches. The Dutch pension funds ABP and PGGM run a joint private equity firm called Alpinvest. Similarly Australian superannuation funds have teamed up to create their own in-house management, the Industry Funds Management (IFM), which manages the investment in alternatives assets.

34. A pension fund can also combine several of the above options. In Canada, the private equity investment vehicle of Ontario Teachers' Pension Plan, called Teachers Private Capital, has a strategic partnership with two US private equity firms, Providence Equity Partners and KKR. Long term partnership with a single private equity firms appears to be an attractive solution when a pension fund is considering direct investment in a company. Many jurisdictions prohibit ownership concentration (a pension fund being a direct shareholder of a company) above a significant level, typically 5% and sometimes less. As a result, pension funds seeking enhanced ownership rights in a company often need to go via private equity funds, or for that matter *any* investment vehicle, to bypass restrictions on ownership concentration. In 2007, e.g. Ontario Teachers teamed with other Canadian institutional investors and with its private equity arm Teachers Capital to buy-out Bell Canada, the country's former telecom monopoly. The partnership with private equity firms allows the Canadian pension fund's stake to remain formally under the regulated limit of 30% of voting rights in the target company, although the pension fund exercises *de facto* control over the company[23]. Similarly, in March 2008, AP4 and EQT launched a joint bid for the takeover of the Swedish state-owned enterprise V&S, which the government had decided to privatise[24].

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[20] www.privateequityonline.com 11 July 2008
[21] AP4 joins bid for Absolut vodka, IPE.com 28 March 2008. For more information on Swedish pension funds and private equity, see also TUAC 2008a
[22] "Pension fund looks for private partners", FT.com, 28 January 2008
[23] "Ontario Teachers' plan invests C$10bn in private equity", Financial Times, 12 April 2007. The Canadian scheme's private equity investments can only be expected to grow in the future. In March 2008, the public pension announced that a €263m co-investment with the Canadian state-owned pension reserve fund – Canada Pension Plan Investment Board – in a new Asian private equity vehicle called FountainVest, whose general partner is a former executive of Singapore's sovereign wealth fund, Temasek.
[24] Although pure direct investment is not common in the pension industry, some high profile transactions, or declaration of intents, are worth noting. In Korea, the state-owned reserve fund, National Pension Service, declared its interest in taking over the leading bank of the country, the Korea Exchange Bank, whose takeover

III. The Workers' Capital

35. Trade unions have a special relationship to occupational pension schemes. They often are the ones to negotiate the creation of the scheme (and its fund) with employers. Even if a pension scheme has not been built through labour-employer negotiation, a trade union would still have a duty to inform its members and workers at large about their pension rights, as well as the impact of their pension savings on the economy. Modern trade union policy with regard to pension funds' investments recognises the need to ensure "stewardship of workers' capital". The concept was developed by the North American labour movement, notably the AFL-CIO, in the 1990s[25]. It was followed at the international level by the creation in 1999 of the ICFTU/GUF/TUAC Committee on international cooperation on workers' capital[26] (now the Global Unions Committee on Workers' Capital). It has since spread across the OECD, particularly in the Anglo-American jurisdictions, the Netherlands, and the Nordic countries. The concept was developed on the premises that listed equity would remain the pension funds' main investment class. As we argue below, while its application to private equity represents an opportunity, there is little doubt that it might, concomitantly, generate important complications, notably because of the un-regulated nature of the private funds.

The concept

36. In practice, stewardship of workers' capital consists in member-nominated pension trustees (most often nominated by the trade union that negotiated the scheme), whose task is to ensure a responsible use of the shareholder rights attached to the pension funds' holding in listed equity. Responsible shareholder investment has been developed by the international labour movement in the form of a statement "on responsible approaches to the stewardship of workers' capital", of which some key extracts are reproduced below.

37. Workers' capital stewardship hence draws on the broader move toward "shareholder activism", with the specific purpose of defending worker's rights and trade union values, including unconditional respect for core labour standards as defined by the ILO. Shareholder activism *per se* ranges from regular 'engagement' with the management of listed companies (informal communications), all the way to hostile resolutions at the annual general meeting of shareholders (AGM) with the aim of enhancing financial performance (increase dividends and share buy-backs, corporate restructurings), or reinforcing the accountability of the board and management (board composition and remuneration).

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by the US private equity group Lone Star in 2007 sparked controversial debates in Korea. NPS is further understood to take part in the "privatisation" of Woori, a state-owned insurance group. The re-capitalisation of US and European banks in the fallout of the subprime crisis has also created new opportunities for direct investment. The New Jersey Investment Council participated in the recapitalisation of Merrill Lynch and of Citigroup.

[25] See "What Is Capital Stewardship?" http://www.aflcio.org/corporatewatch/capital/whatis.cfm

[26] www.workerscapital.org

38. Stewardship of workers' capital uses the various tools of shareholder activism at its disposal in order to increase corporate accountability; its compatibility with other trade union strategies aiming at strengthening workers' voice in corporate governance (such as worker participation and representative bodies within the company) remains, however, an imperative (TUAC 2005). Several trade union confederations have initiated or supported a broad range of initiatives to facilitate a responsible and sustainable/long-term investment policy by pension funds: a key instrument is the trustee education programmes[27]. At the other end, trade unions have also initiated or supported annual surveys on how asset managers exercise the shareholder votes delegated to them by their clients – including pension funds – in key accountability-related resolutions presented at the AGM[28]; similarly, they have supported corporate governance surveys of large companies[29]. Trade unions can also contribute to shareholder campaigns targeted at specific companies, such as Wal-Mart or companies operating in Burma.

Global Unions Statement on Responsible Approaches to the Stewardship of Workers' Capital

> *"The labour movement believes that as part of the prudent and loyal management of workers' capital, fund trustees and managers need to account for the broader social and environmental consequences of their investment decisions. […] As long-term investors, pension funds are doubly exposed to the consequences of irresponsible corporate behaviour. First, they suffer losses when corporate misconduct is revealed and stock prices decline in response to a loss of investor confidence. Second, they suffer when the costs of irresponsible corporate behaviour is passed on to society rather than being paid for by the offending corporation. […]*
> *The Global Unions call upon all involved in making decisions about the investment of workers' capital to be mindful of the international legal framework in which investment decisions are being made, which includes respect of internationally recognised human rights and labour standards. Moreover, investors should take steps to ensure that the behaviour of the companies in which workers' capital is invested is consistent with the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy and the OECD Guidelines for Multinational Enterprises.*
> *Consequently, the Global Unions urge pension funds, their trustees and fund managers to include in their investment decision-making process consideration of the impact, both positive and negative, of their investments on workers, communities and the environment."* (GLOBAL UNIONS 2007).

[27] For example the Australian Institute of Superannuation Trustees (www.aist.asn.au), in Canada the Shareholder Association for Research and Education (www.share.ca/en/education), in the UK the TUC trustee training programme (http://www.tuc.org.uk/pensions/index.cfm?mins=356&minors=349), in the US, the AFL-CIO Office of Investment webpage includes links to various programmes (http://www.aflcio.org/corporatewatch/capital/links.cfm)

[28] See for example in the UK the TUC 2007 Fund Manager Survey (http://www.tuc.org.uk/extras/fundmanagers07.pdf)

[29] See for example in Spain the Comisiones Obreras' survey "Ibex 35: Gobierno Corporativo 2006. Junta de Accionistas 2007" (http://www.ccoo.es/comunes/temp/recursos/1/43971.pdf)

39. For a workers' capital strategy to be effective, however, certain conditions have to be met:

- First of all, it requires a sizeable national pension industry as part of the national pension system. In countries where the pension system relies heavily on pay-as-you-go financing, pre-funded pension schemes are relatively unattractive.

- Second, regulation needs to be flexible enough to allow the funds to invest freely in listed equity. If pension funds are by law required to invest most of their money in public bonds, the interest of such funds is considerably lessened, obviously. On that it is important to verify that the regulation of the asset management industry ensures a minimum level of accountability to asset owners.

- More fundamentally, regulation should allow trade unions and their workers to claim ownership of the capital accumulated in the pension funds, and hence have a voice in the governing body of the fund[30].

- Last but not least, a workers' capital strategy requires robust capital market infrastructure, including cost effective financial and extra-financial analysts, legal advisers and other financial intermediaries, as well as independent supervisory authorities.

40. Workers' capital strategies were designed for listed equity, in particular in the case of large multinational enterprises with relatively diluted ownership structures; in other words, companies for which the AGM is an important decision maker. In practice, the past decade has seen a growing number of pension funds adopting a high profile in AGMs, voting against the recommendation of the board of directors on issues such as director remuneration, CEO and Chair separation, independence of the board, transparency of the company, etc. Such activism lies in stark contrast with the passivity that these very investors seem to adopt when investing in private investment funds. At hearings on private equity held at the British Parliament in June 2007, Paul Myners, the well known pension expert, says: "Investors [in private equity] can be quite lethargic… [we] should ask why they invest in private equity with its association with aggressive capital structures, high incentives for management and a minimalist approach to governance … while adopting an entirely different approach when investing in public equity". This testimony convinced the British MPs to continue working on the issue area and "to re-examine why their requirements of PLCs and of private equity-owned companies are so different" (COMMONS 2007). Indeed, the application of the

[30] In addition to having member representation on the board of the fund, workers' ownership of the fund's capital would require regulation on any surpluses generated by the fund to be secured and not to be captured by the sponsoring employer. The workers' capital concept assumes that pension retirement benefits are "deferred wages", and hence belong to workers' ownership. In opposition, employers typically consider pension benefits as a "contractual promise", made by the pension sponsor (i.e., themselves), and the financing of which therefore cannot be owned by the beneficiaries. This opposition of views over pension funding ownership is crucial in the discussion on pension funding and how to fix pension deficits when they occur. On the other hand, it has less importance with respect to the investment policy of funds and to the workers' capital concept, as long as member-nominated trustees are in numbers. In jurisdictions where the investment policy is fully liberalised (such as common law countries), the duties of members of the governing bodies are strictly regulated, irrespective of the ownership of the funds. Regulations such as the US ERISA 1974 prevent conflicts of interest (notably affecting the employer/sponsor), and ensure that the fund's investment policy is designed and implemented in the financial interest of the plan members.

workers' capital concept, and more broadly that of investor activism, to private equity funds runs into a number of serious obstacles.

41. The first of such obstacles is the disconnection between the ultimate asset owner (the pension funds) and the invested entities (the private companies) created in the regulatory void within which the private equity funds, and the unlisted firms that are under control of the private funds. Unlike direct investments – whereby a pension fund holds 100% of the share capital of a company – investments via private equity funds are managed by the private equity firm that run the funds, not by the investors of the funds. The weak regulation of these private funds, and their un-listed portfolio companies, is a strong barrier to investor activism. Across the OECD, far weaker accountability and transparency requirements for both private equity funds (or, for that matter, LPs) and unlisted companies exist than, respectively, for retail mutual funds and for listed equity. Such difference in regulatory treatment can be explained by taking a look at history. Until the current boom in private equity, stock exchange listing has been regarded as the ultimate mode of governance for large successful groups, providing for the best growth and wealth creation opportunities. Unlisted company status (private equity) constituted the second best option that was fit for SMEs and/or for developing countries with poor capital market infrastructure. This legitimised the difference of regulation between public and private corporations, which became obsolete with the rapid transformation of the private equity industry over the past five years from a niche to a mainstream business: a transformation that has not yet been matched by comparable changes in national regulations and international cooperation.

42. The same can be said about the difference of regulatory requirements between the LPs (whose clientele used to be essentially made up of individual fortunes, or 'high net worth individuals" as they are now called), and investment corporations as well as retail investment funds, which all needed strong regulatory oversight because of their proximity with regulated collective investment schemes, including the pension funds. The fact that pension funds are tied to investment vehicles, such as LPs, that grant virtually no rights to investors (as outlined below), poses exactly the same kind of concerns than when a large company is privatised.

The new conglomerates

43. The responsibilities as potential employer that may accrue to the private equity firms running the funds has become a crucial issue across the OECD. Private groups employ a growing number of workers via the funds that they manage. In the US, according to American trade unions, the five largest private equity houses – KKR, Carlyle, Blackstone, TBG, BainCapital – employ 2.1 m workers and are ranked in the top 10 employers in the US. In the UK and France, over a million workers in each country are believed to be under private equity regimes. As is well known, trade unions have campaigned intensively in certain OECD countries to alert the public at large on the social and employment impact of the private equity mode. Since the landmark speech by John Monks, General Secretary of the ETUC (and former GS of the British TUC), on "The Challenge of the New Capitalism" in London on 14 November 2006 (MONKS 2006), several national and international trade

union centres have initiated campaigns on private equity, and produced various documents on what trade unions should do when dealing with companies under private equity regime[31].

44. Most reports and statements point to a specific feature of the private equity model: the fact that strategic decisions that have highest impact on workers are rarely taken at the level of portfolio companies, but at the level of a holding structure dependent on the fund itself. This means that established mechanisms for industrial relations and collective bargaining cannot adequately function, as part of the decision making process falls outside the remit of traditional labour legislation. This is particularly true in Europe, where trade unions and the ETUC have argued that legislations on workers' right to information and consultation prior to a takeover are not adapted to the private equity model. Similar concerns have been raised by trade unions in Japan, and to some extent in the US.[32]

45. Private equity managers fervently deny any employer responsibility in conjunction with the management of the private equity funds and their correlated portfolio companies. They portray themselves as financiers managing private pools of capital, in which all non-financial issues, including labour and employment relations, are to be left in the hands of the management of the portfolio companies. And indeed much of the private equity model boils down to the LBO operation, which essentially consists in a balance-sheet restructuring of the target company (reduce capital, increase the debts to inflate return on capital).

46. Clearly, this version of the story does not come without contradictions, the most disturbing one of which is the fact that the private equity firms claim to have expertise in turning around a loss-making portfolio company into a profit making centre. Examples abound of private equity firms bolstering their "industrial know-how" when engaging a buy-out offer[33]. Presumably such know-how is acquired by accumulating, cross-comparing and capitalising experiences drawn from diverse portfolio companies, etc. If this is the case, then one may legitimately question whether global private equity houses such as Blackstone, KKR and others, and the funds that they *de facto* run, are re-constituted conglomerates as they existed in the 1950s.

47. Ironically enough, in the UK, the potential employer responsibilities of private equity firms has generated a vivid public debate following concerns by regulators about the financial sustainability of the portfolio companies'… pension schemes. As more companies fall under private equity regime in the UK, so do their respective occupational pension schemes. Under British legislation (as is the case in most common law jurisdictions), the funding level of an occupational pension scheme is largely dependent on the quality of the employer covenant that binds the sponsoring company to its pension scheme. The company's pension scheme acts as a creditor to the company. The balance sheet restructuring that follows a buy-out – contraction of capital, explosion of debts – puts intense financial pressure on the company to repay the debt contracted to finance the buy-out. It adds a new creditor to the company – the

[31]See ITUC 2007a, AFL-CIO 2007, RENGO 2007, TUC 2007a, ETUC 2007, UNI 2007, IUF 2007, TUAC 2007a, ROSSMAN 2007, UNI et. al 2006

[32] See the trade union statement for the G8 Summit in June 2008 (TUAC 2008b).

[33] An example is given by the announcement on the Carlyle group website of the takeover of a subsidiary of Korean Group Hyundai. In support for the acquisition, the Carlyle press release states: "In addition to the infusion of new capital, this partnership allows HCN to access Carlyle's global network of telecommunications and media companies. HCN and the cable TV companies owned by Carlyle (including Eastern Multimedia Company in Taiwan and Insight Communications in the U.S.) will share cable management know-how and global best practices with the goal of providing world-class broadcasting, Internet and value-added services to Korea's cable television subscribers." http://www.carlyle.com/Media Room/News Archive/2006/item6830.html

owners themselves – and creates uncertainty about the priority between the owners and the other creditors of the company: banks, bond holders, and the company's own pension schemes.

48. Recent high profile buy-outs in the UK have led to a turn for the worse for the solvency of the company's pension fund. According to the British trade union GMB, early 2007, over a quarter of the insolvent company pension funds officially declared under protection of the Pension Protection Fund, are from companies owned by private equity: 38 schemes out of a total of 160. Overall, according to GMB, 10% of insolvent pension funds are under private equity regime (GMB 2007). Meanwhile, it should be noted that 5% of the workforce in the UK are employed by companies under private equity regime (HALL 2008). The management buy-out of Alliance Boots by KKR and former executive Stefano Pessina is often cited as a case study. The takeover was resisted by the trustees of the companies' pension schemes. After the buy-out was completed in 2007, they further insisted on strengthening the employer covenant as the newly acquired company was ahead of a £8bn worth debt repayment to re-finance KKR's buyout.

49. More recently, trustees of the pension scheme of EMI alerted the British regulatory authority (The Pension Regulator), after negotiations with the private equity firm managing the fund (owner of the company) had broken down[34]. These concerns have been supported by a recent survey of 250 British trustees, according to which three out of four trustees would be "worried" about a possible leveraged buyout of the sponsoring company; a clear majority was in favour of regulatory requirements to inform trustees of any bid approach from a private equity firm[35]. The British government is considering expanding the enforcement powers of the Pension Regulator: it has stated that "aggregate resources of a whole group of companies may be considered" (i.e. including those of other portfolio companies in other funds managed by the same private equity firm), in order to judge whether the funding level of the target company's pension scheme is appropriate (DWP 2008).

50. In sum, it may be legally correct, but it remains economically wrong and politically illegitimate to claim that private equity firms and the general partners of the funds they run have no employer responsibilities over the portfolio companies.

Back to the stone age of governance

51. The OECD appears particularly enthused by the governance model of private equity funds. In a report issued in July 2007, a group of experts on corporate governance praised private equity funds as "informed and active investors" whose role is "positive for corporate governance" (OECD 2007c). Private equity funds are said to be particularly useful "when equity markets are characterised by information asymmetries" and hence "the cost of collective action by investors" to curb entrenched management (i.e. pursuing their own goals and interests rather than those in the "best interest of shareholders") becomes high. The OECD experts further recognise the added value of private equity funds, alongside activist hedge funds, in situations where collective action problem "are made worse by the side-effects of prudential regulation that limits the share of equity held in a company by some

[34] EMI trustees hand over funding issues to TPR, IPE.com 2 May 2008
[35] Survey by Aon Consulting What to do when the wolf is at the door, IPE.com 16 April 2008

institutional investors", notably restriction of pension funds in ownership of equity. With regard to the LP agreement that binds the investors to the private equity firms, the OECD experts argue that "private equity partners [...] commit a significant amount of their own money", thereby "aligning their incentives more closely with their investors". The OECD experts conclude that private equity transactions "make a contribution to improving corporate governance and to improving economic performance" and that, from corporate governance perspective, there is "no need to promote a special set of principles for private equity firms"

52. This reading of the governance aspects of private equity funds is rather surprising when one considers the actual content of the LP agreements of these funds, particularly those under US Delaware jurisdiction, which form the majority of the private equity funds active in the OECD area. These agreements are confidential documents, rarely disclosed to the public, except for specific circumstances; e.g. in application of the US Freedom of Information Act which requires the disclosure of documents of public entities, as is the case of public sector pension funds.

53. Annex 1 lists the main content of a Delaware LP agreement ruling the internal governance of a $6bn fund set up by Texas Pacific Group in 2004. It shows that the internal governance of the fund is limited to default rules – lifespan and profit sharing – and that it severely restricts the role and powers of the investors, the limited partners. In comparison to the OECD Principles of Corporate governance[36], the LP agreement appears in blatant contradiction to many of the OECD founding principles on transparency and rights of investors; in other words, there is little doubt it entails regressive governance regimes (see Annex 2). The private equity firm – the "general partner" in the LP agreement – has exclusive control over the management and operations of the partners, and, among others, can shield the identity of a specific investment to investors themselves, if the private equity managers believe "in good faith" that disclosure would "cause a risk of jeopardising that investment or the anticipated returns". Recourses to legal action are very limited, if not non-existent. In a rare case involving the public sector pension fund of the state of Connecticut against private equity house Forstmann Little over two investments in IT companies at the height of the high-tech bubble, the court ruled in favour of the pension fund, but denied the award of the $125m that were claimed in compensation for the losses[37].

54. As shown in annex 1 the LP agreement runs counter to the reforms and changing practices adopted in the past decade to ensure more responsible and active investors, notably during the post-Enron era 2002-2005. Compared with shareholder activism in listed equity AGMs, the LP is a return to the stone age of governance. In particular, there is very little room to introduce non-financial considerations. The best hope lies in the "opt-out" clause, which allows an investor not to participate in a specific investment by the fund. NYCERS and CalPERS have made such a clause a condition of their deals with private equity houses. In the case of CalPERS the clause excludes the privatisation of public services and outsourcing that "may cause public sector workers, including CalPERS members, to be laid off and be offered new private sector jobs in which they perform the same work but with inferior wages, benefits or working conditions" (CalPERS 2004). Obviously their weight and experience make it relatively easy for these pension funds to negotiate such clauses in agreements. How to obtain better terms and conditions under the LP agreement is work in

[36] While focussed on publicly traded companies, the Preamble to the Principles states that the Principles "might also be a useful tool to improve corporate governance in non-traded companies", both financial and non-financial (OECD 2004).
[37] Forstmann Little Loses but Avoids Damages, 2 July 2004, Washington Post

progress in the pension industry. Some have suggested systematising "pooled" private equity mandates – several large asset owners working jointly – to be able to better dictate conditions to the private equity firms.

IV Concluding remarks

55. Efforts are underway to promote trustee education and awareness about private equity investments. However, recent parliamentary debates have shown that there are limits to what can be achieved on a voluntary basis. Re-regulation of private equity is needed. It is yet too early to draw definitive conclusions on the sudden deepening of the financial crisis on 15 September 2008. In principle, 100% ownership of a company can only play in favour of effective stewardship of workers' capital. It is clear however that without the creation of a new agenda on financial regulation, the transactions costs of applying stewardship of workers' capital to private equity funds, and to other lightly regulated investment funds, will remain high, if not prohibitive.

Trade union and government trustee guidance

56. The trade union campaign against private equity has in the past two years produced a number of trade union blue prints and guides. Global Unions[38] in particular have been singularly active in 2007. The IUF produced a "Workers' Guide to Private Equity Buyouts" (IUF 2007), UNI, a set of "Global Principles for Private Equity" (UNI 2007). However, these guides (as well as most of the trade union literature on the issue) are mainly concerned with the employer responsibilities of private equity firms and do not directly address the role of investors in the private funds run by the private equity[39].

57. On the specific role of pension trustees, three official trade union statements were released in 2007:

- In March, the Dutch FNV released an interpretation of its 2000 SRI guidelines "Goed Belegd" (Well Invested) in the specific case of pension fund investments in hedge funds and private equity. While noting the potential benefits of private equity to the economy, the FNV review warns against pension funds bearing "the entrepreneurial risks" implied by the private equity model, and calls for a level-playing field between private equity and listed equity with regard to corporate transparency, including reporting on environmental, social and governance impact. The FNV guidance further calls for robust pension fund risk management of their private equity undertakings and for the private equity funds not to become "instruments for quick wins". (FNV 2007)

[38] www.global-unions.org

[39] In fact the IUF guide briefly mentions the role of pension funds: "unions shareholder strategies, using union pension fund investments in a company or though alliances with other shareholders, or both, have been successfully used in some cases to block a private equity takeover" (IUF 2007)

- In June, the General Council of the ITUC adopted a resolution calling upon “trustees and fiduciaries of pension funds to consider investments in private equity and hedge funds with extreme caution” and “to pay due consideration to the real profitability record of such investments, the risks associated with them, the many negative impacts they may generate, and the direct or indirect impact they may have on the workplaces of the beneficiaries of the pension plans of tomorrow” (ITUC 2007).

- In October, the British TUC issued a “guide for pension fund trustees on private equity”. Some of its key recommendations call for union trustees to engage actively with the private equity firms, arguing that “if the private equity industry is to be encouraged to develop in a socially responsible direction it is necessary for trustees, as clients, to make clear that such factors are important to them”. The TUC paper further calls on trustees to participate in public lobbying activities “for broader public disclosure of standardised individual fund performance figures” and to facilitate “work with other investors to push for better terms from general partners of private equity funds” (TUC 2007b).

58. To date the most comprehensive work on trade union trustee guidance is provided by report by UNI Global Union in July 2007 (UNI 2007). A shown in the following inbox, the report proposes a checklist for trade trustees whose funds invest in private equity. Of particular interest is the last guidance requirements, which would see trade union trustees seek to “negotiate better terms from the private equity firm”, including in the areas of CSR, disclosure or labour standards.

UNI Global Union trustee guidance on private equity

Educate trustees and facilitate union coordination when pension schemes consider private equity investment.

Apply Responsible Investment Criteria to Private Equity, such as the UNI Global Principles and the UN Principles for Responsible Investment.

Ensure private equity firms are held accountable for the behavior of their portfolio companies among other, by asking private equity firms to agree to the following principles:

- *Transparency (including tax payments, government and other sources of public funding, employee compensation and benefits, all forms of debt incurred by the company).*
- *Employment (commitment to all trade union rights and core labour standards, as well as livable wages and other benefits)*
- *Public Health (commitment to environmentally responsible production and phasing out the use of toxic chemical)*
- *Global Labour Standards and Human Rights (unequivocally commitment to universal human rights and global labour standards, including by promoting and adhering to ILO Labour Standards, OECD Guidelines and the UN Global Compact).*

- *Taxes (commitment to not take advantage of provisions of the tax code that give unfair advantage over other forms of corporate ownership or capital formation)*
- *Anti-Corruption (commitment to work against corruption)*
- *Monitoring of the above compliance by independent third parties*
- *Trustee collaboration (negotiate better terms from the private equity firm).*

Source: UNI 2007

59. The concern that pension trustees do not necessarily measure the real risk exposure associated with private equity is shared by some pension supervisors. In February 2008, the International Organisation of Pension Supervisors (IOPS) – a network working at arm-length of the OECD – released a set of "Good Practices in Risk Management of Alternative Investments by Pension Funds". The basic requirements of the IOPS text are significant of the concerns pension supervisors have with regard to private equity. Other than rather traditional requirements of robust "diligence procedures" and risk management by the pension funds, the IOPS believes it necessary to remind pension trustees to have a "clear understanding" (!) of the risk characteristic of the invested products. As to the negotiations of LPs, the IOPS further insists that such contracts should have "clear and explicit" terms, "unambiguous limitation of risks", "contingency measures", "lock-up periods", "cancellation and termination conditions", that any "side letters" offering preferential terms to certain investors be disclosed and be transparent with regard to the fees captures by the general partner. Finally, the supervisors' organisation calls for "transparent communication with stakeholders" (IOPS 2008). At national level, some OECD pension supervisors, such as the Australian Prudential Regulation Authority have also developed due diligence procedures to check if pension trustees have the required knowledge and risk management procedures to handle the complexity that is inherent to alternative products.

Gaps in regulatory coverage

60. These guidance initiatives were much needed – and very welcome. Yet, whatever the level of awareness of pension trustees and the robustness of the risk management of their fund, important regulatory issues with private equity cannot be easily disregarded. According to a recent international survey of 226 investors, "58% are unhappy with current rules on private equity" (PWC 2008). Because of the regulatory gaps that benefit private equity managers, recent trade union campaigns have also stressed the need for capital market reforms in this area. In its annual statement to the G8 in Heiligendamm in 2007, the Global Unions – including ITUC, sector-specific Global Union Federations and the TUAC – called for "a level playing field between alternative funds and other collective investment schemes" with regard to transparency and reporting on performance, risk management and fee structure (TUAC 2007c). Private equity was addressed by trade unions once again in 2008 on the occasion of the G8 Summit in Hokkaido 2008. Global Unions called for G8 government to revisit "legal aspects of employer liability to protect established rights of workers under private equity regimes" (TUAC 2008b).

61. Trade union concerns were supported by the relatively high level of parliamentary activism on private equity, as evidenced by the TUAC (TUAC 2007d). Parliamentary hearings were conducted over the summer2007 in the US, the UK, and in Australia, while

private equity-related proposals of law or amendments were submitted in the US, Germany, Denmark and the Netherlands, among others. They touched upon controversial aspects of the private equity model:

- Workers' rights to information & consultation, impact on employment and/or inequality, protection of public services and/or strategic industries;
- Impact on financial sustainability and credit markets, on the portfolio company, spill-over effects on listed equity ;
- Taxation of the private equity LPs, including "carried interest", deductibility of debt of portfolio companies, and offshore transactions;
- Corporate governance and transparency of the portfolio company, prevention of conflict of interests and market integrity in buy-out transactions.

62. The rights of institutional investors in private equity fund were also addressed in parliaments. In public hearings in August 2007 before the Australian Senate, the Australian Securities and Exchange Commission (ASIC) shared concerns about the opacity of the financial arrangement used to sell the LBO debt to investors. In particular ASIC alerted to the fact that the investors did not necessarily understand the derivative products they were buying: "while cognisant about the degree of risk attached to equity and business investments", investors "are often confused about the amount of risk that can be inherent in fixed interest investments". At the British House of Commons in July 2007, the Financial Services Authority noted that "methodologies for disclosure, valuation and performance reporting used in the private equity market are not always applied consistently". This assessment was shared by the Bank of England which stressed "the importance of lenders to remain vigilant regarding the due diligence undertaken in respect of loan issuance" and alerted to the risks associated with weaker loan covenants in light of the recent sub-prime mortgage crisis. As noted above, the British House of Commons hearings were particularly instructive in exposing institutional investors' "behavioural" gap between listed and private equity.

63. However the most promising regulatory initiative has come from the European Parliament (EP), and in its Economic and Financial Affairs Committee. In September the EP agreed on a set of recommendations on regulation of private equity and hedge funds proposed by MEP and former Prime Minister of Denmark Poul Nyrup Rasmussen.

Re-regulation in the aftermath of the crisis

64. It is yet too early to draw definitive conclusions on the sudden deepening on 15 September 2008 of the financial crisis that broke out in the summer 2007. The fall in world equity indexes will inevitably lead to pressure on the funding of the pension industry, notably in the US, Canada, the UK, the Netherlands and the Nordic countries. Not only do these countries have very large and mature pension industries, their jurisdictions impose no, or very few, quantitative restrictions and hence pension funds have had a free hand to invest in listed equity and alternative products: structured products, hedge funds and private equity. In addition to the current fall in equity, pension funds may also come under pressure from the expected implosion of the private equity industry in 2009, when funds that were raised at the peak of the private equity boom in 2004-2006 come at maturity.

65. The aftermath of the immediate urgency measures might require political-level international cooperation and dialogue to put content in the quid pro quo for bailing out the financial system. Work on a new regulatory architecture has already begun, including within the international labour movement. Lately the trade union statement to the G20 crisis summit that took place in Washington on 14 November 2008 called for "regulating private investment firms such as hedge funds and private equity, and combating regulatory arbitrage within large financial groups and between jurisdictions" (GLOBAL UNIONS 2008). A "re-regulation" agenda – something the Bush administration but also the British government have been resisting fiercely in global forae including the G8 – may become politically obtainable with the incoming Obama administration in the US. But resistance to change from the international finance industry should not be underestimated. It remains to be seen how the new global agenda on financial regulation will affect the pension fund and private equity industries. So far, international financial institutions have been calling for timid regulation of products and transactions, including derivative products, but have stayed away from broader regulation of financial institutions such as private equity and hedge funds. The outcome of the G20 summit crisis in Washington has the merit of acknowledging that there are regulatory gaps in the global financial system, which was not the case in past G8 statements. In particular the G20 leaders have committed to undertaking "a review of the scope of financial regulation, with a special emphasis on institutions, instruments, and markets that are currently unregulated". It is not yet clear, however, whether such a review would effectively tackle the regulatory gaps that benefit speculative hedge funds and private equity groups and other un-regulated pools of capital. In the short term, the G20 leaders appear to hope that private equity and hedge funds will be able to police themselves, since the declaration limits itself to calling on these funds to take the initiative to develop "a set of unified best practices" for later consideration by governments.

66. What is sure, on the other hand, is that the business of private investment funds, including private equity funds, does not fit adequately the concept of stewardship of workers' capital and, for the matter, pension fund's investment policy. Despite all the efforts to increase trustee education and awareness about the complexity of private equity funds, there is one stumbling block: the opacity and weak governance – to say the least – that prevails in the legal structure that underpins the funds private equity firms operate: the LP agreement. Transparency and re-regulation of all forms of LP agreements within the OECD is urgently needed. Unless such new global agenda is created, the transactions costs of applying the workers' capital principle to private equity funds will remain high, if not prohibitive.

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Annex 1: Structure of a limited partnership agreement

Organisation	• Purpose of the fund, jurisdiction & registration of the partnership; • Prohibited & authorised investments and transactions; • Power to the GP to establish parallel investment entities to facilitate "from a legal, tax or regulatory standpoint the making of Investments"
Partners and capital	• Minimum level of capital commitment by the GP (3.5%), maximum size of the fund ($3.5Bn); • Prohibition for LPs to "participate in or take control of the Partnership business" or to demand the return of their capital contributions, other than at the discretion of the GP; • Rules applying to the cash contributions by LPs, power of the GP to solicit unused capital commitments by the LPs; rules applying to defaulting LPs; • Restrictions on investment (specific regime for IT investments, non-OECD investments and public sector pension fund 'ERISA' partners); • Right of the GP to keep an investment confidential, should disclosure "cause a risk of jeopardising that investment or the anticipated returns"; rights of the GP to admit new LPs; • Authority of the GP to establish alternative investment vehicles to avoid "tax, legal, business, accounting or regulatory impediments to the making of a potential investment"
Distributions and allocations	• Carried interests: Rules setting the amounts and priority of distributions between LPs and the GP: o up to 8% return : distributions to LPs exclusively, o then 80% to the GP until GP cumulative distributions reach 20% of total distribution, o then 80% to LP and 20% to GP. • Claw back provision: review of effective valuation of the fund after 6 years of existence, and if needed, adjustments of distributions to respect the 80% - 20% division between LPs and GPs
Rights and duties of the General Partner	• GP has full, exclusive and complete right, power and discretion to operate, management and control the affairs of the Partnerships; • Valuation of the fund investments is conducted by the GP, if needed assisted by third party verification • Plan asset committee of representatives of ERISA partners and other large LPs to review compliance of the GPs' certification to act as a venture capital operating company; • Rules applying to transfers of capital to other funds run by the private equity firm; • Rules applying to prevent conflicts of interest of the GP in managing the fund, parallel investment entities or alternative investment vehicles; • Definition of termination & liquidation trigger events (linked to other funds of the PE firm, material breach by he GP or filing for bankruptcy by the GP)
Management fee	• Fixed annual fee to cover for organisational expenses – legal advice and travel of person (here $1.25m); • Management fees of 1.25% to 2% of annual contributions by LP (with an upper limit of $200m) •
Advisory committee	• Comprising LP representatives including ERISA partners • Mandated to review the accounts, transactions and overall compliance of decisions by the GP with the limited partnership agreements
Confidentiality	• Strict confidentiality of information included in LP agreements ; • Strict confidentiality of the identity of LPs;
Other clauses	• Transfer of the general partner's interest; dissolution, liquidation and termination of the partnership; consents, voting and meetings; power of attorney; records and accounting, reports; fiscal affairs; representations, warranties and covenants of the general partner
Side letter	• Disclosure of other side letters • Most Favour Nation principle with respect to other side letters • Provision ensuring compliance with jurisdictions applying to the LP (typical a public pension fund) • Anti-bribery and compliance with the law provisions • Preferential terms or exemptions in distribution of proceeds, contribution or exiting the fund

Source: TPG 2004

Annex 2: Applying the OECD Principles to a Private Equity LP Agreement

The table below compares relevant recommendations of the OECD Principles of Corporate Governance with the internal governance of a Delaware state ruled private equity Limited Partnership. For this purpose the LP's "limited partners" are assimilated to a company's "shareholders" and the LP "General partner" to the company' executive officer. Principles that appear to depart significantly from the LP structureect are framed and marked by an '?'. Since no equivalent body to a board of directors exists in an LP agreement the last chapter of the Principles **–** The responsibilities of the board **–** is not taken into account.

OECD Principles of Corporate Governance, 2004

I. Ensuring the basis for an effective corporate governance framework

The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

A. The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity, the promotion of transparent and efficient markets and the incentives it creates for market participants. **?**

B. The legal and regulatory requirements that affect corporate governance practices in a jurisdiction should be consistent with the rule of law, transparent and enforceable.

C. The division of responsibilities among different authorities in a jurisdiction should be clearly articulated and ensure that the public interest is served.

D. Supervisory, regulatory and enforcement authorities should have the authority, integrity and resources to fulfil their duties in a professional and objective manner. Moreover, their rulings should be timely, transparent and fully explained.

II. The rights of shareholders and key ownership functions

The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

A. Basic shareholder rights should include the right to: 1) secure methods of ownership registration; 2) convey or transfer shares; 3) obtain relevant and material information on the corporation on a timely and regular basis; 4) participate and vote in general shareholder meetings; 5) elect and remove members of the board; and 6) share in the profits of the corporation. **?**

B. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as: 1) amendments to the statutes, or articles of incorporation or similar governing documents of the company; 2) the authorisation of additional shares; and 3) extraordinary transactions, including the transfer of all or substantially all assets, that in effect result in the sale of the company. **?**

C. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures, that govern general shareholder meetings:

1. Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

2. Shareholders should have the opportunity to ask questions to the board, including questions relating to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions, subject to reasonable limitations. **?**

3. Effective shareholder participation in key corporate governance decisions, such as the nomination and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval. **?**

4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

D. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed. **?**

E. Markets for corporate control should be allowed to function in an efficient and transparent manner.

1. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

2. Anti-take-over devices should not be used to shield management and the board from accountability.

F. The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.

1. Institutional investors acting in a fiduciary capacity should disclose their overall corporate governance and voting policies with respect to their investments, including the procedures that they have in place for deciding on the use of their voting rights.	?

2. Institutional investors acting in a fiduciary capacity should disclose how they manage material conflicts of interest that may affect the exercise of key ownership rights regarding their investments.

G. Shareholders, including institutional shareholders, should be allowed to consult with each other on issues concerning their basic shareholder rights as defined in the Principles, subject to exceptions to prevent abuse.	?

III. The equitable treatment of shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

A. All shareholders of the same series of a class should be treated equally.	?
1. Within any series of a class, all shares should carry the same rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares which are negatively affected.	?

2. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress.

3. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

4. Impediments to cross border voting should be eliminated.

5. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

B. Insider trading and abusive self-dealing should be prohibited.

C. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.

IV. The role of stakeholders in corporate governance

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

A. The rights of stakeholders that are established by law or through mutual agreements are to be respected.

B. Where stakeholder interests are protected by law, stakeholders should have the opportunity to obtain effective redress for violation of their rights.	?

C. Performance-enhancing mechanisms for employee participation should be permitted to develop.

D. Where stakeholders participate in the corporate governance process, they should have access to relevant, sufficient and reliable information on a timely and regular basis.	?
E. Stakeholders, including individual employees and their representative bodies, should be able to freely communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing this.	?
F. The corporate governance framework should be complemented by an effective, efficient insolvency framework and by effective enforcement of creditor rights.	?

V. Disclosure and transparency

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on:

1. The financial and operating results of the company.	?
2. Company objectives.	?
3. Major share ownership and voting rights.	?
4. Remuneration policy for members of the board and key executives, and information about board members, including their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.	?
5. Related party transactions.	?
6. Foreseeable risk factors.	?
7. Issues regarding employees and other stakeholders.	?
8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.	?
B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.	?
C. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.	?
D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.	?
E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.	?
F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.	?

VI. The responsibilities of the board

(Not applicable)