**HEDGE FUNDS**

**AND PRIVATE EQUITY –**

**A CRITICAL ANALYSIS**

**EXECUTIVE SUMMARY**

**Our Europe**

In this new era of globalisation, conditions have changed for our welfare states. We know that globalisation offers new opportunities and enormous potential wealth - if we bring the European social market economy and the global economy together in the right way. And this must be our concern whether we are formulating concrete, new initiatives in the real economy or the financial markets.

This is not a discussion as to whether we should reform or not. We need reforms of the real economy, the labour market, business, education, service etc.

We must combine social justice and social security with full employment, growth and competitiveness. And we can do it - a number of European countries have proved it. We - all stakeholders in the real economy as well as in the financial markets - will base our strategies on our common values.

\*\*\*

**The question**

The question is, do we have today, with the increasing dominance of hedge funds and private equity funds, a financial market in Europe, which lives up to optimal conditions? This has given rise to concern among progressive, political parties, PES and the PES Group in the European Parliament, trade unions, corporate businesses, and employees.

Hedge funds and private equity funds have been operating for many years but their enormous growth is the most striking new challenge for our societies, and the structures, transparency and business practice on the financial markets. We regard it as a common responsibility to assure that this new development leads to higher efficiency on the capital markets, effective financing of long-term investment, and full transparency. And we are certainly aware of the related risks i.e. financial instability, imperfections or abuse of the capital market.

HFs and PE funds cannot be analysed in a fair and consistent way without placing these capital funds in a broader context. This is our social Europe. In 2000 in Lisbon the European Council defined the strategy for making Europe “The most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth, more and better jobs and better social cohesion.

This was confirmed at the Spring European Council 2005. The PES Group was precise in its preparation for this council decision by presenting its report: “A Europe of Excellence - the Lisbon process: Getting from declarations to results”. Europe’s choice must be based on its competitive strategy on excellence, on a high quality of infrastructure, its public services, its workforce and labour markets, its environment and welfare, and its companies.

**The need for long-term investment**

The need for long-term investment, coherence and permanent learning and education is further underlined by the latest decisions in the European Council. In the summit in March in 2007 the Council took a great leap forward in making Europe a front-runner in tackling climate change and energy policies. But to make that happen in real life is involves the same challenges defined in the Lisbon goals.

We still believe in the market, but we insist on “social market economy” not on “a market society”. These words of a “highly competitive, social market economy” were repeated in the spring 2005 communication from the European Council.

We now see the outlines of a new, smart, green growth strategy for Europe with millions of jobs and wealth ahead, if we make the right decisions. We have shown in the New Social Europe report, agreed at the PES Congress in December 2006 in Porto, that such an outcome is realistic and achievable within the coming years. And we have documented that more than 9 million new jobs are waiting to be realised through that strategy in the coming 6 to 8 years, at the top of our base line in the European “do as you have been used to”-prognosis.

**The need for long-term financing**

Here is what we demand of the financial markets: All our policies require long-term investment, and therefore long-term financing. The demands on every actor and stakeholder in our economies are clear - and that goes for the financial markets too!

This is the very essence of this report. The decisive question is to what extent the fast growing “alternative investment industry”, HF and PE funds, conform and contribute to a positive, efficient and long-term role for the capital markets in financing the enormous amount of investment needed for a New Social Europe?

Unfortunately, we cannot expect coherent answers from the European Commission.

In July 2005 the European Commission launched a public debate on possible ways to enhance the European framework for investment funds. The Commission established a couple of “alternative investments expert groups” to describe “how they see the future development of the hedge funds and private equity funds in Europe and whether there are any European-level regulatory or other obstacles, which hold back the efficient organisation of the business in Europe”. Already, in this brief, the responsible Commissioner seemed to be presuming that the major problem is too much existing regulation. When the result of this work was published in July 2006, our worries were confirmed.

**No real answer from the Commission**

The PES Group is highly critical of the fact that these reports were made on a biased basis by experts coming exclusively from organisations with a strong interest in no regulation or the “light-touch regulation” proposed in the report. The analyses in the reports were strongly biased towards deregulation. The market imperfections and implications of non-transparency, asymmetric information, enormous growth in leverage, short-term financing, tax evasion, systemic risks on financial markets, and increasing vulnerability of public companies after the involvement of private equity funds – all these were hardly touched upon.

These reports are in striking contrast to the very well-documented worries about lack of transparency expressed in reports from the ECB, the World Bank, the FSA, and American monetary institutions like the SEC. The PES Group has already voiced its criticism of the work of the European Commission through a number of comments on reports by the so-called “alternative investment expert groups”.

Recently, the responsible commissioner, McCreevy, has expressed his views: “Private equity houses and activist fund managers of all kinds - including hedge funds - play a much more valuable role than any government or any regulator in reducing the cost of capital”.

We are not aware of any other voices expressing similar views - neither in Europe or the USA - nor at the London and New York stock exchanges. With the exception of Commissioner McCreevy, all others have reached recognition that some change is needed to ensure a better-functioning capital market.

\*\*\*

**The PES Group report**

The PES group has taken full account of the Commission’s attitude and of the present lack of coherent analysis and reflection on how to tackle the new trends on the financial market. Therefore, the PES Group has decided to set up our own group of experts to analyse and to consider the need for regulations.

We insist on facts and clear commitment to the future of Europe. We have no wish to demonise any actors at the financial markets, but our ambition is to ensure a better functioning market, subordinate to the real economy. This report is based on a number of case studies from the real economy, documenting the strategies followed by most HF and PE funds.

On the basis of a coherent analysis and a systematic reflection on six concerns, closely related to our European vision of New Social Europe, we introduce some reflections on a number of tentative proposals that can serve as inspiration for future regulatory issues, incentives, monetary regulations etc. All these considerations are based on the need for assuring optimal financing of consistently high investment in knowledge, research, advanced employment, more and better jobs, energy and climate control - all in all, the European knowledge-economy, the New Social Europe.

\*\*\*

**Part I: Hedge funds and private equity funds - how they work**

As in all other industries there are huge differences to be found among the investment funds. Venture capital is invested in new and upcoming companies, which require high investment for high-tech, IT, R&D etc. Venture capital funds generate real growth, support good, innovative ideas, and stay in business financing the long-term investments - there is a reason why venture capital is often referred to as “business angels”. Other investment funds, like so-called expansion capital, act similarly with important implications for the investment market. But this is a fact not to be confused with the other side of the market.

During the past few years, very low interest rates coupled with an imbalance of world trade flows have resulted in massive growth of liquidity in the world markets, seeking attractive yields. This is the basis for the very high expansion rate of HFs and PEs we see during these years.

**The anatomy of hedge funds and private equity funds**

The anatomy of hedge funds is best understood if we think of them as being unregulated and having unlimited choices on the capital markets: freedom to choose any investment strategy, unlimited view of leverage, not subject to regulation, a high network of very rich individual investors, no transparency or disclosure, and extreme fees and management remuneration. Only big investors can put money into HFs, including very rich people and in recent years pension funds, insurance companies etc. In recent years, the so-called funds of funds (FOHFs) are playing an increasing role, especially for investors like pension funds. They have a less risky profile and a lower level of leveraged capital.

While all the important decision-making and risk-management is retained in the hedge fund itself, a part of its original task is done mainly by external providers. Prime brokers offer brokerage and other professional services. Like the large hedge funds and private equity funds, the prime brokers are heavily concentrated in a very small number of investment banks. London is Europe’s leading centre for HF and PE fund manager operations.

But in 70% of cases, offshore, due to a wish to minimise tax and place itself in a de-regulated environment. The offshore funds are usually structured as corporations.

The HF and PE industry is the fastest growing major actor on the financial markets, not only in Europe but across the world:

• It is estimated that hedge funds in 2007 manage some 1.7 trillion USD. There are around 6,900 single hedge funds worldwide.

• The US is still the dominant centre for hedge funds and PE operations, counting for more than 68% of the total capital under management. But their activities in Europe are rapidly expanding now making up more than 25% of the global hedge fund industry.

• Looking at private equity funds the expansion is dramatic, too: European leverage buy-outs in 2006 amounted to 160 bn Euros, an increase of 42% on 2005. With the usual leverage ratio of 3/4, this corresponds to a buy-out capacity of 640 bn Euros in 2006.

In Europe, buy-out investments account for more than 70% of the total under management. By contrast, venture capital investments only represent 5%. This is very worrying bearing in mind our need for long-term investment to realise the Lisbon goals.

• To take an overview of the total amount of capital allocated for leverage buy-outs, it is certainly necessary to include the US-based funds. Despite the enormous growth in leveraged buy-outs of European companies, it is still striking to see the dominance of the US funds. They are simply the most powerful funds in the world. US funds like Texas Pacific Group, Blackstone and KKR, together have a capacity equalling more than 30% of worldwide equity.

\*\*\*

Hedge funds, PEs and the banks, including investment banks, enjoy ever closer cooperation and interdependence. HFs are very important partners for prime brokers and investment banks providing revenues and services. This increasing interplay and interdependence also increases systemic risks and there seems to be an extra argument for claims of disclosure, transparency and regulations such as already exist for commercial banks and investment banks. This argument is underlined by the high complexities in asset evaluation of derivatives, managed by the hedge funds. When HFs compete in delivering high returns, there is the possibility of careless evaluations and even miscalculation.

\*\*\*

**The pension funds**

Where does all the money invested in HFs and PEs come from? Over the years very wealthy people have taken the dominant position and still do with around 40% of all input to the HFs and, indirectly, also huge amounts to private equity.

But since the mid-nineties, pension funds have invested heavily both in hedge funds and in private equity. In private equity and thereby also leverage buy-outs, the pension funds and insurance companies accounting for about 1/3 of all funds raised. In the hedge fund industry including FOHF they also account for at least 50% of the total investment each year.

The pension funds in particular need more transparency and disclosure from HF and PEs since in most cases they have no real chance of judging the accuracy of asset evaluation or the net risk connected to their investments in the alternative investment industry.

**Investment strategies**

Hedge funds and private equity funds are based on investment strategies with a much shorter time horizon than is needed for long-term investment in the real economy of Europe.

Looking at the LBOs’ major strategies, there is an even stronger shortening of the time horizon for retrieving the money invested with extremely high benefits. Several methods of ensuring these returns and fees are at his disposal: extraordinary shareholder dividends, stepped increases in leverage, fees, job cuts, sale or flotation. The LBO managers take their time and choose the exit method that would maximise the cash-flow. All this is done quite independently of the long-term interest of the company.

**The leverage and the consequences**

Highly leveraged investments are also a common strategy for HF and PE funds. The high growth of leverage is, of course, influenced by the extreme pressure on average performance.

In a very low interest-rate landscape it is highly possible that the appetite of investors for risk and performance is bigger than risk-free instruments (typically bonds) can offer. This militates towards placing assets in HF and PEs.

It looks like a vicious circle and it would be completely reversed in a high-interest rate scenario. This forms part of the discussion of systemic risks. Margin loans, securities lending and use of derivatives could lead to a total estimate on the enormous amount of leverage.

In the HF industry the total debt including derivatives is something between 150% and 250% of HF single values, i.e. 2.0 - 3.3 trillion USD.

Within this broad framework we see extreme cases. LTCM is well-known and CITADEL’s leverage amounted to 11.5 times. This is an example of groundbreaking ability to access capital markets for unsecured debt. The majority of HFs only have a few ways of boosting returns - and extensive leverage is one of the few - think LTCM.

\*\*\*

The PE industry and its use of LBO in many ways has serious, direct consequences for the target companies: The PE funds usually co-finance an acquisition ¾ through leverage and ¼ its own assets. Thus the PE is acquiring a high return on the investment and at the same time pushing down debt on the target company.

**Extreme management fees and remunerations**

In the HF industry calculation of fees is based on two components: a 2% management fee charged on the total acquired asset plus a performance fee of 20%. The performance fee is typically determined as a share of the attained absolute return in excess of a specific hurdle rate. This calculation of fees is an established rule of the game in the PE industry as well.

To maintain these extreme payouts and to keep investors – including pension funds - confident and satisfied, HF and PE funds need growth in returns of more than 20%. This is doubly problematic because the fee structure and level is not a “law of nature” or historically based. Neither is it market based. It is simply an unchallenged “characteristic” of the industry.

\*\*\*

**LBO: The target company - before and after**

Leveraged buy-outs of good, sound, listed companies are frequently criticised in public. The debate is fuelled also by the simple fact that there is neither transparency nor disclosure of the operation of the private equity fund leverage buy-out.

In this report we have undertaken a set of case studies covering the majority of European countries. Combining this picture of LBO activities in the past five years with a well-known public report, we can describe the LBO-phenomenon. A typical LBO involves the following three steps:

1. The PE funds form a company (often a company limited by shares) which borrows the capital to acquire the shares in the target company. To this purpose the PE fund’s acquiring company is typically heavily leveraged.

2. The PE funds acquire the target company.

3. The target company is merged with the newly formed company owned by the PE-fund. In this way the creditors’ security rights give access to the assets of the target company.

In a number of cases where the merger is based on real economic concerns for the future of the company, we see constructive results. But, as shown in Part II, we often see a clear asset stripping of the company acquired with major detriment - not only to its debt level, but often also to its employees and investment capability for the future.

The LBO itself only uses its own money to a very small degree, often of ¼ the acquiring sum. The majority of the funding is borrowed through leverage. This is creating the so-called leverage effect: the difference between the return on equity and return on capital employed. Through leverage it is possible for a target company to deliver a return on equity exceeding the rate on return on all the capital invested in the business, i.e. its return on capital employed.

And at the top of that the company has to use its liquidity and earnings capability to pay interest and debts. The company will be forced to use most of its earnings for this purpose and is - in worst cases - no longer capable of investing in further development of the company. In a so-called “secondary sale” the last part of the company’s added-value is extracted with damaging effects on the workplace, investment capabilities, competition and the company’s employment and education of employees etc.

**Their returns - better than others?**

The “financial performance” has for years been a “strong selling point” of both HFs and PEs. Studies identify a number of biases that exist in the published indices of HF returns and show that with adjusted annual returns, the HFs returns seem to be well below those achieved by a simple portfolio of 50% bonds and 50% equities in the period of 1995-1999 and 2000-2002.

Like the HFs, the supporters of LBOs constantly claim a positive, general effect on financial returns. The gains from operating and selling on an individual company within 3-4 years have several sources.

There are few studies of this theme. US studies suggest that there are important differences of return within and between LBO funds. The overall average level of return seems to be far from exciting. Studies found that average buy-out returns in the period 1980-2001, after the big fees have been deducted, are approximately equal to those of the big stock market companies from S&P 500. Some funds produce high returns, equally many often perform worse. The overall performance of the funds will often depend on a small number of successful investments with losses on others.

**Tendency of crowding**

Where HFs are pursuing similar strategies, there is a similar risk that they will buy or sell their positions at the same time - thereby disturbing liquidity, i.e. the normal drive of supply and demand. Such behaviour could in turn leave HFs and their co-operators like banks and institutional investors highly vulnerable to adverse market dynamics. Even in cases of strategy differences, our calculations and analyses show that there is still a strong correlation among HF actions on the financial markets.

The ECB has highlighted this crowding problem recently in its 2006 financial stability report: “The fact that correlations are trending higher not only within some strategies, but also among strategies, raise concerns that a triggering event could lead to highly correlated exits across large parts of the hedge fund industry”.

**Short-term versus long-term**

Most of private equity engagement in companies, especially through leverage buy-out, plans for a time horizon of 3-4 years, often even shorter.

Rating agencies such as Standard & Poors have analysed the big LBOs with the following result:

o In 2004 the LBOs got 64% of their invested capital back just after 29 months.

o In 2005 PE LBOs got 27% of their invested capital back in just 20 months.

o In the first half of 2006 PE LBOs have got 86% of their investment back in just 24 months engagement in the target company.

**Lack of transparency and disclosure**

Almost all accessible reports on hedge funds and private equity published in the past two years underline the lack of transparency and disclosure. The G7 meeting for finance ministers in Essen, in February 2007, decided to ask the International Financial Forum to have a closer look at transparency problems in the HF industries. In the report we show that the vast majority of hedge funds and private equities are established in offshore centres for reasons of “light regulation and tax-minimising reasons”. In the global economy, market imperfections on financial markets can have far reaching consequences but effective monitoring against market abuse, asset assessment, accountability, early warning etc. is simply not possible without transparency.

**Societies’ response - current national and European regulations**

The report analyses national regulations and shows a quite substantial set of differences among member countries - but with limited effects on the actual operations of the alternative investment industry. At European level the existing legislation does not cover in any substance the activities of the alternative investment industry, but there is a basis for developing new European relevant and feasible responses.

HFs and the PE industry have shown very impressive growth over recent years and have developed into a very important alternative investment industry - for good in some cases – but unfortunately also for bad, in far too many cases, i.e. the risk of destabilising the financial markets, conflicts of interest with corporate business, and contradictions between the need for long-term investment in companies’ global competitiveness and the short-term thinking in the HF industry.

\*\*\*

**Part II: Six concerns about our European social market economy**

Our analysis in Part I has shown our reasons for concern about the financial aspects of the LBOs and hedge fund industries on some of the most important issues:

• The effects on the efficiency of capital markets. Lack of transparency, information asymmetry, insider trading - all contribute to inefficiency and imperfect markets.

• The effect on the productivity and long-term growth of the firms and industries in which HFs and LBOs invest. It increases financial risks, requires preoccupation with cash flow and reduces the capacity to invest and manage long-term efficiency, productivity and innovation.

• The effect on our public sector and the special public service obligations of industries like infrastructure sectors and public housing. It minimises or abandons the obligation and undermines the risks allocated by the authorities associated with the obligations through re-evaluation - this is the basis for additional cash withdrawals to the LBO funds.

• The lack of transparency. This is not a coincidental characteristic of HFs and LBOs. Unnecessary and costly, complex holding structures are created - and effectively make it impossible to lift the corporate veil to the detriment of all parties with an interest in the firm - regulators, tax authorities, trade unions and others.

• The incentives created for CEOs of the target company, such as special bonuses, stock options are all extremely high and threaten the efficient management of all potential target companies.

Our case studies confirm the risks and negative impacts on our Social Europe. Add to this our vision of a modern, coherent, European knowledge-economy in the globalised world, and you have the basis for our six concerns.

**Economic viability of private companies**

In many cases of LBOs, transparency is lacking and information is lost to the public, especially when a PE fund de-lists the target company from the stock exchange. LBOs’ strategy of total corporate control after an acquisition risks deterioration in corporate governance. And there is more to corporate governance, or good business management than narrowly looking after shareholders’ interest. A stakeholder-based approach cannot be evaluated purely in terms of performance or financial management, but must include the care for the company’s human resources, employee participation and the pursuit of environmental, social goals.

LBO investors generally have a short-term stake in a listed company, from 2 to 4 years or even less, which means that its capital is not permanently available to the company, creating competitive problems when the long-term investment has to be financed.

Today, it is not unusual that a leverage buy-out is financed by 20% capital share from the PE fund and 80% debt capital. The major effect is that the target enterprise is burdened with a high level of debt as a result of leverage buy-out financing and dividend recaps by private equity funds. Its own capital is transformed into debt through the removal of undisclosed reserves and the sale of assets which the private equity funds deem to be unnecessarily tying up capital. These assets could otherwise serve as a buffer in the event of a market slump or be used for investment in the sustainable development of the enterprise and innovation or human resource management and training. Should interest rates rise there would be a risk that the debt could no longer be serviced, bringing the target enterprise to the edge of bankruptcy.

**Decent work and workers participation**

It is often alleged in the business news that PE funds have triggered considerable corporate growth and created many new jobs. However, this report’s experts are not aware of any serious academic findings that support this position. The academic studies carried out are based on scientifically assailable methods. Similarly, they do not in all cases separate organic growth from cases of mergers or changes in the macro-economic environment in different periods of time.

The case studies in this report show some negative effects on jobs. The example of the German company Grohe, is one. Even in a relatively good market situation and a stable company - for example, KKR’s involvement in NCU Arrow Engines in Germany - PE funds immediately look for job cuts. The focus of the new LBO managers is commonly on the core business, resulting in the sale of all other saleable group asset.

In most of the case studies, PE investors have very quickly pursued the aim of reducing wage costs. The more critical the position of the target enterprise because of high levels of debt, the stronger are the attempts to cut wages. In the vast majority of existing examples, new owners have withdrawn from social dialogue and in some cases failed to honour existing collective agreements. Europe already faces growing skills and training shortages. The European Commission has already highlighted certain areas where shortages of skills are of the most concern, notably ICT. However, short-term approaches from equity funds threaten workers’ commitment to their companies and their willingness to upgrade their company-specific skills.

Employee co-determination is a form of rights in which employees have role in the management of the company. In some EU member states employees have virtually no role at all of that kind. In other member states, like Germany, co-determination plays an important role. In the cases of PE investments studied in Germany, the work councils interviewed consistently pointed out that the atmosphere between them and the management had become frostier owing to the ‘financial’ investors moving in. It appears that a great many LBOs do not see themselves as long-term-oriented strategic investors. As such, they have little interest in the relationship with stakeholders such as employee representatives. We believe that their approach conflicts with the idea that the possession of companies involves both rights and duties - including duties towards employees.

**Public sector and universal provision of services**

Recently the LBO funds have entered some traditional, public utility industries providing basic infrastructure services for the economy, in particularly airports and telecommunication. There is much to suggest that infrastructure operators in Europe will be high priority targets for HFs and PEs over the next few years. Private equity funds have increased their investments tenfold in state-owned companies in recent years. From a PE point of view, infrastructure operation takeovers are attractive due to the relatively small risks and the potential for enormous financial gains. Most infrastructure managers, according to our case studies, seem likely to be receptive to bids given their custodial management style, the diversity and relative passivity of the public stock ownership, and the possibilities of large personal gains for the management.

The effects of LBOs on infrastructure operators are magnified because of their unique characteristics. The most significant impact is on their capability to efficiently finance long-term investment programmes. This is where we see the short-term priorities of the PEs in conflict with the long-term priorities of infrastructure operators. After the acquisition, the new owners have a powerful incentive to pay themselves the major portion of the large, internally generated cash-flow that would have been used for re-investment. The company is forced to acquire the large debt borrowed by the LBO fund. The net result is that the company is no longer well positioned for making efficient long-term investment.

The entry of PE funds into the infrastructure industry raises serious questions over investment in these incumbent operators, holding strategic positions with significant monopoly power and public service responsibilities. The telecom industry is the key example.

**Pension fund investments and long-term real value**

The risk for pension fund investors in HFs and PEs has been analysed in the report. Existing measures only provide limited protection. They do not sufficiently address the numerous key risks such as: legal and governance issues, prudential supervision, conflicts of interest within the HF and PE systems, valuation risks, disclosure, promotion and marketing issues, intermediary competence and risk classification.

Pension funds aim to generate a long-term flow of income from their accumulated capital in order to meet their commitments - paying out pensions - also in the long-term. This suggests that investment in the short-term and highly risky forms of investment should at the most be a marginal activity for such funds. However, we see examples in which the systemic pressure on fund managers is pushing them to “go with the flow” and not to let the return fall significantly below the current best performers in the industry. But as pension fund money flows into alternative investments, which are by definition niche markets, it is increasingly unlikely that, as a whole, they will continue to be able to extract “alpha returns” over and above the normal market rate of returns.

Lastly, we are risking a division between the interest of the retired workers whose pension funds are pushed to adopt high-risk strategies in hedge funds and private equity - and younger employed workers, who are facing cuts in pay and conditions as a result of the very same activity. And this is likely to exacerbate the already serious problems of achieving inter-generational equity in designing and reforming the public pension systems.

**Stability of financial markets**

A key concern regarding HFs and financial market stability is over increasing similarities or correlation among hedge fund strategies. Observers have also stressed that the liquidity of many HF investments may be decreasing.

Since June 2006 the European Central Bank (ECB) has pointed to the stability problem in its reports on hedge funds. In a clear hint of rising concern it says the situation “Warrants close monitoring”. In addition, the ECB stressed “The essential lack of any possible remedy” to deal with the threats.

**Coherence, co-responsibility and ethics**

We need to remember that not only are the fees paid to LBO managers extremely high, but also that their gains will be taken out not as income, but as capital gains, which has huge tax advantages when the rate of income tax is high, in the UK, for instance, 40%. The Financial Times reports rumours that leading British LBO partners pay taxes of scarcely more than 4-5% on multi million incomes. As we can see, these leverage and business models are providing the framework for the extreme enrichment of a small elite.

This in itself threatens the feeling of coherence and responsibility among stakeholders and social partners in our societies. How can we seriously ask employees and wage earners to show responsibility for society during trade union negotiations given these extremely high fees? There is an enormous potential for all people in Europe in bringing our New Social Europe and the global economy together in a new dynamic interplay. But there is also a need for change to ensure a sustainable New Social Europe in relation to the financial markets.

\*\*\*

**Part III: Lessons to be drawn for future regulation**

In our reflections on possible regulation we are focusing on potential legal instruments responding to the impact of private equity funds and hedge funds: The consequences of their strategies range from declining tax revenues, lack of transparency, and reducing the capacity of target companies to invest, to job cuts and worsened work conditions. At the centre of our thoughts is how to promote sustainable financing of the long-term investment needed to realise our vision, the European knowledge-economy and New Social Europe.

It is clear that the market cannot do it alone through automatic adaptations on the financial markets. Unless the member countries and the EU intervene, these market imperfections will stay and probably grow. But if we in Europe can regulate the financial markets to be subordinate to the real economy without negative implications, there are enormous, real economic opportunities ahead of us for the future of the whole of Europe’s population. That is why we need a new strategy for the financial markets in member states and at the European level.

The aim of our proposals for regulation is not only “to protect”, it is first and foremost to create the conditions for realising the enormous potential for smart green growth and new, better jobs.

Legal instruments, incentives and proposals for regulations are presented in connection with specific policy areas such as: taxation, corporate governance, social responsibility, supervision etc. There is no single set of regulations to answer all the new challenges - it is rather a coherent mix of national, European and possibly global instruments.

Some HFs and PEs would argue that regulation will “force them” to seek out to regions outside Europe. We think there are three answers to this:

1. Europe’s single market is the world’s biggest economy and enormously attractive for foreign investors.

2. “Creativity” and “financial engineering” to avoid the effects of regulators will always be an ongoing phenomenon - as regulation is also a permanent process.

3. We are aiming at appropriate and carefully targeted regulations, not disproportionate general prohibition or over-detailed regulations.

Better investor protection, better tax revenue, proper corporate governance, long-term financing of long-term investments and prospects of decent jobs will be our road map for reforming the real economy as well as regulating the financial markets.

Our thinking for development of our instruments is based on the following:

• Ensuring transparency and disclosure through regulations and incentives at the European and national levels.

• Protecting and ensuring dynamic long-term competitive decisions in companies through some protective regulations in company legislation.

• Protecting and promoting the real value and sustainability of wage earners’ pension savings in pension funds through adequate, protective regulation of pension funds.

• Ensuring financial stability through adequate incentives, monitoring and regulations at the level of financial markets, nationally and within the European Union.

**Transparency in practise**

Some are thinking of indirect regulations - as a further development of already existing frameworks. But this seems more and more insufficient because investment banks - including prime brokers - are strongly dependent on PEs and HFs for their business volumes and profits. They are increasingly active themselves in proprietary HF and LBO business.

In realising transparency and supervision, it is natural to focus on the interests of our societies in Europe, our view is, in principle, to fully harmonise the framework for European HFs in order to create a unitary category of onshore funds with a common minimum investment threshold. It would obviously not prevent some investors from keeping their activities secret in offshore funds, but it would offer an alternative choice for the rest of investors, through a higher level of safety, a guaranteed level of professionalism of fund managers, and oversight by regulators. Such EU-regulated projects will be offered as complementary to off-shore funds.

The transparency and disclosure regulation relating to alternative investments needs to be improved to enhance accountability and ensure a high degree of consumer protection. To this end the EU should draw up minimum reporting standards.

To detect liquidity risk, the aggregate deposits for all HFs in key markets should be made known to bank supervisors. Those data, indicatively not to be publicly disclosed, should be shared by prime brokers and bank supervisors. We are fully aware of the difficulty of introducing common supervision of such projects undertaken by a unique supervisory body, for instance the ECB. But we still consider this possibility as the only effective way to achieve such an aim.

As far as investor protection is concerned, especially pension funds’ interest, the focus should be on the information side. Pension fund managers should be able to assess and compare financial returns and risks of the different types of management. Transparency requires more frequent disclosure of returns and risk characteristics, and a resulting public database should be available to all investors. Besides the information disclosed to the supervisors, disclosure to the general public is of common interest.

• New standards relating to the sale and promotion of alternative investment projects needs to be developed to protect consumers from mis-selling and mis-representation of risks. Funds that are eligible for marketing to retail investors should conform to a number of safeguards.

• A number of concerns have been raised about the valuation of assets within alternative investment funds including HFs. The European Commission should establish robust minimum standards.

As far as private equity is concerned, the following initiatives should be considered:

• The regulatory step to be considered is to increase the transparency of the key funds by requiring reporting at regular intervals to an appropriate regulatory authority on (i) the investment strategy of the company, (ii) details of the assets held by the company, (iii) disclosure of the risk management model used, and (iv) the management’s incentive structure.

• Direct supervision of LBO through the appropriate agencies should take place via guidelines and direct controls. It appears worth considering whether new tasks within the framework of supervision and regulation could be transferred to the ECB.

• At EU level one could at least argue for a directive defining minimum standards for disclosure.

**Systemic risks and financial stability**

To promote better management of systemic risks, the EU should introduce new requirements for national regulators to improve reporting procedures.

As far as financial stability is concerned, the link between credit and liquidity risks is the gist of the matter. Given the credit risks and to make indirect regulation via banks workable, monitoring the extensive use of derivatives is crucial. The global HF leverage is run by a very restricted number of prime brokers. So the first task of financial authorities should be to ask prime brokers for a periodic full disclosure of the exposure to the different categories of financial risks.

**Corporate governance**

As far as HFs are concerned the following should be considered to ensure best functioning of corporate governance:

• Rules relating to the fair and the equitable treatment of different classes of share holders are needed to ensure that funds cannot use pricing policies to attract potential investors or dissuade potential sellers. The EU should establish rules to ensure this.

• The EU should create a framework to allow the HF industry and PEs to be rated according to investment strategy and risk.

• The EU Commission should also reflect on the “conduct of business rules” enacted by the financial community. These rules should include strong sanctions modelled after the City Code on Takeovers and Mergers of the LSE.

• Reporting requirements should include not only assessment of risks and returns but also a corporate responsibility report to allow investors to understand the impact on other stake holders in the investment chain (employees).

As far as LBOs are concerned, we should try to create incentives for longer-term investments. It needs an overall effort to ensure the further development of the Rhenanian model of public companies. This model guarantees the engagement of all stake holders including employees and other investors. The following proposals should be considered:

• Besides creating incentives for long-term investments, long-term investors should be rewarded by permitting weighting of voting rights according to duration of share holding and by means of differentiated taxation of income from shareholders.

• In order to prevent value extraction, limitations on the withdrawal of liquid assets from the target company should be introduced.

• One could also imagine restricting owners’ freedom to set managers’ remuneration packages (stock-options) autonomously.

• The desired character of investments could also be channelled in the right direction by capital-maintenance provisions which proscribe a limitation of the transfer of debts to companies that are the object of LBOs, through the restriction of credit financing.

• In order to ensure a better protection of pension funds investing in LBOs, we can consider relevant regulation at European level.

**Ensuring more and better jobs**

Another way to ensure the long-term increase of company value might be to take the approach used in the OECD Corporate Governance Code to define proper behaviour for companies. Perhaps a code could be developed for the conduct of alternative investment funds using the OECD code as a model. In order to strengthen the accountability of LBO-acquired companies some accounting rules should be respected by LBOs after acquisition: minimum capital standards, maximum levels of debt, fair advisory fees, adequate funding of pension schemes etc.

Clearly, the governance authorities for the infrastructure industries need to have their regulatory powers strengthened to govern effectively. The primary concern must be to provide transparency with respect to all transactions affecting the implementation of existing public service responsibilities, including investment and expenditure activity.

For all its major financing activities, the infrastructure operator could be required to obtain advance approval from the regulator that they are in the public interest. The regulator would need broad competences to require the operator to supply all information necessary to make the public judgement. The strengthened regulators’ powers suggested here are not without precedent. In the past, most regulatory agencies in the US and Canada had similar strong, financial, regulatory powers over public utilities, precisely because they were businesses which affected the public interest. Some of these regulators retain financial regulatory powers today. A leverage buy-out of an incumbent public utility operator could not take place in the US without advance approval.

**Tax policy**

We must distinguish between taxation of funds and taxation of fund managers. The funds themselves are - as the broad majority - located outside the European Union, first and foremost for the reason of tax minimisation and light regulatory regimes. The consequences of tax losses for the region of Europe cannot be calculated exactly, due to a lack of information, but we are talking about a huge amount of money. This loss of income cannot be saved by ensuring the managers pay the correct amount of tax for their onshore activities.

We know that most “end-investors” are located offshore. Ideally, a uniform, progressive capital gains tax rate should be applied in all member states. The progressive rate should be high for short-term arbitrage deals, to discourage the short-term buying and selling of firms on the market for corporate control. Taxes should be paid in the country where the object of the transaction is located.

The fact that investors in private equity funds are most often untaxed is exploited by the funds, partly by utilising the low rate of corporation tax and partly by allocating large dividends from target companies, since the latter are not in reality subject to taxation.

Leverage buy-outs mean that both the acquired company and the associated holding companies have contracted a considerable amount of interest-bearing debt. Since it is possible in most countries to establish joint taxation or tax consolidation, the acquired company is allowed to deduct the interest expenditure inquired. Result: The tax base is eroded. Therefore, common rules should be considered in EU countries to counter-act such tax erosions:

• Rules should be introduced limiting deductions for expenditure on interest in the target company, its holding companies and its subsidiary companies once the target company has been taking over through a leverage buy-out.

• The limitation could take the form of no deductions being allowed for interest expenditure by the local holding companies that have been established to carry out the takeover.

• The limitation could also take the form of removal of the deduction for interest expenditure by the target company, in respect of interest on the debt incurred in order to pay an extraordinary dividend after the company has been taken over by a LBO.

• There should be various protection rules to prevent the crass over-exploitation of tax saving opportunities.

In the area of taxation of hedge funds, there are mainly two proposals:

• To introduce a fiscal discrimination, including FOHFs and all tax-exempt organisations, against offshore projects.

• To address the risks associated with offshore jurisdiction, consideration should be given to changing the tax rules, so that the location of the manager determines the tax position of hedge funds.

**Our point of departure**

Societies must, of course, involve themselves in how to avoid negative consequences on the financial markets of heavy leverage activities from HFs and LBOs. Our studies give rise to a substantial number of worrying questions. There is a central argument for reducing risks associated with the increasing role of HFs and PEs in the financial system. Given the good case for regulating banks, investment banks and other financial actors - why should hedge funds and private equity be any exception? Given the readiness for reforms of our labour markets, the European countries as well as our target markets - why should the new development of the financial markets be exempted from this trend? And finally, the social partners, representatives for employees, and their unions with a long-term stake in the companies who have been used to dealing with company-minded managers now have great difficulties in getting into contact or dealing with the coalitions of investors, because the only reference point of these investors is a global financial market with an entirely new set of rules. Every investment is viewed as a portfolio of financial assets - not a place of employment.

The shorter time horizon and changed behaviours of these financial actors is a new trend in Europe and it is creating worries among many stakeholders in our society. Not only as far as the actual functioning of the real economy of Europe is concerned, but especially worrying because it seems to be an increasingly problematic factor on our way to each of our common goals for our European knowledge society.

The problem is that the powerful actors of HF and PE funds do not see themselves as “the servants” or stakeholders in good functioning, financial markets for the real economy. From many examples we can see that they seem to gain the advantages of wealth created by the real economy without contributing either to its functioning or its future. There are, of course, important exceptions to this general trend, especially when looking at the venture capital funds. But overall this development does not seem to be a part of the solution of financing our huge long-term investment needs.

The demand for change and better regulation seems only to grow.