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Labour/Management Programme

Regulating Private Equity
Overview of recent parliamentary hearings and legislative initiatives

TUAC Labour/Management Seminar on "Financialisation of the Economy: Regulating Private Equity" (Prepared by the TUAC Secretariat)

12 November 2007

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

Executive summary

Intensive trade union activities on private equity in the past year have had an impact in the media and been reflected in parliamentary discussions in different countries. Several parliamentary hearings were conducted over the summer, while some private equity-related proposals of law or amendments have been or are under consideration by other parliaments. This preliminary survey compares recent parliamentary initiatives with the four-pillar regulatory reform framework on private equity that was identified at the March 2007 meeting organised by the TUAC, namely: workers' rights, taxation, financial sustainability, and corporate governance. It confirms the relevance of this approach, and the fact that key OECD jurisdictions – including the US, the UK, Germany, the Netherlands - are taking the issue of regulation of private equity very seriously. While most of the recent legislative reforms have touched upon the tax regime of private equity, other policy areas may be addressed by several OECD jurisdictions in the future: workers' rights to consultation and information, transparency and the risk of LBO financing in the wake of the sub-prime financial crisis, and countering short-termism due to shareholder activism.

Issues for discussion

Do the four policy issues identified in March remain the central priorities?

What overall lessons can be drawn from the acceleration of parliamentary hearings?

Has financial instability of recent months changed the regulatory debate?

How can issues of competition between jurisdictions be resolved?

Is the appropriate level of regulation regional or supranational (G8, OECD, IMF, FSF)?

What should be done to increase data collection and information on private equity?

What should be our reaction to the private equity industries' attitudes to voluntary codes?

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OVERVIEW

1. In March 2007, the TUAC organised a meeting for Global Unions on financialisation and private equity (PE) at the OECD to take stock of the phenomenal growth in 2003-2006 of the leverage buy-out (LBO) industry across the OECD countries, and the concerns of trade unions vis-à-vis the PE model which is seen in many regards as threatening the sustainability of companies, their workers, and the process of equitable wealth creation in general. In their assessment, unions have argued that most excesses in recent PE investments are due to the weaknesses of national jurisdictions and international regulatory cooperation, which have not kept pace with the rapid transformation of PE from a niche to a mainstream business model. Unions themselves have had to revise their assessment as private investors have moved beyond venture capital funds and "distress funds".

2. Four key regulatory and policy issues were identified:
- tax treatment of leveraged buy out transactions and of private equity firms,
- transparency and prudential investment rules of private equity firms and funds,
- corporate governance (under private equity regime) and

- workers' right to information, consultation and representation.

3. Since March, several TUAC affiliates and other international and regional trade union organisations have gone further by issuing statements, monitoring closely private equity investments or campaigning. Such trade union advocacy activities have had an impact in the media and been reflected in parliamentary discussions in different countries. Several parliamentary hearings were conducted over the summer, while some private equity-related proposals of law or amendments have been or are under consideration by other parliaments:

- In the United Kingdom, the House of Commons Treasury Committee set up an Inquiry into the private equity industry, which resulted in public hearings between 12 June and 3 July 2007 and a report published at the end of July;

- In Australia, the Senate Standing Committee on Economics organised public hearings on 25-26 July and 9 August on Private equity investment in Australia, and issued a report in August.

- In the United States, several bodies of the Congress have been engaged in discussions and legislative initiatives. The House Committee on Financial Services held a public hearing on "private equity's effects on workers and firms" on 16 May. In parallel, the House Committee on Ways and Means held public hearings on taxation of hedge funds and private equity on 11 & 31 July and on 6 September. On the legislative front, the Senate Finance Committee introduced in June new legislation extending the tax regime of Investment Corporations to Publicly Traded Partnerships (the preferred legal status for US PE firms to go public), while the Ways and Means Committee agreed on 1 November on a proposal of tax reform that, among other things, would change the tax treatment of PE managers "carried interest" from the capital gains rate to an income tax rate.

- At the EU-level, the European Parliament approved a Resolution on Financial Services Policy (2005-2010) on 27 June that was proposed by EP Committee on Economic and Monetary Affairs. The resolution includes a chapter on the regulation of alternative investment vehicles, including PE.

- In the Netherlands, the House of Representatives Cross-party Finance Committee held hearings on 11 April. Further to these and to the conclusions of the Frijns Committee – an advisory group on corporate governance and shareholder activism – the new government announced on 19 June that it would investigate how employee rights could be strengthened in cases of takeovers and mergers, and how further disclosure of the ownership of activist shareholders could be achieved.

- In Germany, private equity was discussed on several occasions at the Bundestag, but no specific parliamentary Inquiry was set up. Several regulatory or administrative reforms have however been implemented since the beginning of the year: in July the government introduced a Bill establishing a regulatory separation between PE buy-out and early stage "venture capital" investment and reinforcing tax relief measures for the latter in September, as well as administrative restrictions on the influence of PE investors in the planned privatisation of the state-owned railway Deutsche Bahn. In September legislation was introduced to enhance the notion of "shareholders acting in concert" to curb aggressive shareholder activism. Recent parliamentary discussions have suggested increasing the powers of Works Councils in the face of PE investment and takeovers.

- In Denmark, the Parliament approved in June a proposal by the government to limit debt tax deductibility.

- In Japan, a new financial regulatory framework came into force in October – the “Financial Instruments and Exchange Law” – which tightens transparency requirements and the taxation regime of foreign investment funds operating in Japan.

Parliamentary and legislative initiatives in 2007

4. The table below summarises how the various OECD parliamentary hearings and other legislative initiatives that took place since the beginning of 2007 have addressed the policy issues identified by trade unions in March. Overall the table shows that regulation of PE has been a serious issue for parliaments. As shown under the ‘UK’ column, the British parliamentary Inquiry has been very comprehensive in terms of policy coverage as it touched upon all four policy areas: corporate governance, workers’ rights, financial sustainability and taxation. Taxation of carried interest and deductibility was the most frequent policy issue to be addressed by legislative initiatives.

5. In the parliamentary discussions some common features can be identified: lack of information on the industry, the fear that increasing domestic regulation would increase offshore PE, and, as a result, the need for further analysis and regulatory impact assessment.

* : addressed in public hearings or in the drafting of legislative proposals;
**: formal recommendations for government review / action;
***: legislative reform proposal

Country	**UK**	**Aus.**	**USA**	**Ger.**	**DK**	**EU**	**Ned.**
Labour and public interest							
Workers’ rights to information & consultation	**		*	**			**
Impact on employment and/or inequality	*	*	*				
Protection of public services and/or strategic industries		*		***			
Financial sustainability						*	
Impact on the portfolio company	**	*	*	*			*
Spill-over effects on PLCs and the credit markets	**	*					
Protection of creditors	**	*	*			*	
Institutional investors' investment policy	*		*				
Taxation							
Carried interest	**	*	***	***			
Deductibility of debt	**	**		*	***		
Tax regime of PE firms			***	***			
Offshore transactions	**	**	*		*	**	
Corporate governance							
Transparency of the portfolio company	*	*					
Prevention of conflict of	**	*		***		**	***

interests and market integrity

Lack of information and data

6. The lack of reliable and comprehensive information and data on the PE industry and its impact on the real economy was a common feature of the parliamentary discussions. Even in the UK – where most European surveys originate – the British Inquiry noted *"not much of a track record"* for PE and in particular for very large transactions. The main source of information is provided by the PE Industry itself, and the problem of quality and reliability of data was acknowledged by several participants, including PE industry representatives themselves, thereby relaying some earlier concerns by trade unions[1]. David Walker – who is heading a British PE industry working group – referred to the *"partiality and unsatisfactory nature"* of the data. Paul Myners[2] described the data available as *"inconsistent and/or lacking in completeness or independence"*. At the Australian hearings all key supervisory authorities, the Reserve Bank of Australia (RBA), the Treasury and the Australian Taxation Office (ATO) admitted that there was insufficient information available to be certain about the impact of increased PE investment activities, notably on tax and government revenues. The British Inquiry concluded: *"Given the absence of comprehensive industry-wide data on the private equity industry, we look forward to seeing […] more detailed proposals [by the PE Industry] for developing a respected capability for providing such data that commands confidence within the industry and externally when he publishes his final guidelines for the private equity industry in the autumn."*

7. Interestingly, the fact that information and data were lacking did not necessarily prevent some authorities from adopting definitive conclusions on the PE industry. For instance, while the Australian Treasury considered that *"there are few grounds for concern that increased levels of PE activity would affect government revenue levels significantly"*, it nevertheless conceded at the same hearings that the *"assessment of private equity is that it is not something that we are in a position at this stage to make a call on. …In terms of what the revenue effect is. It is extremely unclear"*.

The fear of regulatory competition

8. The recent parliamentary hearings have come to different conclusions. The British Inquiry interim report proposes an extensive list of recommendations and further government actions. The Australian Inquiry however *"does not consider that any convincing case has been made for any further regulation of private equity activity in Australia at this time"*, but nevertheless *"recognises and endorses the ongoing watching brief maintained on this issue by the Treasury"* and other Australian supervisory bodies.

For unions, the main cause of the lack of information is the very un-regulated nature of the PE business and the opacity of the PE firms and funds. Considering recent parliamentary discussions and this causality link between this lack of regulation and lack of information, there appears to be a dilemma: (i) because PE is un-regulated, there is insufficient information and data on the industry, and (ii) because information is lacking, any discussion on regulation becomes… problematic.

[1] On union side, a report commissioned by the British Transport & General Workers' Union in May 2007 concluded that "number of flaws, both in sampling and in data quality, rendering their estimates of employment impact effectively worthless." (HALL 2007)

[2] Author of "Institutional Investment in the United Kingdom: A Review", March 2001 (also known as the "Myners Report")

9. The fear of over-regulation and hence, losing competitive advantage vis-à-vis other jurisdictions is another commonality of recent parliamentary hearings, particularly in the US. For Member of Congress Charles Baucus *"An overly proscriptive, rules-based approach to regulation of private pools of capital could stifle the industry and drive private equity firms and their capital offshore or to investments in other countries"*, while member of Congress Richard Baker warned: *"what happens if the U.S. rulebook is unreasonably fattened? There is a high probability that money will go elsewhere"*. In all parliamentary hearings, the PE industry representatives used the argument of regulatory competition to resist any change in regulation.

10. Against this background, some parliamentarians regretted that past regulatory discussions on PE has not been conducted in a sufficiently informed and comprehensive manner. In the explanatory section of its Resolution adopted in July, the European Parliament noted: *"Commissioner McCreevy so far seems only to promote these alternative investors as providers of liquidity and as activist shareholders. His main concern is to take away barriers for private placement and he resists any discussion about further regulation"*. In the Resolution itself the EP *"regrets that* [the European Commission's recent studies on hedge funds and private equity] *so far have focused only on barriers to growth of such funds" and "regrets that up to now [the European commission's commitment to engage careful, independent and professionally conducted regulatory impact assessments] has not been fulfilled in a satisfactory manner"*.
Regulatory impact assessment may be needed for example to disentangle the role of various sources of regulation in explaining the growth of PE. The British Inquiry noted that *"while PE and PLCs have respectively comparative advantages and potential problems, there remains a debate in the case of some large-scale private equity takeovers about how much of the profit can be attributed to financial engineering compared with value extraction and creation"*.

LABOUR AND PUBLIC INTEREST

11. Labour issues have been at the centre of several parliamentary and other legislative initiatives in the past 12 months. Three issues have been raised: (i) rights of workers when a PE takeover takes place, (ii) quantitative and qualitative social impact of the PE model, and (iii) protection of public services and/or strategic industries.

Workers' rights to information & consultation

12. In the majority of OECD countries, workers are granted either through law or through collective agreement, rights to information, consultation, and representation in corporate governance. Those rights are essential for workers and their unions when a company is taken over and to ensure continuity of their negotiated rights.

13. In Europe, these rights are regulated, among others, by a pan-European legislation, the Acquired Rights Directive (ARD)[3] according to which workers' representatives are granted right to information and consultation on the proposed takeover, and the continuity of employment terms and conditions are guaranteed. The directive further specifies that dismissals that would be directly linked to the transfer of ownership shall be considered as unfair labour practice. In the US, "successorship clauses" in collective agreements also guarantee the continuity of the collective agreement after a take-over. However in some cases the clauses require agreement between the union and the acquiring investors prior to the effective takeover. These 'ex-ante' rights have been very useful recently to facilitate 'worker-friendly' private equity investments in the steel industry (WSJ 2007).

14. The protection of workers' rights has been challenged in recent years with the increase in PE investment. In the case of Europe, the ARD legislation is activated only when there is an effective transfer of ownership of the company from one identified employer to another. However, the legal and financial mechanisms of LBO transactions do not necessarily involve a formal transfer of ownership: in essence LBO transactions are no more than shareownership and balance sheet restructuring. As noted in a report by Brian Bercussion, Kings College, for the European Trade Union Institute:

> *"none of [the ARD] protection is available in cases of take-overs by private equity. This is because the legal form of the take-over is a transfer of shares from the company's existing shareholders to the private equity firm. There is no change in the identity of the employer. As the employer remains the company (though with new, private equity shareholders) the [ARD European] Directive does not apply." (ETUI 2007)*

15. This issue was discussed at the British hearings. Several trade union representatives said that the British transposition of the Directive, known as the Transfer of Undertakings (Protection of Employment) Regulations (or TUPE), had not been applied in recent PE buy-outs. As a result of the hearings, the British Inquiry decided *"to ask the Government to clarify the application of TUPE to takeovers in time for the resumption of our Inquiry"*.

16. Other European countries have considered strengthening the regulatory framework of workers' right to information and consultation in response to PE. In June, the Dutch government announced that it would investigate whether the position of the employees should be strengthened and how this could be realised, particularly in cases of mergers or takeovers. In Germany a legislative proposal is under consideration to enhance the rights of works councils.

17. In the US, the hearings of the House Committee on financial services stressed the importance of dialogue between the PE firms and the trade union of the targeted company, and the need for congress to legislate on union recognition under PE take-over.

Impact on employment and social equity

18. Regarding the impact on employment, the lack of reliable and independent sources of information on PE did not facilitate parliamentary discussions on this topic. The British Inquiry concluded that *"no sufficiently reliable and comprehensive data exit, meaningful overall figures are elusive"*. In the case of Australia, positive impact figures provided by PE associations were mentioned, but no further endorsement or discussion was engaged. On the other hand, the qualitative impact of PE on wages, pension and healthcare was discussed extensively in the US and the UK hearings. Cuts in wages and in other social

[3] Council Directive 77/187 of February 14, 1977, amended by Directive 98/50/EC of 29 June 1998, and consolidated in Directive 2001/23 of 12 March 2001.

benefits were reported by unions in several recent PE takeovers. British unions provided evidence where the portfolio company's pension schemes obligations had been at risk following the buy-out operations, and called on pension obligations to be clearly ranked ahead of buy-out related bank lenders, and called on increased scrutiny by the British Pensions Regulator. In response the British Inquiry accepted *"that ensuring that company pension fund commitments are securely funded is a vitally important matter when major changes are made to the structure and financing of a company, especially when such changes include an increase in leverage and thus increased risk to pension funds, and we will return to this matter when we resume our Inquiry into private equity"*.

19. In introduction to the hearings of the US House Committee on Financial Services on the effects of PE on workers and their firms, the chair of the Committee, Barney Frank put the regulation of PE in the context of increasing inequalities in the US. He stated: *"there is the fear that, to the extent that private equity is accompanied by significant increases in debt in some cases, this may have a negative effect on workers. If we have a situation, private equity, where enormous values are created, as apparently they are, and if only a few people get these large sums of money, and the workers are either no better off or worse off, then from a public policy standpoint that seems to me to be undesirable."*

Protection of public services and/or strategic industries

20. An important theme of the Australian hearings was the adequacy of the private equity models to 'strategic industries' and public service deliveries such as health care, and more broadly to Australia's national interest. An academic expert suggested a *"precautionary approach"* to PE to safeguard the national interest in sensitive industries. Such approach could materialise in placing restrictions on the level of debt of PE companies, or in requiring the PE fund to commit secured funds to cover any disruption of essential services to which portfolio companies would be bound to respect. National interest grounds were also invoked in the case of PE investment in health care industries and the potential adverse consequences of exclusive focus of management on financial outcomes rather than service delivery. In its conclusions the Australian Inquiry rejected such *"narrowly held view"* and stressed the importance of PE to attract foreign direct investment. Other countries have taken a more proactive stance on protecting sensitive industries from PE investment. In July, the German government imposed restrictions and conditions to PE investment in the forthcoming privatisation of the state-owned railway Deutsche Bahn. The protection of key industries from foreign PE buy-out should also be seen in a broader move toward regulatory restrictions to domestic acquisitions by foreign "sovereign wealth funds", as seen in Germany, France and the US, and the controversial investment of a Chinese state-owned fund in the US PE firm Blackstone.

FINANCIAL SUSTAINABILITY

21. Several parliamentary hearings addressed the potential sustainability of the increase in debt relative to earnings and/or to equity as observed in recent PE acquisitions. The ratio of debt to equity is typically 70/30 (or 230%) for PE companies, compared to 30/70 (or 43%) for public companies, and has increased in the recent years as deals have become bigger. The Reserve Bank of Australia confirmed that: *"In recent years, buyouts in Australia have typically resulted in debt-to equity ratios [...] of around 250%,*

compared with pre-buyout ratios of around 50% and a gearing ratio for the non-financial corporate sector as a whole of 65%". In the UK the debt/EBIT[4] ratios of the five largest transactions in the UK in the twelve months to June 2006 was 6.41 which was described by the FSA as *"a high figure relative to [...] leverage levels observed in large deals historically"*.

22. The issue of increasing debt levels of PE companies was addressed in parliamentary hearings mainly through their impact on the sustainability of the portfolio companies (and their spill-over effects on listed companies), as well as on the protection of creditors and more broadly the systemic risks to financial markets. In addition, some discussion addressed the responsibility of institutional investors, including union pension funds, in financing PE activities.

Impact on the portfolio company and spill-over effects

23. Trade union representatives in British, US and Australian hearings warned that the high debt levels in buy-out deals and the high fees that were captured by PE managers could put workers and companies at risk. As noted above on the impact on employment and inequality, high leverage levels create pressures for management short-termist behaviours such as cutting costs that are counterproductive to *"the stated goals of private equity firms to create long-term value and productivity"*.

24. Several parliamentary discussions also addressed the capacity of highly leveraged PE companies to face adverse lending and credit conditions, as widely anticipated in the wake of the US sub-prime financial crisis. A tightening of bank lending standards might pressurise companies that were acquired during the boom time in 2003-2006 and have since been loaded with "recapitalisation" debt. The British FSA referred *"to the possibility of jobs in 'overleveraged' private equity companies starting to look increasingly precarious, and also identified potential risks to lenders and to financial stability if such lending turned out to be imprudent."* The Bank of England and the Reserve Bank of Australia (RBA) shared concerns about the spill-over effect on listed companies which, adopting *"defensive behaviour"*, were increasing their own debt levels to make themselves *"less attractive to private equity overtures"*. The Bank of England estimates that, following recent leveraged buyouts, "*the UK corporate default rate could be up to 0.8% points higher on average over an economic cycle"*. For the RBA, the behavioural changes in listed companies may be the most important aspect of the rise in PE investment rather than leveraged buy-out activity itself.

25. In response the British PE Industry representatives argued that the increased level of debt imposed *"discipline on firms to focus on profit maximisation"* and enabled people *"to understand risk a lot better and be able to price risk better"*. It was further argued that LBO-related debt issuance were agreed following extensive due diligence both by private equity firms and by banks. For a US PE Industry representative intervening before the US House Financial Services Committee *"the level of due diligence of private equity firms today compared to 20 years ago is [...] far better. Sometimes it takes private equity firms 2 years before they actually make an acquisition, so they raise funds, but they are not investing all of their funds immediately"*.

26. In its recommendations, the British Inquiry notes that, *"however extensive the due diligence conducted, higher levels of leverage are likely to create additional risk, and that this becomes more significant the more important highly-leveraged firms become in the economy"*. The Inquiry further urges *"the FSA to investigate the operation of due diligence in highly-leveraged firms"* and *"the Bank of England to examine the potential impact of an economic downturn, both on highly-leveraged firms and on the wider economy"*.

[4] earning before interest and tax.

Protection of creditors

27. Another aspect of LBO-financing was the quality of the protection of lenders against credit default risk. In the UK, the quality of loan covenants has weakened substantially in 2006 with a sharp increase in the number of covenant-lite agreements[5], which, according to the FSA, increased the likelihood of credit events. For the British PE Industry representatives however, lighter agreements allow *"greater flexibility for the portfolio company to restructure itself, including in the event of market downturn"*, while the extensive due diligence undertaken prior to the PE transactions ensures appropriate credit protection guarantees.

28. More broadly, several participants in parliamentary hearings have highlighted systemic risks to the continuing erosion of LBO credit quality. Like the mortgage credit market, a majority of LBO-loans are not held on the balance sheets of the banks but are re-packaged into un-regulated collateralised debt obligations and then sold to the markets (securitised) divided into various tranches ('senior', 'second lien', 'mezzanine') reflecting different levels of credit default risk and yields. Complexity is increased by the opacity of the holding structure set up for the purpose of the LBO and the fact that the collateralised tranches are issued by different intermediary investment entities (parent holding, sub-holding, portfolio company).

29. The British FSA noted that *"methodologies for disclosure, valuation and performance reporting used in the private equity market are not always applied consistently"*. This assessment was shared by the Bank of England which stressed *"the importance of lenders to remain vigilant regarding the due diligence undertaken in respect of loan issuance"* and alerted to the risks associated with weaker loan covenants in the light of the recent sub-prime mortgage crisis. The Australian securities and exchange commission, ASIC, shared the same concerns about the lack of transparency of the derivative products used to sell LBO debt to retails investors. In particular ASIC alerted to the fact that the investors did not necessarily understand the products they were buying: *"while cognisant about the degree of risk attached to equity and business investments"*, investors *"are often confused about the amount of risk that can be inherent in fixed interest investments"*.

30. In its report, the British Inquiry urges *"the FSA and the Bank of England to continue to monitor the incidence and nature of covenant-lite loans, with a view to assessing the extent to which heavily leveraged deals are consistent with the remits of the FSA and the Bank of England for financial and economic stability"*. It further calls on the FSA to *"examine incentive structures relating to debt"*. In the same vein, the Resolution adopted by the European Parliament in July points out that *"the growing role of non-bank financial institutions such as hedge funds and private equity"* would affect *"the nature, source and transfer of systemic risk, and thus the effectiveness of existing ex-ante risk mitigation tools"*. The Resolution calls for *"evidence-based identification and evaluation of the sources of systemic risks and the underlying dynamics of financial crises in this context"*.

[5] A loan covenant is a contractual agreement between borrower and lender setting the terms and conditions of the loan. Covenants cover terms of 'maintenance' which require the borrower to meet certain financial tests on regular basis, and terms of 'incurrence', setting special conditions when particular events occur, such as default of payment. Covenant-lite agreements are limited to incurrence/event-driven conditions, and set no maintenance conditions to protect creditors' right.

Institutional investor' investment policy

31. The responsibility of institutional investors was pointed out in some parliamentary discussions. The Australian Inquiry highlighted the importance of superannuation funds (ie. occupational pension funds) in funding PE investments in Australia. At the hearings of the US House Financial Services Committee, the role of pension funds was also raised. Union representatives pointed out that most of the union pension funds are governed by fiduciary responsibilities that would not allow them to place particular kinds of requirements. They also pointed out to the restrictive governance system of limited partnerships under which PE funds are rules, which gives a limited role to limited partners in the decision-making process. At the British hearing, on the other hand, Paul Myners said that theoretically institutional investors should be in a position to insist on key governance standards such as disclosure, but in his experience *"investors can be quite lethargic in this respect"*. He pointed out the inconsistency of institutional investors' investments policy in private equity and in listed equity: *"These investors should ask why they invest in private equity with its association with aggressive capital structures, high incentives for management and a minimalist approach to governance ... while adopting an entirely different set of approaches when investing in public equity."* A British academic expert *"linked the willingness of investors to pay high fees to the general lack of information about the private equity industry."* In its recommendations, the British Inquiry invites institutional investors *"to re-examine why their requirements of PLCs and of private equity-owned companies are so different, and we will take further evidence on this in the autumn."*

TAXATION

32. The issue of the appropriate tax regime applying to PE firms, PE transactions, and to PE portfolio companies was extensively discussed in parliamentary hearings and addressed by other legislative initiatives. Current legislations – it is argued – are not adapted to the transformation of the PE industry from a niche to a mainstream activity and as a result allow for several regulatory loopholes in national tax systems. Of particular concerns are the low taxation of 'carried interest' – which are assimilated in most jurisdictions to capital gains and not income – the deductibility of debt from the portfolio company's corporate income tax base, the tax regime of PE firms themselves, and widespread offshoring of PE activities.

Carried interest

33. PE general partners usually receive annual management fees, which typically are around 2% of the fund's assets, reimbursement for investment expenses, and "carried interest" which is the share of the profit that the general partners receive when the fund exits an investment. A carried interest is usually at 20%. In most jurisdictions, carried interest are treated as capital gains and as such are taxed at much lower rate (10-15%) than the normal income tax rate (35-45%). The tax treatment of carried interest as capital gains was a major issue for discussion in the parliamentary hearings. It was argued that, since general partners receive carried interest without investing initial capital to the amount, these should be re-qualified at normal income tax rates.

34. The British hearings spent substantial time on the issue, including a vigorous exchange between British MPs and representatives of the PE industry. In addition to the favourable tax treatment of carried interest as capital gains, the British legislation allows for additional tax relief beyond a 2-year holding period (known as the 'taper relief'). As a result PE managers pay less than 10% tax on their carried interest. Not only that, the management fees collected by PE managers were reported to have remained close to 2% although the PE investments have grown exponentially in volume in the UK. In its report, the Inquiry *"questions whether the reward is disproportionate to the risk and whether the carried interest should be regarded as a capital gain or a reward for services"*. In its recommendations, the Inquiry calls on the British Treasury and the Revenue and Customs to consider further the issue, and in particular to review a 2003 Memorandum agreed with the PE Industry that allows capital gains treatment to apply to carried interests. The Inquiry also invites the PE Industry to increase transparency on fee structure.

35. In Australia, tax treatment of carried interest was not discussed as priority issue because most PE firms operating in Australia are based abroad and are thus likely to be exempted from tax on their capital gains. Under Australian jurisdiction foreign residents are only subject to capital gains tax on real estate property, mining interests and *"assets used through a permanent establishment in Australia"*. At the hearings, a legal expert estimated that, based on 25% annual return on investment, the tax exemption applying to current PE investments in Australia would amount to about AUS$9bn on a potential capital gain of AUS$29bn. It was also reported that the Australian Taxation Office (ATO) was investing the issue under a general tax compliance investigation of PE.

36. In the US, the House Ways & Means Committee examined the issue in public hearings in September. The panel discussions set forth arguments that *"carried interest is a fee that is received in exchange for the provision of services and should be taxed accordingly – rather than as capital gains under current law"*. In October the Committee presented a legislative proposal to treat carried interest as income, not capital gains, as part of a broader tax reform package which also included tax relief for working families.
In Germany, a Bill was introduced in July to reduce tax exemption on the carried interest in early stage venture capital funds only from 50% to 40%.

Deductibility of debt

37. The negative impact of highly leveraged financing on the PE companies' corporate income tax base – and thus on corporate tax collection – is another important tax issue of PE. The massive increase in interest payments that results from the leverage financing significantly reduces the portfolio company's payment of corporate income tax, as debt interests are generally deductible from corporate income tax base.

38. At the British hearing, trade unions gave the example of the PE takeover of Alliance Boots which had resulted in a substantial increase in debt interest payments and according a loss in tax collection estimated at £144m per year. The Association of British Insurers (ABI) had a *"legitimate concern"* that risky financing structures create a bias towards *"inefficient economic decision-making for the longer term, but which is made good by the tax benefits of high levels of debt finance at the start"*. The Committee expressed concerns about the issue and warned against potential *"economic distortion if the tax system significantly favours debt over equity as a form of company funding"* and looked forward the outcome of an on-going review by the British Treasury. In its recommendations the Inquiry suggest that, beyond considering tax revenue issues, the Treasury takes of broader approach and addresses the potential economic distortions created by the deductibility between equity and debt financing.

39. At the Australian hearings, a legal expert estimated that the recent PE takeovers of five listed companies[6] by US PE funds had generated a net loss in tax collection of circa AUS$1.2bn per year (to be compared to circa AUS$49bn in corporate tax collection 2005/06, representing a fifth of the total tax collected). These estimates were contested by others on the ground that they overlooked other positive effects that might offset the loss due to deductibility such as: increased profitability of the portfolio companies and increased capital gains tax paid by shareholders selling their shares in a buyout. Another aspect discussed by the Australian Inquiry was the tax deductibility of some PE takeover "transaction fees" that were paid to advisers that had close relationship with acquiring PE firms. While the Australian Inquiry did not recommend any specific action, it was noted that the Australian tax authorities are reviewing the issue under a general tax compliance of PE investigation.

40. In Denmark, a public debate emerged end-2006 when it was suggested that Telecom Denmark Corporation (TDC) – the largest corporate taxpayer in the country – would not pay corporate income tax "in the foreseeable future", following its acquisition by a consortium of PE funds. The scandal prompted the Danish government to enact new legislation on corporate tax income which came into effect in July 2007. The new law puts three limits to tax deduction of interests:

- a maximum level of debt is set in proportion to the total tax value of the portfolio company's assets (ie to avoid tax deductions that would exceed the intrinsic value of the portfolio company, and thus be assimilated to hidden financing of shareholders);
- a maximum interest rate corresponding to the average interest rate on bonds plus 2.5%;
- a minim level of corporate tax income base corresponding to 80% of the company's EBIT.

As a result of the new rules, PE portfolio companies had been put back into a tax position approximately corresponding to their taxation before the take-over.

Tax regime of PE firms and offshore transactions

41. The tax treatment of PE firms themselves came also under public scrutiny when several leaders of the PE Industry in the US, including Blackstone, announced their intention to go public on stock exchanges. The legal status that was chosen for the Initial Public Offering (IPO) of Blackstone, the Limited Partnership, would allow the PE firm to by-pass tax obligations that would normally apply to such investment company. Further to the AFL-CIO warning in May against the far reaching implications of the proposed Blackstone IPO; including the creation of a major tax loophole in the US system[7], a Senate Bill proposal was presented in June to tax as corporations all publicly traded partnerships. Max Baucus, co-chair of the Senate Finance Committee said "*If left unaddressed, the tax concerns presented by the public offerings of investment managers, like private equity and hedge fund management firms, could fundamentally erode the corporate tax base*"[8]

42. The discussion on the tax regime of PE firms was often linked to the offshore nature of their transactions. For example,

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[6] Coles Myer, Tabcorp, Woolworths, Qantas and Westfarmers.

[7] In a letter sent on 15 May 2007 to the Securities and Exchange Commission, the AFL-CIO called on the SEC to block the IPO of Blackstone on the grounds that the legal status chosen for the IPO – the Limited Partnership – did not correspond to Blackstone's activities (which should normally fall under the jurisdiction of the Investment Company Act). Listed limited partnership companies have far weaker requirements in terms of transparency and reporting, corporate governance requirements, and tax obligation.

[8] press release http://finance.senate.gov/press/Bpress/2007press/prb061407e.pdf

- at the British hearings it was reported that *"only 40 of the top 200 private equity partners are tax domiciled in the UK"*, which pushed the Inquiry to ask the Treasury to inform on its current review of British legislation on "Residence and Domicile rules". It also suggested that *"both the British Treasury and the Revenue and Customs should demonstrate that they have a rigorous approach towards claims of non-domicile status, given the apparently rising number of offshore PE firms, and perception that monitoring is weak"*.
- In Denmark, it was the tax authorities' inability to tax private equity funds – which were offshore – that led the legislators to focus on the deductibility of the interest payments of the portfolio companies.
- In Australia, and as indicated above in the discussion on carried interest, vast majority of PE firms and their investors were located overseas, leaving few room for manoeuvre for Australian legislators.
- In Japan the new financial regulatory framework that came into effect on 1 October – the *"Financial Instruments and Exchange Law"* – requires foreign investment funds operating in Japan to register and thus abide by Japanese regulation, including its 40% tax regime on profit.
- In the US, the hearings of the House Ways & Means Committee in September also addressed the issue and the regulatory options *"to prevent investment funds from operating offshore"*.
- Finally the Resolution adopted by the EP in July *"urges the Commission to assess the quality of supervision in off-shore locations and to step up cooperation with the supervisors in these jurisdictions; intends to join forces with the US Congress Financial Services Committee of the House of Representatives in investigating, inter alia, tax measures to respond to the undesired flight of capital to tax havens"*.

CORPORATE GOVERNANCE

43. Apart from workers' rights to information and consultation – as discussed above – the main corporate governance issues that were considered in recent parliamentary hearings were: (i) the transparency and disclosure requirements of portfolio companies in comparison to listed companies, and (ii) the prevention of conflicts of interest that may arise when a PE fund makes a takeover bid for a company and/or when a general manager runs several funds investing in the same portfolio company.

Transparency of the portfolio company

44. At the British hearings it was noted that the difference of transparency and disclosure requirements between PE and listed companies would widened with the introduction of the new Company Law Act, notably on social and environmental impact, relation with suppliers, and executive compensation. For the British TUC, disclosure and transparency requirements should be determined by the economic and social impact of the companies, rather than ownership structure. A similar position was held by National Institute of Accountants in Australia for which PE is *"a means by which entities can avoid public reporting obligations"*, and argued that *"reporting requirements should be standardised based on the nature of the company's activity rather than its ownership structure"*. For the Australian Treasury however, *"the amount of secrecy in PE deals"* is largely over-estimated, as PE companies have the same reporting

obligations under the Corporations Act as PLCs. In its recommendations, the British Inquiry calls on the PE industry to enhance in its forthcoming guidelines the following: *"portfolio companies' approach to stakeholders, on how value has been created, on level, structure and conditionality of debts, and independent monitoring."*

Prevention of conflict of interests in buy-out transactions

45. The Financial Services Authorities (FSA) has identified several situations where conflicts of interest may emerge:

- those affecting the general partner (differing levels of investment in the portfolio companies; running several funds at different life cycles investing in the same portfolio company; sitting on the Board of directors of the portfolio company; paid by the PE firm for consultancy during the PE transaction) and
- the top management of the target company (receiving financial incentives from the PE firm bidding for the target company).

46. In its conclusions, the British Inquiry *"perceived conflicts of interest as an area of significant risk"* within PE market and remained to be convinced as to the effectiveness of existing rules and mechanisms (incl. legal contracts, ownership structure, and supervision). The Inquiry also noted the on-going work of the FSA on this issue, and said it would itself address the issue in the future.

47. In Australia, the "Takeovers Panel" (established under the jurisdiction of the securities exchange commission, ASIC) issued in 2007 a Guidance note (n°19) in relation to insider participation in takeover transactions. In case of non-compliance, the Panel can issue a public *"statement of unacceptable circumstances and orders"*. At the Australian hearings, based on the current implementation of the Note, the head of the takeovers Panel saw no particular need for further regulatory changes on PE investment.

48. The threat to market integrity and shareholder transparency was also addressed in Germany, where a law was introduced in September broadening the definition of shareholders "acting in concert", including obligation to launch a takeover bid if the concerned shareholders own over 30% of shares. In the Netherlands new transparency requirements were introduced lowering from 5% to 3% the threshold for disclosure of interests by shareholders, as well as reinforcing transparency of beneficial ownership (i.e. exact identity of shareholders). In its Resolution, the European parliament *"asks for a broader and more critical approach [by the Commission] with regard to the risks of market abuse"*.

Source

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