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Private Equity and Hedge Funds, AFL-CIO Executive Council Statement, Chicago, Illinois, August 8, 2007

Approaches and Policy Issues Concerning Hedge and Private Equity Funds - RENGO - Japanese Trade Union Confederation, September 2007

Les LBO, Une technique particulière de financement des entreprises, CFDT, October 2007

Private equity - a TUC perspective, TUC Evidence to the Treasury Committee Inquiry, May2007

Socially responsible investments, Hedge Funds and Private Equity, FNV – the Netherlands, 8 March 2007

"Financialisation", TUAC/ETUC/Global Unions Seminar, Summary report, TUAC Secretariat, 16 March 2007, OECD, Paris

ETUC

Financial market turbulence, risks for growth and employment, and the need for better financial market regulation - Policy statement adopted by the Executive Committee, ETUC, Lisbon, 17-18 October 2007

Global Unions

Resolution on Private Equity and hedge Funds, General Council, ITUC, Brussels, 20-22 June 2007

Private Equity: Why this matters to trade unions Looking for a fairer sharing of risk and reward: UNI Global Principles (extracts), June 2007

A Workers' Guide to Private Equity Buyouts (extracts), IUF, May2007

AFL-CIO Executive Council Statement
Chicago, Illinois, August 8, 2007

Private Equity and Hedge Funds

In the past year, the global labor movement has mobilized to address the issue of what John Monks, president of the European Trade Union Confederation, has labeled the "financialization" of the global economy.

Financialization describes the growing dominance of finance over the real economy, and, in the United States at least, over politics as well. At the heart of financialization are the growing size and power of hedge funds and leveraged private equity funds—leveraged private pools of capital that benefit from extensive tax subsidies and are unregulated and shrouded in secrecy.

The AFL-CIO has long favored greater investor protections and regulatory oversight of hedge funds, as the Executive Council reaffirmed in its statement last March. However, the recent dramatic growth in both leveraged private equity and hedge funds has made it necessary to state the labor movement's views on the challenges these funds pose to policy makers, to workers and their unions and to fiduciaries entrusted with workers' capital.

Leveraged buyout funds and hedge funds have been around for years and are not going to disappear. Pension funds and other institutional investors have used them properly in modest amounts to help round out their portfolios and offset the volatility of other investments. But it is both dangerous and illusory to believe that pension funds in general can achieve sustained above-market rates of return for large portions of their portfolios by investing in leveraged asset pools. And there is no reason why these funds should be secretive or unaccountable. Finally, there is no reason why the individuals who manage private equity and hedge funds should receive tax subsidies that leave the burden of paying ordinary tax rates to working people.

It is easy to generate high returns to equity with a combination of cheap debt financing and tax subsidies. That is not a long-term strategy, nor does it require genius—and there is a real cost. There is a hidden cost to the investors who are paying for the leverage with risk, a real cost to workers and their companies that are managed for short-term return and a real cost to the rest of us who subsidize the massive redistribution of our wealth and tax dollars to billionaires.

While leveraged buyouts can provide needed capital to troubled companies, a mania for leveraged finance sets in motion a dynamic in which companies are acquired and hollowed out to make them appealing candidates for being flipped back into the public markets. Workers' jobs, their health and retirement benefits and, in the end, their communities are nothing more than costs that can be converted into debt repayments. America's workers experienced this dynamic in the late 1980s, and now we are experiencing it again.

In response, the AFL-CIO's policy on private equity and hedge funds addresses government policy makers, pension fund fiduciaries and private equity and hedge fund managers themselves.

First, policy makers should enforce our existing laws, protect investors and, most of all, ensure that our tax system is fair. Private pools of capital should be required to play by the same set of rules as everyone else. The Securities and Exchange Commission should enforce the Investment Company Act and require private equity and hedge funds that wish to sell interests in their underlying investment pools to register as investment companies.

The IRS should look into self-dealing tax avoidance schemes by private equity funds and hedge funds going public. The IRS and the SEC should investigate whether the positions taken by these funds going public with each agency are mutually consistent.

The AFL-CIO strongly endorses both the Grassley-Baucus bill, S.1624, and the Levin-Rangel bill, H.R. 2834. The Grassley-Baucus bill requires private equity firms and hedge funds that go public to either provide investors with the protections they are entitled to under the Investment Company Act or pay corporate taxes on their earnings, while the Levin-Rangel bill requires hedge fund and private equity managers to pay ordinary income tax rates on their wages like any other American. We commend the authors and co-sponsors of these bills for their leadership in this area, together with those in Congress who have asked the regulators to enforce the existing tax, investor protection and national security laws. Both bills are badly needed correctives to a tax system that has become grossly unfair.

The AFL-CIO calls upon politicians who think billionaires should have lower tax rates than firefighters and teachers to explain why they deserve the votes of working people.

The AFL-CIO recommends that fiduciaries exercise great care in investing workers' capital in leveraged or opaque private investment vehicles. We urge fiduciaries to invest only in hedge funds that are registered with the SEC as investment advisors, and to ask hedge fund managers to agree to be bound by key protective provisions of ERISA. Some funds also have adopted policies that address the workplace practices of private equity and their impact on long-term value creation.

We particularly urge fiduciaries to work with their asset consultants to ensure the total exposure to either of these categories is modest and the expectations in relation to long-term risk-adjusted returns are realistic.

Finally, the AFL-CIO calls upon the hedge fund and private equity industries to act responsibly—to engage in dialogue both in the United States and globally around investor protection, taxation and workers' rights in the companies they control and influence. There are models for responsible behavior—leveraged buyout firms with a significant history of working productively with workers and their unions, both in the United States and overseas, generating healthy returns while preserving jobs and treating workers with respect.

We particularly urge the industry to engage in a dialogue around investor protection, tax fairness and workers' rights with the global labor movement. America's workers and their unions stand in solidarity with our brothers and sisters around the world in facing the challenge of financialization.

A RENGO Perspective - Approaches and Policy Issues Concerning Hedge and Private Equity Funds

RENGO - Japanese Trade Union Confederation

September 2007

Adopted by RENGO Central Executive Committee
in its 25th Session, 13 September 2007

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INTRODUCTION

(1) The Current Situation and the Background to the Emergence of Investment Funds

In recent years, the increase in corporate mergers and acquisitions (M&A) involving investment funds, notably private equity (PE) funds and hedge funds, has had a significant impact on the economy and on employment, raising important issues for the international labour movement. The inflow of funds into investment funds has been expanding steadily, with assets managed globally by hedge funds reaching $1,740 billion and by PE funds $700 billion.

This rise is said to be caused by a global “money glut,” there being an expanding inflow of oil money due to rising oil prices and growing foreign currency reserves among emerging economies. Also, financial institutions and pension funds have recently incorporated into their portfolios investment funds that used to be investment vehicles which were reserved mainly for wealthy individuals. There is also a problem in that the money that workers have deposited or contributed through investment funds can be used to help destabilize jobs and working conditions.

(2) The Relationship between Enterprise Value and Workers

In the meantime, there have been public debates at various forums over “who owns companies.” If one subscribes to the notion of shareholder supremacy, where the ownership of a majority of equity shares in a company ensures control, then a company is just a physical object for buying and selling (a commodity), with little attention paid to the flesh-and-blood employees who work there. The enterprise value of the company as a commodity is simply the market capitalization of its shares and the appraised value of assets held. As shareholders are overly eager to pursue higher share prices and fat dividends, corporate managers pursue short-term results and profits and become reluctant to invest in the development of human resources and basic research from a longer-term perspective.

However, a company, in our view, is a public organ in society where a group of employees as human beings develops a business, generates intellectual property and contributes to society, that is to say, it is a company of human beings (a community).

The meaning and value of labour differs significantly depending on whether one considers it a cost or a resource. If labour is taken as a cost, a company’s management acts as if it is guided by the notion that the lower the cost, the better. However, when labour is considered a resource, management behavior is geared toward the enhancement of the quality of labour through capacity development and education. In a company as a community, needless to say, labour is a resource. In order for a company to enhance enterprise value and realize sustained development, it needs to develop an environment where employees can work enthusiastically.

(3) The Formation of an Undisciplined Market and Policy Issues

In Japan, however, the revision of the Company Law, oriented toward a shift to the U.S.-style system, has led to excessive deregulation, and an undisciplined market is being developed to promote corporate buy-outs.

While the Financial Instruments and Exchange Law, put into force in September 2007, may ensure a certain degree of control over and transparency in investment funds, it falls short of regulating their investment behavior. Furthermore, in labour-related legislation, some fundamental problems, including that of employer liability, remain unresolved.

Based on this understanding of the current situation, we have looked at the policy issues involved in the development of a disciplined and sound capital market and at trade union responses, and have formulated RENGO's basic approach to M&A activities by investment funds. We hope the "Basic Approach" will serve as a good reference for trade union responses and for policy recommendations regarding investment funds not only within RENGO organizations but also in other quarters.

1. INVESTMENT FUNDS AND THE LEGAL FRAMEWORK FOR CORPORATE BUY-OUTS AND M&A

(1) The Current State of Investment Funds and M&A and the Problems Involved

Investment funds are "collective investment schemes for funds and money, where funds are collected from investors for investment in companies, etc. and investors are rewarded with dividends from target companies and with proceeds from their exchange listings." Investment funds are diverse in type, depending on the investment target and stance. They include such traditional investment funds as mutual funds as well as hedge funds, private equity (PE) funds and activist funds, which have shown continued growth in recent years.

RENGO has no intention of rejecting investment funds or their activities per se. Rather, RENGO fully understands that these funds can perform an important social role in that they can financially support the sustained growth and development of companies and the economy, and provide job security for workers. The problem lies in the existence of some investment funds that are preoccupied with paying the highest possible dividends to investors, thereby distorting the genuine raison d'etre of an investment fund. Such funds eat away at the growth potential of companies by acquiring them through a circumvention of market rules and by slipping through holes in the law by using for leverage a massive pool of funds. They then demand exorbitant dividends through personnel cuts and the sell-off of company assets, or they obtain huge margins in an extremely short span of time by demanding that the management or some other party concerned buy back the company at prices far in excess of the fund's own acquisition costs.

Moreover, since many PE funds procure acquisition funds using the assets of target companies for collateral, these borrowings are recorded as debts in the balance sheets of the acquired company after the takeover. The horizon of a PE fund is generally said to be three to five years. Thus, investment and business plans mapped out on the basis of strategies for a few years down the road can hardly be regarded either as sufficiently sustainable to contribute to the long-term interests of an acquired company or as adequate to maintain good working conditions and steady employment.

In addition, due to the derivatives trading that is practiced by hedge funds and others, amounts of money far in excess of the actual investments made are racing around global markets in a fraction of a second, raising the specter of the failure of just a handful of funds causing dysfunction in the global financial system as a whole.

Some investment funds escape legal requirements such as for registration, notification of incorporation, and information disclosure by taking the form of investment associations. The real investors in such funds remain unknown to the outside world due to the high degree of anonymity involved, and, in many cases, their investment performance or the scale of funds under their management are far from transparent.

The total amount of capital dedicated to private equity business globally is said to be a little over $700 billion as of the end of 2006. Large corporate buy-out funds have set foot in Japan one by one in recent years. Trade unions must give full heed to the possibility of most of their money being used to acquire Japanese companies.

Also, rules for corporate acquisitions have been significantly relaxed due to the recent revision of the Company Act. The stock swap system was introduced in 1999, and the ban on the so-called triangular merger structure was lifted in May 2007. These measures are perceived to have made it easier for foreign corporations with enormous capital strength to acquire Japanese companies. RENGO does not necessarily regard every case in which a foreign firm acquires a Japanese company as evil. What matters is whether the acquisition is really conducive to enhancing the enterprise value of an acquired company and whether enough heed is given to working conditions and jobs as well as to industrial relations.

At general meetings of shareholders in 2007, many Japanese companies proposed measures to defend themselves against hostile acquisitions and have had them endorsed. While some criticism was heard that corporate managers were proposing defensive measures for their own protection, the widespread approval for these measures at the meetings was seen as vindication that management was indeed introducing defensive measures in the interests of shareholders as a whole. Given that the relevant laws and market rules are still inadequate, individual companies' efforts to introduce defensive measures against takeovers are to some extent worthwhile. However, a mechanism to prevent corporate acquisitions that threaten the sustained growth of industries and companies should primarily rely on legislation and market rules.

(2) Currently Legal Forms of Corporate Buy-outs and M&A in Japan

In a normal corporate buy-out and M&A, an acquirer makes an approach of some sort to a target company and after negotiations they proceed toward some form of business integration. Procedures and issues of concern differ depending on whether the target company accepts or does not accept the acquiring company's proposal.

In a management buyout (MBO) where the managers and/or executives purchase the controlling interest in a company from existing shareholders, a possible conflict of interest needs to be taken into account because the acquirer would continue to serve as the management team of the acquired company.

a) When a Target Company Accepts an Acquirer's Bid

When a target company accepts an acquirer's proposal, the acquirer and the to-be-acquired company consider the most suitable procedures for the integration of their business. They then adopt integration procedures based on a bilateral agreement between the two parties. More specifically, various procedures, such as the following, can be assumed: a merger and a stock swap or a transfer arrangement, depending on the business operations of both companies, together with a post-integration vision for the company. Another possibility is for the acquirer to launch a takeover bid (TOB) and for the target company to give its consent to the TOB procedure.

However, even if the target company ultimately accepts the acquirer's bid, it is possible that the to-be-acquired company was compelled to accept it due to heavy pressure being brought to bear on it by the acquirer or by major shareholders in the run-up to the final accord. Also, the managers of the target company may agree to the takeover because they put their own personal interests ahead of the enhancement of the enterprise value of the to-be-acquired company. Therefore, even when the target company accepts an acquirer's bid, trade unions need to ascertain whether or not unreasonable decisions were made in the process leading up to the acquisition agreement.

b) When a Target Company Rejects an Acquirer's Bid

When a target company rejects an acquirer's acquisition proposal, procedures for their integration cannot be taken on the basis of an agreement between the acquirer and the to-be-acquired company. Thus, if the acquirer is to realize the proposed acquisition, it has to replace the management team of the target company in some way or other and elect a new management team that complies with the acquirer's wishes, and then it can take the appropriate integration procedures.

In order to replace the management team of the to-be-acquired company, the acquirer must have enough votes to pass an agenda item for the election of board members at the target company. It is therefore necessary for the acquirer to obtain a majority of the outstanding shares of the target company or to secure enough supporters among the shareholders so that their holdings, combined with those of the acquirer, make up the majority of outstanding shares.

When the acquirer wishes to obtain the majority of outstanding shares in the target company, it launches a hostile TOB for the to-be-acquired company. When the acquirer seeks the support of like-minded shareholders whose holdings, together with its own holdings, make up the majority of outstanding shares, it submits a shareholder's proposal for the election of members to the board of directors and solicits proxy votes to garner enough support to have its proposal approved.

When the target company rejects the acquirer's bid and the acquirer launches a hostile TOB or chooses to solicit proxy votes from supportive shareholders, the takeover battle is decided by which side, that of the acquirer or that of the target company, wins the support of the majority of the shareholders. In such a case, the target company's management can be expected to carry out defensive measures against the hostile bid in an effort to increase its support among the shareholders. Usual measures of this kind can include the management increasing the company's capital through a third-party allotment of new shares or the issuance of share warrants with discriminatory conditions, following which it can then ask shareholders to vote in support of the management. However, once management launches such a defense action, the acquirer will very probably file a court injunction against the issuance of new shares or share warrants and thus bring the battle into the courtroom.

Even when the target company rejects the acquirer's bid, the management team of the target company may make decisions by putting their own personal interests ahead of the potential enhancement of the enterprise value of the target company. Thus, trade unions need to ascertain whether or not unreasonable decisions were made by the existing management team in the series of developments leading up to management's final decision to turn down an acquisition bid.

c) When the Management Buys Out the Company

Aside from acquisitions by outside acquirers, the managers and/or executives of a company may decide to buy out the controlling interest in the company and turn it into a privately-owned company. Most of the management buyouts (MBOs) carried out in recent years are described as "buy-outs by the management." In reality, however, many MBOs were carried out under schemes where the funding for the acquisitions came from investment funds and other sources, with the management financing only part of the acquisition costs. The existing management team then continues to operate the bought-out companies.

At any rate, in MBOs, the problem of a conflict of interest arises because the acquirer of the company is the existing management team of the same company. Therefore, trade unions need to ascertain whether or not the management team is acting genuinely for the interests of the company or is trying to advance its own personal interests at the expense of the interests of the company.

2. POLICY ISSUES AND DIRECTION

In this section, given the current situation surrounding investment funds and on the basis of our existing policies, we propose the future direction of RENGO's policy. If and when we decide to propose new demands in this area, the Policy Committee should have an opportunity to make a review.

(1) Issues Concerning Enterprise Laws and Related Measures

a) Issues about Laws and Market Rules and Our Responses

[The Company Law in the Loss of the Original Form of the Company]

The enforcement of the revised Company Law in 2006 led to the loss of the original form of a joint-stock company, as companies that used to be categorized as companies with limited liability were made into joint-stock companies, and policy-related systems introduced under laws with limited periods of validity, such as easier regulations on equity capital and a company's ability to buy back its own shares on the market, became permanent. Primarily, joint-stock companies should be those companies that have many stakeholders, have a great deal of social influence and are the hardest to manage. Another big problem is that the basic concept of a company has become ambiguous, with corporate governance and other systems disintegrating and becoming inconsistent because of the concept of 'free design.'

[Lack of the Notion of 'Workers']

We are also concerned about the lack of the notion of 'workers' in the Company Law. Workers and trade unions are legitimate constituents for the achievement of the mission of a company and are indispensable entities for the enhancement of an enterprise's value. However, considering the current situation where judicial precedents regarding corporate acquisitions and defensive measures against acquisitions have partially taken trade unions' views into account if we understand the legislation of the Law Concerning the Succession of Labour Contracts, Etc. upon the Divisive Reorganization of Company as a special exception to the Company Law, the notion of workers is actually being incorporated into the concept and framework of the Company Law.

[Role of the Trade Unions and the Revision of the Company Law]

Trade unions, as stakeholders responsible in part for the enhancement of an enterprise's value, should objectively and matter-of-factly judge whether investment funds and other acquirers of companies are truly investors and equity participants who can help enhance the enterprise value of a company. The tasks and responsibilities of trade unions in strengthening corporate governance are extremely serious and important, so trade unions must strengthen their ability to deal with management so that they can accurately understand and grasp the company's financial situation and business environment.

Over the medium- and long-term, RENGO needs to work to have the Company Law provide for the positions and roles of workers and trade unions in some form or other.

[Tougher Regulations over M&A by Investment Funds]

We must also intensify our efforts in policy areas regarding the regulation and the securing of the transparency of investment funds as well as regarding improvements in corporate acquisition rules. With the enforcement of the Financial Instruments and Exchange Law, a registration system was introduced for financial instruments companies. Compared to the previous framework, the new law marked a step forward in that we can now have a picture of what kinds of funds are operating in Japan and we can also track the flow of funds from financial institutions to investment funds. However, provisions under the new law fall short of securing the transparency of investment funds through disclosure of information and of safeguarding the rights of workers at companies in which funds invest. We need to continue our efforts in these areas.

Regarding legal regulations and the rules for corporate acquisitions and defensive measures against takeovers, we need to consider improvements in market rules. The Company Law was revised with U.S.-style free competition in mind. Because of inadequate market rules, however, individual companies find it necessary to devise their own defensive measures against hostile acquisition bids. However, since the United States has different legal systems concerning corporate organizations and corporate acquisitions, as shown by the lack both of federal corporate laws and of takeover defense measures in state law, there seems to be little Japan can refer to in U.S. systems to help it improve corporate acquisition rules in the Japanese market. Thus, Japan needs to develop and improve its corporate acquisition rules fitting in a way that suits conditions in Japan (including the introduction of an obligation to purchase all outstanding shares) with reference to the "City Code" introduced in U.K. and other European countries, while seeking to strengthen the monitoring ability of the Securities and Exchange Surveillance Commission (SESC) and of other public supervisory institutions.

We must also seek an integrated improvement of the legal system concerning corporate acquisitions, including a stricter monitoring of corporate merger screening under the Anti-Monopoly Law and a review of inward investment regulations under the Foreign Exchange and Foreign Trade Control Law.

b) Strengthening Responses in Taxation

The behavior of investment funds is likely not only to affect the productivity of acquired companies and the employment and working conditions of their workers but also to result in tax revenue reductions for national and local governments. For example, when an acquired company pays dividends to an investment fund with borrowed money, the tax base shrinks because of the deduction of the acquired company's interest payments on debt and because of the measure that excludes dividends received by the investment fund from gross revenue. Profit-making even jeopardizing the sustainability of companies and jobs must be taxed in an appropriate manner under the principle of equity and from the viewpoint of securing tax revenues. Efforts are under way to tax investment funds properly in other countries. In 2007, the governing and opposition parties in Denmark forged an agreement on tax reform, and a supra-partisan group of legislators is examining the issue in the United States.

Investment funds often take the form of associations under the Civil Code, i.e. they are anonymous associations and investment business limited partnerships. In these cases, associations or partnerships are not taxed, and taxes are imposed on individuals and corporate entities that invest in the associations or partnerships (pass-through taxation). Thus, the question is how we can ensure proper taxation of these investors.

Previously in Japan, when funds distributed profits to non-residents and foreign judicial persons, they were not required to withhold income taxes. But a measure to collect the 20% withholding tax was introduced under the FY 2005 tax system reform. However, associations with a membership of less than 10 are still exempt from the withholding obligation. Furthermore, there was not enough information available on the assets and income levels of these funds. Under these circumstances, in the FY 2007 tax reform, Japan required all anonymous associations to collect income taxes at source, and funds that are organized as associations were also required to submit documents regarding their financial situation. For the time being, we need to monitor the implementation of these measures.

Following the lifting of the ban on triangular mergers, under the FY 2007 tax reform, a measure was introduced to defer taxation at the time of a merger if business continuity and certain other conditions are met, while gains on the sale were made subject to taxation without deferment in the two cases of a merger through a subsidiary that exists in name only or of a merger brought about by the delivery of shares from an insubstantial parent company registered in a tax haven. Going forward, tax authorities need to boost their organizational preparedness to help enhance the effectiveness of these measures.

However, it is still possible that taxation may remain inadequate in cases of cross-border corporate acquisitions. In triangular mergers, for example, under the FY 2007 tax reform, if the shareholders of an acquiring parent company and an acquired company are both non-residents, gains on the sale of shares are taxed at the time of a merger in order to secure taxation in Japan. However, in revisions in recent years to the bi-lateral tax treaties that Japan has concluded with other countries, there has been a trend toward changing the point of taxation in dividends and other income from the country that is the source of the income to the taxpayer’s country of residence. These changes are accompanied by reduced rates or exemptions on withholding income taxes for non-residents and foreign judicial persons. Depending on the tax treaty, it is conceivable that taxes are uncollected not only in Japan but also in the country that is the other party to the treaty.

Adequate taxation measures are not taken either concerning the income of equity participants in investment funds or fund managers. Tax rates for income taxes on dividend income and capital gains on stock sales, currently assessed separately, have been lowered several times in the past, and further preferential treatment was accorded under the FY 2003 tax reform. As a result, these people’s present tax rates are lower than the income tax rates for ordinary workers.

Given these circumstances, it is necessary to prepare an appropriate framework of taxation for investment funds and fund managers and also to work toward greater international co-ordination. Specific measures can include (a) the immediate abolition of preferential treatment for income tax on dividend income and capital gains and the establishment of higher-than-usual withholding tax rates on high dividend income and large capital gains, particularly those arising from short-term transactions; (b) the introduction of a taxpayer identification number system and the shifting of financial income taxation from a separate to a consolidated income taxation system; (c) limitations on measures for the exclusion from gross revenue of dividend receipts in corporate taxation, when investment funds, as judicial persons, receive excessive dividends or fees from acquired companies; (d) efforts to secure Japan’s right of taxation and to increase the withholding tax rates in tax treaty revisions; and (e) the review of guidelines (such as the “OECD Model Tax Convention”) at the Organization for Economic Cooperation and Development and other international organizations in view of the behavior of investment funds, together with continuous consultations with countries that serve as tax havens.

c) The Need for Socially Responsible Investment (SRI)

Various pension funds and financial institutions often invest in investment funds. It is necessary to work on pension funds and financial institutions to practice socially responsible investment (SRI) so that funds contributed by workers and trade unions do not have an adverse impact on jobs and workers’ conditions because of the activities of investment funds.

(2) Labour Policy-Related Issues

One of the major issues related to labour laws and/or labour policy and investment funds is the problem of employer liability on the part of the investment funds. Regarding this problem, at the urging of RENGO, the Ministry of Health, Labour and Welfare (MHLW) set up a study group (The Study Group on Industrial Relations at Companies Acquired by Investment Funds, etc.) and in May 2006 this group produced a report (see the attachment, “A Report by the Study Group on Industrial Relations at Companies Acquired by Investment Funds, etc.”).

When an investment fund acquires shares in an acquisition target company, it is just one shareholder, and no one can claim that the fund, simply because it is a major shareholder, is a negotiating partner for a trade union in collective bargaining. The big problem with the current Trade Union Law is the lack of provisions for the definition of an employer. According to past court precedents, even in the absence of a direct employment relationship, a party can be recognized as having employer liability if it is in a “position to realistically and specifically control and make decisions on basic working conditions, etc. to a degree identical, even partially, with that of an employer.” The afore-mentioned report by the study group of the MHLW also concluded that as it is difficult to present uniform criteria for judgment regarding specific requirements for employer liability, it is appropriate to make judgments on a case-by-case basis.

RENGO believes that in judging the employer liability of investment funds, an investment fund should be recognized as having employer liability if the fund owns a certain ratio of shares in an acquired company and actually wields influence over the acquired company both qualitatively and from a personnel viewpoint, for instance, if it sends in its people to sit on the board of directors of the acquired company. The definition of employer liability should be clarified in relevant labour laws.

Furthermore, the report of the study group stated, as “points” to build good industrial relations between investment funds, etc. and acquired companies and their workers, that (1) investment funds, etc. recognize that they could become employers; (2) both acquired companies and investment funds, etc. recognize the importance of collective bargaining at acquired companies; and (3) investment funds, etc. offer opportunities for pre-acquisition explanations and for an exchange of views about post-acquisition management policies. It is of particular importance to have labour-management consultations to clearly convey the views of employees and to exchange views.

While the MHLW has said it will strive to make the above-mentioned “points” widely known, given developments so far, that effort alone can hardly be expected to ensure their effectiveness. RENGO, in addition to legal provisions for the definition of employer liability, will press the MHLW to at least develop guidelines as quickly as possible and to formulate measures to make it possible to provide guidance to investment funds, etc. RENGO will also make continued efforts to develop amicable industrial relations in corporate acquisition cases.

3. COOPERATION WITH THE INTERNATIONAL LABOUR MOVEMENT

In March 2007, the Trade Union Advisory Committee to OECD (TUAC) issued a statement calling for a new set of international regulations regarding the transparency and taxation of PE funds. Recognizing that “the very high rates of return required to finance private equity debt-driven buy-outs can jeopardize target companies’ long-term interests and the provision of decent working conditions and security for employees,” the statement called on the Group of Eight (G8) leaders to create an international regulatory task force, comprised mainly of OECD member states, to address the following four areas: the principle of transparency, the securing and promotion of workers’ rights, the reconfiguration of tax regulations, and the establishment of corporate governance. In response, the OECD is considering the application of the OECD Guidelines for Multinational Enterprises.

The International Trade Union Confederation (ITUC) at its General Council meeting in June 2007 adopted a report entitled “Where the House Always Wins: Private Equity Funds, Hedge Funds and the New Casino Capitalism”. Global Union Federations (GUFs), as part of the international labour movement and agreeing with the recognition above, have also formulated or are in the process of formulating their own responses to investment funds. Also, regarding socially responsible investment (SRI), in particular the UN Principles for Responsible Investment, the ITUC and other global trade unions are about to publicize guidance of for trade unions in the autumn of 2007.

Investment funds are operating in markets around the world. As national regulations and measures concerning investment funds have their limitations, efforts must be made from a global perspective with the cooperation of all countries. While statistics are not necessarily clear, Asian countries, where market regulations and rules remain under-developed, will probably experience even greater effects from investment funds than Japan. Thus, Japan’s role and its responsibilities are extremely important.

RENGO will continue to express its views and provide information to the international labour movement regarding economic and labour policies that contribute both to the stability of workers’ employment and their working conditions and to sustainable economic growth and development.

REFERENCE: GUIDELINES FOR TRADE UNION RESPONSES

In this section, we provide guidelines for trade union responses to M&A' and other investment fund activities as a reference for the formulation of manuals and policies by member organizations and individual trade unions

(1) Everyday Efforts

a) Basic Approach

A characteristic of industrial relations in Japan is the effort to maintain labour-management communication through the labour-management consultation system. Indeed, labour-management consultative organizations are set up at 84.8% of companies where trade unions are organized. According to the Survey on Labour-Management Communications (2004) by the MHLW, the labour-management communication system is in better shape at companies with trade unions than at companies without them.

In addition, Japanese companies generally have top executives who have climbed up the in-house ladder of promotion. At large corporations, it is not uncommon for top executives and other officers in managerial positions to be former trade union members.

Trade unions in this model of industrial relations play the role of partners in company management. Those who must bear the onus of management decisions made by the current managers are the next generation of managers who will take over from the current teams and employees who now work under them. In other words, many of trade union executives at present are steersmen of corporate communities who will become part of the company's management team in the future.

It is important for any shareholder to treat workers and trade unions as important stakeholders and to seek sufficient communication with them. If trade unions and management can share the same perception of corporate management and build good industrial relations with a due sense of tension, that should prove a short cut to the enhancement of enterprise value and be in the best interests of all stakeholders, including the shareholders. So, it is necessary to seek fruitful labour-management consultations on a routine basis and to develop sound industrial relations with a due sense of tension.

b) Protection of Employees in Corporate Buyouts and M&A

It should be noted that under any corporate buy-out and M&A scheme, the Companies Law or the Financial Instruments and Exchange Law do not directly provide for the protection of employees.

The Company Law governs such matters as the relationship between companies and their shareholders, who are equity participants in joint-stock companies, and supervises members of the companies' boards of directors as well as the internal auditors and accounting auditors who assist the directors. Under the law, employees are those employed by directors to sustain a company's operations. Employees are not subject to governance by the current Company Law.

The Financial Instruments and Exchange Law is designed to ensure the fair issuance of securities and fair transactions in financial instruments, the smooth circulation of securities, and fair prices for financial instruments through the full realization of capital market functions. Regarding joint-stock companies, the law provides for fair trading in stock markets (in other words, the protection of shareholders). Thus, though it has provisions for managers of share-issuing companies and for those who trade in shares (shareholders), the Financial Instruments and Exchange Law does not govern employees employed by directors to sustain a company's operations.

Furthermore, theoretically, corporate acquisition and M&A schemes alter only the capital structure and the composition of directors, and bring no changes to a company's operations. Thus, as long as business operations continue, changes in equity participation in a company or its directors do not alter the relationship between the company and its employees. Under such circumstances, labour laws and court precedents do not allow for any unilateral change that is detrimental to employees.

As discussed above, the Company Law seeks the proper management of companies by the governing equity participants, the directors, and those who oversee corporate management (internal auditors and accounting auditors), while the Financial Instruments and Exchange Law seeks to maintain a fair and sound stock market by governing equity participants (shareholders), issuing companies (companies) and their managers (directors). Thus, the maintenance of an appropriate relationship between a company and its employees has to be dealt with, legally, under the Labour Standards Law and other relevant laws.

Therefore, as it is difficult in many cases to consider responses directly based on the Company Law, trade unions must begin by preparing for matters that can be approached in the context of industrial relations and labour laws.

c) Collective Agreements: Industrial Relations, Clarification of the Status and Rights of Employees

Regardless of any change in the capital structure of companies or in the composition of a company's directors, it is necessary to secure the status and rights of employees in line with the Labour Standards Law, collective labour agreements, etc.

In particular, if ambiguous aspects remain unresolved in industrial relations, it is highly likely that they will lead to problems in the securing of proper terms and conditions for labour. Thus, it is important to keep collective labour agreements in good shape and to clarify matters between trade unions and management concerning labour-management consultations and working conditions. It is necessary for trade unions to secure satisfactory collective agreements while collaborating with superior organizations as necessary (RENGO's Guidelines for Model Collective Agreements, [2001] provide for responses in terms of corporate restructuring and collective agreements).

Furthermore, if collective agreements do not have any provision for a period of validity, companies may unilaterally give an advance notice of termination 90 days prior to the intended termination date. It is therefore important to ensure that collective agreements provide for a period of validity and not fail to make procedures for the renewal of collective agreements.

d) A Solid Labour-Management Consultation: Grasp the Situation and Strengthen Routine Activities

Even when the capital structure of companies and the composition of directors are altered, employees may not face any particular problem as long as there is no change in industrial relations, and employment and working conditions are maintained. Changes in the capital structure and the composition of directors may even produce a synergy with an acquirer being able to boost corporate performance. The execution of so-called good acquisitions can benefit employees.

However, problems arise for employees if the acquisition brings in a new capital structure and new directors, and the new employer seeks to enhance a company's performance through the lowering of working conditions. However, we need to make it clear that even with changes in capital structure and the composition of directors it is not legally permitted to change working conditions to the disadvantage of employees without reasonable reasons.

Trade unions need to routinely keep the labour-management consultation system solid and operational in order to forestall any unilateral lowering of working conditions as a result of acquisition-driven changes in the company's capital structure and directors. In particular, numerous cases in recent years, in Europe and the United States as well as in Japan, show that PE funds are often hostile to trade unions. It is therefore necessary to put a mechanism in place to enhance the knowledge and skills of trade union executives and internally to accumulate enough know-how through routine activities for trade unions to present their views, opinions and proposals in consultations and negotiations with the new management teams in the event of a corporate acquisition or M&A.

It is also important for trade unions to strengthen their presence not only before any acquirers but also in front of the current management through their routine efforts and activities. Each member of a trade union needs to be aware that the in-house accumulation of a variety of technologies and skills and the reliable relationship with customers are the very source of enterprise value. Trade union executives must recognize that the steady execution of day-to-day business operations and the growth of each member of a trade union contribute to the enhanced presence of the trade union.

(2) Responses to Corporate Buy-outs and M&A

a) Basic Approach

Corporate acquisitions and M&A are carried out in order to control the management of a target company through a majority acquisition of the company's capital structure so that they can bring the company under their control, at which point the management of the two parties can then be integrated.

Changes in capital structure and in the composition of the directors are ultimately determined by the shareholders who are equity participants in the target company. Needless to say, it is impossible for an unspecified majority of shareholders to negotiate directly with a potential acquirer. As such, negotiations with the acquirer are conducted primarily by the management team that has been entrusted by shareholders with the running of the company. Yet, the shareholders make the ultimate decision. The success and failure of the acquisition bid depends on the judgment of the shareholders who decide whether or not to accept it at a general meeting of the shareholders or on whether or not to sell their holdings in response to the TOB. However, the criteria for shareholders' decisions, when deciding whether or not to accept or reject the acquisition offer, is whether the offer will enhance the enterprise value of the company they own. Employees are the human element of the company that organically combines with physical elements, such as plants and equipment, to constitute the value of the business (enterprise value), and as such, they are an extremely important element in the formation of enterprise value.

Therefore, the views of employees about the acquisition offer can be considered significant in influencing shareholders' decisions and may even affect the success or failure of the acquisition itself.

Since the views of employees about the acquisition offer are an important factor that can potentially influence the success or failure of the acquisition bid, trade unions must try and gather and transmit information in an appropriate and fair manner in order to use their de facto clout in an appropriate and fair manner.

b) Prompt Collection of Accurate Information

Since an acquirer's bid is very sensitive trade information, it is not easy for trade unions to obtain that information while behind-the-scenes negotiations are being carried out following the acquirer's approach to the management of a target company.

However, it is necessary for trade unions to ask the management to disclose any relevant information as quickly as possible through labour-management consultations, etc., and at the same time to review the information management systems of trade unions and to make the utmost efforts to prevent any leak of such information.

After the acquirer's proposal is disclosed, trade unions should also consider making approaches to the acquirer for a broader disclosure of any information they want to know, in addition to seeing officially disclosed information and materials. While the disclosure of information to trade unions has no legal grounds, trade union approaches to the acquirer could still effectively elicit a response. Another option is to obtain necessary information by posing questions through the management to the acquirer.

Specifically, trade unions should strive to obtain information on post-acquisition policies and business plans, and must also make efforts to improve their knowledge and skills so that they can understand and analyze the contents of such management policies and plans.

In the case of a hostile takeover bid, it is useful for trade unions to examine what sort of information is necessary, even in the absence of a specific bid, so that they can make the necessary approaches in a timely and appropriate manner once such bids are actually made. It is also useful to run a simulation on who should be approached and in what manner in order to obtain any necessary information.

At the same time, it is also important to obtain and analyze information about the track record of corporate takeovers by the acquirer in question. The same acquirer can have different objectives (pure investment, participation in management, etc.) for individual cases. It is important to ascertain the intentions of the acquirer and to analyze the contents of the takeover bid.

c) Examination of the Contents of Acquisition Bids

After obtaining accurate information on the acquirer's proposal, it becomes necessary to examine the reasonableness and relevance of the proposal from a trade union standpoint. As proposals from potential acquirers can vary greatly, trade unions cannot really consider acquisition proposals until after the bids are actually filed. It is difficult to prepare in advance, but it is still possible for trade unions to consider and prepare for things like their initial response, for instance, as to which members should initially be assembled to analyze the contents of the bid.

d) Transmission of Information and the Gathering of Opinions within Trade Unions

After trade unions have obtained sufficient information and have conducted a preliminary examination, it then becomes necessary to convey this information to individual union members and to gather their opinions in order to form the collective view of the trade unions.

If trade union members are scattered among branch offices and plants across the country, it is not easy for trade unions to disseminate information to all union members and to gather their opinions in a short period of time. Therefore, trade unions need to consider, in advance, the methods and systems for disseminating such information to individual union members and for collecting their opinions accurately.

e) Systems for Forging Trade Unions' Collective Views and their Expression

Even after gathering the opinions of individual trade union members, in order to develop the collective view of the trade unions and to transmit it externally, it again becomes necessary to obtain the support of individual union members for union policies. It is necessary to consider and develop systems to make the whole process workable. Trade unions also need to consider ways of communicating their collective views about the acquisition proposals externally and to think of ways to coordinate with management concerning such communication.

Depending on the contents of the acquisition proposal, there may be cases where employees feel like accepting an acquisition bid even if it is hostile (a bid rejected by the management). In such cases, trade unions will express their support for the bid after careful analysis. There have been cases where the management unfairly pressured individual trade union members into opposing bids that they rejected. To deal with such eventualities, trade unions need to have an opportunity to express their opinions from fair and independent viewpoints and to consider ways of securing such opportunities.

f) Consultations with New Management, Confirmation of Employer Liability

After the consummation of the acquisition, trade unions should hold labour-management consultations with the new management as soon as possible and examine post-acquisition management policies and business plans anew to ascertain that they are not detrimental to jobs and working conditions. While it is necessary to conduct collective bargaining as the occasion demands, the important thing is actually to have consultations and negotiations with the counter-party that has control over the company. Even when the acquirer is an investment fund, the employer liability of the fund can be recognized if it actually has a controlling influence over the management of the acquired company. Since there are no clear legal provisions for the definition of employer liability, trade unions have to deal with the issue on a case-by-case basis. Individual trade unions and their superior organizations should cooperate with one another, while drawing upon court precedents, and they should also consult lawyers and other legal experts as necessary.

g) Strengthening of Negotiations

If, despite such action by the trade union regarding the M&A, the acquirer continues to react unfairly regarding jobs, working conditions and industrial relations, trade unions need to strengthen their negotiations and to prepare contingency responses for every possible scenario. In such a case, on the strength of full collaboration among individual unions, superior organizations and legal experts, trade unions will launch powerful responses in line with their respective policies.

LES LBO

Une technique particulière de financement des entreprises

Les LBO (« leverage buy-out ») font aujourd'hui la une de l'actualité financière et économique. Plus de 5000 entreprises françaises seraient contrôlées par des fonds d'investissement ayant utilisé des méthodes de LBO, à l'origine sur des PME mais aujourd'hui de plus en plus sur des grandes entreprises. Les LBO sont souvent accusés d'inscrire dans une logique de court-terme, de renforcer les objectifs financiers des entreprises, au détriment de l'investissement, de l'emploi et de la stratégie industrielle. De fait, restructurations, plans sociaux, licenciements dans des entreprises sous LBO sont fortement médiatisés. L'arrivée des fonds LBO dans une entreprise suscite du coup la crainte des salariés.

1. La présence des fonds d'investissement dans l'économie française

Le marché français du capital investissement représente 61 milliards d'euros, pour 1150 milliards au niveau mondial. Le capital investissement vise les entreprises qui ne sont pas cotées en Bourse (d'où le terme anglais « private equity » : valeurs privées, non cotées sur le marché boursier).
En 2006, les entreprises qui faisaient l'objet d'un financement par du capital investissement étaient au nombre de 5000 en France, dont une grande majorité de PME (83% des entreprises concernées ont moins de 500 salariés). L'AFIC, Association française des Investisseurs en capital, qui représente les fonds d'investissement, estime que les entreprises sous LBO et autres formes de capital investissement représentent plus de 1,5 million de salariés dans notre pays, soit près de 9% des effectifs du privé.

Réalités bien distinctes derrière le terme « capital investissement »

- **Le capital risque** pour lancer des jeunes pousses (start-up).
- **Le capital développement** pour accroître l'activité d'entreprises qui veulent investir
- **Le capital transmission** pour effectuer la vente de société par leurs dirigeants. C'est dans ce cas de figure qu'intervient la technique du LBO. Les dirigeants de l'entreprise sont souvent intéressés par ces techniques, les salariés très rarement.
- **Le capital retournement** pour racheter les entreprises en difficulté.

Les techniques du LBO

Un LBO implique un montage financier et juridique spécifique.
Le LBO consiste à créer une holding dont le métier est d'acheter des entreprises et de gérer celles-ci pour une durée de 3 à 7 ans en moyenne. L'achat se fait en recourant à un procédé qui allie investissement sur les fonds propres de la holding et sur l'emprunt auprès des banques notamment. L'effet de levier correspond au fait que pour acheter l'entreprise, la part empruntée varie dans une fourchette de 50 à 80% de la valeur de l'entreprise cible. La dette est remboursée avec les dividendes récoltés dans l'entreprise achetée, dont la gestion est optimisée pour accroître le dividende. De plus, le LBO a pour objectif de revendre l'entreprise à un prix plus élevé que celui de l'achat, de manière à améliorer encore la rentabilité de l'opération (2e effet de levier).

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2. Les évolutions du financement des entreprises

Pour la CFDT, le développement des nouvelles techniques financières, dont les LBO s'explique par la transformation du rôle des banques dans le financement des entreprises.

Parallèlement à la désintermédiation bancaire, on observe aussi que la liquidité mondiale disponible pour s'investir dans les entreprises s'est considérablement accrue. Les taux d'intérêt mondiaux bas, la croissance de l'épargne retraite des américains et les excédents commerciaux asiatiques ont développé des masses importantes de liquidités qui cherchent à se placer.

On se trouve aujourd'hui à la conjonction de deux phénomènes :

- **Sur le marché financier, les liquidités sont abondantes,** les fonds de pension cherchent à diversifier leurs actifs notamment en les plaçant sur des fonds d'investissement.Les banques font du crédit et offre des capaci-tés d'endettement aux LBO.
- **Du côté des entreprises, nombre de PME sont à la recherche de financement** (Reprise d'entreprise lors de départs en retraite des chefs d'entreprise, besoin de développement de la taille des entreprises ou revente de filiales par les maisons-mères).

La modification du rôle des banques dans l'économie

Dans les années 60 et 70, les banques finançaient directement les entreprises pour leur investissement, soit en leur octroyant des prêts, soit en prenant des parts du capital des entreprises. A la fin des années 80 en France, la libéralisation des marchés de capitaux s'est accompagnée d'une « désintermédiation bancaire » : les banques ont arrêté ces formes de financement des entreprises. Les grandes entreprises ont dû se tourner vers le marché boursier pour se financer. Les banques se sont recentrées sur le conseil aux entreprises dans le placement en Bourse (courtier et banque d'affaires). Du coup, tout le tissu d'entreprises moyennes s'est retrouvé avec des difficultés de financement, pris en étau entre le recentrage du rôle des banques et le coût d'accès à la Bourse. Cet assèchement des ressources financières des PME a conduit à un développement de formes alternatives de financement, dont les LBO. Ceux-ci pourraient cependant pâtir des conséquences de la crise du subprime américain.

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Et les « hedge funds » ?

Parfois, les fonds de LBO sont aussi considérés comme des hedge funds. Ceux-ci sont pourtant différents. Les hedge funds sont des fonds spéculatifs, qui cherchent à se couvrir des baisses des cours et profitent des hausses pour revendre. Ils ne s'intéressent pas à une entreprise en particulier, mais visent plutôt les actions des entreprises cotées ou encore la spéculation sur les cours des matières premières. Ils obtiennent des performances déconnectées du marché.

3. Une nouvelle confrontation des logiques

Les LBO viennent perturber le fonctionnement du capitalisme financier qui s'était mis en place après les affaires Enron, Vivendi ou Parmalat. A cette époque de graves dérives dans la gouvernance des entreprises étaient apparues au grand jour. Elles avaient conduit les autorités boursières à mettre en place des règles de transparence permettant aux actionnaires des entreprises d'exercer un meilleur contrôle sur leur gestion.

Une des conséquences a été de donner aux actionnaires une place prépondérante au détriment des autres parties prenantes de l'entreprise, notamment les salariés. D'une confrontation entre deux logiques au sein de l'entreprise : celle des salariés et celle des chefs d'entreprise, on est passé à une confrontation à trois.

La pérennité de l'entreprise, l'évolution nécessaire de ce qu'elle produit dans une économie mondialisée, est de fait une préoccupation majeure des chefs d'entreprises et des salariés. Il n'en est pas toujours de même pour l'actionnaire qui peut n'être intéressé à l'entreprise que comme un moyen de faire fructifier son argent. La préoccupation essentielle peut être uniquement le taux de retour sur investissement qu'il attend pour une période donnée.

Contrairement au capitalisme boursier, où les détenteurs de capitaux sont invisibles, anonymes le plus souvent, peu intéressés à l'entreprise, si ce n'est à sa cote en bourse, désolidarisés du chef d'entreprise et de la stratégie industrielle, les fonds d'investissements LBO peuvent apparaître comme un moyen de rapprochement entre stratégie de développement d'une entreprise et capital investi.

Avec les LBO ces règles sont bousculées. Dans la plupart des cas quand un fonds rachète une entreprise, il implique les dirigeants (très souvent ils sont nommés par le fond). Pour cela, il rémunère fortement les dirigeants de l'entreprise cible du LBO.

Quant aux salariés, ils sont mis à contribution pour améliorer l'efficacité et la productivité de l'entreprise, souvent au prix de plans de restructuration. Nous revenons sur les conséquences négatives des LBO.

4. Les risques liés au développement des LBO

4-1 Des investissements dont l'objectif final est de revendre

Les LBO sont critiquables dans la façon avec laquelle ils modifient les techniques de gestion, en intégrant deux paramètres d'appréciation :

- le cash-flow[1] qui sort de l'entreprise sous forme de dividende pour rembourser la dette du fond d'investissement acquéreur de l'entreprise. Cette exigence de cash-flow pour rembourser la dette est déterminante sur les pratiques de management et a de lourdes conséquences sur la gestion sociale de l'entreprise.
- Faire de l'entreprise, une entreprise rentable pour trouver acquéreur au moment de la revente plus tard (3 à 7 ans après l'achat). Il n'est pas rare aujourd'hui de voir des entreprises qui sont à leur 3° ou 4° LBO, ce qui implique un risque de restructurations successives.

[1]Cash flow : flux de trésorerie, encaissements et décaissements de l'entreprise.

4. Les risques liés au développement des LBO (suite & fin)

4-2 Un risque d'éloignement des centre de décisions

C'est désormais au niveau des fonds d'investissement que se prennent les décisions stratégiques de l'entreprise cible : business plan, projets de développement, restructurations... Or, ces fonds d'investissement sont souvent situés à l'étranger, loin des enjeux locaux de l'entreprise cible. Pourtant les représentants du personnel de l'entreprise ciblée par les fonds restent prisonniers des modes de représentation nationale auprès des dirigeants de l'entreprise, alors que ceux-ci ne sont plus véritablement aux commandes de l'entreprise. Il en résulte un éloignement du centre de décision des institutions représentatives du personnel qui restent attachées à la réalité locale de l'entreprise.

4-3 Un rôle des banques ambigu et dangereux

Les banques qui ont un simple métier de crédit, prête de manière importante aux fonds d'investissement qui rachètent une entreprise cible. Pour éviter de supporter seules le risque, elles transforment leur dette en « titres » sur le marché financier. Ainsi la dette se dilue, et les banques reportent le risque sur d'autres agents économiques. C'est une situation qui peut fragiliser l'économie.

L'abondance des liquidités mondiales, la mondialisation des financements des entreprises et le développement du marché de la reprise d'entreprise devraient concourir au développement des fonds d'investissement. Ce n'est pas sans risques. Les banques ont externalisé leurs risques. En effet, les banques ne conservent pas les risques des prêts consentis aux fonds d'investissement pour pratiquer des LBO. Elles revendent ces prêts sous formes de titres sur le marché boursier, plus particulièrement aux fonds à gestion alternative (hedge funds) voire même à des fonds de pension alléchés par des promesses de rentabilité plus élevée de ce type d'investissement. Si le fonds rembourse la banque, il n'y a pas de problème. Si le fonds se trouve en difficulté pour rembourser, ce n'est pas la banque qui a prêté qui sera en difficulté. Ce sont les fonds (hedge funds ou fonds de pension) qui ont acheté les titres représentant l'emprunt des LBO qui perdent leur investissement. Le risque est donc diffusé à l'ensemble des acteurs financiers mondiaux.

Les deux paradoxes des LBO et du capital investissement

Premier paradoxe : les fonds d'investissement visant une entreprise ont souvent un projet industriel. Celui-ci vise à développer l'entreprise d'une certaine manière pour la rendre plus profitable par tous les moyens (ce qui peut inclure de la casse sociale). Ils prennent part directement à la gestion de l'entreprise, à la différence des investisseurs boursiers. Ces derniers ne font souvent que passer au capital de l'entreprise visée, ils se moquent du projet industriel et cherchent avant tout un bon placement rentable.

Deuxième paradoxe : Alors que les grandes entreprises passent leur financement par la Bourse pour éviter les banques, les fonds d'investissement qui reprennent des PME utilisent largement les banques. Celles-ci prêtent la dette qui sert à acquérir l'entreprise cible et conseillent aussi le fonds d'investissement sur le choix de l'entreprise ! En même temps, les dirigeants sont financièrement impliqués ce qui ravive les inégalités au sein de l'entreprise.

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5- Quelles pistes pour la CFDT ?

Avant tout, il nous faut revenir sur le contexte général du rapport salarial. Le conflit « capital – travail » ne peut se résoudre par un intéressement des salariés à la marche de l'entreprise au travers la détention de quelques pourcentage d'actions. Il ne faut pas nier l'importance que cela peut avoir. Mais les « salariés actionnaires » sont tout d'abord des salariés et les « dirigeants actionnaires », dirigeants parce que actionnaires principaux. Dire cela, ce n'est pas ressusciter la lutte des classes. C'est tout simplement reconnaître que la logique des uns n'est pas la logique des autres. C'est en reconnaissant cette réalité que des réponses les plus appropriées pourront être trouvées au travers d'une vraie confrontation.

Aujourd'hui, plusieurs pistes de réponse sont possibles :

1. DANS LE CAS D'UN LBO :

- ***Donner une nouvelle dimension à notre activité syndicale :*** dès que l'opération est rendue publique, les organisations syndicales doivent avoir accès au «plan de développement» de l'entreprise et au mode de gestion qui sera mis en œuvre. Ainsi la confrontation doit avoir lieu sur la stratégie qui sera mise en œuvre pour le développement de l'entreprise.

2. SUR LE CONTEXTE GÉNÉRAL DES LBO :

- ***Agir sur l'environnement juridique des LBO :*** demander que la transparence sur l'identité des fonds acheteurs soit assurée pour les instances représentatives du personnel. Cela implique de mieux réguler les opérations de LBO en garantissant l'information aux salariés par la législation. Il convient également de faire que l'État s'intéresse aux modes de financement des entreprises, autrement que par une fiscalité qui favorise les LBO.

- ***Faire évoluer les mentalités des fonds d'investissement :*** en développant une communication offensive rappelant les objectifs sociaux, environnementaux et sociétaux de toutes les entreprises, y compris celles sous LBO, les syndicats peuvent aussi contribuer à faire émerger l'idée de la RSE chez les fonds d'investissement.

- ***Donner des exigences aux banques.*** Nous l'avons vu, les banques ont externalisé leurs risques. Elles doivent être d'avantage responsabilisée. Là encore la fiscalité et la réglementation bancaires sont des leviers pour les pouvoirs publics, afin de les inciter à un autre comportement. La crise du subprime de l'été 2007 confirme cette exigence.

3. CONCERNANT LA FAÇON DONT L'ÉPARGNE EST ORIENTÉE VERS LES LBO :

- ***Sécuriser l'épargne salariale vers l'investissement socialement responsable :*** en tant que participant à la gestion de l'épargne salariale, les syndicats ont l'opportunité d'orienter les choix d'investissement vers de portefeuilles d'investissement socialement responsable, vers des entreprises qui acceptent de se faire noter sur leur comportement social.

- ***Engager une démarche pour que les fonds d'investissement répondent à une logique « Socialement responsable ».*** Les différents fonds doivent être incités fiscalement ***à se soumettre à une notation extra-financière.***

Contact : Service Économie et société
email : economiesociete@cfdt.fr

Rédaction : Service Économie et société
Service Communication

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Private equity - a TUC perspective

TUC Evidence to the Treasury Committee Inquiry

Summary

1.1 The role of private equity in the economy has grown rapidly in recent years. Following an increase in the size and number of private equity buyouts, around 1.2 million people, one in twelve private sector workers, are currently employed by private equity owned companies. Until recently, the sector was operating out of the public spotlight; however, given its major economic assets and significant economic and social impacts it is right that public scrutiny should be increased. The TUC welcomes the Treasury Committee Inquiry as an important part of this process of public scrutiny.

1.2 The TUC's major concerns about private equity sector are summarised below.

i) The regulatory environment has not kept pace with the rapid rise of private equity and is inappropriate given the sector's major economic assets and impacts.

ii) The disclosure requirements for private companies are considerably weaker than those for quoted companies. This means that when a quoted company is bought by a private equity fund its disclosure obligations are significantly reduced.

iii) The TUC believes that large private companies should be required to produce a full business review and to publish their full annual report on their website.

iv) Employees and their representatives in companies bought by private equity companies face particular difficulties in terms of receiving information about company plans both before and after the buyout and recognition of and negotiations with trade unions post-buyout.

v) The TUC believes that the Government needs to examine how the Information and Consultation Regulations operate in relation to a change in company ownership and make recommendations to ensure proper implementation and enforcement.

vi) The TUC proposes that the Transfer of Undertakings (Protection of Employment Regulations) should be extended to cover changes of company ownership.

vii) The TUC believes that a working group should be established by the Government to examine the impact of mergers and takeovers on employment rights and put forward proposals for reform.

viii) The TUC is concerned about the risks associated with the very high levels of leverage now being used in private equity buyouts and is concerned that employees shoulder a disproportionate share of that risk.

ix) The TUC urges the Treasury Committee to investigate the rise of corporate debt and its implications for economic stability.

x) The TUC believes that there is a fundamental difference between debt used to fund organic growth through investment and debt used to buy up other companies. The TUC argues that reflecting this distinction in the tax rules so that tax-deductibility on debt would not apply to debt used to buy up other companies merits further investigation.

xi) The TUC believes that the regulatory regime for limited partnerships is not appropriate for organisations that control increasing swathes of the UK's corporate sector. The TUC believes that private equity funds should be required to publish an annual report and accounts, and required to make this publicly available via their website.

xii) The TUC is concerned about the potential for conflicts of interests, both between limited and general partners within private equity funds and between private equity fund managers and the long-term success of the companies they own.

xiii) The TUC is concerned that directors' duties as set out in the Companies Act 2006 are not suited to the fixed time horizons of private equity owners, and urges the Government to look into this area as a matter of urgency.

xiv) The TUC believes that it is essential that private equity partners pay income tax on their earnings.

xv) The TUC is concerned that private equity buyouts are reducing the size of the stock market and that scaled up private equity buyouts would make the distribution of wealth generated by UK companies for more unequal than at present.

Introduction

2.1 The TUC welcomes the Treasury Committee inquiry into private equity. Private equity has risen rapidly up the news agenda in recent months, and has not only dominated the financial pages of the broadsheets but been widely covered throughout the media as a whole. Widespread concern has been expressed about the impact of private equity on the companies they buy and on the wider economy. Trade union campaigns around particular companies have generated considerable publicity, but it is also clear that trade union concerns have struck a much wider chord, and a host of commentators have joined in the debate about the role of private equity in the UK economy.

2.2 The TUC represents nearly 6.5 million workers in 63 unions and welcomes the opportunity to submit evidence to the Treasury Committee inquiry. One of the areas where both trade unions and other commentators, including Paul Myners[1] and John Plender of the Financial Times, have raised concerns is the employment impact of private equity buyouts. This issue is not directly referred to in the

[1] Author of Review of Institutional Investment, 2001

Treasury Committee inquiry's terms of reference, but the TUC believes that employment issues are central to public concern about private equity and merit proper consideration.

The regulatory environment

3.1 A number of macroeconomic factors have facilitated the rise of private equity, including high levels of global liquidity, low interest rates and a drive from investors for ever-higher returns. However, the regulatory environment has not kept pace with the rapid rise of private equity, and in particular is not suited to the current situation where private equity funds are able to buy up increasingly large quoted companies.

Transparency

3.2 There are two distinct issues with regard to "transparency on the activities, objectives and structure of private equity funds": the disclosure requirements for companies owned by private equity; and those for private equity funds themselves. The issue of transparency relating to private equity funds themselves will be dealt with below in the section on corporate status of private equity funds. This section will deal with transparency in relation to companies bought by private equity funds. This is significant because private equity companies are increasingly buying quoted companies and taking them private.

3.3 The disclosure requirements for private companies are considerably weaker than those for quoted companies. A private company does not have to file its annual accounts until nine months after its year end and does not have to produce quarterly earnings or interim results. Crucially, it does not have to place its annual report on its website, greatly diminishing public access to the information contained therein. While the public can gain access to company reports via Companies House, this is not a free service and a charge is made for each download.

3.4 Requirements for non-financial reporting, an area of particular interest to the TUC, have recently been strengthened for quoted companies by the Companies Act 2006. From October 2007, all quoted companies, even the smallest, will have to include in their business review the directors' view of "the main trends and factors likely to affect the future development, performance or position of the company's business". Information on the company's employees and suppliers, on environmental matters and on social and community issues must also be included, including information on company policies relating to these areas and their effectiveness. However, all private companies, even those employing tens of thousands of staff, are excluded from these requirements.

3.5 Executive pay is another area where there is a stark contrast between the obligations on private and quoted companies. While the Directors' Remuneration Report Regulations 2002 require quoted companies to produce a report on directors' remuneration and put it to the vote at their AGM, private companies are not covered by this legislation and are subject only to the general Companies Act requirements, which are much weaker.

3.6 The phenomenon of private equity companies taking large quoted companies private, overnight weakening the transparency of major UK businesses, throws a spotlight on this two-tier system of disclosure and illustrates the weaknesses of making ownership structure rather than economic and social impact the determinant of disclosure requirements. For example, on completion of its purchase by KKR, Boots, a company with 2,600 outlets, 1,500 pharmacies and 85,000 UK workers, will have its disclosure obligations significantly reduced, at the same time as there is heightened employee and public interest in the company's plans and activities[2].

3.7 The social and economic impact of a large private company is no less than that of a quoted company, and there is a legitimate public interest in the plans and activities of companies, regardless of their ownership structure. The TUC believes that large private companies should be subject to the same non-financial reporting requirements as quoted companies. It is essential that the disparity between quoted and private companies with regard to reporting and the reduced transparency caused by the rise of private equity buyouts are addressed by regulatory reform, and not left to voluntary initiatives, which will inevitably result in patchy and uneven reporting.

3.8 The TUC believes that

i) large private companies should be required to produce a full business review; and

ii) large private companies should be required to publish their full annual report on their website.

The regulatory environment – respecting the rights of workers and their representatives

Informing and consulting employees

4.1 The TUC is particularly concerned about the difficulty that employees and their representatives have had in obtaining basic information about company plans and strategy prior to and following private equity buyouts. The rights of employees and their representatives to be informed and consulted about important developments that may affect their interests have been recognised and set out in the Information and Consultation Regulations 2004, which have been in operation for organisations of 150 or more employees since 2005 and will apply to organisations with 50 or more employees by April 2008. These state that employers should consult employee representatives on matters that include:

i) The recent and probable development of the undertaking's activities and economic situation;

[2] These comments relate to what Boots will be required to report, and do not prejudge what information the company will decide voluntarily to put into the public domain.

ii) The situation, structure and probable development of employment within the undertaking and any anticipatory measures envisaged, especially where there is a threat to employment within the undertaking.

4.2 The general principles of the Takeover Code require a board to advise shareholders of "its views on the effects of implementation of the bid on employment, conditions of employment and the locations of the company's places of business". This requirement demonstrates the importance of the impact of mergers and takeovers on employment. However, the takeover rules also require that "all persons privy to confidential information, and particularly price-sensitive information, concerning an offer or contemplated offer must treat that information as secret and may only pass it to another person if it is necessary and if that person is made aware of the need for secrecy".

4.3 This requirement of secrecy is interpreted by companies involved in takeovers as preventing any consultation taking place with employees about a potential takeover. Despite the fact that boards are required to inform shareholders of the employment impact of a bid, they feel constrained by the Takeover Code from even informing employees that a bid is taking place. This applies to all mergers and takeovers, not just private equity buyouts. Because of the concern about the impact of private equity buyouts on employment, newspaper speculation about private equity buyouts has created particular uncertainty and insecurity for staff in the companies concerned, but it is important to note that this stems from a general problem about how mergers and takeovers operate in the UK.

4.4 The TUC understands the rationale behind the Takeover Code and its aim of ensuring that information that could affect share prices is not revealed prior to a concrete bid being made. Nonetheless, the TUC does not regard it as acceptable for employees to be kept in the dark about an issue as major as a takeover of their company. Employees should not be treated as pawns whose fate will be decided by others while they themselves are not even informed about key decisions affecting their future. The TUC believes that employees should be informed and consulted about mergers and takeovers prior to a bid being presented to shareholders. Issues of secrecy could be addressed as they are in countries with board level employee representation, where employee representatives undertake to respect the confidentiality of papers under discussion. The TUC believes that the injustice of the current situation must be addressed as a matter of urgency.

4.5 Clearly, once a buyout has taken place the rights of employees to be informed and consulted over plans and future activities should be guaranteed by the Information and Consultation Directive. In practice, however, unions have informed the TUC of their difficulties in obtaining information from companies once they have been bought by private equity funds. The TUC believes that the Government needs to examine how the Information and Consultation Regulations operate in relation to a change in company ownership and make recommendations to ensure the proper implementation and enforcement of the Regulations.

Recognising the role of trade unions

4.6 Trade unions both in the UK and internationally have highlighted experiences where a good relationship between the union and company management has been destroyed by a private equity buyout. In some instances, unions have found themselves in the position of trying to negotiate with a management that is no longer the prime decision making body in the company. Indeed, this experience fits with one of the arguments put forward in favour of private equity – that a much smaller number of highly-invested shareholders is able to exert far more influence and take a much more hands on approach to management than is the case with listed companies. Clearly, the traditional model of trade union representation and collective bargaining does not work if the real decision makers are not present at negotiations (and indeed at times are not even clearly identified).

4.7 A study of private equity buyouts in the UK and the Netherlands found that the number of companies recognising trade unions fell after a buyout from 34 percent to 29 percent, although over time it reverted to the original level. The study also showed high levels of hostility to trade unions among company managers in the buyout firms, with only one in ten managers having a positive attitude to trade unions and 40 per cent admitting to being hostile[3].

4.8 It is not only trade union rights that may be jeopardised when a company is bought by a private equity fund. There is a heated debate about whether overall private equity buyouts destroy or create jobs, but what is clear is that in some instances private equity buyouts have been followed by very large numbers of redundancies. It is particularly important in a situation where management is proposing major layoffs that workers and their representatives are fully consulted on plans and are given the opportunity to comment and put forward alternative proposals. These rights are enshrined under the Directive on Collective Redundancies, implemented in the UK by the Trade Union Labour Relations Act of 1992.

4.9 There is some evidence that workers' terms and conditions may be weakened by private equity buyouts. As well as anecdotal evidence, a study carried out by Centre for Management Buy Out Research and Nottingham University Business School found that buy-out firms had significantly lower annual wage growth than non-buyout firms. The downward pressure on wages was particularly great in management buy-ins (as opposed to management buy-outs). The study also indicates that the larger the company, the greater the downward pressure on wages[4]. Given the high returns that private equity funds earn from the firms they buy, a key question is why employees are not sharing in these financial benefits.

4.10 The Transfer of Undertakings (Protection of Employment Regulations) or TUPE preserves employees' terms and conditions when a business or undertaking,

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[3] Bruining H, Boselie P, Wright M and Bacon N, The impact of business ownership change on employee relations: buy-outs in the UK and The Netherlands, The International Journal of Human Resource Management, March 2005

[4] Ammess K and Wright M, The wage and employment effects of leveraged buyouts in the UK, International Journal of Economics and Business, forthcoming, in Phil Thornton, Inside the dark box: shedding light on private equity, The Work Foundation, March 2007

or part of one, is transferred to a new employer through, for example, an outsourcing arrangement. The TUC proposes that TUPE should be extended to cover changes of company ownership. It would be possible to explore variations of this model so that selected protections such as trade union recognition, maintenance of collective bargaining and some terms and conditions would be protected.

4.11 The TUC believes that a working group should be established by the Government to examine the impact of mergers and takeovers on employment rights and put forward proposals for reform. The terms of reference should include:

i) issues relating to consultation with, and the provision of information to, workers and their representatives prior to a bid;

ii) how any proposed redundancies are dealt with;

iii) recognition of trade unions after a takeover has taken place;

iv) terms and conditions of workers after a takeover has taken place.

Leverage and debt

5.1 Leverage in many private equity buyouts has been extremely high. Major purchases have been made using one part of equity to three or four parts of debt. The Financial Services Authority found that in the five largest leveraged buyouts involving bank lending in the 12 months up to June 2006, the average share of equity was just 21 per cent[5]. This is in contrast to a typical takeover by a quoted company, which might be funded with roughly 70 per cent equity and 30 per cent debt.

5.2 There has been much debate in the press about the pros and cons of such highly leveraged deals. Defenders of the private equity model have argued that debt provides an effective discipline on management. This seems to imply that managers in UK companies are only able to respond to immediate financial pressures rather than being able to make decisions in order to implement a strategy for long-term company success and growth. This is a very negative view, and if it is accurate, there is an urgent need to improve the quality of management in UK companies.

5.3 It has been suggested by some commentators that most public companies do not make sufficient use of debt[6]. However, the TUC does not believe that it is possible to generalise about an optimum level of debt that applies to all companies; optimum levels of debt for a company will depend on that company's particular circumstance and crucially what the debt is to be used for. Marks and Spencer is an example of a company that fought off a bid to take the company private and has then successfully turned itself round while remaining a quoted company. In

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[5] FSA, Private equity: a discussion of risk and regulatory engagement, November 2006

[6] Eg, Weighing up the debt balancing act, Financial Times 12 March 2007

order to do this it has increased its levels of debt and this investment has clearly paid off. However, this is fundamentally different from using debt to buy another company. A highly indebted company may find it difficult to find the funds for the sort of long-term investment that Marks and Spencer was able to make.

5.4 The TUC believes that there are clear risks associated with such high levels of debt. A significant rise in interest rates would have a major impact on the economic rationale of highly-leveraged buyouts and on the balance sheets of companies carrying significant levels of debt. Equally, companies carrying such high levels of debt have no buffer to protect them against a general economic slowdown. A rise in interest rates, particularly a sudden rise, or an economic slump would increase the risk of large-scale company closures and a sharp reduction in private equity returns.

5.5 Standard and Poor's, the ratings agency, has said that the quality of debt backing private equity deals has fallen dramatically, and that there is now a one in five chance that companies that are taken private using leverage will fall into default. Its research shows that at the end of August 2006 the loans backing three-quarters of European private equity deals were rated in the single "B" range of junk debt. The quality of debt backing private equity deals has declined significantly since the end of 2002, when less than one third of debt was in the B range and 57 per cent was in the BB range, which gives it a risk of default of one in twenty. Currently only one in ten deals has a default rating of one in twenty.

5.6 The Financial Services Authority has talked about "excessive leverage", and has said: "The amount of credit that lenders are willing to extend on private equity transactions has risen substantially. This lending may not, in some circumstances, be entirely prudent. Given current leverage levels and recent developments in the economic/credit cycle, the default of a large private equity backed company or a cluster of smaller private equity backed companies seems inevitable"[7]. Similarly, the Bank of England lists high and rising leverage in parts of the corporate sector as one of six key sources of vulnerability for the UK financial system. These assessments of risk from a major ratings agency, the UK's financial watchdog and the Bank of England are a serious cause for concern.

5.7 This raises the very important issue of how that risk is distributed, both among investors and between investors and other stakeholders such as creditors and employees. The TUC is very concerned that employees carry disproportionate risk in private equity buyouts. It has been noted above that employees' wages appear to grow more slowly after private equity buyouts. And if things go wrong, the levels of debt are likely to mean that job losses are more rapid and more severe than in a company that could use its equity and other economic resources as a buffer to protect itself from external pressures.

5.8 The impact of private equity buyouts on employees has been highlighted by Paul Myners and Financial Times journalist John Plender. Paul Myners has argued that "the one party who is not rewarded is the employees, who, generally

[7] Private equity: a discussion of risk and regulatory engagement, Discussion Paper 06/6, Financial Services Authority, November 2006

speaking, suffer an erosion of job security and a loss of benefits"[8]. Similarly, John Plender has written that "of the various stakeholders involved, employees stand to lose most from a change of ownership", highlighting the impact on jobs and arguing that debt to equity ratios create "potentially job-threatening vulnerability"[9].

5.9 The FSA has described the ownership of risk in private equity deals as "unclear". It argues that the use of "opaque, complex and time consuming" risk transfer practices, combined with increased use of credit derivatives, makes it hard to know exactly who owns the risk in a leveraged buyout and how these owners will react to a crisis.

5.10 As well as the risk of catastrophic failure caused by a rise in interest rates or economic slowdown, such high levels of leverage may create pressure for the company to become as profitable as possible in the shortest possible time. There is a danger that such pressures may lead to a "quick fix" approach that will leave the company vulnerable in the longer-term and unable to take advantage of opportunities for future growth and development. For example, the impact of private equity takeovers on levels of research and development investment within companies is an area of potential risk that merits further investigation.

5.11 The TUC urges the Treasury Committee to investigate the implications of the rise of corporate debt for economic stability.

Leverage and tax

5.12 One factor that has encouraged the high levels of leverage that are seen in private equity takeovers is the tax treatment of corporate debt. Interest payments on debt are tax deductible, meaning that companies can offset interest payments against their tax bill, thus reducing the costs of debt-financing. It is important to note that tax deductibility of interest is not limited to private equity and extends to all companies in the UK and indeed is a common international practice.

5.13 However, there is a concern that the tax-deductibility of interest payments is influencing the economic rationale of takeovers, and favouring debt over equity as a means of financing buyouts. It has been widely suggested that the tax relief on debt is a significant factor in the profitability and returns generated by private equity takeovers. Julie Froud and Karel Williams from the University of Manchester have argued that if the debt leveraging is stripped out of the equation, the returns generated by private equity would be mediocre at best compared with the stock market as a whole[10]. Similarly, a study for Citigroup also came to the conclusion that the higher returns for private equity disappeared if the high degree of leverage was stripped out of the model.

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[8] Interview in the Financial Times, 21 February 2007

[9] Private equity cannot escape the public eye, The Guardian, 24 April 2007

[10] CRESC Working Paper Series No 31, Private equity and the culture of value extraction, February 2007

5.14 This raises two important issues of public policy. Firstly, if the tax regime is a significant factor in the economic rationale for highly-leveraged takeovers, the Government - and indeed all those with an interest in the area - would need to be assured that it believes that encouraging such highly-leveraged deals is in the public interest. The TUC is not convinced that this is the case.

5.15 Secondly, if the tax regime favours debt-funded takeovers over equity funded-takeovers, this risks distorting the market for corporate control. The market for corporate control is widely regarded as an important discipline on company management that facilitates the efficient allocation of capital. A system that favours debt-funded takeovers over equity-funded takeovers risks damaging the ability of the market for corporate control to lead to improved company performance.

5.16 The TUC believes that there is a fundamental difference between debt used to fund organic growth through investment in research and development, innovation and training and debt used to buy up other companies. The TUC believes that reflecting this distinction in the tax rules so that tax-deductibility on debt would not apply to debt used to buy up other companies is an approach that merits further investigation. The size of debt relative to company turnover could be used as a possible proxy to distinguish between debt to fund organic growth and debt to fund takeovers.

5.17 The Governments of Denmark and Germany are in the process of discussing proposals to amend their tax laws to address concerns about tax-relief encouraging excessive leverage. In March, Financial Treasury to the Secretary Ed Balls announced a review into the "current rules that apply to shareholder debt where it replaces the equity element in highly leveraged deals". The TUC believes that this review should be widened to examine tax relief on debt more generally and in particular whether it is in the public interest for tax relief on debt used for takeovers to be treated in the same way as tax relief for debt that will be used to invest for long-term, organic growth.

Corporate status of private equity funds

6.1 Private equity firms are generally run as limited partnerships. As such they are treated as a collection of private interests, despite their major economic assets and impacts. Limited partnerships are subject to a very light regulatory regime. It is necessary to register a limited partnership at Companies House, but other than the registration form and any subsequent amendment (such as a change of partner) no other information has to be filed. Registration costs £2, and requires the following information:

i) The firm's name

ii) The general nature of the business;

iii) The address of the principal place of business;

iv) The full name of each partner, listing general and limited partners separately;

v) The term (if any) for which the partnership is entered into;

vi) The date of its commencement;

vii) A statement that the partnership is limited and the description of every partner as such; and

viii) The sum contributed by each limited partner, and whether it is paid in cash or otherwise.

6.2 It is not possible to view registration forms on the Companies House website, although copies will be sent out to members of the public on request.

6.3 This is an extremely light regulatory regime for organisations that own such major economic assets and control increasing swathes of the UK's corporate sector. Given the role that private equity is currently playing in the UK economy, the TUC strongly believes that greater transparency from private equity funds about their operations, plans and impacts is in the public interest. The TUC believes that private equity buyout funds should be required to publish an annual report and accounts and required to make this publicly available via their website. These should include information on the distribution of investment, returns on each investment and distribution of these returns. In addition, the annual report should contain:

i) The development and performance of the fund during the financial year;

ii) A description of the principal risks and uncertainties facing the fund; and

iii) The main trends and factors likely to affect the future development, performance and position of the fund.

6.4 This would ensure that information about the activities of the private equity buyout fund over the past year were set out in the public domain, and would also require private equity funds to set out their future plans and strategies. All those affected by private equity buyouts, including the many employees working in companies that have been or will be bought by such funds, have a strong potential interest in greater information about the priorities, plans and activities of these funds. It would also be of benefit to investors and trustees.

Distribution of risks and reward and conflicts of interests

6.5 The TUC is concerned about the balance of risks and rewards within the limited partnership model. The general partners who run the fund generally charge high fees, and gain a high percentage of any profits that are generated. While their control is extensive, it is not matched by their level of risk. Even in private equity deals that have been regarded as failures, like Little Chef, it would appear that the general partners have still been able to make money and protect their own interests. Returns to limited partners are generally significantly lower than those to general partners, who often receive around 20 percent of annual returns.

6.6 Limited partners investing in private equity funds include pension funds and insurance companies with long-term commitments to beneficiaries. Paul Myners recently questioned whether pension fund trustees are looking sufficiently closely at the costs of investing in private equity against public stocks[11]. His recent intervention is significant because in his Review of Institutional Investment in 2001, he encouraged pension funds and other institutional investors to invest in alternative assets in order to diversify their investment portfolio.

6.7 One of the issues for pension funds and other limited partners of private equity funds is that their investments are illiquid and cannot be retrieved outside the terms of the agreement. This means that trustees and other investors are exposing themselves to much greater risk in comparison to investing in the stock market, which allows risk to be diversified. Commentators have questioned whether the returns from private equity are sufficient to compensate for this illiquidity.

6.8 The FSA has warned of the potential for conflicts of interest, both between general partners and limited partners and between the private equity fund managers and the companies they invest in. For example, general partners are often able to over or under commit to specific company investments through "co-financing" deals. This could enable them to cherry pick the best deals for extra investment, while capping their exposure to more risky deals. Or, a fund manager may be managing investment funds at different stages of the investment cycle, both of which are invested in the same company. The interests of the two investment funds may diverge (for example, in terms of whether the private equity fund should sell to realise profit now or wait until later), while the fund manager has responsibilities to both groups[12].

6.9 The potential for conflicts of interest between private equity fund managers and the long-term success of the companies they own is an area of great concern to the TUC. The potential for conflicts of interest starts as soon as a buyout is proposed, as often company directors are offered highly lucrative stakes in the company if the bid succeeds. This may create a conflict of interest between the company's board and its current shareholders. Once bought, fund managers' intention of selling the company after a specified time and the fact that a company is one among many of its investments may create a divergence between the interests of fund managers and the long-term success of the company. The FSA also highlights the potential for conflicts of interest between fund managers and the firms they buy as an issue of concern[13].

6.10 The Companies Act 2006 enshrined what the Government has called "enlightened shareholder value" as the basis of UK company law. The duties of directors as set out in the new Act require directors to serve shareholder interests, and require that in so doing they have regard, among other matters, to the interests

[11] Interview in Financial Times, 21 February 2007

[12] FSA, Private equity: a discussion of risk and regulatory engagement, November 2006

[13] ibid

of employees, relationships with suppliers and customers, social and environmental impacts and the likely consequences of their decisions in the long-term. The thinking behind enlightened shareholder value was that in the long-term, the interests of different company stakeholders converge, thus making it unnecessary to put responsibilities to employees and other stakeholders on an equal footing to responsibilities to shareholders[14].

6.11 These duties are not suited to a situation where shareholders have defined their interest as maximising a sale price for the company after two to five years. There is a risk that directors may be serving existing shareholders' interests at the expense of the interests of other stakeholders, future investors and the long-term success of the company. If the owners stated interest is to sell the company after a few years, having generated maximum profit along the way, this may not be compatible with the sort of business decisions needed to put the company on a sustainable long-term footing. An example of the kind of action in question is when company assets are sold to generate funds at the expense of future revenue streams. For example, the private equity owners of Debenhams sold the ownership of its stores in a refinancing deal, requiring the company to pay rent for stores it previously owned indefinitely.

6.12 The motives of the private equity fund managers and their commitment to the long-term sustainability of the company have been questioned by the FSA: "The entrance of new types of market participant with business models that may not favour the survival of distressed companies adds further complexities…which may create confusion which could damage the timeliness and effectiveness of work outs following credit events and could, in an extreme scenario, undermine an otherwise viable restructuring"[15].

6.13 The TUC does not believe that it should be legal for private interests to buy a company and then run that company for their own benefit, at the expense of the company's long-term future. The TUC believes that it is necessary to address the issue of conflicts of interests between private equity fund managers and the companies they own, and urges to Government to look into this area as a matter of urgency.

Private equity fund managers and tax

6.14 The rewards for general partners of private equity funds are inflated by the fact that their fees are taxed as capital gains tax rather than income tax. This enables them to pay tax at 10 percent (and commentators have argued that the effective rate may be as low as five per cent), rather than 40 percent, the rate of income tax for higher earners.

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[14] It should be noted that the TUC consistently argued for pluralist directors' duties, which would require directors to balance the interests of shareholder with those of employees and other stakeholders.

[15] ibid

6.15 The origins of this go back to 1987 when the Government allowed performance fees to be taxed as capital, rather than income, in an attempt to encourage more venture capital funding for small companies. However, the gains from this change were dramatically increased in 1998, when the Government reduced capital gains tax from 40 percent to just ten percent for people owning shares in their own or unlisted companies, providing they had owned the asset for ten years. In 2002, however, the ownership requirement was reduced to only two years. This new "taper relief" encouraged many companies to set up share-based pay schemes to allow highly paid employees to take their income in the form of capital gains, and in 2003 the Government moved to address this by introducing new rules requiring employees to declare shares received as part of their pay package as income. However, the British Venture Capital Association negotiated a special deal with the Government, exempting private equity firms from the new rules.

6.16 Whatever the arguments for encouraging venture capital investment in small firms, these do not apply to individuals making very large sums of money from buying and selling major British companies. The TUC believes that treating carried interest as capital gains rather than income for tax purposes is an anomaly that is extremely unfair to the very many people on far lower incomes who pay much higher levels of tax for the greater good of society. The TUC believes that it is essential that the exemption for private equity funds should be abolished, and that private equity general partners should pay income tax on their earnings.

Impact of private equity on investments in the long-term

7.1 The number and scale of private equity buyouts has risen sharply in recent years, to the extent that private equity is now contributing to a reduction in the size of the stock market. Last year, UK buyout funds made up over a quarter of all British-based takeover deals; nine years earlier, the figure was under seven percent[16]. At the same time, the UK equity market capitalisation shrank by £46.9 billion in the first half of last year, and has not grown since the last quarter of 2004. The FSA attributes this shrinkage to the impact of public to private transactions, share buy backs and special dividends (sometimes as part of a defence against a private equity bid) and reduced capital flows from the private sector[17].

7.2 This goes to the heart of the workings of the UK's capital markets. Reducing the size of the stock market directly reduces the liquidity of capital, which is seen as vital in ensuring the efficiency of capital investments. If an increasing proportion of investment monies, including those from institutional investors such as pension funds, are tied into particular private equity buyouts, such investors are increasingly dependent on high returns being generated in a much more limited number of companies, rather than across the stock market as a whole. This clearly increases their exposure to risk.

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[16] Tom Burroughes, Private equity returns slow amid M&A boom, The Business, 7 March 2007

[17] FSA, Private equity: a discussion of risk and regulatory engagement, November 2006

7.3 This is linked to distributional impacts. Private equity buyouts reduce the number of investors benefiting from the returns generated by UK companies. Companies that were previously generating returns for millions of pension fund beneficiaries and others through the stock market are now generating returns for a narrow group of individuals, plus some wider beneficiaries in the form of the limited partners. However, the proportion of returns paid to limited partners is limited by the structure of private equity funds, with general partners frequently extracting a fifth of generated returns as 'carried interest'.

7.4 Even when some of the investors in private equity funds are pension funds, this is a tiny proportion of those who would have previously benefited through the stock market. Scaled up, the TUC is concerned that private equity buyouts would create a situation where the wealth generated by UK companies would be distributed far more unequally than at present. The TUC believes that this would be both socially and economically damaging. Given the crucial role of the stock market in pensions provision, significantly reducing the size of the stock market could have a major impact on the incomes of millions of future retirees.

Conclusion

8.1 At the heart of the debate about private equity is the question of whether it is fuelling short-termism within the economy through creating pressure within companies to take decisions based on short-term gains rather than long-term value creation. There is a danger that private equity buyouts are geared towards value extraction for the few rather than value creation for the many, and this is central to the economic and social concerns raised about the sector. A major issue facing the Government is whether the regulatory framework for private equity funds is appropriate for companies that are not just funding start-ups with venture capital but are now able to buy household names like Boots. This TUC submission has argued that given the major economic assets under the control of private equity, the current regulatory regime is inappropriate and should be strengthened to ensure that private equity funds and the companies they own operate in the public interest.

FNV – The Netherlands

Date
8 March 2007

Subject
Socially responsible investments, Hedge Funds and Private Equity

1. *In general*

Employees in the Netherlands want a good and affordable pension. The second pension pillar ensures that each generation contributes to the future quality of pensions through funded pension schemes.
The FNV wants a good pension for all employees as well as for self-employed with no staff.
This pension must be designed in such a way that people can fairly maintain the level of prosperity they attained during their working lives. The quality of pensions is to a large extent determined by the combination of long-term self-funding contributions and optimal pension profitability, which holds a good balance between high investment returns and low profitability risks.
In short, the pension funds investment policy aims to offer the best possible pension against the best affordable contributions. Finding pension funds with high profitability and low risks.

The FNV wishes to shape the investment policy in a socially responsible way. Prosperity and risks are indeed important factors but we must also consider sustainability and corporate social responsibility. The FNV feels that in the long term, the three P's of Profit, People and Planet are not competitors but in fact complement and strengthen each other.
The FNV specified this policy in the policy document "Well Invested (Goed Belegd)", which was presented in July 2000. Since then, the investment policy on pension funds has further developed, also in reaction to the miscellaneous developments in the financial markets. This is a reason for the FNV to reflect again on the issue of socially responsible investments by means of pension funds.

The most important developments since the end of the 1990s are:

- Since the second half of the 1990s, the interest has decreased all over the world and has reached a historically low level. Since the end of 2006, a small but gradual increase can be seen but it is not clear whether this increase implies a new structural trend. This situation forces funds to think even more over an alternative for investing in bonds if they are to be able to adapt the pension agreements to wage en price increases.

- Legislation applicable to companies quoted in the stock exchange has increased. These companies must comply with more rules and codes. As a result, more and more - mainly small - companies withdraw from the stock exchange. We must reflect on how pension funds can also invest in starting and small companies and thus not only in large companies, which would be become overvalued as a result.

- The attention for corporate governance issues has also strongly increased in the pension world. Pension funds take – because of the insight that good governance contributes to producing a considerable return – corporate governance seriously and translate it into their investment policy. Furthermore, they are increasingly called to account on their responsibilities as shareholder.

- Pension funds increasingly diversify their investments over financial products spread all over the world. Pension funds aim at risk-mitigation in combination with optimal returns. Risk-mitigation is achieved by spreading the investments over more and more categories, such as hedge funds, (in)direct real estate, raw materials, private equity, infrastructure, strategic investments by means of derivatives, etc. In addition, there is an obvious trend of investing more and more globally and in emerging-economy countries such as China, India, Russia, etc. This causes for the investment policy of pension funds to increasingly become a trade on its own. As a result, members of the pension funds' executive boards are faced with higher qualification requirements.

- Investments in companies which are not quoted on the stock exchange – also known as Private Equity - have increased substantially.

- In recent years, investments in hedge funds have increased. Hedge funds are a very diverse group of investment funds. Some show very active investment behaviour with long-term as well as short-term possibilities. They also use relatively much loan capital. Most hedge funds do not specialize in an activist shareholder's role. They mostly specialize in niches in the investment market where it is possible to yield relatively favourable returns by dealing in financial values.

- Some hedge funds are indeed funds that try to produce short-term investment returns through an activist shareholder status. This is occasionally accompanied by hostile takeover bids and/or a 'battle' with the boards of directors and the supervisory boards.

These developments require a reflection upon the FNV policy with regard to socially responsible investments, as well as a further specification of this policy. In this note, we mainly focus on private equity and hedge funds.

Paragraph 2 shortly summarizes the current FNV policy as well as the progress made during the last six years.
Paragraph 3 goes on to explain the difference between investing and entrepreneurship / participating in a company.
Paragraph 4 gives an overview of the requirements the FNV wishes to be imposed to investments in private equity and hedge funds.
Paragraph 5 shortly elucidates the part pension funds should take upon them as shareholder and paragraph 6 finally describes the relation between the union agenda

within the framework of concluding labour agreements and the use of investment policy as a union weapon.

2. *Implementation of the policy document 'Well invested (Goed belegd)'*

The FNV has set forth its investment policy in the policy document "Well Invested (Goed Belegd)" from July 2000. Shortly summarized, the policy implies:

- No investments in countries, which seriously violate human rights and which have been sentenced for these violations by the UN and the ILO.
- Mainly invest in companies which score high on all three P's (People, Planet, Profit) and gradually assess all investments by these criteria.
- Engage in a constructive dialogue with those companies that do not meet the People, Planet, Profit criteria. This dialogue will however not be without problems. It should not lead to insider dealing. Furthermore, such a dialogue is time-intensive and therefore expensive which means that priorities will have to be set.
- Link pension funds' corporate social responsibility (CSR) and corporate governance (CG) activities.
- The executive boards of pension funds must fix this policy in CSR-codes.
- Transparent communication with regard to the investment policy towards all participants and parties involved in the pension fund.

This policy has been implemented as follows:

a. It was incorporated into the recommendation "Modern and affordable pensions for all participants" by the Netherlands Joint Industrial Labour Council (StAr), which must be discussed by the executive committee of CSR pension funds.
b. In large funds, investment codes were established.
c. Steps in the 3P-approach.
    1. The investment analysis has been extended to People and Planet.
    2. 3P experiments.
    3. A dialogue with companies was established.
    4. The corporate governance-approach has clearly become more active.
    5. Assisting colleague organisations in other countries.
    6. The corporate governance network of pension funds has been strengthened tremendously through Eumedion.
d. At the initiative of the United Nations, the Principles for Responsible Investments were established in 2006. The Dutch funds ABP, PGGM and the branch pension fund Metalektro (iron and steel industry) were among the initiators. This UN-initiative follows on from the activities of 'The Global Compact', which focuses on promoting corporate social responsibility. The FNV wishes for pension funds to be stimulated to join this UN-initiative. Also OESO guidelines are a significant international norm when it comes to corporate social responsibility. Investors should request that companies actively submit themselves to these guidelines.

e. The Code Tabaksblat was established. Pension funds are not only allowed to vote, they are under the obligation to do so. At least, they must account for their policy as shareholder. The committee Frijns monitors if the code Tabaksblat is being observed.
f. The Principles Pension Fund Governance were established.

In the period 2001-2006, the FNV has had to focus mainly on the issue of significantly reduced returns but also on ensuring that the prepension is preserved. This pushed more structural efforts with regard to socially responsible investments to the background. Since then, these issues have, to a large extent, been solved and the FNV now wishes to give more attention to the implementation of pension schemes, including the investment policy.
The FNV believes that focusing on a strategy of corporate social responsibility for pension funds now will pay off in the long term.
But there are also more defensive reasons to act now. The difficulties encountered with regard to hedge funds prove that there is every reason to focus more on this in the coming years.

If we assess the steps made since 2000, the FNV can conclude that:

- The issue has clearly been raised
- CSR in practice proves to be more obstinate than CSR in theory. The following complications occur:
    - The report on People and Planet is still too gentle and little transparent. Since then, the 'Enhanced Analytics Initiative', which collects and activates a lot of research with regard to investments, has been established. It will be possible to appeal stronger to the asset managers' social responsibilities than at present. Also the Global Reporting Initiative (GRI), which focuses on developing a worldwide uniform reporting system for Planet- and People indicators, was launched.
    - The stock exchange value of a number of companies, which do well on Planet and People, has increased significantly. This is good news and in line with our policy. A drawback however is that they have sometimes become overvalued. As a result, their return prospects lag behind the stock exchange value. Of course, pension funds take this into account in their investment policy.
    - A lot of companies, such as large banks, do nearly equally well when it comes to People and Planet. In a large number of sectors, there is no obvious distinction between 'good and bad guys'.
    - This especially applies to 'People' related activities in the Netherlands and in the rest of the industrialised world. The problem with regard to the 'People' criterion arises when multinationals use the possibility to contract out certain activities to low-wage countries, which they increasingly do, especially in the production industry. Activities which have been contracted out are less transparent and are accounted for less than activities under own management.

- Pension funds can not afford to completely exclude large companies which really count in the benchmark, also because of the performance requirements. Therefore, also and in particular companies which do badly when it comes to People and Planet should be addressed in the dialogue.

- The above mentioned complications make it clear that in our policy, we must focus more on the way the investment process is to be shaped. The dialogue, and thus the link with corporate governance are essential elements in this process. Furthermore, we must come up with much better reporting tools for People and Planet criteria in our policy implementation. Especially for those elements which can clearly be distinguished. The fact that less transparent investment solutions such as private equity and derivatives could lead to less public accountability is a separate point of particular interest. In consideration of good social accountability, this effect should be prevented. Here, too, socially responsible investment criteria will have to be considered when it comes to evaluating a similar investment in the portfolio of a pension fund.

- Another point of interest is how the FNV can come to a more aggressive approach in its investment policy. This would enable the FNV to set an example, especially when the position of employees and/or FNV members is threatened by the investors. A recent example is the position FNV Bondgenoten took with regard to two hedge funds at Stork. Not that the FNV is not aware that trade unions take up a different position in their role as representative of employees than in their role on the board of a pension fund. The FNV wishes to balance both positions as well as possible. In this respect, corporate social responsibility and socially responsible investments could have an important bridging function.

- The final conclusion is that the FNV approach in general remains successful. The time has now come to further work out this general approach and to anticipate and respond to new developments.

3. *Investing versus participating / entrepreneurship*

It is advisable to first go further into the difference between investing on the one hand and participating / entrepreneurship on the other hand.

Investing means providing with capital without controlling stake and without the purpose to influence the enterprise policy.
Participating means providing with capital with the purpose to (to a certain extent) influence the enterprise policy. Therefore, participating involves taking a substantial part of the total capital. It is a matter of strategic interest and thus there is a considerable hold on the funding, organisation and strategy of the enterprise.

An investor – in his position as shareholder – will be mainly interested in a good organisation of the company's corporate governance. This corporate governance role has been further specified in the policy document "Well Invested (Goed Belegd)". The main standards by which corporate governance is evaluated are:

- A high-quality annual report, from a financial as well as a social and environmental point of view;
- A varied and high-level composition of the company's supervisory board, with an eye for all aspects of corporate social responsibility;
- A good system for management development and for recruiting future board members;
- A socially responsible and transparent method for the remuneration of the board members and the supervisory board;
- Proper statutory provisions to enable the board of directors and the supervisory board to anticipate and respond to hostile takeover bids;
- Verification of the quality of the corporate social responsibility policy.

In this regard, the pension fund will increasingly take in the position of an active shareholder. An investor will therefore take little interest in dealing with or changing the company's strategy.

A 'participant' however will be interested in both aspects. Still, there is no black-and-white distinction between investing and participating. It is more a matter of intermediate forms. Investors are also becoming more interested in the company's strategy and maintain relations with the company's management in this respect. As a result, more funds concentrate on participation in companies. Then, the pension funds can invest in these funds.

Another thing is that the advisory commission Staatsen and the Nederlandsche Bank (DNB) impose limitations on the participation and/or entrepreneurship of pension funds. The most important objection was that the executive board of pension funds does not have the means to also act as entrepreneur.

This argument is refuted by working with intermediary organisations. ABP and PGGM participate in companies through the intermediary Alpinvest.

The responsibility for the entrepreneurship then no longer falls (directly) on the executive board of pension funds but on the management of Alpinvest. It even occurs that Alpinvest does not participate directly but also indirectly by investing in intermediary funds. Also other pension funds participate indirectly through similar funds. These developments have lead to the fact that pension funds increasingly need to have a vision on the corporate governance side of a funded company as well as on the company's strategy and the consequences for People and Planet.

4. *'Well Invested (Goed Belegd)' and Private Equity and Hedge Funds.*

Since the middle of the 1980s, pension funds have increasingly invested in business values and less in fixed interest (government) bonds. The main reason for this change in investment policy was the ambition to keep the accrued pension rights stable in value or better in prosperity against affordable contributions. Investments in business values started with investments in shares and real estate, followed by a process of continuing diversification. Since then, also investments in hedge funds, private equity and several other categories of investment were made. This diversification not only brought about better risk-mitigation but also higher returns.

Private Equity

Since then, the above mentioned investment strategy has continued to develop, which resulted in an even broader offer of investment solutions aimed at a further risk-spreading and higher returns. By investing in private equity, it became possible to also invest in (mostly smaller) companies which are not quoted in the stock exchange. The private equity investments cover a wide range, from venture capital (investments in business start-ups) and development capital (seed investments for growing enterprises) to buy outs (removing companies from the stock exchange) or just the opposite, that is financing companies just prior to their stock exchange flotation.

It is safe to say that this development has contributed to a more efficient capital market for starting, small and medium-sized companies. The FNV wants that attention is also paid to self-employed with no staff but also to the contribution pension funds can make in financing micro-credits in developing countries.
This is highly important for a healthy economic development in which businesses are constantly renewed and in which monopoly positions are prevented through a healthy increase of new companies.

However, as with all investments, there are also some snags attached to private equity. It often involves less liquid assets with a generally higher risk profile and a less transparent corporate governance structure. There is a certain reputation risk involved for pension funds when investments go wrong. Members of the executive board of pension funds and fund managers must therefore possess the expertise to lead the investments in the desired long-term direction.

If we look at the preliminary mid-term review, the experiences with private equity are favourable. It has lead to the desired return and risk-mitigation and it has also stimulated and improved investments in business start-ups. The FNV does however detect that a number of private equity funds seem to evolve from medium-term investors to (very) short-term investors. This requires for the pension funds – in their role as investor - to become more observant with regard to the social aspects of such an investment strategy.

In short, there are no fundamental objections to investments in private equity. If done thoroughly, they could be a strong stimulus to improve the capital supply for smaller and growing companies. Pension funds must however see to it that they do not bear the entrepreneurial risks themselves. Therefore, there must be a clear distinction between the role of the company's management and the investment by the pension fund. Also transparency is highly important. Private equity companies should report just as much on their 'People' and 'Planet' activities as large companies that are quoted on the stock exchange and the pension funds must also strongly request that they do so and assess these private equity companies based on the received information. Furthermore, it is desirable that private equity investments concentrate on the medium-term (4 to 6 years) and do not become an investment instrument for 'quick wins'.

Hedge Funds

Investments in hedge funds aim just as much at risk-mitigation and optimal returns. Hedge funds are by no means a homogeneous group. They use a large variety of strategies. ABP alone already uses 14 different hedge fund strategies.
In its investment policy, the FNV mainly focuses on risk-mitigation and realistic returns, which, in the long term, are (at least) similar to investments in shares. But hedge funds are a hard to understand phenomenon. Furthermore, they are often not subject to regulation and they are also often little transparent. A number of hedge funds show an activist shareholder status, which often leads to publicity commotion.

If we apply the policy from the policy document “Well Invested (Goed Belegd)” to hedge funds, the following observations can be made:

- There is a role for hedge funds in a good functioning capital market. This particularly applies to the wide range of very diverse funds. The FNV’s observations and question marks particularly relate to those funds, which chose an activist shareholder status.

- Hedge funds – mainly funds with an activist shareholder’s role – carry a large risk for pension funds with regard to the assessment of a good social policy (People component).

- In any case, hedge funds involve more publicity risks for pension funds. This especially applies to hedge funds that aim at short-term returns through a very activist shareholder’s role. This is often at the expense of less activist long-term shareholders, or even worse, at the expense of the position of employees.

- The occurrence of hedge funds raises the question whether the boards of directors and supervisory boards should not better protect themselves against the activist role of shareholders with a minority stake.

- Hedge funds that in fact want a seat in the company’s management, place the executive boards of pension funds in an impossible position. A pension fund that invests in such a hedge fund becomes indirectly responsible for the company’s policy. This is a role that pension funds, as investors, should not want to pursue.

Pension funds must be wary of these observations when they decide to invest in hedge funds. If they decide to do so, the following requirements must be fulfilled:

1. Investing in hedge funds is not objectionable in all cases. Especially not when hedge funds help to correct imperfections in capital and money markets and produce returns which can be used to guarantee good pensions. The FNV mainly criticises

investments in activist funds, which aim to produce short-term returns at the expense of employees' rights.

2. The FNV fundamentally disapproves of investments in hedge funds which in fact are intended to obtain a seat in the company's management. This would cause for the executive board of pension funds to become (indirectly) responsible for the company's policy and thereby withdraw from its role as shareholder. The executive boards of pension funds simply do not have the means to do so and this would result in an undesirable and complex entanglement of responsibilities.

3. Hedge funds, but just as much equity, must live by the corporate social responsibility code, in which the policy with regard to People, Planet and Profit has been detailed. This policy must be formulated in such a way that it can be specifically tested in individual case situations. This should also apply to 'fund of hedge funds' and PE-funds where smaller pension funds work with.

4. For each participation, a separate plan of implementation must be drawn up in a transparent way. Pension funds, as shareholders, must also gain insight in the individual case.

5. Hedge funds, but just as much equity funds, should not only engage in a dialogue with the company's management but also with the relevant trade unions and works councils. The basic principle should be that they respect the working conditions. Furthermore, they must offer at least a commitment to job security.

6. Hedge funds, but just as much equity funds, must – in their role as shareholder - extensively account for the People and Planet aspects.

7. Pension funds must actively take up their role as shareholder (also in close consultation) by attending meetings for shareholders and thus by making their voice heard. In their role as investor, they must focus on a good interpretation of the corporate governance in companies. Pension funds can also make their vision clear to the company's management without being an activist shareholder. We must remark that the structure where pension funds invest in companies through hedge funds is really somewhat strange. They could just as easily invest directly without using the hedge fund as intermediary. This indirect way of working indicates that pension funds miss out on returns, because they do not take up their direct role as shareholder actively enough. In other words: hedge funds fill gaps left by shareholders. This also involves a preventative effect towards all executive boards, which will potentially be working with hedge funds.

8. Pension funds must make high demands on the socially responsible investment policy of internal and external asset managers. Pension investments are done more and more through external asset managers, who subsequently invest in hedge funds. It is undesirably that the investment policy continues to be centralised and that the

responsibilities of the pension funds' executive boards are no longer clear as a result. Another consequence is that no 'owner' bears and accepts the direct responsibility for the functioning of the hedge fund. This particularly applies to the smaller pension funds which contract out their investment policy.

By making these requirements, there is some supervision over investments in hedge funds. These requirements also illustrate why the executive boards of pension funds should regularly meet to discuss socially responsible investments in the broad sense.

It is highly desirable to also include umbrella organizations of pension funds in these complicated discussions to create a broadly based dialogue where experiences and ideas can be exchanged.

5. Corporate Governance and the activist shareholder

It becomes increasingly difficult for pension funds to remain passive in their role as shareholders. This applies just as much to other institutional shareholders, such as asset managers, banks and insurers. All shareholders benefit from good corporate governance in the company in which they invest.
Since the establishment of the code Tabaksblat, it is more and more understood that good corporate governance can not be achieved without an active role of shareholders to urge executive and supervisory boards to assure sufficient countervailing power.

The FNV makes a distinction between an active and activist shareholders' role. An active shareholders role implies that pension funds attend the general meetings for shareholders and also put forward positions and ideas during these meetings. This contributes to a more effective general meeting of shareholders and it also prevents that a small group of shareholders is able to obtain a disproportionate amount of influence. An active role as shareholder is therefore more obvious than a passive role. Especially in companies of which a pension fund knows it will always have a certain level of investments because of benchmark requirements.

In the world of pension funds, this idea was first introduced by the 'Stichting Corporate Governance Onderzoek voor Pensioenfondsen', the Netherlands Foundation for Corporate Governance Research for Pension funds. This idea has also been adopted by Eumedion: a broader cooperation between pension funds, insurers, banks and other financial institutions.
Eumedion offers the possibility to come to bundling. However, not the social partners but the managers of the investment policy of pension funds are actively involved in the management of Eumedion.

Cooperation between pension funds in their role as shareholder is very likely. Not only does this increase their influence, it also prevents that funds should have to incur disproportionately high expenses to have an active role as shareholder at all. This particularly applies to the smaller funds but more cooperation and thus an increase in

scale is also favourable for better quality, more influence and lower expenses for large funds.
It is not only the companies that carry out the pension schemes that should increase in scale but also more cooperation between the pension funds that determine the pension schemes is required.
In the world of industry-wide pension funds, it is desirable that this is done through the Dutch Association of Industry-wide Pension Funds, of which the executive board is made up of social partners.

A more active role of shareholders is not the same as an activist shareholders' role in e.g. hedge funds. Activist shareholders in hedge funds buy a considerable minority stake with the purpose to have a say in the company's management. Their primary goal is to gain short-term returns. They often achieve this by splitting up companies. They first try to appease the management by holding out the prospect of bonuses. If the management does not accept or opposes, they then try to replace the management by straw men that do cooperate. The FNV feels that the executive boards of pension funds cannot accept responsibility for this. This is a strong argument against investing in similar funds.

6. Union agenda and investment policy

Our Anglo-Saxon colleagues very consciously also use their investment policy to realize their political trade union goals. Their goals can be divided into three categories.

- To negotiate collective labour agreements and/or improve the industrial relations within companies (e.g. the Wal-Mart campaign).
- To lecture asset managers and companies that run political campaigns that contradict the trade union goals (e.g. the State Street campaign).
- To call shareholders to account for their long-term social responsibility within companies (e.g.: the Proxy Voting surveys with an assessment of what pro-employee voting behaviour implies).

The Dutch approach was characterized by mainly structural efforts with regard to the 3P-approach without focussing on actual targets like our Anglo-Saxon colleagues do. However, the two approaches are now clearly growing towards one another. The general approach increasingly exists of a mix of structure and real targets, as well in Anglo-Saxon countries as in continental Europe.
The FNV will therefore have to detail and implement actual targets in its policy. Special attention must be paid to the number of sectors/companies that increasingly try to exclude the trade union when it comes to determining the working conditions for business-related services.

This could imply that Dutch pension funds increasingly call anti trade union companies to account according to the Anglo-Saxon approach. It is often possible to join the activities of sister organisations.

Finally

In 2007, the FNV will systematically focus more on its role in the executive boards of pension funds. The FNV will particularly focus on issues with regard to socially responsible investments and corporate governance. The FNV will unite the forces and will equip the trade unions, which assist the executive boards of unions in pension funds, with facilities. By strengthening the coordination, knowledge exchange will be more efficient and this will improve the quality of our input on the board of pension funds'.

TUAC trade union advisory committee to the
OECD organisation for economic cooperation and development
■ CSC commission syndicale consultative auprès de
OCDE l'organisation de coopération et de développement économiques

"Financialisation"

TUAC/ETUC/Global Unions Seminar
OECD Headquarters
16 March 2007, Paris

Summary report prepared by the TUAC Secretariat

The TUAC seminar on Financialisation held on 16 March 2007 under the OECD Secretariat PAC Labour Management Programme focussed on the challenges and the opportunities associated with the current surge in "leveraged buy-out" (LBO) operations by private equity (PE) firms across the OECD. The seminar was chaired by Ron Blackwell (Chief Economist of the AFL-CIO) and brought together over 50 OECD-based and international trade union representatives as well as representatives of the ILO, the European Trade Union Institute and members of the European Economic and Social Committee. The morning session consisted of an exchange of views with several OECD Secretariat experts in corporate finance, corporate governance and taxation, as well with an academic expert and a fund manager. The afternoon session was reserved fpr trade union participants only.

Overview of the trade union discussions

The meeting's discussions underlined the concern among trade unions about the current surge in PE buy-out transactions across the OECD. Unlike venture capital and 'first generation' private equity, 'buy-out' operations involve mature businesses and increasingly large established companies. Acknowledging some of the ambiguities in relation to PE funds, the overall message from the trade union representatives was that the change in scale of the industry – moving from a relatively marginal asset class to an almost dominant form of corporate ownership – constituted a threat to workers, to established forms of social dialogue, to the stability and the health of the 'real' economy, as well as to government revenues collected through corporate taxes. Several of the trade union speakers summarised the issues related to private equity funds as regarding regulation, transparency, taxation, and the question of information and consultation with workers and their unions. In the statement (annex) that was adopted at the end of the meeting and released publicly, these issues stood out as the areas that regulatory reforms should address (i) transparency, prudential rules and risk management, (ii) workers' rights to collective bargaining, information, consultation and representation within the firm, (iii) tax regulation, and (iv) corporate governance.

Summary of the morning session's presentations

The morning session discussions gave divergent but highly informative views on the PE investment model. The session consisted of presentations by Adrian Blundell-Wignall (Deputy Director of the OECD Directorate of Financial and Enterprise Affairs), John Monks (General Secretary of the ETUC), Michel Aglietta (Professor at University Paris-Nanterre) and a Principal with an American PE firm. The session ended with a brief exchange of views with two OECD experts on respectively tax policy and corporate governance: Grace Perez-Navarro (OECD Centre for Tax Policy and Administration) and Grant Kirkpatrick (OECD Corporate Affairs Division).

Adrian Blundell-Wignall (OECD DAF) argued that PE firms have turned inefficient and non-competitive companies into much more streamlined, value-creating actors – among other things by putting much more pressure on managers. He pointed out several factors behind the current surge in PE investments: high level of liquidity on the global financial markets (notably because of Asian surpluses), strong balance sheet of the target companies, low interest rates (making debt financing particularly attractive), institutional investors' search for higher yields in a context of diversification of investment portfolio, as well as recent legislative pressures on publicly listed companies (such as the Sarbanes Oxley Act in the US). Target companies, he said, were usually companies that have a high level of cash-flow, are under-leveraged, have profit margins below their peers and a below average market valuation. He acknowledged that PE firms were increasing buying out less obvious targets, i.e. companies in volatile environments and with too limited cash-flows. The best way to avoid being the target of a PE firm was to ensure a well governed and performing company with low operational costs and flexible labour force, all which being reflected in high stock market valuation. He asserted that PE was actually a response to the increased short-termism of publicly listed companies (PLCs), which were bound to report on financial performance on a quarterly basis. PE managed companies do not have to present quarterly reports and are thus less exposed to short termist pressures and are more prone to adopt long term strategies. Similarly, PE firms can spend more resources and time monitoring the individual performance of the companies they owned, than can investment bankers who are constrained by the large and diverse size of their portfolio.

The representative of the American PE fund had had a long career as a trade union representative, including extensive knowledge of pension fund management and corporate restructurings, and had recently joined a union friendly PE firm. He was, on balance, positive on the value of PE investments for both pension funds and for target companies and their workers. Average annual returns on his PE firm's investment were 36% over a twenty year period. He asserted that PE solutions can create value when the target firm was underperforming, including times when incumbent management "had fallen asleep" in terms of innovation and competitive strategies or in need of an infusion of capital. His firm relies on the cooperation of incumbent unions when they represent a significant part of the firm and as a matter of due diligence always contacted the relevant unions before engaging negotiations with a company. Many of the deals that his firm had obtained had been brought by union leaders themselves who were looking for ways to enhance their members' job security. As advice for the union movement, he called for increased expertise in investment fund and leverage buy-out transactions and increased knowledge of the PE industry itself. Trade unions, he said, should ensure the right kind of relationship with PE firms and should have a seat at the table during negotiations on the buy-out transactions so that the gains are shared with the workers. In this view, financialisation is "neither inherently good or bad, it is what you make it".

A much more critical view of the PE industry was presented by John Monks (ETUC). He expressed concern about the social damages generated by the surge in PE transactions in Europe and particularly in the UK, Germany and France. Corporate innovation and value creation needed time to unfold, he said, and such long term horizon was rather incompatible with the characteristics of most recent PE buy-out investment strategies. Regulatory responses were needed in the areas of taxation and regulation, as well as information and consultation of workers. He noted that some heads of government and central bankers in Europe had expressed similar concerns about the lack of transparency of the industry, but pointed to the limitations in the current debate on regulation. Some governments appeared to value attracting global financial hubs – such as Wall Street and the City of London – higher in importance than the 'real' economy. The current focus on PE, and on hedge funds should not leave PLCs and traditional banking industry out of scrutiny however. Many PLCs and investment banks were also involved in buy-out activities. The issue of financial short-termism should be considered from a broader perspective than the PE industry alone.

Michel Aglietta (Paris-Nanterre University) contradicted the claims of high average returns of PE funds. As PE were exclusively on absolute return performance, he argued that there was no performance projection, no guaranteed return, no market valuation under PE regime. Monitoring PE fund management was virtually impossible for outside partners. There were huge disparities of performance within the industry and even within sectors, which, he concluded, made standard risk assessment tools unfit for the PE model. PE investment significantly departed from normal distribution of probability of risks, as there are much higher probabilities of high level of losses than under standard portfolio analysis. He added that the excess returns claimed by the industry did not take account of the compensation for the illiquidity of the investment. He also contested the prevailing view according to which PE was an asset class on its own, because the industry was in fact highly correlated with the PLC market. A study indicated that if one applies the same leverage to a sample of US mid-cap PLCs and compares the performance backwards over a 10-year period, the PLC sample actually fares better than the PE sample. In his conclusion he warned against the high societal costs generated by the PE model, including the negative impact on employment (except in the financial sector), the inherent pressures on labour costs, the deterioration of social climate within companies – PE firms, he said, had no interest *per se* in negotiating collective agreements – and lack of investment in human capital. He argued that there were conflicts between long-run investments required to provide the services of public infrastructures – a new target of PE firms – and the PE model.

Following these presentations, the OECD Secretariat gave some input on its work in the areas of taxation and corporate governance.

Grace Perez-Navarro (CTPA) said that the OECD's Committee on Fiscal Affairs has not initiated a review of tax issues arising in the context of PE. The CTPA was trying to identify what specific tax issues – if any – are unique to PE financing schemes that OECD member countries might want to evaluate. The CTPA's initial consideration of possible tax issues raised by PE transactions suggests that the types of tax issues that arise are not new and also arise in other contexts where sophisticated tax planning is involved. Some of the issues that may arise are: the tax status of the fund; the effective (or inappropriate) granting of treaty benefits; the tax treatment of the fund's return (income vs. capital gains); the tax characterization of investment instruments (possible arbitrage, use of debt/equity hybrids, terms of debt may lead to re-characterisation as equity); minimisation of dividend taxes (though anti-deferral rules may apply in some countries); maximisation of deductible expenses; and VAT issues. Tax administrators are assessing whether there are increased compliance risks to be addressed and some tax policy makers are reviewing how existing tax rules apply and whether the tax results and effects on the revenue base are desirable. She noted that some countries such as Denmark have proposed legislation to address what are seen as undesirable outcomes from the application of the tax laws currently in place. The CTPA is monitoring developments in its member countries to evaluate whether there are any tax issues of particular relevance to private equity and that would benefit from a CFA review.

Grant Kirkpatrick (OECD DAF) informed on the outcomes of a forthcoming OECD report on the corporate governance implications of alternative investment vehicles. The report would focus on buy-out operations of PLC, so-called ‘Public To Private’ (PTPs) transactions. He noted the positive impact of PE model on the performance of the Board of directors. Boards tended to be smaller, more focused and more skilled under PE regime, he said, adding that directors had usually stronger incentives and clear objectives that were closely linked to the value creation strategy. He did note however, some potential concerns that may arise with respect to the incoming management, which was often a party to the takeover and therefore may be exposed to conflicts of interests.

Annex

TUAC	trade union advisory committee to the
OECD	organisation for economic cooperation and development
■ CSC	commission syndicale consultative auprès de
OCDE	l'organisation de coopération et de développement économiques

FOR IMMEDIATE RELEASE

UNIONS CALL ON G8 LEADERS TO WORK ON NEW TRANSPARENCY AND TAX RULES FOR PRIVATE EQUITY

16 March 2007, Paris

Unions from 15 countries and a dozen global organisations meeting at the OECD in Paris issued a strong call for the activities of companies to be oriented toward long term sustainable investment strategies that create wealth for all, and good employment opportunities for workers.

Unions note that private equity firms have in a short period become owners and movers of vast pools of capital, significant swathes of the economy and of employment. The share of private equity investments in the total volume of mergers and acquisitions exceeds 20 percent in some OECD economies. These alternative funds are highly "leveraged" (i.e. debt financed) and are exempt from many of the regulations that apply to traditional collective investment schemes, to banks and to insurance companies, notably in the areas of investment prudential rules and reporting requirements.

The very high rates of return required to finance private equity debt-driven buy-outs can jeopardise target companies' long-term interests and provision of decent employment conditions and security for employees. Rather than corporate restructuring for the purpose of shared productivity gains, some private equity firms are seeking to extract maximum value over a short period before reselling the company (or what remains of it) and banking a substantial premium. Trade unions' experiences with employment and working conditions in leverage buy-out firms are alarming. There is a strong concern that the private equity model poses risks to the stability of the international financial system and the sustainability of national economies.

The growth of private equity investment requires a coordinated regulatory response by the international community and by OECD governments in particular. Regulatory reforms should address four areas:

- Transparency, prudential rules and risk management: There needs to be a level playing field between those alternative funds and other collective investment schemes with regard to transparency and reporting on performance, risk management and fee structure. Importantly, the investment policies of private equity within the OECD zone should be regulated according to prudential rules aimed at both financial market stability and long term asset value creation.

- Workers' rights to collective bargaining, information, consultation and representation within the firm should be regarded as key mechanisms by which the long-term interests of companies can be secured and promoted.

- Tax regulation – including tax deductibility of debt service, tax on capital gains and tax havens – needs to be reconfigured to cover private equity regimes so that tax systems remain investment-neutral and are not biased toward short-term investor behaviour. Some countries have already either proposed tax legislation to curb the negative tax effects of the activities of private equity funds (e.g. Denmark) or announced that they would further investigate the effect on their tax systems of such activities. Comprehensive answers should be developed so that the increasing activities of private equity funds does not jeopardise government revenues from corporate taxes.

- Corporate governance: Current national corporate governance frameworks focus on publicly traded companies and generally have far more weaker requirements for un-listed companies. In addition, they do not have sufficient mechanisms to guard against short term value extraction and to promote long term value creation. They are not suitable to address the challenges of private equity's short-term ownership regime. The responsibility and powers of the boards of directors to preserve long-term interests of companies under private equity regime need to be reinforced.

Unions call the OECD Ministers and G8 leaders to create an international regulatory task force on private equity including the OECD, the IMF, the Financial Stability Forum, relevant UN agencies, and the ILO.

TUAC has consultative status with the OECD and represents 66 million workers in 56 affiliated organisations in the 30 OECD countries. It is part of the Council of Global Unions representative of some 180 million workers worldwide.

For more information, contact the TUAC secretariat: tel.: 00 33 (0)1 55 37 37 37 – Email: tuac@tuac.org – website: http://www.tuac.org – 15, rue La Pérouse - F-75016 Paris

EXECUTIVE COMMITTEE
Lisbon, 17-18 October 2007
177.EC

Item 6 on the agenda

Financial market turbulence, risks for growth and employment, and the need for better financial market regulation

Policy statement and background note

The Executive Committee is asked:

- to take note of this document

ETUC/EC173/RH/RJ/bd/-30/11/2006

EUROPEAN TRADE UNION CONFEDERATION
CONFEDERATION EUROPEENNE DES SYNDICATS
John Monks, General Secretary
Boulevard du Roi Albert II, 5 • B - 1210 Bruxelles • Tel: +32 2 224 04 11
Fax: +32 2 224 04 54 / 55 • e-mail: etuc@etuc.org • www.etuc.org

Financial market turbulence, risks for growth and employments and the need for better financial market regulation

Draft Policy statement

Introduction

1. Over the past decades, financial markets throughout the OECD have been liberalised. Whereas the objective was to improve the efficiency of financial markets and to ensure a broader access to affordable finance, the result in practice is that the 'financial' sphere has come to dominate the 'real' economy. Financial institutions, being much less subject to prudential oversight, have systematically triggered 'boom-and-bust' cycles in which debt build-up and asset price bubbles have reinforced each other to a point where debt became too high to be sustainable and the 'speculative pyramid' collapsed, thereby endangering jobs, economic growth, welfare and social systems. So, over the past 15 years, financial crises have been hitting the world economy at average intervals of three years (US Savings and Loans beginning of the nineties, LCTM-collapse 1997, Asian crisis 1998, ICT-bubble 2001 and now the subprime bubble bursting).

2. Financial market liberalisation has also worked to establish a powerful level playing field for profits for the entire world economy: Investment, hedge, private equity, pension and other types of funds set unreasonably high standards for profitability (sometimes as high as 20% a year), thereby driving 'real world' firms all over the world to meet these profit standards, to keep wage growth below productivity growth, as well as to keep improvements in unit wage costs from (completely) spilling over into lower prices for consumers.

3. Over the summer, a new financial crisis has suddenly erupted. The origin of this new financial crisis is to be found in US subprime mortgage lending where, over the past years, new lenders (called special investment vehicles but basically subsidiaries of banks) have been offering risky loans to low income households. Moreover, financial innovation techniques allowed the subprime risk to be transferred to other financial market actors, thereby reducing the incentive for the initial lender to apply a prudent lending policy.

4. One peculiar aspect of this crisis is the extent of leverage that is involved. A couple of tens of billion dollars of losses in subprime has caused global stock market capitalisation to fall by a couple of thousand billion dollars and has left another couple of thousand billion dollars of 'asset backed securities' unable to find buyers. At the same time, interest rate spreads on enterprise loans have shot up and, despite the fact that central banks are providing several billions of liquidity to banks each day, so have interest rates on three months' interbank loans.

Macro-economic demand policy needs to be vigilant to keep "subprime" from contaminating the "real" economy

5. The subprime crisis and its possible spill-over effects to the real economy coincides with a slowdown in economic growth that was already in the pipeline and was induced by policy. It is vital that Europe, with the Euro area in particular only in the second year of a robust expansion after five years of economic slump, decouples itself from the US downswing, which it failed to do in 2001. Moreover, in Europe, subprime induced financial distrust comes

on top of the fact that households in those countries where mortgage lending is mostly done on the basis of variable interest rates are confronted with major increases in interest rate payments.

6. ETUC welcomes the swift action taken by the ECB to avert a banking crisis but calls upon all macro-economic policy makers to be extremely vigilant to the dangers to economic growth. The ECB, unlike some others, has been pragmatic and has made swift and substantial action to stabilise the banking system by injecting liquidity into the interbanking market. However, such intervention is not suffient to stabilise the growth dynamics of the European economy. The combination of monetary restriction already in the pipeline with the unfolding 'subprime' crisis risks derailing the process of growth in Europe. On top of this, the 'leveraging' of many enterprises that has been driven by private equity industry has left the capital structure of these firms very vulnerable to a downturn and/or a hike in interest rates.

7. To address all of this, policy makers should shift their focus from (non-existing) inflationary dangers to the real danger of aborting the short-lived economic recovery in Europe, in particular in the Euro area. Timely and sufficient action should be taken on:

a. *Reducing short term interest rates*
b. *Exchange rate management(shared responsibility* of the ECB and Ecofin)
c. *Coordinated fiscal policy action in Europe*.

What in any case should be avoided is repeating mistakes from the recent past where fiscal policy in Europe is deployed in a fragmented way with each member states acting on its own, at a different moment and in a different way.

Financial regulation and subprime:

8. The financial turmoil has led to serious questions about the adequacy of regulation and supervision. In a number of directions regulatory measures heve to be envisaged.

- Failure to reign in <u>unscrupulous lending</u> to 'sub-prime' borrowers by banks and mortgage lenders. This suggests a need for tighter regulation on the selling of financial services and products and also reasonable limitations on the sort of products that can be sold.. Policies to encourage home ownership need to be rethought and taken out of the hands of profit-maximising entities or strictly regulated.
- The <u>selling on of mortgage debts</u> by the originator to other investors in the form of so called collaterised debt obligations (CDOs). This practice is not objectionable in principle. It can enable risk to be distributed optimally geographically and between different investors. However, key issues arise concerning public information about the location of such risk. This implies the need for additional regulations regarding transparency and disclosure of assets.
- Conflicts of interest by <u>rating agencies</u> are widely believed to have made securitisation risk-enhancing rather than risk-reducing. They are also immune to legal challenge (barring outright fraud) as they merely express 'opinions'. Regulation of the ratings agencies clearly needs to be tightened to ensure that they produce the 'public good' of impartial assessment of risk.
- Reminiscent of the huge Enron-style corporate scandals of a few years ago based on <u>off-the-books accounting</u>, so-called 'conduits' and 'structured investment vehicles'

have been a prominent feature of the recent crisis. Banks set them up as separate entities in order to avoid regulation and enable riskier forms of investment. Clearly the regulatory loopholes that enabled banks to shift such risky investment off their books must be closed.

- The flight of financial institutions to low-tax and low-regulation jurisdictions and regulatory competition may lead to a weakening of regulatory standards. In the context of the EU, this implies the need either for the centralisation of regulatory competence at European level or much greater coordination and harmonisation between the rules of national authorities.
- Certain financial institutions, notably hedge funds and private equity funds are often seen to operate in a 'legal vacuum'. Steps must be taken to ensure that all financial institutions are subject to an appropriate regulatory regime and that, here too, regulators keep pace with the ingenuity of financial market actors in devising 'new' forms of institution that escape regulation.

Replacing 'debt-and asset bubble led' growth by 'wage and (public) investment fuelled growth"

9. Concepts of 'price stability' and 'public finance stability' have been abused to squeeze public investments, public services and welfare states. In the Euro area as in the US, the share of public investments has seen a falling trend over the years, inhibiting demand in the short run and most probably undermining supply side and the growth potential over the medium run. Here again, the building-up of private debt to launch an asset price carrousel, pushing down household savings rates, has compensated for the lack of public investment demand supporting overall demand and growth.

10. Europe needs to move away from an economic model in which the growth of demand is based on an ever-increasing debt, on asset price bubbles and on leveraged speculation, to a model in which the expansion of demand is fuelled by workers and households enjoying robust real wage increases, and a strong public sector providing the public infrastructure, networks and services that is necessary.

Company policy, corporate governance and workers rights

11. The financial crisis with its widespread macro-economic effects also highlights those structural and `systemic` changes that the increasing `financialisation` of the economy has induced on the micro-economic level.

12. The `financial bubble` that was triggered by the deregulation of financial markets and the availability of cheap credits on a mass scale has not only diverted investment into speculative territory, spreading uncontrolled risks over global financial markets, but has also contributed to the dramatic emergence of private equity funds and their growing control over enterprises.

13. The emergence of alternative financial investors and financial innovations is not `per definition` detrimental. Detrimental are the excesses and anomalies that are primarily due to the lack of regulatory, legislative and institutional responses. Value creation of debt-financed investments in general is also possible and requested, as these forms of investments can work as engines of growth, job creation and innovation. If debt financed buy-outs however are driven to the extreme and are abused for asset stripping of viable enterprises in order to

generate cash for paying out dividends on a massive scale, then it is the long term perspective of firms that is put at stake and there is an urgent need for regulatory intervention.

14. A shift from managerial capitalism towards financial capitalism takes place, where activist investors dictate company policies on the basis of a short term investment horizon. Corporate governance practices have fundamentally changed in line with the growing influence of activist investors. Transparency and information disclosure obligations are among the most important issues to be addressed by regulation.

15. Transparency in modern capitalism and democracy should however not be restricted to investors only, all stakeholders deserve the same transparency. This is why nothing justifies a different treatment of private firms to public ones and transparency rules need to be aligned.

16. Alternative investment funds must be required to report at regular intervals i) the investment strategy of the company, (ii) details of the assets held by the company, (iii) disclosure of the 'risk management' model used (this is especially important for leveraged companies, and is already used for banks by the banking regulators), and (iv) the management's incentive structure.

17. Regulation has also to address the high level of debt-financed buy-outs. The unlimited tax deductibility of debt has massively contributed to these anomalies. Tax deductibility of debt must therefore be linked to a certain debt-equity ratio (regulatory options of explicitly banning debt/equity ratios beyond a certain level, could be also considered).

18. Stimulating more long term orientation of investments, a wider use of different classes of shares could be more encouraged (higher voting rights for long-term investors, progressive dividend tax for short term profit extraction).

19. The role of workers participation has an important role in the quality of corporate governance, also in terms of respecting the principles of `democracy at the workplace`. It is important therefore that existing legal frameworks on workers participation should be strengthened. ETUC insists that the workers' fundamental rights to information and consultation, collective bargaining, and fair and just working conditions are secured and promoted regardless of the quality of the investor and the legal form of the enterprise. With this regard, existing rules on workers' involvement must be reinforced.

20. The Executive Committee commits the Secretariat

- confront – in the frame of the macro-economic dialogue – the Commission, ECB and Ecofin with trade union policy proposals to respond carefully to the risk of financial market stability and to be vigilant to the dangers to economic growth;

- urge the Commission to set up a regulatory frame for hedge funds and private equity and to set up a corporate governance framework that offers the board of director's sufficient instruments to response or resist imminent take over bits;

- to strengthening cooperation with ITUC, TUAC, EIF on bringing alternative investment funds under better control (concentrating on regulation; information, consultation, negotiation; taxation);

- to monitor and contribute to international regulatory and standard-setting initiatives;

- to support and expand trade union activities and setting up an expert group (in cooperation with EIF, TUAC, ITUC and ETUI).

RESOLUTION ON PRIVATE EQUITY AND HEDGE FUNDS

The ITUC General Council, meeting at its 2rd Session in Brussels on 20-22 June 2007

NOTES with concern the massive increase in private equity and hedge fund investments, the negative effects of many such investments on workers and the risks to financial stability and economic sustainability which result from the short-term, debt laden nature of their activities;

RECOGNISES the substantial investments in hedge funds and private equity by pension funds, and the potential risk to retirement incomes for millions of people associated with this;

CONDEMNS the management culture of many private equity and hedge funds, which seek to cut all possible costs, often destroying viable enterprises and reducing workers' wages, conditions and entitlements including through negation of collective agreements, refusal to negotiate with unions and harassment of trade union members;

DEPLORES the gross inequalities being generated by the activities of private equity and hedge funds, their tax minimisation schemes and the transfer of risk to workers, taxpayers and investors by fund managers who themselves pocket enormous sums at virtually no risk;

INSISTS THAT governments and intergovernmental bodies properly regulate private equity and hedge funds, as well as the companies they de-list from public markets. This regulation must cover transparency, financial stability, taxation, corporate governance and workers' rights, as well as the protection of public services and utilities. It must discourage short term buying and selling of companies, uphold reporting requirements, limit the debt and leverage levels undertaken by companies, close tax loopholes and ensure that private equity firms and activist hedge funds meet their obligations as employers;

URGES trade unions at all levels to promote regulation of and responsible behaviour by hedge fund and private equity;

CALLS UPON the trustees and fiduciaries of pension funds to consider investments in private equity and hedge funds with extreme caution; and if nonetheless considering such investments, 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; and,

FURTHER CALLS UPON private equity firms and hedge funds to accept their social responsibilities and the need for proper regulation, and to negotiate with the trade union organisations representing workers potentially affected by their activities, adopting a positive approach to this as some such funds have done in recent years.

RESOLUTION SUR LES FONDS A CAPITAL-RISQUE ET LES FONDS SPECULATIFS

Le Conseil général de la CSI, réuni lors de sa 2ème session à Bruxelles du 20 au 22 juin 2007,

NOTE avec préoccupation l'augmentation massive des investissements dans les fonds à capital-risque (*private equity*) et les fonds spéculatifs (*hedge funds*), les effets négatifs de tels investissements sur les travailleurs et les travailleuses et les risques pour la stabilité financière et la durabilité économique résultant des caractéristiques d'endettement et de la nature à court terme de leurs activités;

RECONNAÎT les investissements substantiels des fonds de pension dans des fonds spéculatifs et des fonds à capital-risque, et le risque potentiel qui y est lié pour les revenus de millions de personnes réservés pour leur retraite;

CONDAMNE la culture managériale de nombreux fonds à capital-risque et fonds spéculatifs, qui tendent à réduire les coûts au maximum, dans de nombreux cas en détruisant des entreprises viables et en réduisant les salaires, les conditions et les prestations des travailleurs/-euses, et notamment en déniant les conventions collectives, en refusant d'engager des négociations collectives avec les syndicats et en harcelant des membres syndicaux;

DEPLORE les énormes inégalités générées par les activités des fonds à capital-risque et les fonds spéculatifs, leur systèmes de réduction des taxes et le transfert du risque aux travailleurs, aux contribuables et aux investisseurs par des gestionnaires de fonds qui empochent des sommes astronomiques sans pratiquement aucun risque;

INSISTE pour que les gouvernements et les organismes intergouvernementaux régulent adéquatement les fonds à capital-risque et les fonds spéculatifs, ainsi que les entreprises qu'ils radient de la cote des marchés publics. Cette régulation doit tenir compte de la transparence, de la stabilité financière, de la taxation, de la gouvernance d'entreprise et des droits des travailleurs, ainsi que de la protection des entreprises et des services publics. Elle doit décourager les rachats et les ventes à court terme d'entreprises, garantir des conditions applicables à la reddition de comptes, limiter les niveaux de dette et d'effet de levier auxquels recourent les entreprises, combler les lacunes fiscales et assurer que les sociétés d'investissement à capital-risque et les fonds spéculatifs activistes remplissent leurs obligations en leur qualité d'employeurs;

EXHORTE les syndicats à tous les niveaux à promouvoir une régulation et un comportement responsable des fonds spéculatifs et des fonds à capital-risque;

APPELLE les mandataires et les fiduciaires de fonds de pension à envisager les investissements dans des fonds à capital-risque et les fonds spéculatifs avec beaucoup de prudence, à accorder une attention toute particulière aux rapports de rentabilité réelle de tels placements, aux risques qui y sont associés, aux nombreux effets négatifs qu'ils génèrent, ainsi qu'à l'impact direct ou indirect qu'ils sont susceptibles d'avoir sur les lieux de travail des bénéficiaires des fonds de pension de demain; et,

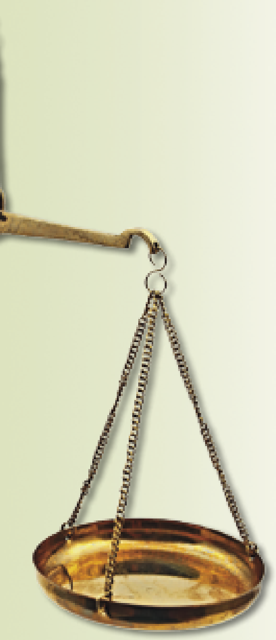
EXHORTE les sociétés d'investissement à capital-risque et des fonds spéculatifs à accepter leurs responsabilités sociales et la nécessité d'une régulation adéquate et à négocier avec les organisations syndicales qui représentent les travailleurs et les travailleuses potentiellement touchés par leurs activités, en adoptant une approche positive à cet égard, comme l'ont fait certains de ces fonds au cours des dernières années.

GB/ESP/kw/MM – 26 juin 2007

Private Equity
Why this matters to trade unions

Looking for a fairer sharing of risk and reward:
UNI Global Principles

global union



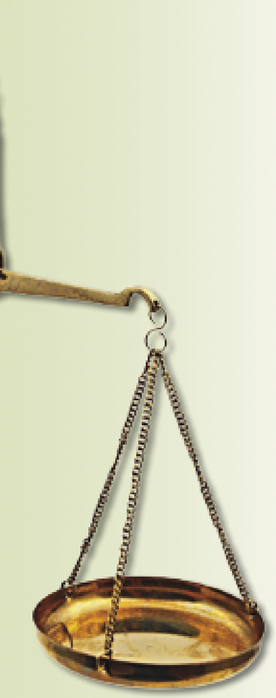
UNI Global Union
Global Principles for Private Equity

The rise and rise of private equity and hedge funds means that millions of workers in more and more countries around the world are employed by such companies. The size of private equity funds is such that no company anywhere in the world is too large to be subject to a private equity buy-out.

It means that many companies are managed by people who have no interest in the long term development of the company concerned. The primary aim of such funds is to make the maximum profit in the shortest possible time. This often means slashing the work force, abandoning pension funds, withdrawing from research and development and most characteristic of all loading the company with enormous debt to finance the purchase as well as the fees and dividends to the private equity fund.

Trade unions cannot simply allow these activities to grow unchecked. In order to bring the workings of hedge funds and private equity into the light of day and to curb abuses trade unions must engage:

- With existing employers to agree succession clauses in the case of a take over which will ensure continuity of employment, conditions of work and employment and union recognition
- With governments at the national and supra-national levels to ensure fair regulation taxation and transparency for such funds;
- With pension funds to ensure prudent use of the pension funds of members;
- With private equity companies directly to guarantee the rights and conditions of the workers affected by the leveraged buy outs.



UNI Global Union

Global Principles for Private Equity

1. The goal of private equity deals should be to create economic opportunities that align the long-term interests of everyone and that build the value of a company.
   - For customers this means a commitment to maintaining good quality services or products
   - For owners it means a fair and reasonable return on capital investment by means of increasing the efficiency and productivity of the company rather than cuts in jobs and benefits.
   - For employees it means protection of wages and conditions, decent work and working conditions and fair treatment free of discrimination.

2. Private equity firms must recognize the role of the Global Union Federations in their respective membership areas. UNI calls upon them to undertake to develop a global dialogue with the Global Unions.

3. UNI Global Union will endeavour to negotiate global framework agreements with the relevant private equity companies.

4. In these agreements, private equity firms will commit to abide by the core labour standards of the ILO, in particular Conventions 87, 98 and 135, the ILO Tripartite Declaration on Multinationals, and the OECD Guidelines.

UNI Global Union

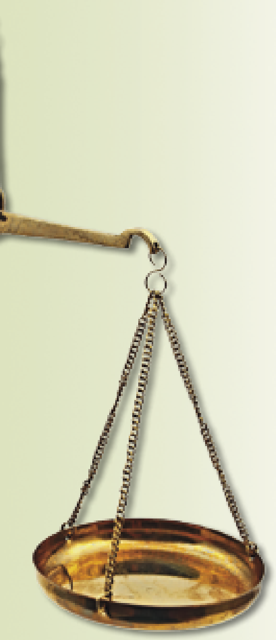
Global Principles for Private Equity

5. Where a private equity firm is buying a company, existing union recognition must continue. Such union or unions must be consulted and be able to negotiate the terms of the workers' participation in the deal and its effects.

6. Such consultations and negotiations should take place, whenever possible, prior to the deal being announced, but in every case prior to the deal being closed. The private equity firm will provide the union with details of the business plan for the company, including equity and debt levels, investment plans, earnings expectations, risks, and other information necessary for the union to be an informed negotiating partner with the company and its new owners.

7. Private equity firms, companies and unions must abide by existing collective bargaining agreements, whether national, industrial, company-wide, or plant-specific. There shall be no unilateral changes or elimination of terms without collective bargaining.

8. Where employees are not already represented by a trade union, companies will recognize their right to organize. The company will allow the union access to the employees. The company will not act in any way to discourage or prevent employees from joining or creating a union.



UNI Global Union

Global Principles for Private Equity

9. As part of a global agreement the private equity company will agree the most expedited, legally-permitted means for determining employees’ wishes to be represented for purposes of collective bargaining.

10. Private equity portfolio companies will sign up to UNI’s responsible contractor policy and only hire contractors that have a demonstrated record of responsible labour practices, including abiding by all applicable labour laws; honouring the right of workers to organize into a union;ensuring workers fair and decent wages and benefits; maintaining safe and healthful working conditions; maintaining a policy of no-tolerance for discrimination; and providing adequate training to workers.

11. Prior to exiting or ceding control of a portfolio company, private equity firms shall ensure that collective bargaining agreements and relatedagreements, including outsourcing arrangements and organizing procedures, shall be continued or assumed by the new corporate entity, owneror owners as a condition of sale.

A Workers' Guide to Private Equity Buyouts

International Union of Food, Agricultural, Hotel, Restaurant,
Catering, Tobacco and Allied Workers' Associations

Contents

TRADE UNION ACTION – THE ORGANIZING CHALLENGE

Private equity buyouts clearly bring about a fundamental shift in the environment in which unions organize and bargain.

How should trade unions respond?

With virtually all public companies now susceptible to a private equity takeover, trade unions are operating in a permanent pre-bid environment. Defensive bargaining tactics prior to a takeover can include union action aimed at:

- strengthening company and sector-wide bargaining agreements to reduce disparities in collective agreements and consolidate bargaining power. Disparities in collective agreements and levels of union organization within a company, and the weakening of national or sector-wide agreements, invite the kind of anti-union aggression typified by the struggles at Gate Gourmet, where the new financial owners consciously targeted the strongest agreements and union organizations in order to isolate them and roll back conditions within the company as a whole.
- negotiating succession clauses or clauses on ownership change that guarantee continuity in employment security and union recognition in the event of a takeover;
- ensuring that such clauses are respected as a legally binding condition of sale when management approaches potential private equity buyers;
- negotiating more comprehensive clauses that act as a “poison pill” to make the company less attractive to private equity funds (similar to shareholder rights or shareholder voting plans in

publicly listed companies), e.g. clauses stipulating that union agreement is needed prior to any restructuring, workforce relocation, transfers or divestment prior to and after a change in ownership.

Negotiating with Private Equity at Linde

When the German Linde Corporation put its forklift division, Kion, up for sale to private equity in 2006, the union was able to impose a review of prospective buyers' business plans for the company as a condition in the bidding process. The private equity firm KKR eventually won the sale by agreeing to maintain investment and employment up until 2011. The Kion case demonstrates that potential private equity owners can be dragged directly into the bargaining process and corporate financing put on the bargaining agenda where unions can exercise sufficient bargaining and mobilizing power.

Collective bargaining strategies may be combined with shareholder strategies and broader legal strategies:

- Union shareholder strategies, using union pension fund investments in a company or through alliances with other shareholders, or both, have been successfully used in some cases to block a private equity takeover.
- Private equity takeovers can also be challenged on legal and regulatory grounds if it can be demonstrated that they would breach competition laws, threaten pension fund schemes, or fail to deliver a public service as stipulated by law.

If a buyout has already taken place, unions can seek to

- aggressively target and directly confront private equity funds as employers in the context of collective bargaining and
- challenge, through the collective bargaining process, the financial arrangements which dictate the new management strategies and negotiate their impact on employment and working conditions. Union bargaining power must be exercised to try to prevent the plunder of corporate resources by, for example, preventing the accumulation of additional debt through dividend recaps etc.

Negotiating effectively with the new financial owners requires a degree of coordination and an ability to respond rapidly to threats which is beyond the current capacity of most trade unions. There is an urgent need to strengthen union work in these areas, in the first instance by increasing research and organizing resources, at national and international level.

TRADE UNION ACTION –

MOBILIZING & INTERVENING FOR RE-REGULATION

Just as the private equity buyout funds use various kinds of "creative financing" to subvert the public interest and undermine the rights and employment security of millions of workers, trade unions need to develop **creative organizing** strategies to reassert the public interest.

The power and reach of private equity relies on a favorable combination of changes to the rules governing financial markets, pension fund investments and corporate taxes. In other words, de-regulation.

The growth of private equity buyouts was built on specific changes to specific laws and regulations implemented as a result of strategic lobbying campaigns and political activism by the private equity buyout industry. These changes are designed to increase the sources of capital available to the buyout funds and reduce or eliminate corporate tax on operations involving substantial debt and the sale of businesses. Such changes in laws and regulations vary in detail from country to country but generally follow the same pattern.

Unions need to mobilize politically to build a regulatory environment that promotes productive investment based on:

- **the long-term interests of working people**
- **long-term employment security**
- **employment creation based on a decent work agenda**
- **comprehensive protection of trade union rights**

In 2003, for example, changes to US tax law redefined certain forms of corporate income for tax purposes and encouraged the growth of dividend recaps in leveraged buyout deals. Also in 2003 the Social Democratic government of Germany abolished capital gains tax on the sale of businesses. This change, introduced at the urging of the financial lobby, paved the way for private equity as a significant presence in that country. New German legislation, which will take effect later in 2007, will allow the incorporation of private equity funds as limited partners, encouraging their further expansion.

In Australia changes to tax laws were introduced in December 2006 to exempt foreign investors from a 30% capital gains tax. This led to a surge in foreign private equity buyout bids, with buyout offers jumping to AUD 33.4 billion compared to just AUD 1.9 billion in all of 2005.

Every stage in the growth of the buyout funds has had the way paved by prior legislative and regulatory changes. These can and must be reversed through political action.

Identifying the critical stages in the step-by-step transformation of tax regimes and financial market regulations which promote private equity buyouts is a necessary element of a trade union strategy for fighting back. Understanding this evolution can help us to challenge and reverse these regulatory changes – and build public support by clearly exposing the role of private equity buyout funds in destroying social wealth.

The leveraged buyout boom in the US in the 1980s crashed to a halt because of movements in interest rates and the stock market which were unfavourable to the buyout business. Some of the funds went bankrupt, others reduced their profile and their activity. Today they're back with a vengeance, and global in their attack. The damage of the 1980s, however, cannot be undone – companies were ravaged and thousands of unionized jobs were scrapped. While some junk bond dealers went to jail, nothing significant was done in the way of regulation to prevent a recurrence – and that is the essential lesson.

Workers – and society as a whole – cannot simply wait for the current cycle to run its course, as financial authorities and private analysts are increasingly predicting it soon will.

At present, there is growing criticism of private equity buyouts, and the buyout funds are on the defensive. The industry response is to continue operating as they have, while espousing the virtues of "self regulation". Trade unions must reject such attempts at self-regulation (or "Codes of Conduct") and pursue a political campaign for regulation by governments.

Reversing and **re-regulating** the deregulation of past years can choke off the more destructive destinations for investor capital and channel it back into useful investment which benefits society as a whole through contributing to sustainable long-term growth. Binding government regulation is the only sure defence against the buyout funds.

A fundamental element in campaigning for re-regulation is to demand that the same disclosure requirements which apply to publicly listed companies be applied to companies acquired through private equity buyouts. These regulations, however inadequate, have been constructed to ensure a degree of transparency and public disclosure and must be applied to private equity buyout funds too.

Transparency is essential not only to shed light on the activities of the funds as a whole, but to permit public scrutiny of their financial operations at the level of the individual companies they buy and sell. We have seen, in the example given earlier of the Linde/Kion deal, how disclosure of the business plans prior to the takeover was a key element in halting the immediate stripping of company assets and securing employment guarantees. We have also given examples of companies reduced to a hollow shell through leverage, recaps and the sell-off of valuable assets. Enforced transparency is a necessary, if not sufficient, condition for blocking this kind of wholesale financial looting.

Markets – and financial markets in particular – have always required regulation, not least to keep them from self-destructing. The private equity firms and their ideologists and apologists claim that returning "value" to investors is in everyone's interest, because investors know best how to invest. This is patently false, as the past and current experience of leveraged buyout booms has demonstrated. What is best for the individual investor is not necessarily best for the individual company, its workers, the wider community or the economy as a whole. Regulating the buyout business and its financial workings is an urgent task of social self-defence.

Meeting this task will take trade union action, at national and international level, to ensure that the funds are curbed and rolled back.