TRADE UNION ADVISORY COMMITTEE
TO THE ORGANISATION FOR ECONOMIC
COOPERATION AND DEVELOPMENT
COMMISSION SYNDICALE CONSULTATIVE
AUPRÈS DE L'ORGANISATION DE COOPÉRATION
ET DE DÉVELOPPEMENT ÉCONOMIQUES

Joint OECD – TUAC Labour Management Programme Meeting "Financialisation of the economy: regulating private equity"

Paris, 12 November 2007
9.30 – 17.00
Room G, OECD Headquarters,
2 rue André-Pascal, Paris 16

Summary report

The TUAC meeting on "Financialisation of the Economy: Regulating Private Equity" on 12 November 2007 gathered over 50 participants from TUAC affiliates, ETUC, ETUI, Global Union Federations and ITUC. The meeting was chaired by Ron Blackwell, Chief economist of the AFL-CIO, and chair of the TUAC Working Group on Economic Policy, and followed a previous TUAC meeting on private equity (PE) organised for Global Unions in March 2007. The objective was to take stock of regulatory and parliamentary initiatives that had taken place across the OECD since the March meeting. The open session in the morning included key statements by David Smith, Majority Chief Economist of the US House Committee on Financial Services, and by Carolyn Ervin, Director of the OECD Secretariat Directorate for Financial and Enterprise Affairs.

Overview

The review of recent parliamentary initiatives on PE prepared by the TUAC Secretariat for the meeting shows a high degree of parliamentary activism across the OECD in the past six months. Parliamentary discussions covered most, and in some cases all of the four key PE policy areas that were identified in March:

- <u>Labour issues and public interest</u> (information & consultation of workers, impact on employment and social equity, impact on public services);
- <u>Financial sustainability of the LBO financing</u> (impact on the portfolio company, spill-over effects, protection of creditors, responsibility of institutional investors);
- <u>Taxation</u> (tax treatment of PE general managers' carried interests, of deductibility of debt, of PE firms and offshore transactions);
- <u>Corporate governance</u> (worker participation, transparency of the portfolio company, Prevention of conflict of interests in buy-out transactions and in PE fund management).

The TUAC parliamentary review shows that PE is a cross-cutting 'horizontal' issue and it was argued that it should be treated as such by the OECD. The PE Industry benefits from numerous regulatory exemptions and gaps in each of these four policy areas that are not, or would need to be justified in the public debates. Further to a letter of John Sweeney President of the TUAC and the AFL-CIO to the OECD General Secretary in August 2007, the TUAC will continue advocating for the OECD to adopt a horizontal approach to PE. In 2008 the TUAC Secretariat will monitor OECD work on PE and other alternative investment funds and, within the framework of the Global Unions Council, will strengthen collaboration with affiliates and with ETUC.

Key issues

The following specific conclusions emerged from the meeting discussions.

- Financialisation: the rapid transformation of the private equity industry over the past five years from a niche to a mainstream business should be considered in the broader context of financialisation of the economy. Private equity is only one aspect of the phenomenal growth of financial products, transactions, and institutions in the past years. This has not been matched by comparable changes in national regulations and international cooperation, and has left the real economy and its workers facing increasing pressure because of financial short termism. Large regulatory gaps and loopholes have appeared and have of benefit to the growth and success of PE managers and to un-regulated markets such as the derivative credit markets. There is further evidence that financialisation is a cause of the observed rise in income inequalities and the decreasing share of wages in national income across the OECD in the past two decades.

- Workers' rights: traditional collective bargaining does not function properly under PE regime because decision making centres are rarely located at the level of portfolio companies. Current European legislations on workers' rights to information and consultation prior to a takeover – such as the European Acquired Rights Directive – are not adapted to the PE model. However, when local unions are powerful enough to influence the takeover bid process PE takeovers can create opportunities for extensive unionisation of the target companies. (Workers' rights to information, consultation and representation were further discussed at an ETUI meeting on corporate governance hosted by the TUAC the day following the meeting on 13 November.)

- Transparency and corporate governance: There remain serious problems of data and information availability on the Industry. The suggestion that is made in some OECD countries that this problem could be solved by self-declaratory initiatives, such as in the UK, misses the point about the un-regulated nature of PE. Voluntary codes of conduct cannot substitute to regulation-backed disclosure requirements. In some countries, corporate governance regimes, including the duties of directors, need to be reviewed to take account of the transformation of the PE model into viable and credible alternative to stock exchange listing.

- Systemic financial risks: the PE Industry and its portfolio companies are particularly exposed to the fallouts of the current sub-prime financial crisis, as the LBO financing model has strong similarities with the credit derivative markets. Like the sub-prime market, it is widely assumed that investors and creditors that invest in LBO transactions do not understand what they are buying, cannot measure appropriately their risk exposure to PE, and accordingly are adopting excessive risk appetite behaviour. Central banks and other national and international supervisory authorities have also failed to prevent or to foresee the crisis that was looming. Investor risk management and private equity asset pricing are major complications for supervisory authorities.

- Regulatory and tax arbitrage: A main attraction of PE lies in its widespread use of offshore entities and transactions. A majority of PE firms and funds are located in offshore centres to avoid tax and/or transparency requirements that apply under the jurisdictions of the portfolio companies. The importance of the regulatory and tax arbitrage in PE are major obstacles to advancing discussions on strengthening PE regulation. These are invariably confronted with the perceived threat of capital and foreign investment flight overseas. The Danish tax reform that was introduced in June to limit deductibility of debt from the corporate income tax base of the portfolio company – a key aspect of LBO financing – is particularly instructive on the ways governments can resolve tax arbitrage. However tax treatment of PE should be considered carefully so as to avoid un-intended consequences on corporate financing of the economy at large.

- Public services and spill over effects: there are serious concerns with the impact of PE in sectors that ensure public service deliveries, and on corporate behaviour of listed non-PE companies. The case of PE investments in the nursing home industry in the US is emblematic in this regard. The LBO financing requirements have pushed PE-owned nursing companies to implement short-termist cost cutting programmes which resulted in a fall in the quality of nursing care services in the US. PE-owned nursing companies influence the standards for the industry that have pushed non-PE nursing companies to adopt similar short-termist management behaviour.

- Views of the OECD corporate and financial affairs divisions: for Carolyn Ervin of the OECD Secretariat, private equity does not necessitate new legislation but should require particular attention on enforcement and implementation of laws. Specific problems may arise in PE takeover bids, such as market abuse and conflicts of interest, and in market reporting and disclosure. Private equity is nevertheless a powerful means to developing capital market efficiencies and the availability of risk capital in the economy.