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Treasury Committee

Private Equity

Oral and written evidence

Tuesday 11 December 2007

Witness:

Sir David Walker

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Oral evidence

Taken before the Treasury Committee

on Tuesday 11 December 2007

Members present

John McFall

Nick Ainger
Mr Graham Brady
Mr Colin Breed
Jim Cousins
Mr Philip Dunne
Mr Michael Fallon
Mr Andrew Love
Mr George Mudie
Mr Siôn Simon
John Thurso
Mr Mark Todd

Witness: **Sir David Walker**, Chairman of the Walker Review, gave evidence.

Q1 Chairman: Sir David, good morning and welcome to our inquiry into private equity. Can I ask you to remind us why you undertook this role and what you hope to achieve for the private equity industry as a result of your chairmanship of this group?
Sir David Walker: Thank you, Chairman. I was asked to take on this review at the end of February by the private equity industry, though I would want to say that, although I confirmed that I would indeed undertake the review, it was not for the private equity industry; I made clear from the beginning my interest was in trying to create a structure, if that were possible, that was in the United Kingdom public interest. As I have said to you and to this Committee before, I have approached it as an independent. My object was to see whether this imbalance between the very substantial rights of ownership that were being acquired by private equity, the rate of accumulation of which had accelerated in the 18 months, two years before the spring of this year, might not be better matched with a sense of obligation on the part of the industry to be more transparent and more open about their activities. I am very happy to take this further in detail, Chairman, but perhaps I can say now that in the process the strongest sense that has emerged in my mind is of the inadequacy of our understanding, including, I have to say, my own, but I think that goes for us all, of the economic impact of private equity.

Q2 Chairman: So, your objective was to make private equity more transparent?
Sir David Walker: Yes.

Q3 Chairman: How would you respond to the allegations, quite a lot of allegations, in the newspapers that you have watered down your final guidelines? For example, attribution analysis, now an industry-wide issue, giving private equity companies longer to publish accounts—from four to six months—giving them the option of an annual report or updating their website and, in terms of the private equity firms which come into this scheme, increasing the £300 million figure for private equity companies, £500 million for unlisted companies, having a figure of 1,000 staff, at least, employed and having at least half their revenues in the United Kingdom. Those are quite a number of changes from your interim document and both *The Financial Times* and *The Daily Telegraph*, I think, feel that you have been got at. *The Daily Telegraph*, for example, when they talk about the arbitrary cut-off, says it shows that the real point of all this is public relations and keeping the unions at bay. That is *The Telegraph* talking. What is your response to that?
Sir David Walker: I would focus on the substance, Chairman, and say most of it is insubstantial. I will begin by saying that there is nothing in the green document, the final report, published just three, four weeks ago, in the light of the comment that has been made, that I would want to change in any direction, but the allegations are just false largely. There are one or two areas, and I will identify those up front, where we did dilute what was proposed. The most significant in my mind was extending the period of reporting by portfolio companies, their annual reports and accounts, from four months, which is a quoted company regime, to six months and for their mid-term reviews from two months to three months, and I had in mind there that, although some of the companies that go into private equity come from the public markets, were quoted and would have little difficulty in moving to four months from the nine months that is allowed for private companies, for companies that were previously private companies the reporting burden and pressure on the accounting and finance function in a firm when they are going through, very frequently, a radical process of change at the beginning of the private equity process was unreasonable, so I thought that it was sensible to allow them a bit more time. That is, in my view, the only material, let us call it, dilution.

Q4 Chairman: But attribution analysis, for example, you suggested of individual firms so that we could decide whether the moneys were coming from financial engineering, multiple expansion or

operational improvements, and now it is on an industry-wide basis. That seems a big opportunity loss there, Sir David.
Sir David Walker: Absolutely not. I comprehensively disagree. What you are asking for, it became increasingly clear—

Q5 Chairman: But you made it very clear in your original document that you wanted attribution analysis for each company.
Sir David Walker: Yes.

Q6 Chairman: And you have changed your mind.
Sir David Walker: But I had a four-month consultation process. I am surprised that you should appear to be suggesting that I was not attentive to the consultation process. We consulted 70 people. There were 70 points of contact.

Q7 Chairman: I am not suggesting that at all, Sir David. What I am suggesting is that somebody like yourself, who is so well versed in the private equity industry, and you have spent a lifetime in banking, came out with such very firm comments in your original report and then went backwards at one hundred miles per hour. That is my suggestion.
Sir David Walker: Chairman, I did not go backwards. If I would be allowed to respond to your question, I am absolutely clear that the importance of attribution analysis is as great, no, greater than I described in the July document; so I am completely with that proposition. If I were pressed by this Committee or elsewhere, what is the most important element in the whole report, high quality attribution analysis would be very high on my list. Why did I move away from the requirement that this be done by individual firms? It was to avoid, Chairman, perverse incentives. I did not realise in July the power of the perverse incentive that would be put in place, and that I will not put my name to. What I have in mind is if we required individual firms now to produce their own attribution analysis, the invitation to them to put the most favourable possible spin on their performance would be irresistible. What they would seek to do, I have to say, and I refer to my experience in financial services—I know what would happen—they would seek to display very little significance from financial engineering, very little significance from the rise in market multiples and a superior performance as a result of their announcement of operational improvement. So, the conclusion to which I came, which is a step on the way, which I think is true for quite a lot that is in my report, is what we need to do first is to establish a clear template to take as much of the subjectivity out of the attribution analysis as is possible. In the three or four months we made very great process with all the firms in discussion of a methodology for attribution analysis. My pretty confident expectation is that about a year from now there will be a template which they can all be held to, and that will be the point to review the question: should they be asked or required to produce these analyses individually? But at the moment I am extremely concerned that if we were to require what I had in mind in July, we would just give a perverse incentive and what would be produced would be non-comparable and, I think, frankly, misleading. They would all want to show how well they had done.

Q8 Chairman: Do you believe your proposed guidelines go far enough to quell public disquiet over the activities of private equity firms, especially given that these guidelines include nothing on remuneration and are silent on the taxation of private equity?
Sir David Walker: As you know, Chairman, I was not asked to look at taxation, so I have no comment to make about that. Plainly the taxation area is important.

Q9 Chairman: Sir David, surely you had a free hand, as chairman, to decide what you wanted to do.
Sir David Walker: I was given terms of reference that did not extend to tax, Chairman.

Q10 Chairman: Did you make any comments to them about that?
Sir David Walker: No, I did not.

Q11 Chairman: It was lopsided then?
Sir David Walker: It is lopsided, absolutely, yes, but if I had spent as much time on the tax questions as I have spent on transparency, openness and disclosure, I presume to give a view to the Committee, but I have not spent that time on the tax questions. On the question of remuneration, I spent a lot of time and have given it a lot of thought and those who seek disclosure of remuneration of executives in private equity firms will continue to be disappointed. Let me give briefly the reasons.
Chairman: We will come on to that later on in some of the questions. Colin.

Q12 Mr Breed: Thank you, Chairman. Do you accept that some people feel that you have produced a code which is the minimum you can get away with on a voluntary basis but that some of us feel in fact it only leads to potentially more support for a legislative process? Therefore, if the voluntary code had been somewhat more robust, there would not be the calls for legislation; whereas what we have got now is perhaps not a particularly satisfactory situation which may bring calls for heavy-handed legislation.
Sir David Walker: Let me make two observations. First, my own view is that these are a substantial set of guidelines and rules. How can I say that? What is the benchmark by which you and I could seek to judge it? The answer is that this is unique in the world. No country in the world has even attempted a framework of the kind that is now in place in the UK on a voluntary, still less on a legislative, basis. So, I think we need to either approach this with a degree of diffidence, in the sense that I knew we were trying to do something that was unique but confidence that it was capable of evolving into something more substantial if that became necessary over time. The model I have had in mind, which

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started and for most of its life was on a voluntary basis, was the Takeover Code, and if I have an aspiration it is that what we put in place here could evolve and come to be seen externally as like the Takeover Code, which is the envy of the rest of the world. Let us see whether this proves to be that. As to legislation, I think there are powerful reasons why that will never be the right approach to this space, not never but not in the short-term. The first reason is what I call the asymmetry argument, which is that it is much easier to move from voluntary guidelines to a legislative solution than it is to move from a legislative solution to a self-regulatory model which has many characteristics that are very positive. The second is flexibility in a self-regulatory, voluntary guidelines model. This is capable of being modified—individual guidelines, the timelines the Chairman raised with me a moment ago—a year or two from now if, in the light of accumulating experience, that is thought to be necessary by the Guidelines Review and Monitoring Group that is now being set up. That flexibility, I think, is very important.

Q13 Mr Breed: The fear is that the flexibility will be used to the advantage of the private equity firms and not to the people who are seeking the transparency; that, in fact, if you allow too much flexibility we are going to get even less than we thought we might do by interpretation and flexibility of rules.

Sir David Walker: The knowledge of this flexibility carries a big obligation on the participants, and I absolutely take that, and it will be very important for the Guidelines Review Group to build a database of experience. My expectation is that that will be a tough process, but I would like to come to what I think is the most important reason for being, let us say, very cautious and thoughtful about going down the legislative path. I call it anti-avoidance. My belief is that if you have a voluntary guideline self-regulatory model that is felt to be owned by the industry, there will be a spirit of commitment to it, and this is what has happened with other self-regulatory regimes; and I am very encouraged by the evidence already today, 11 December, that private equity firms have committed to conform to the guidelines and some have already improved their websites, as you are aware, those proposing annual reviews. However, if you look at legislation, given the obligations, particularly of global corporates under their byelaws and, indeed, the common law, they have a fiduciary responsibility to maximise returns for their shareholders, and if there is put in place legislation which is one-country-centric, the fiduciary responsibility of the board of directors, or partners in a general partner, to maximise value for their owners leads them into looking at avoidance; and anti-avoidance, if you think about it, in some areas, the Chairman has just mentioned one of them, tax, is one of the main preoccupations of the Treasury. I saw recently, in a related but separate context, a formidable HMRC consultative document about corporation tax and tax deductibility of interest. Most of it is about anti-avoidance. I think it would be very unfortunate if we got into that situation fast here when I think it is worth striving, Mr Breed, to have the spirit of commitment to my guidelines.

Q14 Mr Breed: Can I finally say that perhaps the alacrity with which many of the private equity companies have agreed your proposals gives us some concern. We would have perhaps liked a bit more screening.

Sir David Walker: I can imagine that you would have complained that they were dragging their feet if they had not; so it is a heads you win, tails I lose, situation, if I may say so.

Q15 John Thurso: Can I turn to the question of communication. Your final code gives private equity firms the option, the private equity firms of portfolio companies, of either an annual report or regular updates on the website; whereas, I think, your original proposals went for a full annual report. What led you to change your mind in respect of that?

Sir David Walker: It is, frankly, of less profound significance than perhaps you are suggesting. I did not think this was a very big deal. I thought it was a more technological model, if you like, giving them the opportunity to keep their websites continually refreshed. My understanding is that most of them will not only keep their websites refreshed but will produce annual reports, but I thought some flexibility there made sense; so that if you want to look at the website (and they are meant to be very much more user-friendly than they have been in the past), at any moment in time you get an up-to-date statement, for example, of what the companies were in the portfolio.

Q16 John Thurso: I put it to you, the reason why an annual report is useful, particularly if one is looking at a company, is you have got everything you want there, and if you read it diligently and go through all the notes and you know what you are doing, you can find out everything you are legally entitled to; whereas if once a week or once a month somebody whacks something new onto a website, you have a far harder degree of detective work to actually knit all the bits together to get the picture; so I was slightly surprised, if you were quite happy to keep the website, why one should not have an annual report as part of that. It did not seem a very big deal.

Sir David Walker: I well understand the point. My expectation, not necessarily for all of them, is that they will actually do both, and some have already indicated their intention to do both, but in deference to your view, I would say that this is precisely the sort of area where I think the Guidelines Review Group might look at in a year's time and say, "Hey, would it not be better for the two or three who have not managed to get in your report to do so as well as keeping the website refreshed?" So, I will take that point.

Q17 John Thurso: Can I turn to the question of remuneration and the fact that there are no proposals to disclose pay-off fees in your final set of recommendations and ask why you decided to go down that route?
Sir David Walker: Are you talking about the remuneration of individual executives or the charges levied in the form of management fees and carry?

Q18 John Thurso: I would like to ask you about both actually.
Sir David Walker: As I last mentioned management fees and carry, if I start with those, they represent, effectively, the price that is being charged for a product or service, and if one thinks of other areas where price discovery has been a huge subject of discussion and is relevant, for example, in the MiFID legislation which is now on the statute book, price discovery is relevant for users. Those are the people who need good quotes from the Stock Exchange, for example, and the users in this case are the limited partners, of whom there are, compared with investors in the public Stock Market, very few, and they can all very readily find out what carry arrangements are and what the management fees are because they are not buying something off the shelf, they are actually going to have a contractual negotiation which leads to a partnership agreement which lasts for a long period of time. In my discussions, which have been very extensive, with limited partners—we have talked to them individually and we have had a web cast because many of them are outside the UK—I have asked them, is there greater transparency than is currently available that they need, and, pretty universally, not totally universally, the answer is, "We are well satisfied with what we have." So there is no demand from the users of the product or service for greater transparency.

Q19 John Thurso: How can you say, therefore, that there is no interest for other stakeholders in having, not necessarily a detailed knowledge of precisely who got how much carried interest, but, for example, at the end of the life of a fund to know, broadly, how it performed so that employees or others who are affected can have some idea of what has happened?
Sir David Walker: In relation to employees, of course, the portfolio company's report and accounts will give full detail, but if, as I rather expect and hope (to go back to a question posed earlier by, I think, the Chairman), the attribution analysis is published by individual firms, that is simply a question of developing a template, and that will take a year or perhaps a bit more. That information will start to be available as to the performance of the fund. As to management fees and carry, there is not much departure from what we all know, as I have set them out in the report, and although there is a little bit of diversity (some firms charge a bit more, some firms charge a bit less, it depends on the position in the cycle), the structure is not very different in the UK, in Continental Europe and in the United States, and, frankly, one of the reasons that caused me not to specify this report in the annual review of the private equity firms is, it is a bit like looking at the level of the sea, it does not move up and down very much, it stays the same, and I have said to private equity firms, if there are radical changes in your management fee or charging arrangements, you or the BVCA should be attentive and drawing attention to it.

Q20 John Thurso: I put it to you that actually, in a way, that is a very internal view of the private equity industry, because there are a lot of people who are stakeholders via the portfolio companies but, ultimately, who owns them is of considerable importance, and whilst I would happily concur that nobody is looking to see every individual executive's itemised reward package on public display, there is a strong case for showing aggregates for a fund and a process, and so forth, as much to simply prick the bubble of suspicion as anything else. Would you not feel that there really is something the private equity industry should be doing in that regard?
Sir David Walker: If you are talking about the management fees and the carry arrangements, they do not change much, have not changed much and I would predict are not likely to change much from what is generally known. If the question becomes the other very important matter to which you referred, which is the remuneration of executives in private equity firms, in which there has be a lot of public comment that it is a lacuna, it is unsatisfactory that I have not required that, my answer is that, first, the analogy is false. The analogy that is frequently drawn is with directors of quoted companies. That is a mistaken analogy. Private equity executives and the general partners of the private equity firms are like institutional investors in quoted companies. Institutional investors in quoted companies do not reveal their compensation. If I look at Legal and General, of which I am Vice Chairman, the Chief Investment Officer's compensation is not revealed unless he were to be on the board of a quoted company. The remuneration of the hugely significant Chief Investment Officer of Fidelity, one of the biggest institutional investors in the world, is not revealed publicly.

Q21 John Thurso: Is there not a fundamental difference, in that the public market is the protection in that case? Most institutions, while taking an active interest in the portfolio companies they own via the public market, do not actually take an active role in the management—I know one could argue that—whereas as the main distinction with private equity is that the whole point is that they do take an active role, a very close role, and there is therefore quite a different relationship? The point I am really driving at, and I will bring it to a close shortly, is simply that, because the suspicion exists in private equity which does not exist on the public market, this is the occasion to address it and a little now might go a long way, as opposed to having it dragged out of people at a later stage?

Sir David Walker: I think the difficulty is it will be very difficult to drag out. Two observations: in the case of executives in quoted companies, there has to be accountability to the owners, and the only way of doing that, given, as you know very well, the huge number of owners in a typical FTSE 100 company, is by releasing it publicly. I am Chairman of the remuneration committee of a FTSE 100 company and I am very clear; my accountability in that role (and I have to produce a very substantial report to be incorporated in the report and accounts very year) is to our, I think it is, 165,000 shareholders in Legal and General. That is achieved by the management of these stakes in private equity to limited partners and can be done on a private basis. That accountability can be discharged in private. If you say (and I understand the question) there is a wider stakeholder interest in this, I have to say that if the United Kingdom in this very cross-border business were to be the only country in which private equity operates in which we sought to require the private equity, the carry that is enjoyed by individuals, to be released publicly, it would be a very straightforward matter for the relevant contracts to be drawn up outside the jurisdiction and we would not achieve the accountability that you seek. Since I believe there is a reasonable case for protecting that confidence, I have not sought to risk that sort of avoidance activity.

Q22 Mr Dunne: Could I pick that up, Sir David. When you say it is a straightforward matter for contracts to be written outside this country, do you envisage a more widespread shift of the business and the employees and, therefore, jobs out of this country into other neighbouring jurisdictions? Is that what you are implying?
Sir David Walker: No, I have to say, Mr Dunne, I do not like this argument, because if we think something is sensible in the UK, we ought to strive mightily to get people to conform to it. There are private equity firms, there are global private equity firms, who I think it would be fair to say dislike me intensely and would rather this process had never been embarked upon. I think there is acceptance that something like what I have been putting in place has to be done, and I am confident that they will all commit to it, but there had to be a judgment about parts of the structure, where some of you and the media would have liked more information, where I had to exercise a judgment of the kind that I have exercised. I think that the matter that concerns me most is the inadequacy of our understanding of the way private equity operates, and it is relevant to the previous question. I think it is unfortunate and, in a way, typical of the environment that we have in the UK, that most of the discussion has been about the distribution of the financial rewards of private equity and there has been virtually no discussion about the thing that really matters, which is the economic impact of private equity on our society and economy. If it is the case that private equity, as is suggested by very high quality survey work done by McKinsey, by Ernst and Young and, most recently, by the Harvard Business School, pretty systematically produces better economic performance, in particular in terms of jobs, productivity, enhancement of enterprise value, and so on, than quote companies, it is hugely in our interests that we devise a system which, if anything, encourages private equity to become larger in the UK and does not jeopardise its continuance here.

Q23 Mr Dunne: Looking at the cut-off point that you posed in your interim report and confirmed in the latter report, can I be quite clear. You can take FTSE companies, overseas companies now listing and becoming members of the FTSE index. If they do not employ a thousand people in Britain they would be excluded from this disclosure regime if they were taken in private by a UK-based private equity firm. Is that correct?
Sir David Walker: I would say they would not be included, yes.

Q24 Mr Dunne: That would also go for British based companies that might have chosen to move the base of their operations overseas. You might take, for example, Standard Chartered Bank, I do not know whether they employ a thousand people here or not, I suspect they do not. If that was to be acquired by a private equity firm based in Britain, would that be subject to your regime, meeting the other test of being more than a £300 million business?
Sir David Walker: The answer is, yes. I would say two things here.

Q25 Mr Dunne: So this an either/or, is it? If you meet one of the tests of a thousand people or a £300 million transaction?
Sir David Walker: No, they are an "and" and "and". So if the market capitalisation plus the premium for acquisition by the private equity firm is £300 million (which, incidentally, is a tightening up from the July document—I did not pick this up in response to the Chairman earlier—I have tightened, I have lowered the threshold in that particular respect) and they have a thousand employees, they would be brought into the net, but it is not either/or; these things come together.

Q26 Mr Dunne: So in the case of my example, Standard Charter, should they have less than a thousand employees in the UK, they would not be included?
Sir David Walker: No, they would not, but I think they do have more than a thousand. Could I take the opportunity to say that the £300 million figure appeared in my July document alongside, I think I did say there, a £300 million or a FTSE 250 company. I have eliminated the FTSE 250 and I have lowered the 300, and the way in which it is done is this. The FTSE 250 is too high. The medium value market capitalisation of FTSE companies is £1.1 billion. It has come down a bit since July. That is far too high. I want to bring in companies that are much smaller than that and I have retained the 300 million, but if you read, it is not the small print because it is clearly there. The 300 million is the market capitalisation plus the acquisition premium, and in

private equity the acquisition premium is usually more than 20% and is sometimes as much as a third. So we are talking about companies from a public market that have a capitalisation of perhaps 225 million, which is below the bottom end of the FTSE 250.

Q27 Mr Dunne: Do you have a sense for how many companies would be caught within that net?
Sir David Walker: Yes. I am grateful that you asked me, Mr Dunne, for a sense, because we are not absolutely confident. A lot of work is being done on this now. The answer is 65 immediately. My expectation is that when the work is complete and a few private equity firms that are not members of the BVCA but are private equity firms authorised by the FSA have been brought into the net, probably we will have 80 firms on my criteria, but I would also emphasise here that this is precisely the sort of area where I think the Guidelines Review Committee will want to look in a year's time: has Walker put the thresholds in the right place? I think this is very much a matter for review. If, for example, there were companies that would have been the sixty-sixth or sixty-seventh that had 900 employees and it was thought, for whatever reason, that they ought to be in the net, let them be brought into the net.

Q28 Mr Dunne: Do you anticipate that privately owned businesses that are not held by private equity firms, they are held by private individuals, will volunteer to disclose information?
Sir David Walker: Realistically, no. The principle that I set out in the November document, which was not in the July document, having spent a lot of time in consultation on non-private equity, was a principle which, obviously, it is for this Committee and the Treasury and Parliament to gauge—if it is like private equity, in particular if it employs a lot of leverage, the presumption should be that we ought to find a way of bringing them into my framework—and the category I have particularly in mind (which was not really on the horizon, I have to say, in July, this has emerged very substantially in the autumn) is the sovereign wealth funds who do behave like private equity—there are some others also—and use prospectively a lot of leverage.

Q29 Mr Dunne: Do you see any relevance to private equity specifically of extending TUPE regulations to transactions where businesses change hands through a share sale rather than a sale of assets? Is that a relevant consideration or something which is subject to our inquiry?
Sir David Walker: I very much respect the concern that has been put to me by a number of the unions in the consultation process. I understand their concern, but I have to say, yes, I think it is relevant. But it is not uniquely a private equity problem; nor is it a matter for voluntary guidelines, Mr Dunne. As you know well, this is a matter of primary or secondary legislation but it is a matter for this House. I understand the concern, but I did not feel that it was something that I could address in my report. I would rather have a guideline which modifies TUPE though in one area, which I think is very important, I have been presumptuous and have removed derogation for private companies that was provided in primary legislation. We are going to talk about that, if it is of interest, later.

Q30 Jim Cousins: Sir David, I wonder if you could tell us what exactly you expect private equity companies to tell the wider stakeholder community, including their employees, about their goings on?
Sir David Walker: Mr Cousins, I have two answers to the question. I think it flows very well from the previous exchange, because in the guidelines I am requiring portfolio companies, which I think is the focus vis-à-vis employees—the AA, SAGA or Alliance Boots, to take topical examples—to conform to the provisions of the Business Review Provisions of section 417 of the 2006 Companies Act, and it is very significant that Parliament chose to exempt private companies, which of course these now are, the companies I have mentioned, from subsection five of section 417, and that is the disapplication or the removal of the derogation, the sections attached as an annex to the report; and the provisions there require the company, first, in its report and accounts, to give an account of what it has been doing by way of communication vis-à-vis employees in relation to the environment and its wider social responsibilities. That is a material obligation for which there is growing a body of precedent and experience in reporting by voted companies which I expect private companies, these portfolio companies, to have to conform to. It was, I thought, a very serious and deliberate decision to remove that derogation in the 2006 companies legislation. Secondly, in relation to employees, as I said in the report, I think the time of maximum anguish, nervousness, worry for employees, to which I am hugely sympathetic, is when something is happening like an acquisition, like a disposal, like a change of strategic direction, and I think it is (and I emphasise that in the report) at that point that portfolio companies should be particularly attentive to the interests of employees, and the moment the strategy, the acquisition (it might be a take-over) becomes public knowledge, they should give very full communication to their employees; but what I say here, I have to say, is only a modest part of the total picture. Remember that where there is a takeover of a public company, which has been the prime focus of concern in this Committee, I think, sparked by Sainsbury's, which might have been, and Alliance Boots that was, there is now, under primary legislation, the take-over legislation under the 2006 Takeover Directive, for a company to incorporate in its offer document for the target company very full information about the implications for employees in terms of jobs, in terms of conditions of service and pension schemes. So that is one major block. Another major block is the information and consultation regulations that again derive from primary legislation, which provide, from March of next year, the provision for communication and consultation with employees down to companies that employ only 50 employees. I say "only", not

dismissively, 50 employees are very important; I was very struck that in the TUC's submission in the consultation process Brendan Barber said that he was not satisfied that those regulations were being adequately enforced by government; so there is a point to which I have drawn attention there. Finally, alongside what I asked for, is, I think, the enlightened self-interest of private equity firms to communicate effectively. In the evidence that was given to you in July by one of the private equity firms, I think Ronald Easton from Carlisle said that every time there was an acquisition he went before the whole workforce and communicated with them, listened to them and took account of views they expressed. I have said to the private equity firms in the course of my work, if you do this, and it would just be folly not to be doing it, why do you not talk about it and be more open about it? I think they have got the message, is the best I could say.

Q31 Jim Cousins: I think, Sir David, it is important to recollect that when Parliament was guided by the Government in the 2006 company legislation to exclude private companies, Parliament did so on the basis that the private companies under issue then were small family firms. I think if Parliament were to revisit the matter, it might well decide that there was a new category of private companies, represented by private equity companies, that could not be treated in exactly the same way as small family firms. Do you not think that your own concerns to take out subjectivity—that was the phrase you used earlier in this meeting—point to the fact that there is a great deal of concern about what is in fact going on to generate value?
Sir David Walker: I think, yes, I absolutely take the point of the question. On the first, your observation that if Parliament were looking now at these issues it might have sought to not exclude at least some private companies, it is obviously for this Committee to judge what Parliament would do, but I would think they would be wise to take that view, which is why in what I have done I have adopted—

Q32 Jim Cousins: Wise to take which view?
Sir David Walker: To take the view that larger private companies should be subject to the same regime as quoted companies, which is what I have done. Section 417(5) applies only to quoted companies. I have now sought to apply 417(5) to these big portfolio companies in private equity, so I have gone now precisely the line I think you were advocating.

Q33 Jim Cousins: Do you not think, Sir David (another point that you made earlier) that if you introduce a regime in one jurisdiction that is considered in some way to be onerous, there is simply an evacuation into jurisdictions that are more favourable to base yourself for regulation, regulatory arbitrage between national jurisdictions? Do you not think that this simply could be a kind of competition in ineffective regulation that in the end is going to bring about a broad distrust of the way economic decisions are made?
Sir David Walker: I well understand the question. I do not like the external, "If you regulate us heavily, we will go and do it somewhere else", argument, and I think none of us like that argument. My view is that it is extremely unlikely that private equity, which finds the United Kingdom, for all sorts of reasons, an attractive place to do business, is going to migrate its business elsewhere. I think there are some particular points where there could be avoidance. I mentioned, for example, a requirement that the carry arrangements of individuals will, I think, be extremely difficult to enforce, or, let us put it the other way round, very easy to avoid. The regulatory arbitrage that I am concerned about (which I think is extremely serious, and I think it is an area for much more work and I would like to be able to contribute to it through the better analysis of how private equity impacts the economy) is the question which I would specify in these terms. If it is the case that private equity really does perform better than quoted companies—I am not confident about that yet, we need better evidence based analysis, and we have not seen that, but if that is the case—there is a major question: why is it that quoted companies allow private equity to get ahead, and are we satisfied, secondly, that the regulatory arrangements that we have in place are not stimulating an arbitrage into private equity and inhibiting the ability of quoted companies to perform as well? I have to say, my own suspicion is that the answer to the second question is that there is regulatory arbitrage from public companies to private companies and it is something that is very important to look at. It is being certainly addressed in the recent very interesting Harvard Business School article: "Why is it that in the United States private equity does better than quoted companies?"—a major subject for attention in an economy like ours where we are all very concerned to achieve real improvements in productivity, for example.

Q34 Jim Cousins: If there is that kind of regulatory arbitrage, and you seem to have put forward the proposition that there is, where does that leave us with regard to sovereign funds?
Sir David Walker: I think in relation to sovereign funds, if the principle were accepted (the principle I enunciated, Mr Cousins, that private equity, like activity, and I tried to define that, it is not a unique definition is activity where a sovereign fund or major investor employs leverage in the acquisition of a large business) the example that was on the TAPI between July and now was Sainsbury's, though that has now come to an end, I think it is important to try to get those sovereign royal funds to commit to observance of the guidelines of the kind that I have proposed. You said, where does it leave us? I think there is a lot of initiative to be taken vis-à-vis sovereign royal funds to tell them, "If you want to do business in the United Kingdom, you will be expected to conform to this sort of approach." There are wider questions, obviously—there are more being addressed in the United States than in Continental Europe—about do we want to be the capital protectionist? I think that has not been a

consideration that has been raised in this country, but I think, as a minimum, conformity to this sort of guidelines structure is something we ought to be insistent upon.

Q35 Chairman: Sir David, the Rake Committee has been established, or is proposed to be established with you with the Guidelines Review Monitoring Group. Should it not include other stakeholders, like investors and trade unions, who would provide a view and perhaps dispel any misconceptions around private equity? Would you agree with that?
Sir David Walker: Had I agreed with it, Chairman, I suppose I would have made—I think it is a very serious question and I gave it a great deal of thought. It is an area where I would want to be—I am confident about my report, but diffident about some elements. My diffidence is overcome by the possibility of modification in a year or two's time. The reason I came to the conclusion that I did, not without very great thought—. I did think about having major stakeholders on the group and the two I thought of were the union employees and owners. It is very strange; there are no owners in my monitoring group. The conclusion to which I came was that, if I added to the three independents and two industry professionals, outside stakeholders, the group would become very large and potentially unwieldy, and that was, bluntly, the reason for wanting to limit it to a small group, at least at the outset. My submission, Chairman, would be what I had in mind: let us see how this functions over the first year or two and, if it seems that it would be desirable to expand the group to include stakeholders, they would conspicuously be the two groups to be brought in, owners and employees.

Q36 Chairman: But you would not lose any sleep if Mr Mike Rake decided immediately to invite investors and trade unions?
Sir David Walker: No, not at all, and I may say (I do not think this breaches any confidence at all) in conversations I have had, I can say, with Brendan Barber, I have suggested to him that in thinking about independents, on which no conclusions, as I understand it have been reached, that is a matter for the BVCA and Sir Mike Rake, let us think of people who have great experience of employment legislation and perhaps come from a union background.

Q37 Mr Mudie: You said some big players in the industry disliked you. I find that hard to believe, Sir David.
Sir David Walker: You should have been at the dinner.
Mr Mudie: I was never invited!
Chairman: It is a pity.

Q38 Mr Mudie: Only the Chairman goes to dinner on this Committee! Knowing of this dislike and knowing of the fear that was in the industry a few months back, you clearly had to steer a path between persuading these firms to come in or actually putting something on the table that had real integrity and did the job. Who won? If you did the latter you clearly would not get the players to participate. It is a difficult one.
Sir David Walker: I am happy to try to answer that. It is not binary, Mr Mudie. If you take, whatever it is, 16 global private equity firms who are doing this sort of activity around the world, most prominently in the United States but increasingly in Asia, some of them in particular are very apprehensive that an initiative of this kind in the United Kingdom, which is very significant in the private equity business, will be the beginning of a slippery slope that will not lead to a structure of this kind where people will commit to the spirit of the thing and it will be done, hopefully, practically, pragmatically, sensibly, like the takeover panel model which everyone outside has long respected, but will induce others (Continental Europe perhaps) to go down the legislative route. It was not so much that they did not like me, it was the apprehension that this is the beginning of a slippery slope. I think, for the time being, I have won the argument but the Committee will be entitled to say the proof of the pudding is in the eating, absolutely, that this is not the beginning of a slippery slope, this is a practical regime that is being put in place in the UK and hopefully will come to be emulated by people outside, but the message I have given to them very strongly is that if you do not conform to this and show your conformity in very short order, you are attracting the wrath of this Committee, the attention of the media, of Parliament and the probability of legislation will be greatly enhanced, but, most importantly of all immediately, firms that do not conform, and they have all said to me that they would commit to conformity but firms which in practice do not confirm, will attract a huge amount of attention and the last thing these people want, to take the experience of one of them earlier this year, is camels on their lawn, or wherever they are placed. I know that there is a disposition to say there needs to be an independent process of rules and people need to be named and shamed and all that, which ultimately is a sanction at the end of all this, I believe that enlightenment and self-interest of these private equity firms and their portfolio companies will lead to, let me call it, good behaviour in accordance with these guidelines, and for those who do not behave in that way, I think there will be a big price to pay.

Q39 Mr Mudie: *The Financial Times*. You have mentioned attributive analysis and they spelt it out in terms of financial engineering, which we worry about and would like to know more about, multiple expansion, operational improvements and how that affects the returns of individual firms. *The Financial Times* are suggesting you said, and you backed it up in a *Financial Times* interview, that you took that out in terms of the firms because it required fairly serious subjective judgment, and you have repeated that today, and so you handed it to the association. *The Financial Times* has suggested that you did not really do that, you actually have handed it over to the association, who will not do it on an individual basis, but do it on an industry-wide basis which

lessens the transparency. That was watering down, in *The Financial Times'* eyes, and in fact you agreed that you had watered it down in that respect in your interview. Is that not a concession too far: because it seems to me a very major concession?

Sir David Walker: No, Mr Mudie, and I think *The Financial Times* understanding of it was in error. It is not a watering down. I said, I think, to the Chairman, right at the beginning, but I think it is so important I welcome the opportunity to repeat it and reemphasise it, attribution analysis, I think, is one of the most important parts of the whole structure, certainly in my recommendations, because until we have that welled out to a rigorous standard that commands trust, we shall not know what the economic impact of private equity is, and I think that is a very serious deficiency. In July my inclination was to do what you referred to, which is to ask individual firms to produce their attribution analysis. I had not had the consultation or spent enough time on this. When I got into it, and a huge amount of grey matter work has gone into this, not just by me but by others, in particular by one of the major accounting firms who have made this something of a speciality, it became clear to me that there is a lot of subjectivity in the process that we need to squeeze down, and when I said that there were perverse incentives in where we are, what I meant was that if I stuck to my July proposition and said each firm should do its attribution analysis, cynically but I think realistically, what I would expect to happen is that individual firms would give the most favourable possible spin on their performance in a previous period, and, as you rightly say, they would minimise the leverage impact, they would minimise the impact of the rise in market multiples and would minimise in a "Look what a good boy am I" way what they have accomplished through improvements in operating performance. That does not help anybody. That is a perverse incentive. So I decided the right course was not to water down; on the contrary, to commission a very substantial body of work and we have had a subgroup of my group working on this with two major private equity firms and accounting expertise to develop a template. I am not yet happy with the rigor of the template, but we are well on the way. It would not have been ready now to require all firms to conform to it. I hope there will be convergence around the template, which includes an adjudication, a sort of audit process, that "private equity firm A" is not cooking the books and fiddling the figures and putting the most favourable spin on their performance. I think we will be there inside a year or so. I would rather expect, and I have not discussed it with Sir Mike Rake, that Sir Mike Rake at that point to be very interested in saying, "Okay, this is the template. I am going to hold you to it. This is the mechanism. Now produce it on your"—

Q40 Mr Mudie: That is a very interesting answer and a very positive answer. So the impression *The Financial Times* have got is that you are not requiring individual firms, even if it is in twelve months, to produce this information on an individual basis, but they will be doing it to an agreed template, so we can look at any firm and we will be able to see on an agreed basis how they are operating in these three areas, whereas *The Financial Times* is saying, "No, no, they are not doing that. They are doing it by the BVCA. They are doing it on an industry basis"?

Sir David Walker: The sequence will be that all the firms will give their data to an accounting firm, which is the accounting firm which has greatest expertise in this place. Immediately the industry will produce this attribution analysis for the whole industry. When there is satisfaction that the template is sufficiently objective and robust, then there is the possibility, which is a matter for Sir Mike Rake, in the light of opinion at the time, to impose these on individual firms, but there is a chronology, there is a sequence in that, Mr Mudie. I want to reassure you, there is no desire to suppress what I think is one of the most important parts of the analysis.

Q41 Mr Mudie: Let me just press you on this because, as you accept, it is an important point. Following up your answers, your report, your recommendations, are you actually saying this must happen, or are you passing that to the new Chairman of the Compliance Committee to decide, once the template is agreed, whether it is going to be mandatory?

Sir David Walker: I am specifying that the information to enable the attribution analysis to be done as an aggregation of individual terms firms' performance be submitted to the BVCA and the accounting firm being used for the purpose, and that will start immediately. The work will be done and it will be an industry-wide thing. At the end of a period of time, when everyone is satisfied—

Q42 Mr Mudie: In which period of time do you envisage that?

Sir David Walker: I would think, Mr Mudie, about a year.

Q43 Mr Mudie: Okay; good.

Sir David Walker: But this is a huge progress. I feel by the line of your questioning it necessary to say that no country in the world has done anything like it. There is a Private Equity Council in the United States of the same group of major firms as we have in this group in the UK. I do not think they have even thought about requiring an analysis of this kind, so what we are doing here is streets ahead.

Q44 Mr Mudie: Keep going, Sir David. So once they have done this massive peace of work and they have an agreed template, so within two years you can say, with a year to produce it, we will be able to look at individual firms and see how these important areas have contributed to their returns?

Sir David Walker: That possibility will be available—

Q45 Mr Mudie: Is that not the objective?
Sir David Walker: My objective is to get the template created and the aggregate picture clear. Frankly, I think the performance of individual firms is much less important than having this aggregate picture but when the template exists it will be available to the BVCA and Sir Mike Rake to require individual firms to produce their own attribution analysis. My submission is that will be possible; yes, probably it will be done; I think it is of secondary importance. What is of prime importance is to have it for the whole industry.

Q46 Mr Mudie: But you see the *Financial Times* must be seen as an authoritative voice in financial affairs. You have started out saying they have got it wrong. Now you start to weaken and say: "Well, no, we are not doing that, but then maybe it will end up like that because to do it on an industry firm basis is not that important". Well, the starting point is it is seen as important in terms of transparency and the *Financial Times* says: "This is not what is going to happen; you have watered down a report, it was in the initial one, you have been leaned on and you are now retreating back to an industry-wide analysis which takes transparency away". If we said to you the transparency is important, the TUC says it is important, do you think it is very important that we get this individual transparency?
Sir David Walker: No, I do not, Mr Mudie. No, I do not.

Q47 Mr Mudie: So whether the *Financial Times* is right or wrong it does not really matter?
Sir David Walker: The *Financial Times*—

Q48 Mr Mudie: Why didn't you put it in your first report, then?
Sir David Walker: Because I thought, and continue to think, that attribution analysis is of great importance. I have had a consultation process for four months in which I have not just received submissions—

Q49 Mr Mudie: But you say it is important, that is the whole point, you say it is important—
Sir David Walker: It is.

Q50 Mr Mudie: —we have agreed ground there. Your answer to the Chairman earlier and your answer in the *Financial Times* interview was that well, you see if leave it to the firms they will spin it, they will be too subjective, which I think is a very good answer and very astute. So you say: Well, we will take it away and get some other body to do it, so it is done objectively, so we can all be happy with it. But then when I say is that going to happen you say it is not important it happens.
Sir David Walker: The thought in my mind in July is that you will be able to take, say, the 16 firms, their attribution analyses, add them together, and you would have a picture for the whole industry. That will not be worth much, I am now clear, and in that respect I have changed my view since July. I have indicated why I have changed my view; it is the concern about perverse incentives, and many of those who commented to my report did not know what a perverse incentive was; most of them did not know what an attribution analysis was. My concern is to have an aggregate picture which I thought would emerge from adding the figures from the individual private equity firms. That would not be dependable. So let's start with the aggregate, get the template, and I readily agree, Mr Mudie, if it is thought to be important to have the story for individual firms, as I say, I do not feel intellectually persuaded that that is very important, but if others think it is it will be possible to require it in about a year's time when the template is robust. What I am most concerned about is that this Committee, the *Financial Times*, and the rest of us, do not know authoritatively how private equity performs. We have the work to which I have referred. For example, the Ernst & Young study, which is very good, is of the hundred biggest exits from private equity portfolio holdings in Europe in the two years, 2005-2006. If the story that gives private equity were the story for the whole of private equity across Europe or in the United Kingdom, it is something we need to know authoritatively about, because a lot of policy decisions or discussions, like the exchange with Mr Cousins, in my view should flow from it.
Mr Mudie: Thank you.

Q51 Mr Simon: Sir David, carrying on directly from George, because I thought that was a very interesting line of discussion, surely you can see that aggregation is a cloak of anonymity and is therefore the enemy and the opposite of transparency? Surely you can see that if what we do as individuals is grouped together you can no longer see what we do as individuals; that is the opposite of transparency. It is not complementary; it does not go along with it; it is the exact opposite, is it not? If you cannot see what I am doing because it is hidden amid what everybody else is doing and what we are all doing collectively, that is not transparent. That is not me being accountable for what I do; that is what I do being hidden in what everybody else does.
Sir David Walker: The owners of private equity, of course, have a pretty good view of what you do if you are a general partner. They know how your fund is performing. When we talk to calSTERS and calPERS—

Q52 Mr Simon: That is not what we mean about transparency. The whole point about what we mean by transparency is that we can see what they are doing. We know they know what they are doing; the whole question at issue is that nobody else can see what they are doing. To define transparency as something that they themselves know or as something that is OK as long as it is visible at aggregate level is a perverse definition of transparency.

Sir David Walker: I disagree fundamentally—

Q53 Mr Simon: You do or you do not disagree?
Sir David Walker: I do. There is a spectrum, which is being very secretive and closed, which is one end of the spectrum which we all reject as unacceptable. There is the opposite end of the spectrum, which is total transparency in the sense in which you refer to it; they are rather boring—

Q54 Mr Simon: Before you go to that, I did not create any spectrum of total transparency. I just pointed out that your definition of transparency was—
Sir David Walker: I have not given you my definition of transparency.

Q55 Mr Simon: Well, you have implicitly. You have defined them as being transparent to themselves, or transparent at the aggregate level, and I am saying that is not what people understand by being transparent.
Sir David Walker: I did not talk about transparency at the aggregate level—

Q56 Mr Simon: Yes, you did, at some length for at least 20 minutes with George five minutes ago. You repeatedly stated over and over again that aggregating attribution analysis was transparent, and you seem not to be able to see that it transparently is not transparent. It is the opposite of transparent.
Sir David Walker: May I respond?

Q57 Mr Simon: Carefully.
Sir David Walker: I think I have been careful throughout this session—

Q58 Mr Simon: I think you have been glib on occasion.
Sir David Walker: That is a matter of opinion.

Q59 Mr Simon: It is a matter of opinion; it is my opinion, and you respond with your opinion.
Sir David Walker: We have a spectrum with transparency at one end and secrecy at the other. The matter for judgment relates to the degree of openness. You can have openness without full transparency; of course you cannot have full transparency without total openness. The question which is, in all these matters, where you put yourself on the spectrum is what is the purpose. Is there a justification and legitimacy for the, let's call it, enhanced openness that is being sought? I think, and here I hope you would agree, Mr Simon, there is a very powerful case for the degree of openness that is necessary to enable us to understand the economic impact of private equity, and that is my fundamental objective in all this attribution analysis exchange. It requires greater openness.

Q60 Mr Simon: Let's be clear on that, because that is not what anybody else is interested in. Nobody else is interested in an understanding which merely helps them to understand the economic impact of the industry as a whole. Everybody else is interested in the actual behaviour of the real act in the real world and the effect on the jobs and so on of real firms of private equity practitioners. People are not simply seeking to understand the macro level economic impact of the industry, that is not what is at issue at all, and if that is all you have been looking into you have been looking into something that is of no interest to everybody else.
Sir David Walker: Our fundamental disagreement plainly continues. I think it is of very great importance to understand the economic impact of private equity on the whole economy.

Q61 Mr Simon: You said it was the fundamental matter you were looking into, and if that is the main thing you are looking into and if you are not looking into the actual specific micro level behaviour of specific firms and specific cases and how they transact their business in the market place and how transparent that is to the rest of us, if you are not even claiming to treat with that, then you are missing the point, are you not?
Sir David Walker: No, and I am. The enhanced openness that I have called for, and we have been through the requirements I have, let's take the business review provisions, require the portfolio company to reveal in their report and accounts all the things that Section 417(5) requires, so a lot is being revealed about the behaviour of portfolio companies, and on the websites and in the annual reviews of the private equity firms much more is now to be revealed. For example, let me take something very specific which is very relevant for employees in a portfolio company. Who is the individual in this hitherto anonymous private equity firm who is responsible for this 100 per cent stake in the company in which I work? I am requiring that to be revealed. That veil of anonymity has been cut through, and there are many other examples. My point, and I apologise if this is tedious but nonetheless I do not resile from the weight I attach to it, I just do not agree with the proposition that I am saying it is the only thing that matters, is that we need a better understanding of economic impact. I had thought in July, before I listened to the consultation process—which this Committee would surely have wished me to do and I did in relation to some recommendations the Committee made—that simply adding the attribution analysis results of individual firms would give us a good story. I have indicated to Mr Mudie in our exchange why I think that would not be accomplished and why I think it is important to have this template. When we have the template it will indeed be possible to do what you say is very important, which is to require individual firms to produce their own attribution analysis to my standard. Now, if that is important, then that can be taken into account as the discussion in this area evolves, and Sir Mike Rake or whomsoever could determine that that should be required. Then the degree of let's call it openness or transparency that

you seek would be available. What I will not do, Mr Simon, is put my name to something which would give a perverse incentive, and I have to say, looking in Westminster, this is what legislation very frequently does, and there is abundant experience of it in certainly the financial regulation and legislation over the 30 or 40 years of my working life, and I wish to avoid it here.

Q62 Mr Simon: Are there any major private equity firms or practitioners of any note who are not with the BVCA?
Sir David Walker: Yes, there are some, including I discovered the other day Morgan Stanley though, as I have said, my independence goes both ways. I have not sought to influence Morgan Stanley until now and they have certainly not sought to influence me, but I think you can rest assured Morgan Stanley are about to become a member of the BVCA, and there are one or two others who have been on the margins of private equity, not very large in scale but who aspire to get into it in a bigger way.

Q63 Mr Simon: Would it be fair to say that about five years ago there would have been an awful lot more private equity firms that practised private equity in the United Kingdom but which were not members of the BVCA?
Sir David Walker: Pass, Mr Simon. I do not know.

Q64 Mr Simon: I think you can take it from me there would have been, in which case how can it be such a draconian sanction for a potential future firm to be potentially excluded from the BVCA when even now, and very recently, there were a lot more people who with no sanction at all voluntarily choose anyway not to be in the BVCA just as a lifestyle choice?
Sir David Walker: My expectation is that the firms authorised as private equity firms by the Financial Services Authority who are significant, and I will give here an example of the way I have tightened up my requirements since July, will choose to join the BVCA as a matter of good practice. They will want to be firms being seen to be conforming to best practice in this industry, and I have tightened up my requirement in that respect. In July I said that private equity firms who had portfolio companies above the threshold report and had to produce the annual review. I have now strengthened that and said private equity firms that have funds, not necessarily a portfolio company in the United Kingdom, with the capacity and stated intention to invest in the United Kingdom should conform to my guidelines.

Q65 Mr Simon: My question was, given there are firms who already choose anyway not to be in the BVCA, why should we believe that it is going to be such a draconian disincentive to be excluded from something which some people choose anyway, having done nothing wrong?
Sir David Walker: I do not think there are more than two or three—I do not know. I do not think there are any very large private equity firms—

Q66 Mr Simon: But if there are even two or three why would I be so terrified to be the fourth? Why would it be such a terrifying sanction?
Sir David Walker: I really do not understand the thrust of the question. I think they will join the BVCA and they will wish to be seen to be good citizens in conformity with these guidelines.

Q67 Mr Simon: But surely the whole point of this inquiry and the huge furore at the national level that there has been is that they do not seem to care whether people think they are good citizens or not?
Sir David Walker: If I may say so, Mr Simon, you have disregarded the change in the atmosphere in the last six or nine months, partly as a result of the process that led to this report. I can tell the change in the temperature and I can only say this to you from my own discussion with these firms; you can take a cynical view and say: "Well, they would say that, wouldn't they?" That is not the view I take. In the discussion, for example, in the advisory group that I have assembled, and in my discussions with many firms not in the advisory group, to go back to the words I used right at the beginning in the answer to the Chairman's first question, they have acquired in our mature society very substantial ownership rights and they have not recognised they have obligations which are assumed to go with it, and all I can do is assure you with all sincerity I think the atmosphere has changed, and in a way the justifiable response to that from someone who is reasonably sceptical which would be perfectly justified is that we have to wait and see whether the enhancement in performance is as great as I am optimistic it will be, and that is a matter of time.
Mr Simon: Thank you.

Q68 Mr Fallon: Sir David, are you not concerned about the unlevel playing field that is now being created in that you have private companies on the one hand, publicly quoted companies on the other, and now this new tier of Walker-style companies in the middle?
Sir David Walker: Yes, I am concerned about it, though, with respect, we cannot have it both ways. A lot of the criticism and challenge, for example in this Committee and certainly the media, was that what I put in place was too soft or a whitewash or whatever but presumably, if it were not so and if it were tough, that has increased the gap between private companies and private equity, so certainly there is a problem of the kind you describe. My belief is that here it becomes tentative; my belief is it would be useful, going forward beyond the remit I had focused on private equity, to identify the most private equity like companies/investors, and we should think very hard about how to invite the sovereign wealth funds and some of the individuals who behave like private equity in committing a lot of capital of their own but taking on leverage into this camp. It may surprise the Committee that I express this view but I do not think it will be very difficult to get the sovereign wealth funds to come in, and the reason is that when they want to do something in the United Kingdom, like making a substantial

acquisition, it is hugely in their interest to have this House, the media, and shareholders receptive to what they want to do, so their commitment to conform to guidelines like these is rather a positive for them, which is precisely what we found when I talked to the Qatari Investment Vehicle and Delta 2 at the time when they were interested in acquiring Sainsbury's. So I think there is a discussion with these people to be had to enlist their voluntary conformity with these guidelines. I am vulnerable to criticism: "Why did you not bring more of them in so I could tell the Committee they were all signed up?" Well, I tried in not a half-hearted way; I talked to several people in the Middle East; the problem was I realised very rapidly it is quite hard to expect people to sign up to voluntary guidelines when I could not tell them what the guidelines were going to be precisely.

Q69 Mr Fallon: But how will the BVCA or the new monitoring body get the sovereign wealth funds, or indeed the larger private companies, to comply?
Sir David Walker: My proposal to the BVCA, and I have discussed this at length with Simon Walker who has just been appointed, as you know, as the new chief executive of the BCVA, is that he, in the case of the sovereign wealth funds, after discussion with Treasury/Foreign Office, and there needs to be some dialogue because of the sovereign nature of this, should actually talk to these people, and I have indicated to him what I think the priority targets ought to be and I think it is his intention to get on with it. But, Mr Fallon, it will require greater urgency and immediacy and potential leverage and influence when there is a renewed situation vis-à-vis Sainsbury's or some other large name like Mr Tchenguiz, for example, who is in my understanding private equity-like; he is here in the United Kingdom and I think is available to have a conversation with, or his advisers, to enlist his support.

Q70 Mr Fallon: But why should these guidelines not apply also to large private companies, for example Richard Branson's companies, or Philip Green's companies?
Sir David Walker: I did not say they should not—

Q71 Mr Fallon: But do you think they should?
Sir David Walker: If they are private equity-like, and in my view what appears to be being proposed in the case of Northern Rock by Mr Branson's—let's call it consortium, looks very private equity-like to me, so I think the answer is yes.

Q72 Chairman: Sir David, I mentioned taxation earlier. Previously we had Jon Moulton of Alchemy Partners here and he made the point very clearly for us on management fees when talking about the act of not paying tax, "First set up a partnership to run the fund. The UK Limited Partnership contemplated by the memorandum of understanding of the BVCA and Her Majesty's Revenue and Customs is perfect. Consider a thousand million pounds fund with a 1.5% annual 'management fee' payable to the private equity firm as the general partner. The general partner is entitled to draw £15 million per annum from the partnership. What the agreement says is that he can pick and choose which of the partnership's cashflow he gets the £15 million from. The point is that GPs (general partners) get taxed on the cash flows depending on the character of the cash flows but being intelligent general partners select non taxable cashflows, for example the repayment of a loan at par, which do not appear on tax returns at all. This is easy to arrange". Now, I mention that to you as part of the background where suspicion is prevalent and there is a need to try and demolish that. Finally, you have mentioned yourself that private equity is private to the extent of secrecy. I am grateful to you, as Chairman of the Committee, for your courtesy to me and the Committee for keeping us informed of your deliberations, and I think you have made a valiant effort. We realise that private equity is here to stay; the focus was on highly-leveraged buy outs, and certainly those private equity firms who have spoken to me over the months want to remove themselves from the limelight, but to do that there has to be meaningful engagement and transparency. I would put it to you, Sir David, that your report fails to tackle or does not go far enough on a number of big issues. It is silent on taxation, and I mentioned to you that point; vague in communication with employees and other stakeholders; nothing on executive remuneration; watered down attribution analysis; discretion on reporting requirements; uncertainty about how and whether compliance will be in force and, if it is in force, then people leave the BVCA and the guidelines do not apply and they go on their merry way, and, as Mr Fallon says, there is no level playing field with other private firms. Is not the consequence that your proposal will satisfy no-one; you will continue to be disliked by the private equity firms in your works on that, and you will continue to be viewed with suspicion by stakeholders? I put it to you, Sir David, does Will Hutton have a point when he says in describing your code that it is one of the less honourable moments in private equity history?
Sir David Walker: I listed mentally in the observations you made about 15 points and I think my observation on them—and I do not know whether I have time to respond—is no, no, no, no and no! But if I could start with a matter which is not my responsibility—how could it be and I do not believe you are seriously suggesting it should be—Jon Moulton and others have mentioned practices of the kind that he has mentioned to you and my reaction as a United Kingdom taxpayer is one of revulsion from them, and if that sort of evasion—because that is not avoidance; I think that is evasion—is going on then it is a matter for HMRC and the Treasury to deal with it, and I feel as strongly about that as anyone. I did not write down the specific points you made but if I take some of them I have explained why I believe the voluntary guidelines approach is the right approach and I think Parliament will be singularly ill-advised to seek to legislate across the board in this area, though, to take a point that was made I think by Mr Cousins,

if you look at 4175, I think there is a perfectly good case for saying something like that should apply to all big private companies.

Q73 Mr Cousins: Indeed.
Sir David Walker: As to communication with employees, and I have forgotten the adjective you used but I think it was something like "inadequate", I attach very great importance to that.

Q74 Chairman: "vague".
Sir David Walker: I do not think what is in place is vague: we have powerful provisions in the statute, one of which, according to the TUC, needs to be enforced more effectively, and I have laid out very clearly why I think it is important for private equity firms to communicate at inflection points in their lives. As to the attribution analysis, I am hesitant about saying any more. There has been no watering down.

Q75 Chairman: Sir David, can we thank you for your assistance to the Committee and for the opportunity to discuss this Report. As I have mentioned, you have always been very open and courteous with us, and I thank you for that.
Sir David Walker: Thank you, Chairman.

Written evidence

Memorandum from the Department for Business, Enterprise and Regulatory Reform

Introduction

1.1 This memorandum is concerned with the accounting and reporting requirements imposed on UK companies by the Companies Acts 1985 and 2006. It does not therefore cover requirements imposed on companies by the Listing or Transparency Rules which are the responsibility of the FSA.[1]

1.2 The Committee asked for evidence on three areas relating to reporting requirements of public and private companies and the application of the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE). This memorandum deals with the specific points raised as well as providing some additional information relevant to the matters under consideration by the inquiry.

Reporting Requirements

2. The reporting requirements of public companies compared with private companies, including content of reports, timeliness, publication format (ie available on website or have to purchase from Companies House), corporate social responsibility including, where appropriate, the positions before and after coming into force of the relevant provisions of the Companies Act 2006.

2.1 For the purposes of this memorandum, companies formed under the 1985 & 2006 Acts can be divided into three basic categories of company defined in the 1985 and 2006 Acts: private companies, public companies and listed companies. A public company, unlike a private company, is permitted to offer its shares to the public (though it need not do so). A listed company[2] is one whose equity share capital is included in the UK Official List, is officially listed[3] in another EEA State or is admitted to dealing on the New York Stock Exchange or Nasdaq.

2.2 The category of "publicly traded company" is one which is increasingly used in European legislation. It is defined as a company whose securities are admitted to trading on an EEA regulated market. A list of EEA regulated markets is published. Its greatest significance in the context of the accounting and reporting provisions of the Companies Acts, is that UK companies that are publicly traded are obliged to prepare their consolidated accounts in accordance with EC adopted International Accounting Standards rather than in accordance with UK accounting requirements.

2.3 At present, companies formed under the Companies Act 1985 (the 1985 Act) are required under Part 7 of that Act to produce accounts and reports for their members (shareholders) to show those members how the company has been run on their behalf. Companies are required to send those accounts and reports to members, debenture holders and others entitled to receive notice of general meetings, and (with certain exceptions) to file those accounts and reports with the Registrar of Companies, where they are publicly available to interested parties, for a small charge. A table is attached comparing the accounting and reporting requirements imposed by the 1985 and 2006 Acts on private, public, and listed companies.

Companies Act 1985

2.4 While the core requirements on preparing accounts and reports are in Part 7 of the 1985 Act, detailed provisions on their content are set out in the accounting Schedules to the 1985 Act. Some Schedules set out the detailed contents of the accounts and the format in which they must be prepared. Others cover specific types of disclosures (including in the directors' report and directors' remuneration report) or apply to certain categories of companies. Not all Schedules apply to all companies.

Companies Act 2006

2.5 Part 7 of the 1985 Act will be replaced by Part 15 of the 2006 Act. Part 15 and the accompanying regulations will come into force on 6 April 2008, applying to financial years beginning on or after that date. However, the new business review requirements (see paragraphs 2.8 and 2.9 below) in section 417 of the 2006 Act will be commenced for directors' reports for financial years beginning on or after 1 October 2007.[4]

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[1] The Listing Rules can be found on the FSA website http://fsahandbook.info/FSA/html/handbook/LR

[2] "Listed" is the commonly used term for this category. The defined term used in the Companies Acts for this category is "quoted".

[3] "included in the UK Official List" means listed in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000. http://www.fsa.gov.uk/Pages/Doing/UKLA/index.shtml

[4] See article 2(1)(g) of the Companies Act 2006 (Commencement No. 3, Consequential Amendments, Transitional Provisions and Savings) Order 2007 (SI 2007/2194 (C.84), with transitional provision in paragraph 43 of Schedule 3 to that Order.

2.6 The detailed accounting and reporting requirements in Part 15 of the 2006 Act and the accounting regulations to be made under it are substantially the same as those in Part 7 of the 1985 Act and the associated accounting Schedules. Substantive changes in requirements have been identified in the attached table.

2.7 UK accounting and reporting company law requirements are based on European legislation.

Directors' Report (including Business Review)

2.8 All companies are required to prepare a directors' report. As part of that report all companies, other than small private companies, must prepare a Business Review (section 234ZZB of the 1985 Act) which is a balanced and comprehensive analysis of the company's business, consistent with the size and complexity of the business. The Business Review is key to encouraging directors to provide meaningful strategic, forward-looking information. For financial years beginning on or after 1 October 2007 the provisions on the Business Review in section 417 of the 2006 Act will apply in place of section 234ZZA.

2.9 Section 417 provides expressly that the main purpose of the Business Review is to inform members of the company and to help them assess how the directors have performed their duty to promote the success of the company. It must—to the extent necessary for an understanding of the business—include:

- analysis using financial key performance indicators; and
- where appropriate, analysis using other key performance indicators including information relating to environmental and employee matters.

In addition, under section 417(5) quoted companies will be required—to the extent necessary for an understanding of the company's business—to include in their Business Review information on:

- environmental matters (including the impact of the company's business on the environment);
- the company's employees; and
- social and community issues;

including information about any policies of the company in relation to those matters and the effectiveness of those policies; persons with whom the company has contractual or other arrangements essential to the business.

Other entities

2.10 None of the above requirements apply directly to other entities, for example those established as limited partnerships. Nonetheless in certain circumstances Companies Act accounting and reporting rules are applied (with or without modifications) to other entities that are not companies eg a limited partnership formed under the Limited Partnerships Act 1907 where the general partner or partners all have limited liability (eg because they are limited companies). Such entities have to produce similar accounts to those of a UK company.

3. The Rationale for Any Differences in Reporting Requirements

3.1 Corporate governance and the need for financial and other reporting arises from the principal-agent relationship that occurs in companies where there is usually a separation of ownership and control, which in turn leads to the problem of asymmetric information and possibly differing objectives. Managers who control the company on a day to day basis have access to more timely and more detailed information than the investors who own the capital of the company. Reporting requirements are the attempt to mitigate this market failure and ensure that company owners are well informed about their investments. The problem of asymmetric information is particularly acute in public and listed companies who may have many thousands of investors, many of whom may hold their shares indirectly, and are therefore at a greater distance from the management of the company.

3.2 The basic premise behind accounting and reporting requirements for limited liability companies is the idea of proportionate transparency. In return for the protection of limited liability status, companies should have to disclose information about their activities that will help others to make decisions about doing business with them. However, the level of disclosure should be proportionate to the benefit it will provide to others. The amount of information disclosed and level of detail in the accounts and reports will therefore vary depending on the size and type of company.

3.3 In general, a private company that qualifies as small[5] will have to disclose less information than a larger company, and will not have to have an audit report. A small private company is likely to have fewer shareholders than a larger company, and those shareholders are likely to be more involved in the day to day

[5] For the purposes of the 1985 Act and the 2006 Act, a small company is defined as one which meets two of the following three criteria—turnover not more than £5.6 million, balance sheet total not more than £2.8 million and not more than 50 employees—and does not fall into one of the excluded categories (eg public, banking or insurance company). The Department is consulting on regulations to raise the thresholds for SMEs in implementation of Directive 2006/46.

running of the company. It is also likely to have less complicated dealings with a smaller number of customers and suppliers. A large private company will have to disclose more and have an audit. It is likely to have more shareholders who are less likely to be involved in the day to day running of the business, and will therefore have a greater need to be provided with information about the performance of the company. It will have more complicated dealings with a wider range of customers and suppliers.

3.4 Listed companies are subject to additional requirements under the Companies Acts, reflecting the fact that their shares are being traded on key public markets. The application of certain key requirements to listed companies is also in part an anti-avoidance measure, as it is not desirable for companies incorporated in UK to seek to avoid such requirements by listing their shares only on a major overseas market. For example, listed companies must produce a directors' remuneration report as part of the corporate governance framework for listed companies. Listed companies are also required to include additional information in their business review—see paragraph 2.9 above.

4. Employees—Information and Disclosure

The application of Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) to takeovers

4.1 The TUPE Regulations 2006 implement in the United Kingdom the 1977 EU Acquired Rights Directive, and ensure that employees' terms and conditions are protected when a business or part of a business is transferred from one employer to another. This includes pay and hours (for example) and it also ensures that employees' length of service is unbroken for the purpose of any later redundancy.

4.2 The Regulations then prevent an employer from amending these terms by reason of the transfer. However they do not prevent a new employer from, in due course, seeking to renegotiate those terms and conditions—in exactly the same way as the previous employer could have done. In addition, they do not prevent an acquiring employer from making staff that had transferred across to his organisation redundant, although he would have to conduct any redundancy exercise fairly across both his previous workforce and the transferred staff. The legal obligations (arising from the Trade Union and Labour Relations (Consolidation) Act 1992) on employers to consult staff before making collective redundancies are unaffected by a change in share ownership.

4.3 The Regulations do not apply to share sales, as they require a change in employer which generally does not occur where a transfer is effected by a share sale.

4.4 Extending the TUPE Regulations to cover situations where a business has been transferred by way of a share sale would go substantially further than the Directive requires. Such an extension would not prevent employers from either seeking to renegotiate new terms and conditions after a share transfer as the old employer would have done, or necessarily from making redundancies.

Information and Consultation of Employees Regulations 2004

4.5 The Information and Consultation of Employees (ICE) Regulations give employees in undertakings with 100 or more employees, the right to be informed and consulted about issues in the organisation for which they work. However, the obligation on an employer to inform and consult does not operate automatically but can be triggered either by 10% or more of his employees asking for an information and consultation (I&C) agreement, or by the employer starting the process himself.

4.6 The Regulations seek to encourage employers, employees and their representatives to agree to arrangements which best suit their respective needs but set a fall-back provision where it has not been possible to achieve this. Under this fall-back provision, the employer must provide the I&C representatives with *information* on the recent and probable development of the undertaking's activities and economic situation. The employer must *inform and consult* on the situation, structure and probable development of employment within the undertaking and on any anticipatory measures envisaged where there is a threat to employment. The employer is further obliged to *inform and consult with a view to reaching agreement* on decisions likely to lead to substantial changes in work organisation or in contractual relations. The framework of the ICE Regulations was developed and agreed with the TUC and the CBI.

Companies Act 1985 & 2006

4.7 The Directors' Report includes requirements for companies to disclose action it has taken aimed at providing employees with information on matters of concern to them and consulting employees or their representatives on a regular basis so their views can be taken into account. These requirements (paragraph 11 of Schedule 7 to the 1985 Act to be re-enacted in the regulations to be made under Part 15 of the 2006 Act) apply to all companies with more than 250 employees, whether private, public or listed.

November 2007

TABLE COMPARING ACCOUNTING & REPORTING REQUIREMENTS OF DIFFERENT CATEGORIES OF COMPANIES UNDER THE COMPANIES ACT 1985 AND THE COMPANIES ACT 2006

	Small Private[1]	*Medium Private*[2]	*Large Private*	*Public*[3]	*Listed*[4]
1985 Act sections 221 and 222—Duty to keep accounting records. 2006 Act sections 386–389.	Yes	Yes	Yes	Yes	Yes
1985 Act sections 226–230—Duty to prepare either Companies Act or IAS individual entity accounts (the choice lies with the company), and either Companies Act or IAS group accounts (publicly traded companies must prepare IAS group accounts). Much of the content of the accounts (particularly of Companies Act accounts) is set out in the Schedules to Part 7 of the 1985 Act (4, 4A, 5, 6, 7, 7A, 8, 8A, 9, 9A and 11). 2006 Act sections 393–408 and regulations. Under the 2006 Act, the basic requirements on the form and content of accounts that are now in the Schedules to the 1985 Act will be set out in regulations to be made by the Secretary of State, with one set of regulations for small companies and one set of regulations for all other companies. These regulations largely restate the accounting Schedules to the 1985 Act, with only a few changes of substance, mainly to implement Directive 2006/46 to increase SME thresholds and to require note disclosures of related party and off balance sheet transactions. Drafts of the regulations are available at www.berr.gov.uk/bbf/co-act-2006.	Yes	Yes	Yes	Yes	Yes. Parent company whose securities admitted to trading on a regulated market must prepare consolidated accounts in accordance with EC adopted IAS (Article 4 Regulation (EC) 1606/2002).

	Small Private[1]	*Medium Private*[2]	*Large Private*	*Public*[3]	*Listed*[4]
1985 Act Schedules 4, 4A and 8 specify the form and contents of Companies Act individual and consolidated accounts. 2006 Act, regulations.	Schedule 8 sets out the basic form and content of accounts that small companies preparing Companies Act accounts are required to prepare for members. It requires less information than Schedule 4 for other companies. Small companies which are parent companies are not required to prepare group accounts (1985 Act, section 248; 2006 Act section 398).	Schedule 4 sets out the basic form and content of accounts for all other companies. There are some exemptions for medium-sized companies in section 246A. They are exempt from preparing group accounts under section 248. Under the 2006 Act, group accounts will have to be prepared by medium-sized companies which are parent companies.	Schedules 4 and 4A set out the basic form and content of accounts for all other companies.	Schedules 4 and 4A set out the basic form and content of accounts for all other companies.	Schedules 4 and 4A set out the basic form and content of accounts for all other companies.
1985 Act sections 231 and 231A and Schedule 5 require note disclosures in all accounts (whether Companies Act or IAS) regarding related undertakings and particulars of staff. 2006 Act sections 409–411 and regulations.	Yes. Section 246 contains some exemptions from Schedule 5 for small companies.	Yes	Yes	Yes	Yes

	Small Private[1]	*Medium Private*[2]	*Large Private*	*Public*[3]	*Listed*[4]
1985 Act section 232 and Schedule 6 require note disclosures in all accounts (whether Companies Act or IAS) regarding emoluments and other benefits of directors. 2006 Act sections 412 and 413 and regulations. The provisions on loans and similar benefits in section 413 are less detailed than those in Parts 2 and 3 of Schedule 6.	Yes. Section 246 contains some exemptions from Schedule 6 for small companies.	Yes	Yes	Yes	Yes. Listed and AIM companies subject to additional requirement to show aggregate amount of gains on exercise of share options. Quoted companies exempt from Chapter 2 of Schedule 6 because have to prepare separate directors' remuneration report.
1985 Act sections 234–234A, 246A(2A) and Schedule 7—Duty to prepare directors' report including business review, and certain disclosures concerning employees. The main purpose of the Business Review is to inform members of the company and to help them assess how the directors have performed their duty to promote the success of the company. 2006 Act sections 415–419, and regulations.	Must prepare a directors' report (but not a business review) for members. Do not have to deliver to the registrar of companies.	Must prepare and publish a directors' report including a business review. Business review does not have to include non-financial key performance indicators.	Must prepare and publish a directors' report including a business review. It must—to the extent necessary for an understanding of the business—include: — analysis using financial key performance indicators; — and where appropriate, analysis using other key performance indicators including information relating to environmental and employee matters.	Must prepare and publish a directors' report including a business review. Unless qualifying as medium sized, it must—to the extent necessary for an understanding of the business—include: — analysis using financial key performance indicators; — and where appropriate, analysis using other key performance indicators including	Must prepare and publish a directors' report including a business review. Under section 417(5) of the 2006 Act, the business review must also contain, to the extent necessary for an understanding of the business, information about main trends and factors likely to affect company's development and performance, information about environmental, employee and social and community issues and information about those with whom the company has

	Small Private[1]	*Medium Private*[2]	*Large Private*	*Public*[3]	*Listed*[4]
				information relating to environmental and employee matters.	arrangements essential to its business. If any of this information is not included, this must be stated.
1985 Act sections 234B, 234C, Schedule 7A—Directors' Remuneration Report. 2006 Act, sections 420–422, 439–440, and regulations.	No.	No.	No.	No.	Yes. Under the 2006 Act regulations, it is proposed that the directors' remuneration report should include an explanation of how companies have taken pay and conditions of employees across the company into account when setting directors' pay.
1985 Act section 235—Duty to have accounts and reports audited. 2006 Act, sections 475–483.	No.	Yes.	Yes.	Yes.	Yes.
1985 Act sections 238–241—Publication of accounts and reports. Duty to send accounts and reports to members, debenture holders and every person entitled to receive notice of general meetings at least 21 days before meeting at which accounts to be laid. 2006 Act sections 423–425 and 430–438. Under section 423 of the 2006 Act, all companies have to send accounts and	Yes, though can elect not to lay accounts and reports before general meeting (1985 Act section 252). Under the 2006 Act, private companies are not required to have AGMs. The requirement to send	Yes. Under the 2006 Act, private companies are not required to have AGMs. The requirement to send accounts "21 days before an AGM" has therefore been amended to "at the	Yes. Under the 2006 Act, private companies are not required to have AGMs. The requirement to send accounts "21 days before an AGM" has therefore been amended to "at the	Yes. Must lay accounts at AGM, to be held not later than end of period for filing accounts.	Yes. Must lay accounts at AGM, to be held not later than end of period for filing accounts. Under the 2006 Act, quoted companies must make annual accounts and reports available on company

	Small Private[1]	*Medium Private*[2]	*Large Private*	*Public*[3]	*Listed*[4]
reports only to persons for whom they have a current address.	accounts "21 days before an AGM" has therefore been amended to "at the end of the period allowed for filing accounts, or when they are filed if earlier".	end of the period allowed for filing accounts, or when they are filed if earlier".	end of the period allowed for filing accounts, or when they are filed if earlier".		website as soon as reasonably practicable.
1985 Act section 251—Option to provide Summary Financial Statement. 2006 Act sections 426–429.	Yes.	Yes.	Yes.	Yes.	Yes.
1985 Act sections 242–244—Filing of accounts and reports. 2006 Act sections 441–450.	Must deliver to registrar of companies balance sheet and auditor's report (if audited). Must file accounts not later than 10 months from end of financial year. Under the 2006 Act, the period allowed for filing is 9 months.	Must deliver to the registrar of companies annual accounts, directors' report and auditor's report. Must file accounts not later than 10 months from end of financial year. Under the 2006 Act, the period allowed for filing is 9 months.	Must deliver to the registrar of companies annual accounts, directors' report and auditor's report. Must file accounts not later than 10 months from end of financial year. Under the 2006 Act, the period allowed for filing is 9 months.	Must deliver to the registrar of companies annual accounts, directors' report and auditor's report. Must file accounts not later than 7 months from end of financial year. Under the 2006 Act, the period allowed for filing is 6 months.	Must deliver to the registrar of companies annual accounts, directors' report, directors' remuneration report and auditor's report. Must file accounts not later than 7 months from end of financial year. Under the 2006 Act, the period allowed for filing is 6 months.

	Small Private[1]	*Medium Private*[2]	*Large Private*	*Public*[3]	*Listed*[4]
Schedule 8A Form and Content of Abbreviated Accounts of Small Companies Delivered to Registrar. 2006 Act, regulations.	Schedule 8A sets out a shorter version of accounts that small companies can file with the Registrar of Companies (although they must still provide Schedule 8 accounts to members).	No.	No.	No.	No.

[1] For the purposes of the 1985 Act and the 2006 Act, a small company is defined as one which meets two of the following three criteria—turnover not more than £5.6 million, balance sheet total not more than £2.8 million and not more than 50 employees—and does not fall into one of the excluded categories (eg public, banking or insurance company). The Department is consulting on regulations to raise the thresholds for SMEs in implementation of Directive 2006/46.

[2] For the purposes of the 1985 Act and the 2006 Act, a medium-sized company is defined as one which meets two of the following three criteria—turnover not more than £22.8 million, balance sheet total not more than £11.4 million and not more than 250 employees—and does not fall into one of the excluded categories (eg public, banking or insurance company). Department is consulting on regulations to raise the thresholds for SMEs in implementation of Directive 2006/46.

[3] A public company (unlike a private company) is permitted to offer its shares to the public (though it needn't do so on a market).

[4] "Listed" is the commonly used term. In the Companies Acts, the term "quoted" is used. A quoted company is defined in section 262 of the 1985 Act (section 385 2006 Act) as a company whose equity share capital is listed in the UK or in an EEA State, or admitted to trading on the New York Stock Exchange or Nasdaq. The term "publicly traded" is also used in relation to companies preparing accounts using International Accounting Standards. A publicly traded company is one whose securities are admitted to trading on an EEA regulated market.

Memorandum from T Martin Blaiklock, Consultant, Infrastructure & Energy Project Finance

INTRODUCTION

The Treasury Committee has requested further comment with respect to the Inquiry into Private Equity. I am pleased to provide such comment herewith, particularly with respect to: (a) transparency"; and (b) "market abuse and conflicts of interest in private equity transactions".

In the first Part of this Inquiry, I provided written evidence focussing on the impact of Private Equity on public services: PFI/PPP and the like. I have noted, however, that to date your Committee has seemingly not examined this area of Private Equity activity. My comments herewith, therefore, complement those made in the context of the Inquiry Part 1.

Over the last 12 months I have be keeping a particularly close watch on the activities of Thames Water, not least because I am a Thames Water customer, but also because it is one example,—and a good example,—of Private Equity involvement with public services. The case of Thames is significant as it is the UK's largest privatised water utility, serving the Capital and 13 million customers, and also a monopoly service provider!

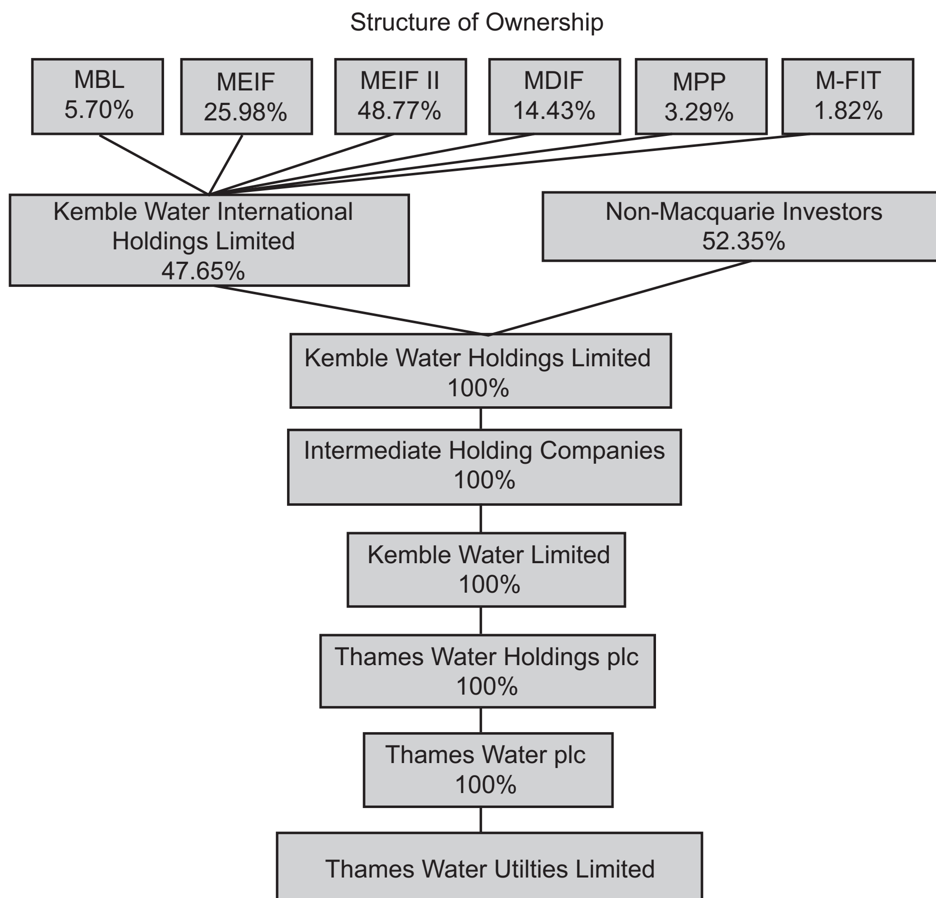
Given that most, if not all, your Committee Members use Thames' services at one time or another at Westminster, they may also be interested in this example of Private Equity activity!

(a) "TRANSPARENCY"

In December 2006, Thames Water, a direct subsidiary of RWE, a quoted European utility, was sold to a consortium controlled by, what can be generically termed, "Private Equity". Just under 50% of the ownership of Thames now comes from Private Equity funds (controlled by Macquarie Bank), the balance from pension funds and the like. Overall, however, Private Equity, in this case, controls the strategic development and management of Thames (ref. Appendix, EV165, this Inquiry Part 1).

In the structure shown overleaf [source: OFWAT Feb 2003 Consultation Doc], Thames Water Utilities Limited (at the bottom) is the utility licenced by OFWAT. However, Thames Water Utilities Limited is 5 or 6 times removed from the controlling investor group (at the top), of whom a number are based offshore in Luxemburg.

Is this the "transparent" corporate structure expected of a UK monopoly public service provider??



["MEIF", etc are Macquarie Bank Infrastructure Funds; "Non-Macquarie Investors" represents offshore pension funds, etc].

(b) Market Abuse/Capital Manipulation

— In June 2007, Thames Water reported (to OFWAT) that in the financial year to 31st March 2007 they recorded a profit after tax of £190.5 million. This was slightly less than the previous year, but not far out of line for the industry.

— In June 2007, Thames distributed dividends of £535.3 million to its shareholders for the financial year 2006–07.

— The only source of funds to pay such dividends, apart from after tax profits, is the Balance Sheet Capital of Thames Water.

— As a result, the recorded reduction in the Capital of Thames, as per the published Accounts, for this period was £310 million (£1,628.5 million minus £1,318.6 million). This represents a reduction in the Capital of Thames of around 20%.

— This reduction in Capital has increased the leverage, or indebtedness, of Thames Water from 57% to 72%.

— Nevertheless, Thames Water maintains its "investment grade" rating—and, therefore, creditworthiness,—albeit that its rating, along with those of other privatised UK water utilities, has steadily fallen since the early 1990's, reflecting perceived increased financial risks in the sector.

— According to recent comment I received from OFWAT on this issue, the exceptional Thames dividend of £535 million represented "a return of equity to shareholders rather than a dividend"!!! Is not a "dividend" a return of shareholders' capital, one might ask?? Such is the world of the Regulators!!!

— The above events have arisen just at the time when Thames needs to demonstrate its financial strength, as it is negotiating the financing of the capital expenditure relating to the Thames Tideway Tunnel Project (est value = £2 billion).

Finally, I should add that I have good reason to believe that the same kind of financial operations can be observed in some, but not necessarily all, of the other UK private water utilities, which have succumbed to ownership by Private Equity in recent times.

Conclusion

There is no doubt that the introduction of Private Equity-type investment into to privatised UK public services has sharpened up the financial management of such enterprises. However, such Private Equity investment has also:

(a) introduced a lack of transparency in the control, governance and, therefore, the accounts of such utilities. Some utilities, such as Thames Water, are effectively owned and controlled offshore, possibly by companies with limited liability and domiciled in tax-havens. Corporate information is, not surprisingly, hard to come by for such Private Equity investments!

Hence, in the event of operational failure by such utilities, (eg the Seafield spill, Edinburgh, April 2007: Seafield was owned by Thames) it is quite possible that the controlling company and its directors cannot be called to account, notwithstanding OFWAT's Conditions P and F licencing requirements (which in themselves are not watertight: pardon, the pun!);

(b) increased the leverage and, thereby, decreased the financial strength of such utilities, at the expense of customers and the security of service; and

(c) introduced corporate uncertainty. The investment horizon for Private Equity is traditionally three to five years, which is short for public service utilities, which require long-term capital and financial stability. The only balancing feature has been the increased intervention, as direct investors, by pension funds and life insurance companies,—as principals, not clients,— albeit some are offshore owned and controlled. Such investors have longer time horizons and are ideal investors for such public service utilities.

Overall, the impact of Private Equity has arguably not been very beneficial to the (private) public service sector, and such investor-types have picked off easy targets against a background of an unsuspecting public. Furthermore, the Regulatory regime may not, on occasion, be robust enough to cope with such developments. It remains to be seen what the long-term impact will be on quality of service, but some other examples, eg BAA, are not encouraging.

December 2007

Memorandum from Professor Mike Wright and Andrew Burrows, Centre for Management Buy-out Research, Nottingham University Business School

Executive Summary

- This memorandum responds to the call by the Treasury Select Committee for proposals for a respected capability for providing comprehensive, industry-wide data on the private equity industry.
- We believe that a respected capability for Providing Comprehensive, Industry-wide Data on the Private Equity Industry needs to have both the specialist expertise in constructing, maintaining and developing large scale databases, as well as having the validation of analyses by the peer-reviewed process.
- We propose that an appropriate capability can be achieved by developing the work of the Centre for Management Buy-out Research which has over 20 years experience in monitoring the private equity and buy-out industry.

Introduction

1. This memorandum responds to the call by the Treasury Select Committee for proposals for a respected capability for providing comprehensive, industry-wide data on the private equity industry.

Background to the Centre for Management Buy-out Research (CMBOR)

2. CMBOR was founded by what are now Barclays Private Equity and Deloitte in 1986 at Nottingham University, in what is now Nottingham University Business School. Barclays Private Equity and Deloitte continue to provide financial support that helps to fund the research staff. The relationship is at arms' length. CMBOR was founded specifically to monitor buy-outs in a comprehensive and objective way; from the beginning this has covered both private equity backed and non-private equity backed buy-outs. CMBOR is an associate member of the BVCA but is otherwise independent of the BVCA. CMBOR has now developed a wide-ranging and detailed database of over 25,000 buy-outs/buy-ins, which provides the only complete set of data on these transactions in the UK and Continental Europe.

3. The founders of CMBOR provide support to build the buy-out database. Their primary interest is in the quarterly trends statistics for which they seek to obtain press/media coverage. CMBOR is regularly referred to in the press as the authoritative source of buy-out data. The number of deals and information fields added to this database each year far exceeds those of other [commercial] databases.

4. CMBOR has published and disseminated papers to a wide audience over several years that include the examination of profit growth and other performance measures such as employment[6] and productivity.[7] These could easily be extended to include other measures. CMBOR would be open to collecting additional detailed data on private equity investment activity as appropriate.

Requirements for a Respected Capability

5. We believe that a respected capability for Providing Comprehensive, Industry-wide Data on the Private Equity Industry needs to have both the specialist understanding of the sector combined with expertise in constructing, maintaining and developing large scale databases on the sector, as well as the validation of analyses by the peer-reviewed process. The latter is especially important to achieve objective, rigorous analyses and if it is difficult to avoid some form of funding of the monitoring body by the industry (see below). CMBOR combines these two elements.

6. The rigour of CMBOR is emphasised by Mike Wright, as founder director, being a full time academic (Professor of Financial Studies), wholly funded by the university and who does not receive any remuneration from the sponsors. Wright organised the first conference on private equity and MBOs in 1981, and his PhD in 1985 was on this topic. His initial work on buy-outs was funded by the ESRC and resulted in a number of peer-reviewed papers. On the basis of his academic research in this area, he received an Honorary Doctorate from the University of Ghent and is a visiting professor at Erasmus University and INSEAD. Wright is an editor of the Journal of Management Studies, probably the leading European-based peer-reviewed management journal.[8]

7. The original premise for establishing CMBOR at a university was that, having built the database, it would be used to develop rigorous academic studies, typically in collaboration with other full-time university faculty at Nottingham or elsewhere. This generally involves taking the basic data from the

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[6] Amess, K and Wright, M, 2007. The wage and employment effects of leveraged buyouts in the U.K. International Journal of Economics and Business, forthcoming.

[7] Harris, R, Siegel, D S and Wright, M, 2005. Assessing the impact of management buyouts on economic efficiency: plant-level evidence from the United Kingdom. The Review of Economics and Statistics, 87, 148–153.

[8] According to the 2006 ISI rankings, JMS was ranked in 11th position out of 64, the highest ranked European-based journal.

CMBOR dataset regarding deal names and combining it with data from other sources, eg the UK government's establishment level survey or the FAME database, etc; this work is generally done by collaborating full-time academics who have no connection with the industry. Currently, CMBOR is collaborating with 20 academics on private equity and buy-out related projects.

8. The academic papers have contributed to the wider understanding of buy-outs and private equity over the period since CMBOR was founded. Most recently, findings on the impact of buy-outs and buy-ins on employment, wages and industrial relations have had extensive coverage and it is interesting that the findings have been used by both the industry and the union side to support their cases.

9. To date, over 40 peer-reviewed articles have been published by Wright and colleagues on this area, and within the last three years 12 have been published, accepted for publication or are in working paper format. It is most important to stress that the results of this academic work have been published extensively in rigorously peer-reviewed international-level academic journals. Referees and editors have never questioned the nature of the CMBOR database; on the contrary it is generally seen as a valuable source because it is comprehensive and located at a university.

10. Although CMBOR informs its founders about what academic activities are being undertaken, the results of which may occasionally be used in press releases, this research agenda is decided solely by the academics. There has never been any attempt to restrict CMBOR's ability to research whatever it wishes from an academic perspective.

Policy Use of CMBOR Data and Analyses

11. The rigour and objective nature of CMBOR's analysis is reflected in reports and advice provided by CMBOR since its foundation to bodies such as: the National Audit Office in the UK [returns on privatised firms and a report on auditing privatisations by buy-outs], ILO, EBRD, EU, OECD, etc. Most recently, CMBOR wrote a detailed report for the OECD on private equity and buy-outs.[9] CMBOR also during 2007 made presentations on private equity to the Bank of England and has held discussions with Treasury officials regarding private equity.

12. CMBOR's data and analysis have been used in recent reports regarding private equity. CMBOR's data was extensively quoted in the 2006 FSA report on private equity. The FSA obtained data from CMBOR on the private equity market that was used in the TSC Vol 1 report on private equity. The quantitative evidence on employment and wages effects of private equity in the Work Foundation report on private equity, which was referred to in the TSC Vol. 1 report, relied very extensively on the studies by Wright and colleagues and specific analyses were provided for the author without charge.

Comprehensive Scope of Monitoring Coverage

13. The Walker Guidelines focused on the largest private equity transactions and therefore do not enable comprehensive, industry-wide monitoring. Although extending coverage to a broader segment of the market raises potential issues about the burden of reporting, it would make for more reliable, meaningful and balanced monitoring of the private equity industry as a whole. In any case, the annual number of large deals completed is quite volatile, with there being few if any very large deals in some years. Extending the collection of data to the mid-market is important in enabling a more balanced view to be obtained, especially in the light of existing evidence of considerable heterogeneity in private equity. For example, there are differences in the employment effects of buy-outs and buy-ins[10] and differences in the extent of post-buyout restructurings and exit timescales according to size and vendor (source) of deal.[11]

14. If deals with enterprise value of £100 million and above were included, the total number of deals reviewed in 2006 would be 58 (9% of all deals) valued at £20.6 billion (78% of total market value). Further extending the approach to cover the £50–100 million range would bring in a further 36 deals in 2006. Furthermore if the threshold were lowered to £10 million the total for 2006 would be increased to 196. Therefore, CMBOR believes there is scope to widen monitoring to include mid market buy-outs from, say, a £50 million deal value upwards. CMBOR's database already provides the basis for tracking these deals.

15. In comparison with CMBOR, academics do not tend to engage in the collection of primary data on a continuing basis. Rather, they make use either of commercially developed databases [eg Zephyr, Thomson One Banker and Corpfin in the UK and Venture Economics in the U.S.]. An alternative is that some academics make use of government data sources [such as the Bureau of Census data in the U.S.] but as this is typically collected for other purposes, the information relating to private equity can be quite limited. A further option for buy-outs of listed corporations is to make use of publicly available data, but again this covers only a limited subset of the market. These different sources of data may then be combined with other information to create larger datasets.

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[9] This report is available from the OECD website or the CMBOR website [www.cmbor.com].

[10] Amess and Wright, ibid.

[11] For a review see: Wright, M, Burrows, A, Ball, R, Scholes, L, Meuleman, M and Amess, K, 2007. The implications of Alternative Investment Vehicles for Corporate Governance: A Survey of Empirical Research, Report prepared for the Steering Group on Corporate Governance. Paris: OECD.

Recommendations

16. The notion of a purely independent body to monitor private equity raises major questions over who will fund it. If such a body receives funding from the industry, it too will be open to criticism that it is not independent. We suggest that a way forward is for an arms' length relationship with the industry that can be achieved by locating a monitoring capability at a university, as is the case with CMBOR.

17. The benefit of using CMBOR is that the data are comprehensive and already provide a basis for monitoring. The CMBOR database comprises 25 years of data covering private equity and buy-outs deals across the UK and Europe. CMBOR goes to great lengths to ensure that it obtains as wide and complete a coverage of private equity deals as possible. Unlike commercially available sources, we also include information on confidential deals, engage in more effort to follow deals post-buy-out, and have a network of academic collaborators who are fully independent from the industry who can undertake rigorous analyses. This work also enables CMBOR to compare private equity with non-private equity backed buy-outs (if the data just looked at private equity backed buy-outs this would be a major shortcoming) as well as to compare private equity and buy-outs with firms in general.

18. Given that the CMBOR database is already extant it is not clear what would be gained by beginning a new dataset ab initio that would be less complete and that would take several years to build up before any trends could be analysed.

19. We suggest that it would be appropriate to explore options whereby the CMBOR database, as the widely acknowledged comprehensive and authoritative holder of deal information, could be used as the source for researchers and other interested parties wishing to conduct analyses of the market. To some extent this occurs already through our wide range of collaborative arrangements but there may be scope for this to be extended.

December 2007

Memorandum from Permira Advisers LLP

Executive Summary

- Permira Advisers LLP welcomes the opportunity to contribute for a second time to the Treasury Committee inquiry into private equity funds.
- Permira recognises the need for greater levels of disclosure and transparency in the private equity industry. Permira believes strongly that the Walker recommendations are an important first step and should be the catalyst for a meaningful change in the behaviour of the industry.
- Permira believes any effort to explain better the workings of private equity and its strong contribution to competitiveness, productivity and the long-term value of its investee companies, is positive.
- Permira believes it is for policy makers to determine what the appropriate level of taxation should be for the UK economy. Our view is that any tax system should operate consistently, and that private equity-backed companies should continue to be taxed on the same basis as other companies.
- Public to private deals ("P2P") represent a small proportion of Permira's total private equity activity. Permira originates transactions from a wide variety of sources. Given the varied sources from which Permira originates deals, we believe that directly contrasting public and private-equity owned companies is misleading, and represents a false dichotomy when examining the merits of private equity transactions.

Introduction

1. Permira Advisers LLP welcomes the opportunity to contribute for a second time to the Treasury Committee inquiry into private equity funds.

2. Permira is an international private equity firm. It has a staff of around 200 with operations in Frankfurt, Guernsey, London, Luxembourg, Madrid, Milan, New York, Paris, Stockholm and Tokyo.

3. The Permira Funds' focus is on investing in large companies that are not fulfilling their potential and would benefit from a period of private equity ownership. The value created in these businesses by the changes effected during this stage in their life—helping them to become stronger, more competitive and sustainable—in turn generates the return for the funds' investors.

4. Permira has raised and advised funds with a combined total of more than €21 billion over the last 20 years. The most recent fund received commitments from more than 70 public and corporate pension funds, more than 40 charities and endowments, more than 20 life insurance companies and eight governmental development agencies. The fund has more than 30 million underlying pension fund beneficiaries, including

approximately one million current and former UK local authority employees. By geography, some 55% of the capital committed to the most recent fund came from European institutions, 35% from North American, 8% from the Far East and 2% from the Middle East.

5. Since 1985, the Permira Funds have completed more than 180 private equity transactions. The Permira Funds are currently invested in around 30 portfolio companies based in Europe and the US and with operations around the world. Examples include New Look, Gala Coral, Birds Eye, AA Saga (Acromas Holdings Limited), ALL3MEDIA and Principal Hotels in the UK; SBS Broadcasting, Dinosol and Borsodchem in Continental Europe; and Arysta Life Sciences and Galaxy Entertainment in Asia.

Transparency

6. Permira recognises the need for greater levels of disclosure and transparency in the private equity industry. Our view is that a long history of high levels of disclosure and communication with limited partners has not been matched by openness and transparency with other stakeholders including portfolio company employees, the media, Government and Parliament, and trade unions.

7. In February 2007, Charles Sherwood, Permira partner, said:

> "What we have to do now, and I've been saying it for quite a long time, the [private equity] industry should be more open about what it does and what [portfolio] companies do. And the companies should communicate more about what they are doing and how they are creating stronger businesses which benefit everybody." ("Permira accepts need to be more open", *Financial Times*, 22 February 2007)

8. Since the second half of 2006 Permira has taken a series of measures designed to improve levels of openness and transparency:

- Permira has established an in-house communications function, with a remit to ensure greater levels of openness and transparency.
- Permira now has a regular informal dialogue with trade union representatives.
- In Spring 2008 Permira will publish an annual review in accordance with the recommendations made by Sir David Walker. Those UK portfolio companies covered by Sir David's recommendations will also be producing annual reviews.
- Gala Coral Group, a Permira portfolio company, published its annual report on 14 December 2007. Gala Coral was the first major private equity-backed company to produce a "Walker Compliant" annual report following the publication of the finalised Walker Guidelines for Disclosure and Transparency in November 2007.

It is Permira's view that the recommendations set out by Sir David Walker in "Guidelines for Disclosure and Transparency in Private Equity" (November 2007) are an important contribution to the industry's move towards greater transparency and disclosure. Permira has clearly signalled its intention to comply with the recommendations and is advanced in its work to that effect.

9. Permira believes strongly that the Walker recommendations are an important first step and should be the catalyst for a meaningful change in the behaviour of the industry. Reporting, after all, is just a proxy for real engagement. As such, Permira intends to continue widening and deepening its engagement with interested parties, from the media to trade unions, and build on the work it has been undertaking throughout the year to that effect.

10. Permira has strong and well-established mechanisms to communicate with its investors. Openness and transparency with investors underpins the successful operation of any private equity fund.

11. In Permira's fund legals there are specific and detailed requirements setting out communication with investors.
A number of mechanisms exist to ensure regular communication with investors:

- Regular updates on the activities and performance of both the investee companies and of the fund itself.
- An annual document detailing the performance of every Permira portfolio company.
- Investors attend an annual meeting during which the performance of the fund is presented and discussed.
- Investors receive annual audited accounts of the funds.

In addition, each fund has an advisory board composed of representatives of its largest investors, which provides oversight on key operational and strategic decisions, and which oversees the resolution of certain conflicts of interest.

12. Permira's most recent fundraising lasted approximately six months. During this time investors were able to meet all of Permira's senior investment professionals, were able to submit detailed questionnaires about all aspects of the firm, conduct detailed due diligence on the firm's track record, as well as being able

to call on advice from highly sophisticated investment consultants. Our investors' satisfaction with the information they receive is reflected in the high rate of reinvestment in our funds; approximately 90% of the investors by weight of capital in our first European fund, raised in 1997, reinvested in our most recent fund.

13. In the case of the other financiers of private equity-backed companies, such as the debt providers, we believe that the disclosure is adequate and is dealt with in the very detailed information requirements set out in the loan documentation.

14. Permira believes any effort to explain better the workings of private equity and its strong contribution to competitiveness, productivity and the long-term value of its investee companies, is positive. As such, Permira welcomed Walker's recommendations for much more extensive collection and analysis of data relating to private equity activity. Clearly the credibility of this exercise will only be enhanced by the participation of independent parties.

The Tax Regime for Private Equity

15. Many private equity funds are established as limited partnerships. From a taxation perspective, these limited partnerships are fiscally transparent, which has the effect that the investors in the funds are taxed on their investment in the fund as if they had invested directly into each investee company of the fund.

16. Since Permira submitted its first memorandum to the Treasury Committee's inquiry into private equity, the UK Government has announced its intention in the Pre-Budget Report to make a series of changes to the UK tax regime. One of the effects of the these changes has been to adjust the tax regime under which private equity firms operate in the UK.

17. Permira believes it is for policy makers to determine what the appropriate level of taxation should be for the UK economy. Our view is that any tax system should operate consistently, and that private equity-backed companies should continue to be, taxed on the same basis as other companies.

18. Permira is on record in stating that changes in taxation will not alter the firms's commitment to the UK. The success or failure of private equity firms is not determined by the level of taxation, but by the firms' ability to improve the performance of the businesses it invests in.

19. Public to private deals ("P2P"), represent a small proportion of Permira's total private equity activity. Permira's last P2P deal in the UK was in April 2004, and the Permira Funds have only completed 3 P2Ps in the UK since 2000. Permira originates transactions from a wide variety of sources.

Origination of Permira UK Portfolio (as of 17 December 2007)

Company	*Source*
AA Saga	AA acquired from Centrica in 2004, merged with Saga Group in 2007.
ALL3MEDIA	Acquired from another financial owner in a "secondary buy out" in 2006.
iglo Birds Eye	Acquired from Unilever in 2006.
Gala Coral Group	Already private equity-backed when the Permira Funds invested in the business in September 2005 (Gala Coral has a long history of private equity ownership).
Principal Hayley Group	Permira backed a management buyout of Principal in 2006.
New Look	P2P (2004).

Given the varied sources from which Permira originates deals, we believe that directly contrasting public and private-equity owned companies is misleading, and represents a false dichotomy when examining the merits of private equity transactions.

December 2007

Memorandum from the EVCA

Introduction

Further to its previous submission to the first call for evidence by the Treasury Select Committee on 9 May this year, EVCA, The European Private Equity and Venture Capital Association, would like to thank the Treasury Select Committee for the opportunity to provide additional evidence in relation to its enquiry into private equity, and again help frame analysis within the wider European context.

EVCA was established in 1983 and is based in Brussels. It represents the European private equity and venture capital (PE/VC) industry and promotes the asset class within Europe and throughout the world. Its role includes representing the interests of the industry to regulators and standard setters; developing professional standards; providing industry research; professional development and forums, facilitating interaction between its members and key industry participants including institutional investors, entrepreneurs, policymakers and academics.

EVCA's 1,200 members represent over 80% of PE/VC capital under management in Europe.[12] Its members represent all main industry stakeholders, from PE/VC fund management companies to institutional investors (banks, pension funds, insurance companies, family offices . . .), to professional advisors (lawyers, placement agents, investment bankers…) and national (European) trade associations.[13]

Comments

As the Treasury Select Committee has asked for respondents to provide comments on a number of specific issues, EVCA would like to focus its comments on the tax treatment of debt, and to draw the attention of the Treasury Select Committee to a number of recent developments in different Member States within the European Union (EU).

In 2007, several EU countries adopted new taxation rules aiming at restricting interest deductions in corporate tax systems. EVCA will publish a paper[14] on the impact of such developments on investment decisions and capital markets early in 2008. Although the research being undertaken is not yet fully complete, EVCA considers it important to share some of its preliminary findings with the Treasury Select Committee.

Thin capitalization rules have been in effect in some EU Member States for a relatively long period of time. These rules qualify interest payments on related-party debt as hidden dividends in order to prevent dominant shareholders from exploiting the differential tax treatment of debt as opposed to equity. More recently, several Member States (Denmark, Germany and Italy) have implemented so-called 'interest stripping' rules. Such rules consider high debt ratios as being a tax abuse and aim to limit the level of related and non-related party debt.

Interest stripping rules can be considered as a reinforcement of thin capitalization rules. Such an evolution appears worrying in the light of the research conducted by Buettner *et al* (2006).[15] This demonstrates that thin capitalization rules negatively impact the investment activity of companies. Therefore, interest stripping rules should be analyzed for their wider impact on the economy, and not just on a sectoral or industry specific basis. Moreover, another dimension should also be taken into account, namely the impact of such rules on the functioning of the European internal market.

The Economic Impact of Interest Stripping Rules

- The first obvious drawback of the implementation of such rules is a reduction in investment activity by companies. This can be demonstrated as follows:
  - The after-corporate-tax weighted average cost of capital (WACC) of companies is defined as $WACC = k_e w + k_d(1-T_c)(1-w)$, where w is the share of capital financed by equity, k_e is the investor's required return on equity, and k_d is the investor's required return on debt, before personal taxes. When interest expenses are not fully deductible from the corporate tax base, the formula changes to $WACC = k_e w + k_d(1-T_c(1-\theta))(1-w)$. To the extent that the pre-personal-tax cost of debt, ie k_d, is unchanged, the WACC of the firm increases for any θ being positive. Consequently, companies will reduce their investment activities as projects that had a positive net present value before the introduction of the interest stripping rule may turn out to have a negative net present value under the increased WACC.

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[12] Source: EVCA.

[13] Further information on EVCA is available online at www.evca.eu

[14] The research is being conducted by the Center for Entrepreneurial and Financial Studies (CEFS), Technische Universität Mnchen—Germany.

[15] Buettner T—Overesch M—Schreiber U—Wamser G (2006): "The impact of thin-capitalization rules on multinationals' financing and investment decisions", Working Paper No 06–67, ZEW.

— A second important drawback is that interest stripping rules have an asymmetric pro-cyclical effect. During macro-economic slowdowns, companies suffering from liquidity constraints would see their situation worsened as a result of taxing earnings before interest due. Indeed, interest stripping rules could result in companies being taxed although their earnings after interest could be negative.

— Thirdly, such interest stripping rules could potentially reduce the value of corporate loans held by institutions such as banks, insurance companies, and pension funds. Such an evolution would not only negatively impact investment, but also overall consumption and saving decisions, thus ultimately depressing and reducing economic growth.

In the current macro-economic context, the implementation of tax mechanisms that could reinforce economic crises seem inappropriate. The risks presented above suggest that EU Members States who have implemented such interest stripping rules have first carefully conducted a cost/benefit analysis of such measures. However, the benefits usually presented by such authorities only relate to preventing a decrease in tax revenues. This argument is questionable, as for the last 30 years corporate tax revenues have increased in the majority of OECD countries. Moreover, in the case of Denmark, the interest stripping rule was introduced as the government expected a decrease in taxes and duties resulting from the effect of leverage on companies of just 0.2% of the total amount due for collection in 2007[16]. Consequently, the benefits of interest stripping rules seem to bear no proportion to their both real and potentially negative costs to the wider economy.

The Impact of Interest Stripping Rules on the European Internal Market

The interest stripping rules that have been implemented in some EU Member States move part of the tax base generated by interest income from the country of residence of the investor to the country of residence of the company. Consequently, the flow of corporate loans across the European internal market could be significantly distorted. Further research should be undertaken in this area to fully understand the impact of interest stripping rules on the well functioning of the internal market.

Conclusion

It appears that the recent developments regarding the tax treatment of interest expenses are a source of serious concern in respect of unintended consequences due to:

— Their potential negative impact on economic growth and the future competitiveness of EU Member States who adopt restrictive measures, as well as for the European Union at large.

— The inappropriateness of some tax measures that could reinforce macro-economic crises.

— The potential constraints on the free movement of capital across the European Union.

EVCA will be pleased to share the final results of its research on the impact of restricting interest deductions in corporate tax systems on investment decisions and capital markets with the Treasury Select Committee and other stakeholders such as the European Commission upon its completion and publication, which is scheduled for early 2008.

December 2007

Memorandum from the British Private Equity and Venture Capitalist Association (BVCA)

Executive Summary

1. Transparency and Sir David Walker's proposals for improving the transparency of the private equity industry
The BVCA has accepted the Guidelines for Disclosure and Transparency recently issued by Sir David Walker. The guidelines make recommendations and set out increased levels of reporting for private equity firms, their portfolio companies and the BVCA as the industry body.

The guidelines apply exclusively to private equity firms which are managing or advising funds that own or control "large" UK companies, or that have a designated ability to invest in such companies.

The guidelines will be overseen by the recently established Guideline Monitoring and Review Group (GMRG). This group, to be chaired by Sir Mike Rake, will be composed of two additional independent members and two GPs or advisers to funds that invest in portfolio companies covered by the guidelines, thus ensuring a majority of independents in the group.

The GMRG will oversee the code as well as keeping the guidelines under review.

[16] Bech-Bruun (2007): "New Danish Interest Deduction Limitations and CFC rules". Downloadable at www.bechbruun.com.

The BVCA believes the levels of disclosure recommended are both appropriate for the various stakeholders, including employees, investors and the general public. This increased disclosure will mean that the ownership and management decisions of the portfolio companies as well as the private equity firms will be more transparent. The collection of more authoritative data will also make clearer to all stakeholder groups, the industry's economic impact. With this in mind, the BVCA has appointed Ernst & Young to collect and analyse more detailed data on large deals.

2. Taxation

Tax treatment of debt and equity

The distinction between debt and equity has been established for many years and is accepted in almost all major jurisdictions. The UK has a vitally important and highly successful financial services sector, and any general change to the taxation of equity and debt would need to be considered very seriously so as not to do damage this.

The Memorandum of Understanding (MOUs) between the BVCA and HMRC

The MOUs provide practical answers in relation to the administration of VC and PE transactions on the basis of the 2003 legislation. We note the Government response to the Committee's interim report that "HMRC has no reason to suppose that the original rationale (of the MOU) is not being followed in the great majority of instances".[17]

Options for further reform of shareholder debt

The BVCA believes that legislation currently in place which oversees the level of debt in any transaction is both conceptually right and appropriate.

Further options for the reform of Employment Related Securities ("ERS")

The 2003 legislation includes a number of anti avoidance rules providing further protection. However, the rules are over complex, and we suggest any reform focus on this area.

The appropriateness of the tax regime for private equity in the light of recent changes to capital gains tax

Whilst in favour of a simplified and certain CGT regime, the BVCA is concerned at the increase in capital gains tax to 18% and the abolition of taper relief as it impacts all member firms. The 18% rate is higher that most European countries, and the new capital gains tax rate therefore damages the UK's competitive position.

3. Other Issues

Why investors make different demands of public companies compared with private equity-owned companies

Investors in private equity funds are usually professional sophisticated institutions, who agree the levels of information flow with general partners. The limited partners' stake in the fund is an illiquid asset, and so the level of information flow to investors in private equity owned companies can be much greater than in public companies.

The implications of private equity-funded takeovers for company pension funds

There is no legal difference between a takeover by a private equity firm, and one involving funds from the public markets. There are therefore no "implications" for company pension funds which are different from non private equity-funded takeovers. New regulations were introduced in 2006 which impose strict consultation requirements on all employers when proposing changes to future pension accrual.[18]

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[17] Government response to Interim Report on Private Equity, p 5.

[18] The Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006—2006 No 349.

The operation of TUPE in private equity takeovers

TUPE was put in place to ensure that when a company sells a business to another company in an "asset sale", the employees who work in that business have their jobs and terms and conditions protected. TUPE applies to all "asset sales", so it applies to all companies, including ones that are private equity-backed.

In "share sales" there is no need for TUPE as current legislation protects workers employment rights, and gives them access to information and rights to consultation, and those protections apply after a share sale just as they do at any other time.

Market abuse and conflicts of interest in private equity transactions

All BVCA-member private equity fund managers in the UK are authorised and regulated by the FSA. In common with other investment managers, they are subject to transaction reporting obligations laid down by the FSA. The BVCA believes that member firms are aware of the controls over confidential and price-sensitive information advocated by the FSA.

Conflicts of interest

The BVCA and individual member firms have been working closely with the FSA in developing a common understanding of the nature and risks of conflicts of interest in the context of private equity.

A. Introduction

1. The BVCA welcomes the opportunity to submit further evidence as part of the Committee's resumed inquiry into private equity. As the representative body for the private equity and venture capital industry, we represent over 400 firms, from small starts-ups to large buyouts, and this memorandum follows our initial submission in April.

B. Transparency

Transparency and Sir David Walker's proposals for improving the transparency of the private equity industry

The structure and effectiveness of the recently established BVCA panel for monitoring, and encouraging compliance with, the code of conduct

2.1 On 20 November Sir David Walker issued his Guidelines for Disclosure and Transparency in Private Equity. Along with the recommendations for portfolio, GP (General Partner) and industry level reporting, the guidelines also recommend the establishment of a guidelines review and monitoring capability.

2.2 Whilst highlighting that the self-regulatory code has been adopted voluntarily by the industry, the BVCA has accepted Sir David Walker's recommendation that a Guidelines Monitoring and Review Group (GRMG) be established.

Structure

3.1 The BVCA has appointed Sir Mike Rake, Chairman of BT, as Chairman of the group. Sir Mike is a highly respected figure, and we believe he will bring considerable independence and authority to the role.

3.2 The rest of the group will be composed of two independent members that are GPs or advisers to funds that invest in portfolio companies covered by the guidelines, ensuring a majority of independents in the group.

3.3 The members of the group are to be appointed by the Chairman and Council of the BVCA, and announcements will be made in due course.

3.4 The group will appoint an independent and respected institution to undertake data processing and assessment on the basis of initial self-assessment, as well as carrying out appropriate spot-check sampling. It is envisaged that this appointment will be made at the beginning of 2008.

Terms of reference

4.1 The group will run independently of the BVCA, with its own secretariat, and will maintain contact with the BVCA on a regular basis. It is envisaged that the group will meet four times a year and publish a brief annual report.

4.2 The group is to review the extent of conformity with the guidelines, through compliance or explanation. It is also tasked with keeping the guidelines under review in light of changing industry conditions, effectiveness of the comply or explain code, etc.

Conformity with the guidelines

5.1 The code is voluntary in the sense that the industry has signed up to it of its own volition, but effective sanctions will be put in place. Membership of the BVCA will be contingent upon signing up to the Walker Guidelines.

5.2 Adherence with the code is on a comply or explain basis. This is a critical element to the flexibility of the structure of the guidelines, and reflects the need to take account of the rapid change which the industry had undergone in the last 12–24 months. Firms, who for reasons of competitive disadvantage (for example, in a bid where a rival bidder does not need to declare the information) cannot meet all of the disclosure requirements, will be expected to explain why they cannot comply with the code.

5.3 If a member firm, or one of its portfolio companies, fails to meet the criteria or provide sufficient explanation as to why they have not, there will be tough sanctions, including the application of substantial pressure from the GRMG, public disclosure, and ultimately, expulsion from the BVCA. We believe this will provide a tough package of measures, with public disclosure and censure a particularly powerful tool, given the level of public attention the industry now faces.

Timescales

6.1 A detailed announcement of the composition, remit and operation of the monitoring group is anticipated early in 2008.

6.2 The Guidelines recommend establishing a whole system of self-regulation. This will take time to implement. However, the BVCA believes this self-regulatory process will provide an effective and appropriate framework for compliance. We are confident that the structure of the group, with a majority of independents, will reassure all stakeholders of the legitimacy of the process.

The appropriateness of the proposed level and type of disclosure for the various stakeholders in private equity-owned businesses

7.1 It is a principle laid down in statute that private companies should not be required to make the same degree of public disclosure as quoted companies. Yet Sir David's guidelines recommend a lifting for private equity firms, of the derogation granted to all other private companies in the Companies Act 2006.[19] In doing so, it asks BVCA member firms to forego this, as well as to make a significant cultural shift in adopting these new practices.

7.2 In recognising the greater influence private equity now plays in the economy, we appreciate the need for our larger member firms to communicate with a wider group of stakeholders.

7.3 The guidelines make recommendations for three levels of disclosure: GP level reporting, portfolio company reporting and industry level reporting. Each of these addresses the concerns of different stakeholders including: investors, employees, and the general public.

7.4 We believe the levels and type of disclosure are appropriate for the following stakeholder groups:

Investors (Limited Partners)

8. Limited Partners (LPs), as investors in private equity funds, already receive a much greater level of information than do the shareholders in public companies, and generally agree with Sir David Walker's conclusion that the current levels of disclosure are sufficient. (See further information below in Section D "Why investors make different demands of public companies compared to private equity-owned companies").

Employees

9.1 The additional levels of information recommended in the report mean the ownership of portfolio companies will become more transparent, and allow employees—who are at the heart of the threshold criteria outlined below, under "private equity companies covered by the code"—to know who is responsible for management decisions in their company.

9.2 The collection of more authoritative and comprehensive industry level data, which the report also recommends, will contain details of levels and changes in employment, and make clear the industry's economic impact in this respect (See more information on industry level data below).

The Guidelines also stipulate communication with employees which is timely and effective at times of strategic change.

[19] Of the need to produce a Business Review, Companies Act 2006 Section 417 (5).

9.3 In addition, the report highlights the legislation already in place in this area, which provides protection for employees:

(a) Companies have an obligation under the Takeover Code to make disclosures in respect of continuing employment, conditions of employment and pensions provision, in a published offer document in support of an offer for a company quoted in the UK.[20]

(b) Information and Consultation of Employee Regulations (Employment Relations Act 2004). All public and private companies in the UK that employ more than 100 employees, and more than 50 employees from April 2008, must set out the rights of employees to be informed and consulted on a regular basis on important developments that may affect their interests. The procedures are triggered by a formal request from employees or at the employer's initiative by starting the process voluntarily.

We believe that the above measures, taken together, represent a level of disclosure and communication with employees which is both appropriate and substantial.

General public

10.1 The range of measures proposed in the Walker Guidelines mean that more information than ever before will be accessible by the general public. Information will be made available on company websites for both private equity firms and portfolio companies, and this will mean much greater levels of and access to information about the ultimate owners of portfolio companies, and the management decisions taken within them.

10.2 The reporting made available on an industry wide basis will allow the public and wider stakeholders better to understand the contribution private equity makes to the UK.

Proposals for a respected capability for providing comprehensive, industry-wide data on the private equity industry

11.1 The BVCA recognises the need to provide industry wide data which is comprehensive, independent and respected, particularly in order to promote better understanding of how the private equity industry operates, and its impact on the UK economy.

11.2 Sir David Walker makes a number of specific recommendations about research and data collection that the BVCA accepts and is planning to undertake. He specifically recommends that: "The overall capability of the BVCA should be boosted so that the BVCA becomes the recognised authoritative source of intelligence and analysis both of larger-scale and of venture and development capital private equity backed businesses based in the UK and a centre of excellence for the whole industry".

11.3 This process of strengthening the BVCA's current research capacity is underway. Further, the BVCA has appointed Ernst & Young to collect detailed data initially on the 20–30 deals done annually with a total enterprise value of over £250 million, starting with those done in 2006 and going forward. Information to be gathered is to be, broadly, as follows:

— Year immediately following investment: general deal information including name, date, deal structure/size, backers, equity holding, debt/covenants, etc.

— Annual data gathering on portfolio company: follow-on investment from backers, new capital investment, acquisitions, tax, sales, EBIT(DA), debt levels, employment levels/changes and other productivity measures.

— Exit information: date, deal size and debt levels—including attribution analysis.

— Attribution analysis: Starting with 2007 exits, looking at the proportion of returns generated by different means (leverage/financial structuring, growth in market multiples/earnings, strategy and operational management of the business).

11.4 Data will be disseminated on an aggregate basis only. The work will be undertaken annually, with results for each calendar year released in the following May/June.

11.5 The enhanced data collection outlined above will also enable the BVCA to publish an enlarged version of the economic impact and associated surveys, currently published, covering both the industry overall and specifically for larger-scale private equity businesses.

11.6 We feel that the industry level attribution analysis is a particularly powerful tool. It will allow an independent assessment of the contribution of private equity firms to the whole economy. By breaking down the way the industry makes its returns into financial structuring, market movements and operational improvements, it will allow a much clearer view of what private equity firms are actually doing, and how they create value.

[20] This obligation reflects the requirements of the European Union Takeover Directive (2005) carried into legislation in the UK through Chapter 1 of Part 28 of the 2006 companies legislation.

The private equity-owned companies to be covered by the code

12.1 The guidelines apply exclusively to private equity firms which are managing or advising funds that own or control "large" UK companies, or that have a designated ability to invest in such companies. "Large" UK companies are those that meet all of the following criteria at the time of the transaction:

(a) More than 50% of revenues are generated in the UK;

(b) There are more than 1,000 full-time equivalent UK employees; and

(c) The company had (at the time of acquisition) an enterprise value of £500 million (in the case of a secondary or non-market transaction) OR a market capitalisation, together with the premium for acquisition of control, in excess of £300 million (in the case of a take private transaction).

12.2 The first estimates indicate that the guidelines will cover approximately 18 private equity houses and 65 portfolio companies owned by them.

12.3 We are encouraged by the commitment shown by our member firms to complying with the guidelines. The process is ongoing. It is expected that once the GMRG is in place in early January, work will commence on identifying further firms who have the designated capability to own portfolio companies of the size specified by the criteria.

C. Taxation

Tax treatment of debt and equity

13. The distinction between debt and equity has been established for many years and is accepted in almost all major jurisdictions. The UK has a vitally important and highly successful financial services sector, and any general change to the taxation of equity and debt would need to be considered very seriously so as not to do damage this.

The Memorandum of Understanding between the BVCA and HMRC

14. Three memoranda of understanding—or agreements—currently exist between the BVCA and HMRC: the 1987 agreement, and two MOUs in 2003.

The 1987 BVCA Agreement

15.1 The 1987 agreement provided a framework for the tax treatment of limited partnerships used as vehicles for investment in unquoted companies. At the time there was significant uncertainty regarding the taxation treatment of venture capital partnerships and consequently most were established outside the UK. The 1987 agreement provides an effective onshore structure for investment funds. The structure and agreement has for 20 years been successful in attracting funds to base their operations in the UK, and key to the establishment of funds for investment in UK companies.

15.2 The agreement did not and does not change the application of the relevant tax legislation but is based on a long standing HMRC statement of practice. It covers the UK taxation treatment of managers and investors in the fund and in particular confirms the tax transparency of venture capital partnerships, such that profits and losses are taxed at the level of investors. Therefore, investors and managers are taxed on profits arising from PE/VC partnerships in the same manner as their other investments.

The 2003 Legislation and Memoranda of Understanding

16.1 Where employees receive equity, any gift or undervalue is treated as remuneration but subsequent profits as capital. Most countries adopt a very similar approach. This basic principle is fundamental and should be maintained.

16.2 The 2003 legislation tightened these rules and also introduced PAYE requirements such that in the absence of action, investors could be left to fund the tax costs. HMRC did not have the resource to value securities in relation to the volume of transactions performed in the UK and elsewhere in the world where UK resident managers invest, particularly as there was a need for these to be agreed prior to investment. There was a concern that this would stifle transactions, which are a very significant part of UK economic activity. Consequently both the BVCA and HMRC had an interest in agreeing a practical solution and so two MOU's were agreed. Neither MOU changes the 2003 legislation, which applies to VC and PE managers in the same manner as any other taxpayer. Both MOU's simply provide practical answers in relation to the administration of VC and PE transactions.

16.3 In addition, we note the government response to the Committees interim report that *"on the basis of the cases seen, and taking into account other anecdotal evidence, HMRC has no reason to suppose that the original rationale(of the MOU) is not being followed in the great majority of instances"*.[21]

[21] Government response to the Interim Report on Private Equity, p 5.

Options for further reform of shareholder debt

17.1 The BVCA believes the legislation currently in place (the "arms length test"), which oversees the levels of debt in any transaction, and ensures that the level of debt could be raised independently, is both conceptually right, and appropriate. We would also point out that, given present market conditions, the levels of debt in future transactions are likely to be less significant, and so the need for the arms length test to be applied will not be as great.

17.2 Moreover, in many transactions, we believe that the interest relief regime is in fact now tilted against private equity investors, as compared to corporates. In many circumstances, a corporate acquirer is able to use not only the capacity of the target company but also its own assets and profits, thereby potentially enabling it to borrow significantly more.

17.3 This should be seen in the context of the wider corporation tax system. Grouping arrangements for UK tax purposes allow corporate owners a number of mechanisms to reduce the overall corporation tax charge of its subsidiaries—for example, setting off profits in one subsidiary against the losses of another. Such grouping arrangements are not available to the private equity investor between portfolio companies.

Further options for the reform of Employment Related Securities ("ERS")

18.1 As mentioned above, the rules on ERS's were tightened in 2003. These rules are amongst the strictest regimes in the world; the only other country which operates a similar regime is the United States.

18.2 Whilst we believe the aim of the legislation is correct, there is still uncertainty in its application, and would like to see further clarity and simplification. For example, the 2003 legislation includes a number of anti avoidance rules providing further protection in relation to value shifts in favour of employees, convertibles which could be used to enhance the value of employee shares, and a catch-all provision entitled "post acquisition benefits". These rules are overly complex and do not take into account the variety of financial instruments used in practice and the international nature of business. We suggest that any reform of the rules on employment related securities should focus on this area.

The appropriateness of the tax regime for private equity in the light of recent changes to capital gains tax

19.1 Whilst in favour of a simplified and certain CGT regime, the BVCA is concerned at the increase in tax to 18% and the abolition of taper relief as it impacts all our member firms. The 18% rate is higher that most European countries, and the new capital gains tax rate therefore damages the UK's competitive position.

19.2 The BVCA is particularly concerned with the smaller companies sector, and recently wrote to the Chancellor suggesting how the adverse impact of the new rules might be lessened in other areas, such as allowing venture capital-backed companies to qualify for tax reliefs aimed at small companies. This is something the BVCA has raised in our Pre-Budget Report submission for the last three years.

D. Other Issues

Why investors make different demands of public companies compared with private equity-owned companies

20.1 Investors in private equity owned companies ("limited partners" or "LPs"), are usually professional institutions, who agree the levels of information flow with general partners. The limited partners' stake in the fund is an illiquid asset, and so private equity-owned companies are able to communicate both historical and forward looking financial information, which is not the case on the public markets, where no forecast information is given for fear of legal suits if trading of securities is done on the basis of the information which then turns out to be wrong. The level of information flow to investors in private equity owned companies can therefore be much greater than in public companies. Indeed the Walker Guidelines document concluded that "the content and timeliness of information flow to limited partners is regarded by most limited partners as fully sufficient".[22]

20.2 In respect of information made available to the wider public, all UK companies are required under companies legislation to file reports and accounts at Companies House. It is a principle laid down in statute that private companies should not be required to make the same degree of public disclosure as quoted companies. All private companies (including those owned by private equity) are required to produce less content and detail than those that are listed. Private companies are required to report less frequently and in less detail than those that are listed, but are still subject to strict prescriptions relating to content and timing of filing.

20.3 The rationale lies in their different ownership structures. Private companies generally have a limited number of shareholders who are often closely connected with the company. By contrast, the shares in quoted companies are widely held—BT has well over a million shareholders—and company law prescribes appropriate levels of public disclosure to ensure that they are properly informed.

[22] Walker Guidelines on Disclosure and Transparency in Private Equity, p 3.

The implications of private equity-funded takeovers for company pension funds

Background

21.1 There is no legal difference between a takeover by a private equity firm, and one involving funds from the public markets. In both cases, the shareholders in the "target" company sell their shares in exchange for cash, loan notes or new shares, or a combination of all three.

21.2 There are therefore no "implications" for company pension funds in a private equity-funded takeover, which are different from non private equity funded takeovers. Any non private equity acquirer of a company has to face the same issues as a private equity acquirer in dealing with the company pension fund. Similarly, the same safeguards and controls in are place to ensure that the position of the company pension fund is not prejudiced by the transaction.

Safeguards

22.1 The Pensions Regulator issued, in April 2005 a "Clearance Guidance" note, which explained how it intended to use its corresponding powers to make "clearance" determinations in relation to proposed transactions. That guidance applies equally to private equity and non private equity acquirers. This point was reaffirmed in September 2007, when the Pensions Regulator issued a new draft of the clearance guidance, which considerably extended the range of circumstances in which the Regulator states that it would consider using its powers in the context of corporate transactions.

22.2 In terms of the benefits provided by company pension funds, there is no evidence to suggest that private equity acquirers are any more likely to take action which is adverse to ongoing pension accrual than other types of owner.

Consultation with employees

23.1 New regulations were introduced in 2006 which impose strict consultation requirements on employers when proposing changes to future pension accrual.[23] These requirements apply equally to private equity financed employers as to any other type of employer. Private equity firms take their responsibilities in this area extremely seriously, and there are no reported instances that we are aware of where the rules have been abused.

23.2 In addition, and as the Walker Guidelines point out: the Takeover Code makes obligations on

> *"disclosures in respect of continuing employment, conditions of employment and pensions provision in a published offer document in support of an offer for a company quoted in the UK".*[24]

Scheme wind-ups

24. When a defined benefit pension scheme enters into winding-up, its sponsoring employer is required by law to pay up any deficit in relation to the cost of securing the benefits in full with an insurance company. The fact that some employers have been unable to meet that deficit either wholly or partially as a result of the employer's insolvency says nothing about the cause of the insolvency.

The operation of TUPE in private equity takeovers

Background

25.1 TUPE (Transfer of Undertakings (Protection of Employment) Regulations 2006) was put in place to comply with EU legislation in order to make sure that when a company sells a business to another company, in an "asset sale", the employees who work in that business have their jobs and terms and conditions of employment protected.

25.2 The basic intention is to ensure that employees are not denied their employment protections by being left behind in a company which no longer operates the business that they work in because that business has been sold.

[23] The Occupational and Personal Pension Schemes (Consultation by Employers and Miscellaneous Amendment) Regulations 2006—2006 No 349.
[24] Walker Guidelines on Transparency and Disclosure in Private Equity, p 26.

Application to private equity

26.1 TUPE applies to all "asset sales", so it applies to all companies, including ones that are private equity-backed.

26.2 Usually, however, when one company wants to buy another (including when a private equity firm backs a buyout) it will buy the shares of that company, rather than its assets. It is a "share sale" rather than an "asset sale". In the sale, the company remains intact and just has a new owner. The company still owns the assets, and still employs the employees, who retain all their employment protections. There is therefore no need for TUPE.

Extension of TUPE to "share sales"

27.1 The BVCA does not believe this is necessary because TUPE was brought in specifically for non share sales, as above. Furthermore, other legislation already protects workers' employment rights, and gives them access to information and rights to consultation, and those protections apply after a share sale just as they do at any other time (see above).

27.2 Employees retain their existing employment protection and the identity of their employer does not change. In relation to any concerns regarding potential job losses, existing employment legislation already requires information and consultation with employee representatives where 20 or more job losses are envisaged. This is similarly the case in respect of concerns regarding pensions, where significant changes are intended (see above).

27.3 Finally, TUPE regulations were last updated in the UK in 2006, following an extensive consultation process. And as recently as June of this year, the European Commission concluded that there was no justification to extend the directive to a change of ownership of shares.

Market abuse and conflicts of interest in private equity transactions

Market abuse

28. Market abuse relates to shares, debt or other instruments traded on public markets. Private equity and venture capital transactions do not generally involve public markets. A private equity firm is therefore most likely to acquire inside information in public-to-private leveraged buy-out transactions, occasional private investments in public equity or exits by floatation.

The potential for leaks

29. The FSA has undertaken work in this area (notably in Feedback Statement 07/3), and we understand their principal concern relates to leaks. Private equity firms rarely launch a hostile bid. They therefore need to conduct due diligence to protect the interests of their investors. We have seen no evidence that the likelihood of a leak is any greater where a private equity firm is involved, than in the context of any other public market M&A activity. Nor is there any evidence that leaks come from the private equity firms. In the vast majority of cases, leaks are absolutely not in the firms' interest.

The interests of private equity firms

30.1 Confidentiality is vital to a private equity bidder. Confidentiality agreements are a common feature of the market. Prior to a buy-out, a private equity firm will derive no benefit from the leak of the fact of its interest in a particular listed company. Indeed, a leak will almost certainly create a speculatory bid premium, which will cost the private equity firm money.

30.2 Where a private equity firm holds securities admitted to trading following an IPO, any preferential access to information will cease, information held by the firm prior to the IPO will be disclosed in the offering documents, and the situation will be no different to any other holding of listed shares. There are also obvious attractions for private equity firms in well-respected, transparent and efficient markets which provide good opportunities for exits.

30.3 In addition, under Rule 20.2 of the Takeover Code, there must be "equality of information" in the bid process, and so all information disclosed to one bidder must also be disclosed to any other bona fide bidder. This is in order to ensure that all shareholders are treated equally during all takeover bids, not just those involving private equity.[25]

[25] Takeover Code, Rule 20.2: *"any information… given to one offeror or potential offeror . . . must, on request, be given equally and promptly to another offeror or bona fide potential offeror even if that other offeror is less welcome".*

BVCA activity

31.1 All BVCA-member private equity fund managers in the UK are authorised and regulated by the FSA. In common with other investment managers, they are subject to transaction reporting obligations to the FSA.

31.2 The BVCA believes that member firms are aware of the controls over confidential and price-sensitive information advocated by the FSA. The BVCA recently held a seminar on this issue for firms, and we understand that firms are reviewing and improving their controls in cooperation with the FSA.

Conflicts of interest

32.1 The BVCA believes that commercial pressures mean that potential conflicts of interest in private equity arrangements are largely well managed. The industry has developed with an emphasis on transparency to investors (see earlier paragraphs 21 and 22).

It is vital to appreciate that:

— the clients of a private equity firm are the funds which it manages; and

— the interests of investors are paramount.

32.2 It is also important to note that the other participants in private equity transactions will invariably retain their own professional advisers to secure their interests.

Investors

33. Investors are almost always sophisticated institutions, advised by lawyers, and others, who negotiate appropriate controls over potential conflicts. Often controls include an obligation to refer potential conflicts to a panel of representative investors. Normally, all investors in a private equity fund participate on the same terms.

Remuneration structures

34. Carried interest and similar executive co-investment structures are a feature of private equity funds. These arrangements are usually the most heavily negotiated by investors, with executive co-investment almost always on the same terms as the investors in the fund.

Investee companies and representative directors

35. Where private equity executives join the board of an investee company, they may encounter a personal conflict between the obligations they owe to their employer-firm and fiduciary obligations owed to the investee company. The issue is identical to that in any other corporate structure in which a shareholder puts a representative on the board of a subsidiary. Long-established controls include provisions in a company's articles of association for formal disclosures of interests and for directors to recuse themselves from certain decisions.

BVCA activity

36.1 The BVCA and individual member firms have been working closely with the FSA in developing a common understanding of the nature and risks of conflicts of interest in the context of private equity. In addition, the FSA is currently consulting a wider range of firms on the topic.

36.2 In addition, those private equity firms subject to the Markets in Financial Instruments Directive (MiFID) have been reviewing and developing their formal conflicts of interest policies as required by the Directive, and the BVCA has recommended that other member firms take a similar approach.

36.3 Finally, this area forms part of the Walker Guidelines on transparency. In producing an Annual Report, a private equity firm must communicate, *inter alia*: "*that arrangements are in place to deal appropriately with conflicts of interest, in particular where it has a corporate advisory capability alongside its fiduciary responsibility for management of the fund or funds*".[26]

December 2007

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[26] Walker Guidelines for Transparency and Disclosure in Private Equity, p. 26.

Memorandum from the Association of British Insurers (ABI)

Introduction

1. This paper is the response of the Association of British Insurers (ABI) to the Treasury Committee's invitation to submit further evidence to its inquiry on private equity. ABI members as institutional investors have around £1.3 trillion of funds under management, which includes around 20% of UK-listed equities, plus substantial other investments in UK financial assets including fixed interest stocks and investments in unquoted companies. As such they are concerned to see that private equity contributes to the overall health of the investment markets. More specifically they are themselves investors in private equity as well as investing on behalf of third party clients.

Executive Summary

2. The final proposals from Sir David Walker on transparency have been strengthened as regards the monitoring role for their effectiveness but their scope has been narrowed to exclude portfolio companies with less than half of their turnover sourced from the UK. This reduces the all-purpose usefulness of the guidelines though investors in private equity will be able to fall back on existing disclosure which is largely adequate. Disclosures proposed to be made at fund level have also been scaled back.

3. Private equity should operate on a level playing field. It is well-placed to take advantage of the imbalance of tax treatment of debt and equity capital but the remedy for this should be reform to achieve a sensible rebalancing, not penalisation of private equity. Tax treatment of carried interest equally needs to fairly reflect the nature of such earnings taken by general partners. On the assumption it will continue to fall within the CGT regime we do not believe there are cogent arguments for a more favourable tax rate than the 18% designed to apply across the board for capital gains.

4. The private equity and quoted plc models are different. This reflects not just the needs of the businesses owned but also the very different investor and capital bases. This in turn produces different governance and financial structures. Private equity is characterised by concentrated ownership giving rise to shareholder representation on the Board, high debt levels and a more defined investment time horizon. This contrasts with quoted companies where shareholders look to the Board, including its non-executive directors, to run the company on their behalf. However, in doing so, Boards will need to be responsive to the expectations of investors.

General Comment

5. We do wish to emphasise, at a general level, that the private equity industry works well as regards information flows to its investors. Appropriate levels of transparency allow informed investment decisions to be made. Nevertheless, there is scope to enhance further the flows of information about private equity funds for the benefit of investors. We consider that this focus on responding to the information needs of investors is the appropriate organising principle around which greater transparency in private equity can best be provided.

Questions for Consultation

Transparency

Sir David Walker's proposals for improving the transparency of the private equity industry; including;

The structure and effectiveness of the recently established BVCA panel for monitoring, and encouraging compliance with, the code of conduct

6. The changes that Sir David Walker has proposed in his Final Report for a more explicit and independent monitoring process of the Guidelines are a welcome strengthening reflecting a clear consensus that the initial proposals did not in this respect go far enough. It is essential that the proposed "comply or explain" framework be made to work. This is a framework that works well in the quoted equity sector where shareholders make judgments as to the appropriateness of departures from best practice benchmarks, and this informs their on-going relationships with the companies in which they invest. Their enlightened self-interest helps ensure that governance arrangements are made to work but participants in private equity are in a somewhat different position.

The appropriateness of the proposed level and type of disclosure for the various stakeholders in private equity-owned businesses

7. The concern as to transparency relating to companies owned by private equity has been the withdrawal of the disclosures that would be made in the normal course of events by quoted companies to their shareholders and, by extension, other investors and other interested parties (stakeholders). We consider that the Report's recommendations to replicate this approach to disclosure are correct. This approach is not, therefore, concerned about reporting to but, rather, about stakeholders. This does not, however, impair its value by extension as a reporting tool to those stakeholders.

Proposals for a respected capability for providing comprehensive, industry-wide data on the private equity industry

8. These proposals for industry-wide data for private equity are appropriately pitched and we hope that the BVCA will be able to take this forward in an effective fashion.

The private equity-owned companies to be covered by the code

9. We consider that the final Guideline formulation to be a step backwards from the original proposals in Sir David Walker's Consultation Document.

10. As regards reporting by portfolio companies, the trigger criteria for enhanced reporting have been changed from a size of consideration or size of workforce formulation to one that kicks in when size of consideration and size of UK workforce exceed the previously suggested thresholds. However, this is all subject to a new criterion that the proportion of revenues generated in the UK exceeds 50% of the total.

11. We consider that the scope of reporting obligations should be consistent, as far as possible, with the scope of reporting by quoted companies. Many companies with their principal stock market quotation in the UK have turnover of significantly less than 50% in the UK but they are no less a constituent of the UK corporate sector on account of this. It would have been better for the Report to have used the opportunity presented by consultation feedback suggesting that UK turnover should be a relevant criterion by adding this whilst leaving the rest of its original formulation unchanged.

12. As regards reporting by private equity firms the obligations appear to have been scaled back. Disclosure of philosophy of approach to employees, working environment and corporate social responsibility are dropped; there is less visibility on attribution analysis between operational performance and financial engineering (where any data will now be cross-sector rather than on a firm-by-firm basis); and other aspects of disclosure are to be made UK-specific (eg it is how the FSA-authorised entity within the firm on which disclosure of investment approach, identification of senior management etc).

Taxation

The tax treatment of debt and equity

13. Our earlier submission to the Committee outlined our view that there are tax disadvantages of equity compared to debt finance that are material and which have grown. This has created an unlevel playing field which the private equity sector has been well positioned to take advantage of. It has done so through exploiting the consequent advantages of increased leverage whilst investment through private equity has proved a particularly tax-efficient route for tax-exempt institutional investment funds, such as pension funds, to obtain investment exposure to the fruits of business enterprise. We do not believe that private equity should be penalised on this account but, rather, we see merit in a more fundamental reappraisal of how the tax system can ensure an appropriate balance in the treatment of debt and equity finance, for the benefit of all investors.

14. There has been discussion about the extent to which anti-avoidance arrangements should be used in the tax system to prevent excessive use of debt where the reality is that a corporate entity requires genuinely committed equity capital. However, the more enlightened approach should be to consider why debt finance should enjoy particular tax advantages compared to equity, or vice versa, and to reassess whether some degree of convergence should be sought. The introduction of the dividend imputation system in the 1970s achieved much in this regard but recent changes have lost some of the advances that were made then.

The Memorandum of Understanding between the BVCA and HMRC

15. Arguments as to whether carried interest should be treated as income or capital gains are relatively finely balanced and we see no particular need to challenge the basis of the memorandum of understanding in so far as it establishes the treatment as capital gain. However, qualitatively, this type of return is different and it does not involve genuine commitment of capital over time by the private equity general partner. Its specific characterisation as, for example, a long-term gain over the life of the fund since inception, is somewhat more difficult to sustain.

Options for further reforms of shareholder debt and employment-related securities

16. We have no observations on treatment of shareholder debt other than to emphasise that this would be less of a difficulty if there were a more level playing field as regards taxation of debt and equity capital.

17. As regards taxation of employment-related securities our understanding is that for many recipients of such securities as part of their remuneration and incentivisation benefits a capital gains tax liability seldom eventuates as the tax free annual allowance is sufficient to cover the gain. For high-paid participants, the benefits of treatment as a CGT liability rather than as liable to income tax at full marginal rate is significant and it is difficult to conclude that withdrawal of taper relief and bringing this within the new and generally applicable 18% CGT rate is an unreasonable or injudicious change.

The appropriateness of the tax regime for private equity, in the light of recent changes to capital gains tax

18. In the context of private equity, the change to the CGT regime is of particular relevance to treatment of general partners' carried interest. Consistent with our earlier comments, we consider that liability to this tax at 18% but with withdrawal of taper relief would be difficult to characterise as constituting unfair treatment for carried interest recipients. We recognise that comparative attractiveness of other tax jurisdictions and the impact this has on decisions as to tax domicile is of greater practical force in giving weight to arguments for maintaining tax rate on carried interest at what may still be considered a comparatively low level.

Other Issues

Why investors make different demands of public companies compared with private equity-owned companies

19. The principle that companies and their businesses are run in a manner that seeks to maximise value over time applies equally to quoted and private equity investments.

20. Investors in quoted equities wish to see growth in shareholder value usually marked by dividend income which is sustained but with growth over time. This should reflect underlying business performance and generation of cash flows whilst providing sufficient balance sheet resilience so that the objective of long-term shareholder value creation is not compromised by short-term financial exigencies. Decisions as to the appropriate capital structure of the corporate entity will be a function of the views of the board in the context of their understanding of the expectations of the company's investors. By contrast, the business model of private equity will often involve a more closely targeted objective that can create enhanced incentives and disciplines to perform but which may provide less resilience and therefore require a change in strategy for the business. The close involvement of the shareholder, generally through representation on the Board underpinned by a shareholder relationship agreement, will be therefore be of key importance to the governance of the investee.

21. The managements of businesses in private equity ownership which perform effectively may receive substantial reward but, conversely, may be replaced at short notice with limited contractual compensation for affected individuals when it fails to do so. The members of plc boards are in a qualitatively different position with major responsibilities to manage the company's business including relationships with stakeholders and, in so doing, to generate value and meet the expectations of shareholders and of the investment markets. The governance structure, as provided for under the Combined Code, will be much more principles-based than for private equity. The status of quoted plc directors, their powers, and their responsibilities and the best interests of the company are all relevant in determining what tenure, remuneration and incentive arrangements are appropriate.

22. The private equity model differs considerably from the quoted plc model but it is one that will be appropriate for some companies and businesses, either temporarily or on a more permanent basis. As well as the circumstances of the businesses owned, private equity's divergence from the norms of the quoted equity sector also reflects the materially different nature of its investor base and the pools of investment capital that it taps. It is unsurprising that there are significant differences, therefore, in the governance of businesses in private equity ownership compared to those on the quoted market, and also in the manner of their financing, and that investors, bearing in mind their own objectives, will recognise the value of both approaches.

The implications of private equity-funded takeovers for company pension funds

23. It is important that decisions to take companies into private equity ownership are not motivated by plans to gear up the investee company and thereby reduce the effective value provided by the company's covenant as sponsoring employer of its pension schemes. Equally it would be wrong for the existence of pension schemes and the interests of their members to be used to inhibit or prevent corporate transactions merited on other grounds.

24. The powers of The Pension Regulator to provide clearance and to impose conditions such as for injection of additional funds into the scheme to raise the funding level are appropriate and helpful. It is important, though, that they are used in a proportionate manner to ensure that members are not disadvantaged but without enhancing their position by more than is necessary to offset the effects of the corporate transaction for which clearance is being sought.

The operation of TUPE in private equity takeovers

25. Where a business undertaking and its employees are transferred from one company to another, or into or out of the public sector, the Transfer of Undertakings (Protection of Employment) Regulations provide an appropriate framework for treatment of the contractual position of employees. Where the identity of the owners of the shares of a company changes, whether slowly over time or more abruptly, there is no such change in the contractual position of employees and TUPE is not applicable. There is no reason why it should be made applicable; indeed it would be wrong in principle to do so as well as very difficult in practice.

Market abuse and conflicts of interest in private transactions

26. These are primarily issues for the Financial Services Authority (FSA) to address. They consulted last year in "DP 06/6—Private Equity: A Discussion of Risk and Regulatory Engagement", to which the ABI responded. We emphasised our concern that leakage of information within the investment banking sector, which is heavily involved in both public and private equity markets, remains an obvious risk if their structures and processes are inadequate or otherwise ineffective. Responding to the requirements imposed under Markets in Financial Instruments Directive (MiFID) will hopefully have helped firms to ensure that their internal structures and processes are well specified and robust and minimise these risks. We have argued that a more specific focus by the FSA, given the challenges posed by private equity conflicts, could be helpful.

December 2007

Memorandum from the Institute of Chartered Accountants in England and Wales

EVIDENCE ON THE TOPIC OF TRANSPARENCY AND SIR DAVID WALKER'S PROPOSALS FOR IMPROVING THE TRANSPARENCY OF THE PRIVATE EQUITY INDUSTRY

Major Points

The ICAEW views Sir David Walker's Guidelines for Disclosure and Transparency in Private Equity ("the code") as a positive development in the disclosure regime for the private equity industry and considers the code to be a proportionate response to calls for greater transparency and accountability. The code separately addresses private equity-owned businesses and private equity firms and their conformity will be on a "comply or explain" basis. The onus is on the industry as a whole to respond appropriately and demonstrate that the code can work so as to enhance market confidence and public trust in the industry and ensure its sustainability. The recently established BVCA panel for monitoring and encouraging conformity with the code will play a major role in this.

The BVCA panel will need to be vigilant as to how the market receives the data analysis and the industry's conformity with the code. If necessary, the panel may need to adapt its approach to meet the objective of enhancing wider public trust in the industry. The panel will also need to be mindful of how the principles underlying the code could influence overseas private equity business.

Comments on Specific Areas set out in Press Notice No 05

The structure and effectiveness of the recently established BVCA panel for monitoring, and encouraging compliance with, the code of conduct

The key principles of a voluntary code of conduct for transparency are:

- confidence in its structure and the practice it promotes;
- flexibility, ie the ability of being modified; and
- a monitoring mechanism which is seen to be independent and effective.

In assessing the structure and effectiveness of the BVCA panel for monitoring and encouraging compliance with the code it is useful to draw analogies with the Corporate Governance Committee of the Financial Reporting Council and the Code Committee of the Takeover Panel.

The structures of these committees are characterised by their independence and their inclusion of the main market participants.

It is significant that both committees have members with experience of or a direct role in reporting. This is particularly important for the monitoring role of the BVCA panel, ie when evaluating conformity, as it will help build the perception of good practice. It would also be an instrumental factor in ensuring that future changes to the regime are considered workable and are accepted.

Thus we support the intended inclusion of representatives of General Partners on the BVCA panel and would support inclusion of advisers to funds who can bring experience of the reporting process. We would also support the inclusion of Limited Partners. This would demonstrate that the interests of the investor community are aligned with the objects of the code and would help conformity with the code to become a generally accepted yardstick.

In addition to structural matters, the BVCA panel will need to consider issues relating to process, such as fair and appropriate sanctions in the case of non-conformity and a mechanism for dealing with objections to decisions. It will also need to evaluate the implications of making public the results from monitoring.

The structure of the BVCA panel and its terms of reference are likely to evolve over time. Developments may come about depending on how the wider public perceives the panel is performing in its objective of encouraging greater transparency in the private equity industry. The panel should be given a reasonable period to implement its terms of reference and to demonstrate its independence and authority. The ultimate test of its effectiveness will be whether the wider public concerns are addressed.

The appropriateness of the proposed level and type of disclosure for the various stakeholders in private equity-owned businesses

During the consultation period the ICAEW highlighted certain concerns that the enhanced reporting requirements for a subset of private companies (in this case, private equity-owned companies) were unfair and could cause market distortion by deterring private equity deals. Notwithstanding this we consider that the disclosures for private equity-owned businesses are proportionate and will address specific needs for communication and acknowledge the importance of maintaining good stakeholder relations.

The requirement to identify the private equity fund or funds that own the business will help prevent mistrust and uncertainty caused by the perception that the owners are anonymous. In terms of identifying the senior executives of advisers of the private equity firm with oversight of the business on behalf of the fund(s), we agree that this will improve accountability but we consider it would be more in line with being transparent not to restrict disclosure to UK-based individuals as is currently the case in the code.

We agree that, in developing the code, it was appropriate to refrain from setting guidelines in respect of board composition and corporate governance of portfolio companies. The board is responsible as a whole for ensuring a balance of skills and experience appropriate for the company and a rigorous appointment process will normally address this. We consider it helpful to stakeholders to expect companies to identify executives of the company, representatives of the private equity firm and outside directors on the board.

The requirement for private equity-owned businesses to include, as part of their annual report and accounts, a business review that conforms to s417 Companies Act 2006 (including subsection 5) is sensible and provides practical guidance for such reporting. As market practice in conforming to the Act's provisions evolves, it will provide a useful benchmark in communicating to the various stakeholders and help reporting focus on the economic substance rather than the legal form of the business.

Much of the negative coverage of private equity activity can be attributed to poor communication and analysis of the context in which private equity transactions take place (including the risks). The requirement that a private equity-owned business's financial review should cover risk management objectives and policies in the light of the principal financial risks and uncertainties facing the company, will bring clarity and increase understanding of the risks involved.

The benefits of additional disclosures by private equity-owned businesses are accompanied by associated cost and time implications. Certain companies will not have previous experience of quoted company reporting requirements and deadlines. Stakeholders and the monitoring panel will need to recognise this when evaluating a business's conformity with the code.

Proposals for a respected capability for providing comprehensive, industry-wide data on the private equity industry

Sir David Walker's proposals for "a respected capability" seek to establish the BVCA as "the recognised authoritative source of intelligence and analysis both of larger-scale and of venture and development capital private equity business based in the UK and a centre of excellence for the whole industry".

The data agenda in the proposals will, in our view, be a major contributor to the reputation and sustainability of the private equity industry providing the following apply:

- There needs to be confidence in the quality of data collected and in the robustness and objectivity of the data aggregation and analysis. This implies that "bad news" or unfavourable performance indicators must also be disclosed. We believe that this can be supported through engaging, as proposed, the services of professional firms. It will also be important for private equity-owned businesses and private equity firms to feel responsibility to provide appropriate data and it is up to the BVCA to create and foster momentum in the process.
- Data analysis must be representative of the industry as a whole and efforts may be needed to persuade private equity firms at the larger buyout end (where they are not members of the BVCA) to contribute data.
- There needs to be commitment to appropriately resource the data capability including the costs of engaging the services of professional firms, the costs to private equity-owned businesses and private equity firms of providing the data and the costs to the BVCA of gathering and reporting data.
- The wider public response to data analysis and the industry's conformity with the code needs to be monitored. If necessary, the panel may need to adapt its approach to meet the objective of enhancing wider public trust in the industry.

We support the publication of attribution analysis as an effective way of encouraging accountability. Doing this, as proposed, on an industry-wide basis will require consistent judgements to be made in preparing the analysis so as to facilitate verification and comparison over time. There have been criticisms of the failure of the code to require individual firms to produce attribution analyses. However, there are suggestions that the industry-wide approach should be treated as work-in-progress towards developing a "template" with which individual firms can conform. We would support this approach as it will help eliminate some of the inherent limitations in producing attribution analyses, such as subjectivity and comparability.

The UK has the largest concentration of private equity business in Europe and private equity is a cross border business. Given also that there is no such code of conduct overseas, the BVCA will be well placed to give early consideration as to how data input requirements on private equity firms and the businesses they own, as well as the resulting analysis, might be developed or expanded to include data on non-UK private equity portfolios and, potentially, data from overseas private equity industries.

The private equity-owned companies to be covered by the code

Companies' legislation requires directors to promote the success of the company for the benefit of members while having regard to a number of other stakeholders. Well-governed companies will provide relevant and proportionate information even in the absence of reporting guidelines.

The private equity-owned companies to be covered by the code have to satisfy a "test of UK significance" as measured by the percentage of revenue generated in the UK. While this provides welcome clarity as to which companies should adhere to the enhanced disclosure requirements, it is important for judgement to be exercised in the case of companies with UK-generated turnover (and indeed other measures such as employee numbers) immediately below the thresholds.

The monitoring mechanism for the code will enable review of the thresholds for private equity-owned companies. It may be appropriate for changes to be made in light of experience, including where reporting is a matter of judgement rather than strict adherence to a requirement.

December 2007

Memorandum from 3i Group plc

TRANSPARENCY

The structure and effectiveness of the recently established BVCA panel for monitoring and encouraging compliance with the code of conduct

We fully endorse Sir David's recommendations and believe that the BVCA panel for monitoring and ensuring compliance with the guidelines to be an effective structure to bring greater transparency to the private equity industry.

The appointment of Sir Michael Rake brings credibility and independence to the panel while further appointments will bring further integrity to the panel.

It is significant that the panel will be independent from the BVCA. This will ensure that the panel is in a position to operate objectively and to effectively implement the "comply or explain" principles set out in the guidelines.

The appropriateness of the proposed level and type of disclosure for the various stakeholders in private equity-owned businesses

The private equity industry has very high reporting standards with respect to the information that it provides during due diligence and subsequent to an investment by a Limited Partner.

The guidelines effectively extend the reporting requirements of larger private equity-backed companies and will result in greater disclosure to employees and other interested parties.

We believe that these new requirements are appropriate and will contribute to making private equity both more understandable and transparent.

The enhanced reporting by the BVCA will also contribute to improving the overall understanding of the private equity industry. Reporting should focus on demonstrating the "value creation" of the private equity industry as a whole and the role that it plays in the broader UK economy.

Proposals for a respected capability for providing comprehensive, industry-wide data on the private equity industry

It will take time for the BVCA to build the additional capabilities to deliver the quality of data that is required under the guidelines. We believe that the appointment of E&Y to collect detailed data on larger private equity-backed transactions is a welcome initiative, although more will need to be done to achieve the objective of comprehensive, independent and respected data for the industry as a whole.

The private equity-owned companies to be covered by the code

We believe that the criteria set out under the guidelines are appropriate as they capture what we believe are the significant, larger private equity-backed transactions.

Taxation

The tax treatment of debt and equity

In view of the significance of the financial sector to the UK economy we consider that any change to the taxation of equity and debt would need to be considered very seriously as there is a real risk of damaging this important sector. Historically most countries have taxed debt and equity differently and although a small number of countries have recently introduced provisions restricting tax relief for some interest costs, the structures of their economies are different to the UK's and it remains to be seen what the economic impact of such a change will be.

The Memorandum of Understanding between the BVCA and HMRC

Currently there are three MOUs in existence between the BVCA and HMRC: an agreement in 1987 and two in 2003, one covering carry and the other manager's equity.

The 1987 agreement was instrumental in making the UK an attractive location for basing a private equity business, leading to the success of the private equity industry over the past 20 years. We shall however focus our comments on the 2003 MOU covering carried interest.

The 2003 MOU does not change the legislation but does set out a safe harbour method of valuing the initial award of carry. This gives certainty to executives who acquire the carry that they will not be faced with an upfront income tax charge and also avoids HMRC having to find the additional resources to negotiate values of carry for many different funds at potentially several different times.

The MOU has been helpful in avoiding the need for negotiations on value with HMRC each time carry is acquired by a participant and we would be concerned if this safe harbour was no longer available due to both the additional administration burden that it would create both for private equity businesses and HMRC and also the inevitable uncertainty that will arise in the tax affairs of carry recipients.

Options for further reforms of the shareholder debt and employment-related securities

The Committee has accepted (paragraph 91 of its interim report) that there is no special tax regime for private equity in respect of interest relief. Having said this, the private equity industry is now potentially at a disadvantage when compared to trade buyers, such as companies. For a corporate acquirer the transfer pricing/thin capitalisation rules apply to both the acquirer and the target entity combined hence giving the opportunity to use the combined resources of both to arrive at a higher debt capacity to fund an acquisition.

A private equity buyer on the other hand, can only rely on the target company's debt. It is therefore possible for a corporate acquirer to fund the entire acquisition price with debt although the effects may not be apparent from the filed accounts of the target since the debt could be put elsewhere in the corporate group.

As a result we consider that no specific private equity provisions are needed and instead any changes should focus on levelling the playing field between private equity-backed companies and corporate groups.

The employer related securities regime is strict by international standards, although similar to the US provisions. The basic principle behind the rules is that, provided someone has paid market value for an asset, then the future growth in value of that asset should not be considered to be employment income, provided its value is not subsequently manipulated. This is a fundamental tax principle and one that should not be altered.

The appropriateness of the tax regime for private equity, in the light of the recent changes to capital gains tax

The change to capital gains whilst unhelpful for the private equity industry did at least demonstrate that the taxation of private equity returns should not be treated differently to other returns of the same nature. The change, however, is unhelpful because it puts the UK tax rate at a level above some of the key European countries, particularly those which are keen to attract private equity businesses. The impact on the climate for entrepreneurs is also of concern, as they are the people who grow and add value to the businesses in which we invest.

Other Issues

Why investors make different demands of public companies compared with private equity owned companies

The difference between a private equity investment, compared to an investment in public equities, is the degree to which private equity, as a form of active ownership, engages with the management team of an investee company to agree a value creation plan to deliver returns to shareholders. The private equity investor will typically sit on the Board of the investee company, have access to monthly management accounts and be in a position to influence strategic decisions and key appointments.

This level of engagement gives the private equity investor a much better understanding of the investee company, its prospects and performance with the result that the private equity investor is in a better position (relative to a public equity investor) to make decisions with regard to that investment. It also means that the private equity investor better understands the risks that may impact an investee company and results in the private equity investor placing different demands on an investee company.

The implications of private equity-funded takeovers for company pension funds

There is no legal difference between a private equity funded takeover and "other" types of takeovers. Therefore there should not be any implications for a company's pension fund whether the takeover is private equity or non private equity funded.

Market abuse and conflicts of interest in private equity transactions

Market abuse relates to the trading of publicly listed securities and would probably be most relevant in the case of public to private transactions. As regulated investment companies, we are not aware of any greater risks of market abuse from private equity than potentially from other investors in listed securities.

Although there may theoretically be a risk of conflict of interests between a private equity investor and its LPs, we believe that the industry manages these potential conflicts well through, in particular, the investment agreements that are put in place between private equity investors and LPs. Conflicts of interest are explicitly dealt with in these investment agreements and, importantly, remuneration structures are put in place to reinforce an alignment of interest between the private equity investors and LPs.

December 2007

Memorandum from the Association of Investment Companies

Executive Summary

1. The Association of Investment Companies (AIC) welcomes the opportunity to submit further views to the Committee's inquiry into private equity.

2. The AIC believes that listed investment companies already represent excellent standards of public reporting at fund level within the private equity sector and welcomes measures to further enhance transparency within the industry. The Walker Guidelines represent a suitable means to achieve this outcome and should be given time to have an impact on reporting practice before an full assessment of their effectiveness can be made.

3. However, the AIC remains concerned that some owners (ie sovereign wealth funds and private corporate entities) of large private businesses with a substantial public impact are not covered by the Guidelines and **recommend** the Committee give consideration to securing greater transparency by these organisations and the businesses they own.

4. The AIC has also explored the reasons why private equity funds may require different information from owners of publicly quoted shares. There are various factors involved but one of the most critical is the way in which different investors engage with the companies concerned. The AIC has concluded that this issue raise no matters of public policy concern.

Transparency

5. The AIC welcomes the Walker Guidelines (the Guidelines) on disclosure and transparency in private equity. They provide a proportionate and flexible basis for the private equity sector to report to the public. They identify areas where there may be a legitimate public demand for information (ie where a large portfolio company is involved) and balance the need to disclose against the legitimate commercial interests of the fund and its investors.

6. The private equity industry has engaged closely with the development of the Guidelines and we anticipate it will take a responsible attitude to future disclosure. With this in mind, we have been disappointed with the critical reception the proposals have received from some quarters. All parties should be prepared to give the industry time (we **recommend** at least two reporting cycles) to develop its approach before making further judgements. This will allow best practice to emerge and provide evidence on whether or not the approach embodied in the Guidelines needs to be revised.

7. As explained in our previous submission, listed investment companies (which are represented by the AIC) are already highly transparent. Regulations already require information to be published on their shareholders and directors, investment strategy, governance and major transactions (amongst other issues). They already offer excellent standards of public disclosure.

8. The AIC believes the scope of the proposed disclosure for private equity vehicles set out in the Guidelines is appropriate. Private equity funds which fully engage with the Guidelines in good faith will make significant strides towards the levels of transparency already achieved by our members. In addition, the Guideline's "portfolio company" disclosures are properly targeted on larger companies likely to have a significant public impact and cover appropriate issues. However, the AIC remains concerned that, even with the Guidelines in place, there are potential gaps in disclosure.

9. These gaps involve owners of large UK private businesses which are not conventional private equity funds but are so-called "sovereign wealth funds" or private corporate entities. Organisations of this type are not covered by the Guidelines nor are the portfolio businesses which they own. The AIC highlighted these gaps its response to the Walker review as it believes the locus for the debate on transparency should not be ownership by a private equity fund *per se* (which is, of itself, an entirely legitimate form of ownership). Instead, the transparency debate should be driven by the need for private businesses with a significant impact on the on the public sphere—however they are owned—to be suitably transparent. If they have a major impact on public life they should make suitable disclosures and, where appropriate, so should their owners.

10. The AIC therefore **recommends** that the Committee consider these remaining "gaps" and how they can be addressed to secure the disclosure standards set out by the Guidelines.

Investor Information Requirements

11. The information made available to investors in public companies does differ from that which private equity funds receive (and pass on to their own investors). This is not inherently surprising and reflects the different nature of the investment proposition and the approach taken by the funds. After all, even shareholders in the same public companies may have different information requirements.

12. For example, passive investors, such as tracker funds, have little need for specific company data as they are simply seeking exposure to a particular index. Other shareholders with a more active approach might be concentrating on selecting asset classes, so again may not be so concerned with huge amount of

detail on the operation of individual companies they are exposed to. Still other approaches will involve investors looking more carefully at the specific circumstances of investment targets. This would include, for example, "value" strategies where prospective purchasers are seeking to identify stocks where the full value of the company has not been expressed in the share price. Perhaps the investors likely to be most keen on securing detailed information and analysis on individual listed companies will be those with an "activist" remit. That is, they seek to make strategic, governance or other adjustments to enhance the performance of the company by making representations to the board and other shareholders.

13. Given that there are diverse information needs for investors in publicly quoted companies it is not surprising that private equity funds also have different information needs. The general view is that private investors demand, and secure, more information from portfolio companies than is available to public investors. There are a number of reasons why this is likely to be the case.

14. The **investment approach** of the private equity owner is likely to differ from public investor as private equity funds will usually seek to implement specific strategic changes. They might be thought of as "super-activist" investors, who require information to determine and direct their strategic interventions as well as to judge their effectiveness. As a consequence, private equity owners will also customarily be represented on the board of the investee company and may even recruit a new management team to implement the desired strategy. Of course, the fact that the company is owned by a private equity fund also means that the fund is also in a position to demand that the required information is provided.

15. Greater amounts of information may also be required by private equity investors because the nature of the risks they face are different. For example, private equity investors face far greater **liquidity risk**. Shares in public companies are easily tradable. By comparison, it might take significant effort to sell a private business, or a stake in one, within a reasonable timeframe and at an acceptable price. This is an additional risk and it also helps explain why private equity investors may demand greater information so that they can assess the risks of a lack of liquidity against the attractions of the business as an investment proposition.

16. Private equity funds may also be exposed to greater **diversification risk** than funds exposed to publicly quoted stocks. It would not be uncommon for a fund investing in public companies to hold many small stakes in a large number—even hundreds—of companies. In contrast, private equity funds are likely to either own outright, or have very large stakes in, a smaller number of companies. This (combined with the greater liquidity risk) is likely to mean that private equity funds and their investors need more information to make an ongoing assessment of their exposure to particular companies.

17. While private equity owners may be in a position to secure more in-depth information from portfolio companies—and may have a greater need for that information because of the risks they face—it should also be recognised that there are good reasons why public companies limit the information they provide in the public domain.

18. Portfolio companies providing information to their private equity fund owners, who may in turn pass it on to their own shareholders, are able to do so on a confidential basis. They do not have to post information publicly to maintain an orderly and fair market in their shares. This means that they can restrict circulation and are able to provide material that might be more speculative or commercially confidential. The nature of private equity ownership reduces the risks of creating misunderstandings about the prospects of the company or compromising its ability to pursue its business objectives.

19. It is reasonable that private businesses issue different information in comparison with publicly owned ones. A critical reason for this is that they can circulate that information on a confidential basis, which creates fewer risks. Similarly, it is not surprising that investors with different strategies have different information needs. The AIC does not believe that this situation provides any issues of general public policy concern.

20. The critical lesson from this discussion is that, if a potential shareholder does not believe that a company (private or otherwise) provides sufficient information to enable it to assess it as an investment proposition, then they should simply not purchase those securities.

January 2007

Memorandum from Unite the Union

Unite the Union welcomes the Treasury Select Committee's resumed inquiry and the opportunity to submit evidence. Unite represents 2 million members employed throughout all sectors of the economy, including the food and drink industry, manufacturing, banking and finance, transport, commercial and contract services as well as the public and voluntary sectors. Unite was formed by the merger of Amicus the Union and the Transport and General Workers Union to form the UK's largest trade union.

Unite has previously expressed strong concerns about the need for legislation and regulation regarding many aspects of private equity. Unite remains very concerned about levels of leverage, advantageous tax regimes and the lack of transparency. Unite welcomes Sir David Walker's recognition that the private equity

industry is too secretive in its dealings and opaque in its communication with other stakeholders. Unite acknowledges the clear recommendation from Sir David that this must change. Unite believes that workers' rights are at the heart of the remedies required and this is the main focus of this submission.

1. Executive Summary

1.1 Unite believes the private equity business model increases the risk for employees in terms of job security, terms and conditions, wage rates and pension provision.

1.2 The private equity model exploits workers and there is no industrial or legal provision for the protection of workers employment rights under this business model.

1.3 Unite believes the Walker report has failed to acknowledge issues around workers rights, high levels of leverage and unfair taxation. The report also fails to offer any pragmatic industrial solutions to issues raised in previous Unite submissions.

1.4 Unite believes that the remit asking for Sir David Walker to supply a set of voluntary guidelines is disingenuous, in that the report precludes any consideration of mandatory guidelines for the sector.

1.5 Unite would recommend a strengthening of the existing information and consultation regulations to accommodate the private equity business model. In doing so Unite believes this could go some way to mitigating some of the worst excesses of bad employment practices currently in operation in the sector.

1.6 Unite believes a voluntary Code of Conduct, monitored by the BVCA is unacceptable. Experience has shown that self—regulation does not work.

1.7 Unite believes that private equity companies should be subject to the same legal requirement for disclosure and transparency as public listed companies.

1.8 Unite is concerned to see that the Walker report undermines the proposal for a facility to provide comprehensive industry wide data on the private equity sector. Workers deserve the right to know what is happening to the company they work for and how the decision making process will affect them.

1.9 Unite believes there needs to be a review of the existing TUPE provision which currently does not include protecting the rights of those workers transferred through share purchase, including the right to request an injunction for non-compliance.

1.10 Unite would argue most strongly for a legal requirement for any pension provision or benefits to be protected and ring—fenced when a private equity group is looking at buying a company out.

1.11 Unite believes there is a significant argument in favour of supporting the introduction of a government levy on private equity profits to establish and finance a special fund to provide enhanced redundancy payments if a company bought out by a private equity group goes into liquidation or administration.

1.12 Unite would like to see the Danish model of taxation reviewed by government to see whether it would work in the UK economy.

1.13 Unite believes that the present advantageous tax regime for private equity companies and partners is wrong. This is a clear case of discrimination. Private equity partners should be subject to the same 40% personal taxation rate as other UK workers.

2. Private Equity Increases Risk for Workers

2.1 Private equity increases risk for workers. Unite's belief on the need for worker rights is predicated on the clear, uncontested fact that the private equity business model based, as it is, on a high degree of leverage, increases the risk for employees in terms of firstly, keeping their jobs and secondly, being detrimental to their wages, benefits especially pensions and other terms and conditions. Unite believes workers are being systematically exploited by the private equity business model and, at present, have absolutely no form of legal redress. Private equity does not share the benefits of its financial success with the workforce in terms of improved pay and conditions. A negative change in the risk of a business makes stakeholders worse off; an increased risk of default of a business makes workers worse off.

3. The Walker Report Proposals

3.1 Having recognised that increased leverage increases risk for employees and private equity's implicit contractual obligations over and above its explicit contractual obligations with employees,[27] the Walker report fails to prescribe solutions. The Walker report is narrow in scope ignoring worker's rights, leverage and tax. It considers only a very limited part of transparency, effectively ignoring the most important transparency for workers namely the right to be informed and consulted on the finance and business plan prior to acquisition/substantial share purchase resulting in a change of control. The value attribution

[27] Unite (T&G section) evidence to the Treasury Select Committee Inquiry, para 4.7.

proposal is weaker than in the consultation. The voluntary proposals for implementing even the inadequate recommendations are ineffective. The report also includes spurious assertions such as private equity is a force for good.

3.2 The Code of Conduct ignores the key issue for workers—workers rights and we elaborate on these in the section below. The notion that compliance with a Code should be voluntary, monitored by BVCA is unacceptable. The proposal for voluntary self regulation by the industry is inappropriate. It cannot work. The report fails to explain how self regulation in the Cayman Islands would work. With a track record for making claims about the private equity industry in relation to creating jobs which have been proven to be "worthless",[28] regulation of the standard of reporting by the industry is a must. Unite suggests that the government investigates further the merits of regulation equivalent to that of the Securities and Exchange Commission who scrutinise prior to publication. The Walker report undermines the proposal for a respected capability for providing comprehensive industry wide data on the private equity industry by making the spurious assertion that private equity is a force for good, yet then acknowledges that there is inadequate information available about the industry.

3.3 The Walker proposals fall far short of the necessary disclosure and transparency requirements. The level and type of disclosure for workers in private equity owned businesses should be strengthened by regulation. Workers should not be kept in the dark. Workers need to know what the future might hold for them and that their jobs, wages and conditions and pensions are safe.

3.4 The report focuses on financial reporting and a narrow view of transparency, stressing communication about company values and "covering attentiveness to interests of employees and communications". This reflects the unsubstantiated claim on which the report is predicated, namely that private equity is a force for good in the economy. There is no evidence that this claim is true. What is true is that available data shows that workers do not benefit under private equity ownership. Existing research shows that private equity reduces wages[29] and completely ignores the evidence that workers do not benefit from private equity ownership.

3.5 Transparency alone will not meet employees' needs. Taking on debt is a risk to workers in terms of jobs, wages and conditions so workers should have the automatic right for protection and compensation for this risk.

4. Workers Rights

4.1 Just as the banks and pension funds can secure their interests in leveraged buyouts so too should workers. In private equity transactions, banks are able to charge risk adjusted rates of interest; pension trustees exercise the right to demand greater up-front funding to compensate for added risk. Regulation should ensure that workers are similarly consulted, protected and compensated. There should not be two standards of protection and compensation in the economy.

4.2 Workers need rights prior to buyout. Workers and their representatives deserve the right to be both informed and consulted on the finance and business plan of any takeover/significant stake prior to acquisition/significant share ownership so that workers' pay and conditions are safeguarded and they are compensated regarding the additional risk. Pre-acquisition (any acquisition)/significant share purchase TUPE rights should apply. The Transfer of Undertakings (Protection of Employment Regulations) should be amended to cover transfer through share purchase, including the right to an injunction for non compliance.[30] Unite believes the case for an amendment of TUPE has been greatly strengthened by the decision in Millam.[31] The Court of Appeal has highlighted how share sales may lead to changes of control of a business, with consequences for employees, justifying extending to them the same protection available on transfer of an undertaking.

4.3 The repeated claims of private equity taking over companies, of their intention to exercise close control reinforces the case for regarding share sales to private equity as falling within the scope of TUPE as defined in Millam. Private equity openly declares its mission to exercise control and vaunts this as a positive advantage. With this should come responsibility towards employees, legally enshrined in TUPE.

4.4 The rule that transfers through share sales do not fall within TUPE was established by the Employment Appeal Tribunal in Brookes v Borough Care Services. A recent Court of Appeal decision in Richard Millam v The Print Factory (London) 1991 Ltd, while upholding the rule in Brookes, states that a change in legal control as a matter of law by way of share sales of itself may not suffice to constitute a transfer within TUPE. The implication is that a change in control as a matter of fact, apart from the share sale, may be a transfer within TUPE.

4.5 The absence of a change in legal control (no new employer in law) is not conclusive where there is a change in control in fact of the business. Lord Justice Buxton concluded: "The legal structure is of course important, but it cannot be conclusive in deciding the issue of whether, within that legal structure, control

[28] David Hall, Methodological issues in estimating the impact of private equity buyouts in employment, May 2007.
[29] Op cit.
[30] ibid.
[31] Court of Appeal decision, Richard Millam v The Print factory (London) 1991 Ltd.

of the business has been transferred as a matter of fact". The Court of Appeal's emphasis in Millam is on the question of fact: not legal control, but control in fact. A finding that there is no transfer, based on the sole fact of a share sale, is inconsistent with this approach. Thus TUPE should be amended.

4.6 TUPE rights need to embody the presumption that a substantial increase in debt as a consequence of a takeover or change in control is a detrimental change to workers terms and conditions. This gives workers the right to demand and receive compensation for the risk to which they are being exposed.

4.7 Through their trade unions, workers should have the right to seek fair compensation and protection should substantially greater levels of leverage be part of a private equity (or any other) takeover Being consulted over any business financial plan is crucial because of the risk to workers. A buyout may mean management would want to change the financial structure of the firm from a ratio of 80:20 equity and debt to 10:90 equity and debt. It might be said that this is unacceptable but reluctantly accept more debt, providing guarantees are given.

4.8 Rights should thus include the right to be at the negotiating table choosing the preferred buyer, to secure the future for workplaces and plants, seek guarantees regarding suppliers and jobs, five year guarantees for wages and terms and conditions especially pensions. Finally, the government should enforce a levy on private equity to establish and finance a special fund for enhanced redundancy payments in case of administration.[32]

4.9 It is clear that the global economic outlook has now worsened significantly. Unite remains concerned that this will magnify the negative impact on jobs and pay as a result of private equity buyouts. Private equity funds may well keep and manage a portfolio company for longer and this will intensify attempts to increase profits and cut costs rather than relying on realising cash from IPO's or secondary buyouts. Our concern is that this will result in more pressure on jobs, more capping or closure of pension funds, reduction in wages, investment, R&D and training, increased pressure on collective bargaining (including using USA anti trade union approaches); pressure on health and safety, as well as growing consumer safety problems.

4.10 A recent report[33] showed the ratio of companies' interest payments to operating surplus is at its highest for 15 years. This is at the peak of an economic cycle which is potentially about to enter a downturn. Debt should be at a minimum as the industry has been through the good times. Our earlier submission pointed out private equity buyouts had taken place in the context of an unprecedented stable economic environment. The credit crunch and the risks of less favourable economic circumstances means that if profitability declines many companies will find themselves with unattainable levels of debt and this could increase the risk of wage freezes, wage cuts and benefit reductions, with further risk of job loss and increases in administration.

4.11 Many employees work for firms already under private equity ownership or control. Through their trade unions they should have the right to be consulted regarding new high leverage to fund dividend recapitalisations on the financial and business plan. Because the risk of private equity/highly leveraged ownership has only relatively recently been acknowledged, there are many employees currently working in businesses where no compensation or guarantees have been secured.

4.12 Workers should have the right to know how much the private equity partners are paid. If private equity ownership means value and wealth are being created, workers should have the right to know how it is being shared out and if that is fair. Details of management bonus schemes and the basis thereof (ie its basis in value creation or simply cost cutting such as job and plant cuts) should also be available. Workers should also have the right to know who are the ultimate owners (equivalent to shareholders in a public company) of the firm that they work for.

5. The Implications of Private Equity Funded Takeovers for Company Pension Funds

5.1 Pension Funds in a company bought out by private equity has protections and compensations for the additional risk of leveraged buyouts which Unite believes should similarly apply to workers. However, despite these, there are many pension funds in firms bought out by private equity which have not had compensatory payments because awareness about the additional risk is a relatively recent development.

5.2 Up until a few years ago, private equity avoided buying companies with a material final salary pension scheme. The risks involved in operating such a scheme ie, small changes in interest rates, stock market returns, mortality, could add meaningfully to the size of a pension deficit. While publicly held firms who could take a long term view and ride out any short term volatility could deal with this, it was anathema to private equity firms who bought companies with the intention of selling them on again in the short term. Firstly, any negative change in the net deficit position of a company's pension fund would directly impact what the private equity firm would obtain upon resale. Secondly, an increase in the pension fund deficit could also require the company to make greater contributions to the scheme, adversely affecting the cash flow so important to private equity firms and, in the worst case, requiring the private equity partners to inject

[32] Op cit.
[33] 20 20 vision, boom, bang or bust—Twenty years of global, technological and financial innovation, Kroll, October 2007.

additional funds into the company which adversely affects the IRR (internal rate of return) so important to private firms. For these reasons, up until a few years ago, having a sizeable final salary scheme was effectively a “poison pill” for companies against private equity firms.

5.3 However, as the size of the private equity funds grew and easy financing became readily available, it became more and more difficult for private equity firms to avoid companies who had final salary pension schemes. Thus, in the last several years, private equity firms have started taking over companies with material final salary schemes. Due to the duties placed on pension fund trustees in the 2006 Pension Act, private equity companies have to negotiate with pension trustees prior to any takeover. The trustees now have the power to demand quicker repayment of any scheme deficit should the company’s risk profile change. The risk profile inevitably changes because the private equity firm intends to load the company up with substantially greater debt than before.

5.4 However, the trustees only have a duty to protect benefits already accrued (ie for pensionable service rendered up to the date of takeover) and generally have no power to protect future pension benefit levels. As a consequence, Unite is concerned that companies taken over by private equity firms have closed their schemes to new entrants almost as a matter of course and many are going further, closing the schemes to existing employees. In their place, Unite is concerned that the private equity firms are instituting inferior money purchase schemes which transfers all the investment and mortality risk to employees and into which the private equity owned firms contribute substantially less money for their employees’ retirement in the first place. Thus, in recent years, private equity firms have become a major agent in destroying the final salary pension arrangements which have provided a decent retirement for so many workers in Britain. Unite believes that the government should commission independent research on the impact of private equity on occupational pension schemes.

5.5 Because the pension trustees have no power to protect future benefit entitlements, it is essential that workers and their representatives have a power, similar to pension trustees, to sit down with private equity firms prior to takeover, and secure commitments from the private equity firms as to what will happen to their pensions (and all other terms and conditions) post acquisition. It is this right and the recognition that the extra debt by itself is a detriment to workers terms and conditions that Unite believes is necessary for workers to have in order to level the playing field with private equity firms. This can only be achieved by changing the law.

5.6 Unite would like to make two comments specifically about pension fund investments in private equity funds. Firstly, given the cartel like nature of the private equity industry, with no competition amongst GPs for the fees charged to pension funds Unite urges that fees charged by the GPs are investigated by the Competition Commission. Even though some of the private equity funds have increased in size, we understand that fees have remained the same even though costs have not increased in line with the size of the Fund.

5.7 Secondly, the statement that returns are higher than equity markets is not proven. Indeed evidence shows that claims about private equity funds performance has been overstated as a result of biased samples and misleading valuations.[34] In a rising market private equity returns ought to be higher than equity returns because there is less equity. Even that is not proven due to the extraction of value by the GPs fees. Moreover in a rising market private equity would be expected to do better than equity. What is yet to be tested is if private equity returns performance over a full economic cycle is higher than equity markets over an economic cycle. This is what we are about to see. Moreover as stated above Unite is concerned that high leverage in less favorable financial circumstances will lead to additional pressure for returns which will be met by value extraction from workers in terms of jobs, pay, less investment rather than value creation.

6. Transparency

6.1 Even within the Walker report’s narrow consideration of transparency, the benchmark used for comparison with the private equity industry is wrong. Transparency is at the core of the pact between business and society, and significant progress has been made on the accountability of public companies. The appropriate transparency benchmark should be the same transparency requirement on public companies not with the current standard of zero requirements for transparency from the private equity firm itself. There should not be two standards of transparency. Private equity should have the same obligations to disclose as if it were a public company.

6.2 The private equity firms (the partnerships) should also have to disclose the same information as if they were a public company. This would mean that they should have to disclose the remuneration of general partners (just as directors pay is disclosed in a public company). They would also have to disclose significant shareholders and the size of their investments. There should be a register of limited partners shareholders available (just as shareholders in a public company are). Finally, the private equity firm should produce group accounts of their holdings just as a public company would. This obligation should apply to all private companies including sovereign wealth funds.

[34] David Hall, Unhappy returns to investors in private equity, PSIRU, Business School, University of Greenwich.

7. Taxation

7.1 Private equity deals are structured so that they reduce or eliminate the payment of tax. For reasons of public acceptability and accountability as well as revenue protection private equity should be fully taxed.

7.2 In relation to the tax treatment of debt and equity, tax relief on interest on debt should be abolished. In Denmark, the tax relief on interest payments has been eliminated with offsets elsewhere. Unite believes this model is worthy of consideration. The tax relief on interest on debt means that the portfolio firms acquired by private equity pay much reduced corporation tax. There is no reason why debt should be given more favourable treatment over equity; this is particularly so when debt is used for buyout purposes, and to fund dividend recapitalisation. Tax relief on interest on debt is an anomaly in Capital Markets theory (CMT). A purist approach to CMT would say there should be no difference between the treatment of debt and equity.

7.3 Arguably debt should be given less favourable tax treatment than equity given that leverage increases the financial risk of the firm and risk of default, shifting risk on to other stakeholders particularly workers, in terms of redundancy, erosion of pay and conditions including pensions. Leveraged buy-outs put new, additional financial costs and demands on the portfolio company and sources of finance have to be found to meet them. Unite is concerned that debt for acquisition and dividend recapitalisations also means less money for investment in fixed assets and training. Moreover highly leveraged buy-outs put pressure on public companies with a more traditional financial structure. In order to avoid being taken over, these firms close or sell off productive operations rather than invest and issue dividends or buy back shares. The knock on effect of debt may well squeeze investment and long term planning across the economy. This is hardly something that should be encouraged by tax relief.

7.4 Equity investors contributing part of their capital as shareholder debt can exacerbate the issue of tax reduction and should be addressed.

7.5 Unite agrees with Nick Ferguson that it is wrong that private equity executives pay less tax than their cleaner. Given that employees on a modest income bear marginal tax rates, including social security taxes, private equity partners should be taxed at the full 40% income tax rate.

7.6 The recent change to capital gains tax is a move in the right direction. It is important that taper relief on carried interest be withdrawn, as the government is proposing. Dealing with tax loopholes, which either deprive the public purse or means higher taxes on those citizens who cannot avoid tax, is necessary but far from sufficient in relation to capital gains or in relation to the whole set of tax issues which are pertinent to private equity. It is the actual rate of tax that matters not the increase—which is why Unite believes that the 18% capital gains tax rate for private equity partners is insufficient and to address the discrimination against other tax payers, private equity partners should pay the full 40% income tax rate.

8. Private Equity Owned Companies and Public Companies

8.1 Private equity leveraged buyouts puts huge pressure on other companies who wish to avoid being taken over, this pressure can result in aversion tactics that can include increasing debt, spending money on share buy backs or issuing dividends and focussing on short term cash flow all to the detriment of jobs, pay, productive capacity and investment in training and staff development. Thus, private equity may well be reducing not only investment of companies they own but of the entire UK economy.

8.2 The Walker report also asserts that public companies may be under borrowing rather than agree that the level of leverage in private equity is high. Unite believes this has not been proven, especially over the course of an entire business cycle. High levels of leverage shifts risk onto other stakeholders, particularly the workforce.

January 2008

Memorandum from Trades Union Congress

Introduction

1.1 The TUC welcomes the resumption of the Treasury Committee's inquiry into private equity and the opportunity to present further evidence on specific issues relating to private equity. Since the Committee's interim report last summer, the financial climate has changed dramatically, with important implications for companies, investors and policy makers alike. The opportunity to understand the impact of the changed economic outlook on private equity funds and their portfolio companies will bring additional value to the Committee's conclusions.

TRANSPARENCY—DAVID WALKER'S PROPOSALS

2.1 For the Committee's information, the TUC is including its submission to the Walker Review as an appendix to this document. The TUC has consistently argued for mandatory reporting requirements for private equity. We were therefore disappointed that the remit to produce a voluntary code given to Sir David Walker precluded even the consideration of mandatory recommendations.

2.2 It is also important to note that disclosure and transparency is just one aspect of the problems surrounding the operation of private equity. Other areas of concern include areas covered in the Treasury Committee's resumed inquiry, including conflicts of interest, taxation of private equity general partners, the levels of leverage and tax-deductibility of interest payments on debt, the impact of private equity takeovers on the stock market and, most important of all to the TUC, the impact of private equity takeovers on workers in its portfolio companies. The TUC welcomes the breadth of the Treasury Committee's inquiry. The TUC urges the Government to follow the Treasury Committee's lead and to recognise that notwithstanding Sir David Walker's report, there remains a wide range of issues surrounding private equity that still need to be addressed.

BVCA PANEL FOR MONITORING COMPLIANCE WITH THE CODE OF CONDUCT

2.3 The TUC believes that effective monitoring is essential for the code of conduct to have any useful impact on the private equity sector. The Walker Report rightly calls for the establishment of a guidelines review and monitoring group that is independent.

2.4 However, the TUC is concerned that being established by the BVCA, the industry representative body, as recommended in the Walker Report, risks jeopardising its independence. The BVCA has a legitimate representational and promotional role in relation to the private equity industry, but this makes it anything but independent of the sector. The TUC notes the recommendation that the monitoring group should have a majority of independent members and an independent Chair; implementation of this recommendation will be vital for the group's credibility. It is important that the group includes members who are independent not just of the BVCA but of the sector itself.

2.5 The TUC will judge the monitoring group by its efficacy in raising levels of transparency from the private equity sector and ensuring that private equity funds and their portfolio companies comply with the recommendations in the Walker Report.

PROPOSED LEVEL AND TYPE OF DISCLOSURE FOR THE VARIOUS STAKEHOLDERS IN PRIVATE EQUITY-OWNED BUSINESSES

2.6 The TUC welcomes the recommendation that qualifying private equity-owned portfolio companies should publish a business review that substantially conforms to the provisions of Section 417 of the Companies Act 2006, including sub-section 5, which covers forward-looking information and information on the company's employees, environmental matters, social and community issues and suppliers. The TUC supports the recommendation that the financial review should cover risk management, including in relation to leverage.

2.7 The TUC was very surprised that the original consultation document of July 2007 argued against the disclosure of fees charged by private equity funds to their portfolio companies. The TUC believes that the practice of private equity funds charging their portfolio companies fees such as deal fees to cover the costs of acquisition and exit, monitoring fees, financing fees and so on is seriously flawed and should end immediately. It is far from clear why the portfolio companies should carry the costs of financing arrangements that primarily benefit the general and limited partners of the private equity fund. The charging of such fees is clearly a matter of interest to all those with a stake in portfolio companies, and the TUC believes strongly that full public disclosure of such fees is essential. While the practice of charging fees is clearly beyond the scope of the Walker Review, TUC believes that failing to recommend public disclosure of such fees in its Final Report is a serious omission.

2.8 The TUC believes that the recommendations for portfolio companies should have included disclosure on remuneration and reward across the company. Given the evidence of job cuts and slower pay growth for workers following private equity buyouts (see section 5 of this submission), it is essential that information that would allow employees to assess their terms and conditions in relation to those of their bosses is disclosed.

2.9 The only recommendation addressing the failure of portfolio companies to inform and consult employees is aimed at private equity owners. It recommends that private equity firms should "commit to timely and effective communication with employees, either directly or through its portfolio company, in particular at a time of strategic initiative". This is too vague to address the current information gap effectively. This issue is explored further in section 5 below.

2.10 In terms of disclosure by private equity firms, the TUC believes there are serious omissions in the recommendations. These include full disclosure of the accounts of private equity funds, including the performance of individual funds managed; disclosure of the remuneration of private equity general partners; disclosure of the fees they charge; and disclosure of the identity of their limited partners.

2.11 The economic significance of the private equity sector and its impact on the companies it buys makes the remuneration of the general partners who are responsible for these actions a matter of public interest. This is not a private matter between general and limited partners, given that the returns from which carry and compensation are calculated are generated from the portfolio companies that they buy. There is a clear matter of public interest in the distribution of the returns from the activities of private equity funds being in the public domain.

2.12 At present there is no publicly available information that would allow a potential investor in private equity or an interested commentator to compare fees charged across the sector. The failure of the Walker Report to address this and include a recommendation of disclosure of fees charged to limited partners is a serious omission. Given the high level of fees charged, and the debate about the extent to which private equity returns justify the fees charged (see section 4 below), it is clearly in the public interest for private equity funds to disclose the fees they charge limited partners.

2.13 Given the economic impact of private equity and the legitimate debate about in whose interests it operates, it is important that there is transparency surrounding the beneficial owners of the funds. Regulation of English limited partnerships requires that the names of limited partners are registered at Companies House, but the use of nominee names prevents this from providing a comprehensive list of limited partners. The TUC can see no justification keeping the identify of limited partners out of the public domain.

Proposals for a Respected Capability for Providing Comprehensive, Industry-wide Data on the Private Equity Industry

2.14 As noted above, the BVCA is a membership body for the private equity industry funded by its members. As a membership organisation, it has an important role in representing and promoting the sector, but is not, of course, independent of the sector any more than the TUC is independent of the trade union movement.

2.15 Over the past year, there has been considerable controversy over the economic and social impact of private equity. Areas of controversy include the impact of private equity buyouts on employment and long-term value with portfolio companies, and the level of returns generated by the sector. While clear and authoritative information is essential in order to inform this important debate, such information needs to be from an impartial source that can be trusted by all participants in the debate. The TUC believes that it is inappropriate for responsibility for filling this information gap to rest with the BVCA, as recommended in the Walker Report, as the need for complete impartiality is incompatible with its function of representing and promoting the private equity sector. In our submission to the Walker Review, the TUC suggested that this role could be undertaken by an academic institution with an existing research capability in private equity, and we still believe that this would be a more appropriate option.

2.16 The TUC notes that the Walker Report suggests that the BVCA could be given "appropriate professional support from one or more accounting firms or other independent capability". The TUC believes that this is preferable to the BVCA carrying out the research function alone, but it does not address our concerns about independence as outlined above.

2.17 The TUC welcomes the recommendation in the Walker Report that the post-exit performance of private equity owned companies should be included in the research exercise.

The Private Equity-owned Companies to be Covered by the Code

2.18 The Walker Report proposes that its enhanced reporting guidelines should apply to private-equity owned portfolio companies which:

(i) employ over 1,000 full-time equivalent employees; and

(ii) generate over half their revenues in the UK; and

(iii) either are valued at over £500 million at the time of transaction in the case of a secondary transaction; or

(iv) have been purchased in a public to private transaction with market capitalisation together with premium for acquisition of control of over £300 million.

2.19 These thresholds do not relate to any other existing thresholds. There is a definition of a large company that is used across the EU that we believe should apply here. This currently stands at companies that meet two of the following requirements: turnover at or above £22.8 million net (or £27.36 million gross); balance sheet total at or above £11.4 million net (or £13.68 million gross); and 250 or more employees. This threshold has resonance within the corporate sector already, as it is the trigger for a range of regulatory requirements. For example, within the business review requirements of the Companies Act 2006, the requirements are fuller for large companies than for medium sized companies, while small companies are exempted from producing a business review at all.

2.20 The TUC believes that the proposed threshold is set too high, particularly in regard to the employment threshold. A company with 1,000 employees is a very large company; less than 0.1% of companies in the UK have over 1,000 employees. The argument for extending the reporting requirements for large portfolio companies is that these companies have major economic and social impacts. They are major employers, will be significant players in their local communities and are likely to be important customers for their suppliers. While the very largest companies such as Alliance Boots or Sainsbury have a national resonance with customers across the country, customers are not the only stakeholder group whose interests should be considered for wider reporting. In terms of social and economic impact, the TUC believes that the existing definition of a large company is an appropriate threshold at which to require enhanced reporting.

2.21 The furore surrounding private equity has illustrated the flaws of making ownership structure, rather than economic and social impact, the determinant of disclosure requirements. Throughout many years of engagement on company law reform, the TUC has consistently argued that non-financial reporting requirements should apply to large private companies, in addition to quoted companies. The TUC continues to believe that the Business Review requirements introduced in the Companies Act 2006 that currently apply only to quoted companies should be extended to large private companies. This would ensure a level playing field between all large companies in terms of disclosure regardless of ownership structure, and would address the point raised by Sir David Walker in his report that very large private equity owned companies, if they follow his guidelines, will be embracing a higher level of disclosure than other private companies of a similar size.

Taxation

The tax treatment of debt and equity

3.1 The desirability of companies taking on very high levels of debt has been hotly debated. The TUC's concerns about the risks associated with such high levels of debt and how that risk is distributed are set out in its previous submission to this inquiry[35] and will therefore not be repeated here.

3.2 One factor in encouraging the high levels of leverage seen in private equity buyouts is the tax treatment of corporate debt. Interest payments on debt are tax deductible in the UK, which means that companies can offset interest payments against their tax bill, thus reducing the costs of debt-financing.

3.3 In March, the then Financial Secretary to the Treasury Ed Balls announced a review into the "current rules that apply to shareholder debt where it replaces the equity element in highly leveraged deals". In the pre-budget report, the Government included just one paragraph reporting on the results of this review. This stated that while the Government was satisfied that the 2005 changes to the Transfer Pricing rules have sufficiently extended the rules to include all private equity transactions, it remains concerned that the rules may be less effective in the context of highly leveraged private equity transactions. It concluded that it will continue to monitor situations where a tax deduction is being claimed for interest on shareholder debt in highly leveraged private equity buyouts. The TUC believes that this very brief response to a significant public policy concern is inadequate.

3.4 There are two main reasons why this issue raises important issues of public policy. There is strong evidence that the tax-deductibility of interest payments has influenced the economic rationale for highly-leveraged buyouts. As alluded to above, tax deductibility of debt interests payments favours debt over equity as a means of financing buyouts, but in addition, it has been widely suggested that the tax relief on debt payments is a significant factor in the profitability and returns generated by private equity takeovers. For example, a study for Citigroup came to the conclusion that the higher returns for private equity disappeared if the high degree of leverage was stripped out of the model.[36]

3.5 If the tax regime is influencing the economic rationale for buying up companies and is favouring debt-funded takeovers over equity-funded takeovers, this risks distorting the market for corporate control. The market for corporate control is often argued to be an important discipline on company management and to facilitate the efficient allocation of capital. While the TUC has some doubts about the extent to which the market for corporate control does in reality lead to improved outcomes for companies, shareholders and other stakeholders, this is still an argument against the tax regime acting to encourage buyouts. If gains can be generated from the debt attached to the takeover, rather than from changes relating to the productive capacity of the enterprise, this will lead to buyouts taking place that do not create long-term value and are therefore not in the interest of the wider economy or company stakeholders such as employees. While the current credit crunch has changed the availability of credit and has therefore challenged this model from the supply side in the short-term, credit markets are likely to become more liquid again over time. It is therefore still important to address this issue to ensure that the tax regime is no longer distorting the buyout market in the long-term.

[35] Private equity—a TUC perspective, TUC evidence to the Treasury Committee Inquiry, May 2007.
[36] "Private equity is casting a plutocratic shadow over British business", *The Guardian*, 23 February 2007.

3.6 The second reason that this is an area of public policy concern is that the tax relief on debt payments deprives the public purse of money that would otherwise be paid in corporation tax. If the Government is giving companies tax relief, it is essential that the country as a whole is getting good value for these concessions. The TUC can understand the argument for tax relief on debt payments when companies wish to borrow in order to invest, or indeed in order to survive in a difficult trading period for example. However, the TUC believes that tax relief going to large, profitable corporations and their new owners just because these new owners have financed their purchase mainly through debt is wholly inappropriate.

3.7 The Government of Denmark has introduced new laws to address this issue. This followed an investigation by the Danish Ministry of Taxation which examined the taxation records of seven large companies that had been taken over by private equity firms and found that collectively they reduced their tax payments by over 85% after the takeovers. It also found that at least one of the companies would now receive a tax refund because of the increased debt interests that it was servicing.[37] The Danish Government estimated that if it did not act, in a couple of years it would be losing around one quarter of the total revenue generated by corporate taxation.

3.8 Therefore in April 2007 the Danish Government passed legislation that restricts the tax deductibility of debt payments for companies. Act No 540 limits the amount of tax-deductible interest to a maximum of 20 million Danish kroner ($3.7 million) per company, provided other provisions are met. Previously, there was no limit. In practice, this provision will cover only the largest 1,000 companies in the country. This was part of a wider package of tax changes, which also cutting the rate of corporation tax from 28% to 25%.

3.9 The German Government has implemented a similar proposal as part of a wider package of measure aiming to simplify the tax system and remove anomalies. The measures, introduced in the spring of 2007, limit the amount of debt service that can be deducted from corporation tax. The package also requires that tax deductions that result from interest payments on debt must be spread over several years. Measures to ease the tax treatment of small venture capital investments were also implemented. The nominal tax rate was reduced, but at the same time many exemptions and allowances were cut. Also in 2007, rules were introduced that require that debt transferred from foreign nationals to German subsidiaries to be taxed. The DGB, the German equivalent of the TUC, supported the proposals, while the German employers' federation was strongly against the changes. The German Government has estimated that while over the first two years the changes may result in lower net corporation tax income, after two years this should reverse.[38]

3.10 The TUC therefore urges the Government to undertake the following:

(i) To publish in full the review that has taken place to date.

(ii) To clarify exactly what work is now taking place on this issue.

(iii) To work with relevant parties to draw up proposals that will address the public policy concerns outlined above and put an end to the tax regime distorting the market for corporate control.

Capital gains tax and private equity

3.11 The TUC's position remains that private equity general partners should pay income tax on their earnings. At present, the rewards for general partners of private equity funds are inflated by the fact that their fees are taxed as capital gains rather than income. Even under the changes to capital gains tax proposed in the Pre-Budget Report 2007, private equity general partners are paying a considerably lower tax rate than the standard rate of 22%. Therefore many private equity partners will still be paying less tax than their cleaners. The proposed rate of 18% is still less than half the higher rate of income tax of 40%, meaning that a private equity general partner will pay less than half the amount of someone earning a similar amount in a different sector.

3.12 The origins of this anomaly go back to 1987, when the Government allowed performance fees to be taxed as capital, rather than income, with the aim of encouraging more venture capital funding for small companies. However, the gains from this were increased dramatically in 1998, when the Government cut capital gains tax from 40% to 10% for people owning shares in their own or unlisted companies, providing they had owned the asset for 10 years. In 2002, this ownership requirement was reduced to just two years. This new "taper relief" encouraged many companies to set up share-based pay schemes to allow highly paid employees take their rewards in a form that would incur capital gains tax rather than income tax. In 2003, the Government moved to address this by introducing new rules requiring employees to declare shares received as part of their pay package as income. The Memorandum of Understanding between the BVCA and HMRC sets out qualifying criteria that, if fulfilled, exempt private equity general partners from the rules requiring share-based payments to be taxed as income and allow private equity general partners to pay capital gains tax on their income.

[37] Ministry of Taxation, Denmark, "Status på SKATs kontrolindsats vedrørende kapitalfondes overtagelse af 7 danske koncerner", March 2007.

[38] Information obtained from the DGB.

3.13 The justification for capital gains tax being lower than standard and higher rates of income tax is that capital gains requires an investment of an individual's own resources that they are risking through their investment. This is combined with a public policy objective of encouraging investment in smaller and start-up companies. However, neither consideration applies in the case of private equity general partners. While private equity general partners generally invest in some of the funds managed by their firm, these investments are only a tiny proportion of the total investment funds. Moreover, in the case of buyouts, the equity injection by the private equity fund is generally dwarfed by the debt component, thus diluting still further the monetary contribution of each general partner. The percentage of the returns generated by the investments allocated to the general partners is therefore much higher than the percentage of their contribution to the investment fund, and even more so when the additional leverage is included. This is very different from a situation where an entrepreneur has been the sole or main contributor of capital to a start-up project.

3.14 Secondly, buying up major UK companies is not akin to investing in start-ups or providing seed capital to newly formed companies. There is no general public policy objective that is fulfilled by taking major listed companies out of public ownership; indeed, the TUC and many others would argue that the reverse is the case.

3.15 Therefore the TUC believes that there is no justification for private equity general partners paying capital gains rather than income tax. The TUC believes that whatever the merits of reforming capital gains tax, it is not appropriate for private equity general partners to pay a lower tax rate than the general population and that private equity general partners should pay income tax on their earnings.

Investment Issues

Why investors make different demands of public companies compared with private equity-owned companies

4.1 This question appears to imply that the different regulatory standards applying to public and private companies stem from differential investor demands. However, the TUC does not believe that investor demand has been the only or even necessarily the main factor in determining the higher standards expected of public companies.

4.2 Over the last 15 years or so the role of investors in corporate governance has been strengthened by successive reviews, codes and legislation. The trend was started by the Cadbury Committee in the early 1990s, and other corporate governance reviews from Greenbury to Higgs followed its lead in attempting to solve problems surrounding how companies were run and governed by strengthening the accountability of directors to shareholders.

4.3 Since coming to power in 1997, the Labour Government has taken a clear policy decision that strengthening shareholder rights is the best way to address governance issues in companies. This can be seen clearly in, for example, the Directors' Remuneration Report Regulations 2002, which attempted to address the controversial issues surrounding directors' pay by requiring remuneration reports to be put to the vote at company AGMs. This approach came from Government and was informed by a wide-ranging public debate around directors' pay; it was not something that investors were demanding.

4.4 Indeed, while there has been a change in investor attitudes towards governance over the last decade, some investors have been reluctant to play a larger role in governance and other issues within companies. This can be seen clearly in the debate around executive pay, which many institutional investors at first saw as a matter for management, not shareholders, of the company. Over time, investors have become more active on executive pay issues, and this is now the main issue that investors vote on at company AGMs. However, while voting levels have risen over the last 15 years, the latest figures (for 2006) show that over one third of votes are still not being cast at AGMs. The 2006 voting rate was 61% in the FTSE 350 and 63.8% in the FTSE 100.[39]

4.5 Thus the TUC does not see investor demand as being the main factor in determining the differential regulatory frameworks surrounding quoted and private-equity owned companies. We believe that the regulatory framework surrounding quoted companies has developed over time in consultation with a wide range of stakeholders, including companies, investors, trade unions, accountants, legal advisors and so on. We would suggest that a key reason for the different regulatory approach taken towards private equity-owned companies is that until recently there was much less focus on these companies. During the Company Law Review there was much less time devoted to the regulatory framework for private companies than public companies, and either very little or no focus specifically on private equity-owned companies.

4.6 The debate over private equity has changed this, and highlighted the regulatory gap that exists in relation to these companies. As with previous corporate scandals, investors are just one voice in this debate and just one interest to be considered along with others in consideration of an appropriate regulatory regime for the private equity sector. While some issues, such as those relevant to companies with multiple shareholders are not generally relevant to private equity owned companies, other issues, including those relating to transparency and the protection of stakeholder interests are very relevant indeed.

[39] PIRC, Proxy Voting Annual Review 2006.

The implications of private equity-funded takeovers for company pension funds

4.7 The number and scale of private equity takeovers has risen sharply over recent years. At the same time, the UK equity market capitalisation has not grown since the last quarter of 2004, and actually shrank by £46.9 billion in the first half of 2006. The FSA attributes this shrinkage to the impact of public to private transactions, share buy backs and special dividends (sometimes as part of a defence against a private equity bid) and reduced capital flows from the private sector.[40]

4.8 Reducing the size of the stock market reduces the liquidity of capital, which is seen as vital in ensuring the efficiency of investments. The stock market plays an important role in spreading risk for investors, but the more the size of the stock market is reduced, the less this is the case.

4.9 Private equity buyouts reduce the number of investors that benefit from the returns generated by UK companies. Once bought by a private equity fund, companies that were previously generating returns for millions of pension fund beneficiaries through the stock market are generating returns for a much narrower group of general and limited partners, which may include a very small number of pension funds. The proportion of returns paid to limited partners is limited by the structure of private equity deals, with general partners frequently extracting a fifth of generated returns as "carried interest". Even when some of the limited partners are pension funds, this is a tiny proportion of those that would previously have benefited from the company through the stock market. The TUC is concerned that scaled up this could have serious distributional impacts, creating a situation where the wealth generated by UK companies is distributed far more unequally than at present.

4.10 There is also the question of the impact on individual pension funds that are investing in private equity. One of the issues for pension funds and other private equity limited partners is that their investments are illiquid and cannot be retrieved outside the returns of the agreement. This exposes pension funds (and other investors) to greater risk than investing in the stock market, which allows risk to be diversified. In addition, the fees charged to limited partners for investing are generally high. These are significant disadvantages for investors.

4.11 The private equity sector claims that its high returns justify both illiquidity and high fees. However, repeated studies have concluded that across the sector as a whole, returns to private equity investments are in fact lower than returns to investment in the stock market as a whole while the variation between top and bottom private equity performers is significantly higher, thus increasing risk for investors.

4.12 For example, a study by academics at the University of Chicago and the Massachusetts Institute of Technology looked at the performance of private equity funds between 1980 and 2001. It found that "on average leveraged buy-out funds returns net of fees are lower than those of the S&P 500"(when fees were stripped out, the returns were, on average, roughly equal).[41] It also found considerable variation between different fund managers. These conclusions were echoed by another study by the consulting firm Watson Wyatt, which examined the performance of private equity funds over the past 25 years. This concluded that while the best private equity managers may be able to generate above-average returns, there is no evidence that the asset class as a whole outperforms publicly-quoted shares.[42]

4.13 Other studies confirm that when the particular risks of private equity—not least the high degree of leverage in buy-outs—are considered together with its other characteristics, private equity investments actually substantially under-perform the market on average.[43]

4.14 Paul Myners has questioned whether pension fund trustees are looking sufficiently closely at the costs of investing in private equity against public stocks. His intervention is significant, because in his Review of Institutional Investment in 2001 he encouraged pension funds and other institutional investors to invest in alternative assets classes in order to diversify their investment portfolios. In another significant intervention, David Swensen of the Yale Endowment Fund, one of the most successful investors in private equity, has commented that "the large majority of buy-out funds fail to add sufficient value to overcome a grossly unreasonable fee structure".[44]

4.15 The wide variation in returns is particularly problematic for investors because of the lack of transparency surrounding private equity funds. This makes it very difficult for pension funds or other investors to be sure that, if they are considering investing in private equity funds, they are investing in a top performing fund, as they will need to do to generate returns that compensate for the high fee structure. Because average returns are lower than average stock market returns, the costs of investing in the "wrong" fund are likely to be high.

[40] FSA, Private equity: a discussion of risk and regulatory engagement, November 2006.
[41] Kaplan, S and Schoar, A, "Private Equity Performance", National Bureau of Economic Research Working Paper 9807, June 2003.
[42] "Pensions alert over private equity", *The Telegraph*, 10 May 2007.
[43] Phalipou, L, Gottschalg, O and Zollo, M, "Performance of private equity funds: Another puzzle?", Working paper, 200.
[44] "Private Money", *Fortune Magazine*, 19 February 2007.

PROTECTION OF WORKERS' INTERESTS IN MERGERS AND TAKEOVERS

The operation of TUPE in private equity takeovers

5.1 The Transfer of Undertakings (Protection of Employment) Regulations 2006 or TUPE protect workers' interests where an undertaking is transferred from one employer to another. TUPE implements the requirements of the Acquired Rights Directive in the UK. Typical situations where TUPE applies would include company outsourcing where employees performing a particular function are transferred to another, perhaps more specialist, company which then becomes their employer. Another common scenario is a public sector organisation "spinning off" a particular function that it has hitherto been performing to a private sector company, which then becomes the new employer of the relevant staff. In these situations, TUPE applies and requires:

- information and consultation of the employees' representatives;
- that the terms and conditions of employment are transferred to the new employer with no variation; and
- that any dismissals due solely to the transfer will automatically be unfair.

5.2 However, TUPE does not apply to takeovers that take place through a transfer of shares, including private equity buyouts. This leaves UK workers particularly vulnerable in comparison with their counterparts in continental Europe, because takeovers by share transfer are so much more common in the UK. In addition, workers' rights to information and consultation, for example through works councils, is generally much stronger in continental Europe, and in many countries workers have a direct voice into decision making through their representation on supervisory boards. The particular vulnerability of UK workers in mergers and takeovers is an iniquity that needs to be addressed.

5.3 The TUC and trade unions have consistently called for TUPE to be extended to apply to share transfers. This would ensure that workers in companies being taken over by private equity funds be informed and consulted about the proposed takeover plans. It would also guarantee that their terms and conditions were maintained after the buyout and that any redundancies carried out solely because of the buyout would automatically be unfair.

5.4 At present, it is too easy for both shareholders and executives to use mergers and takeovers to gain at the expense of employees. Existing shareholders have to agree a price before a takeover can take place, and managers are frequently offered highly beneficial incentives if the buyout goes ahead. However, employees have no rights for their interests to be protected or even considered in the takeover planning. Too often, employees learn of the takeover through the media and face reduced terms and conditions and/or redundancies as a result.

5.5 While the problems with the operation of mergers and takeovers in relation to workers' interests apply across the board, there are particular concerns for employees involved in private equity takeovers. There are two main reasons for this: the high levels of debt taken on by the portfolio company as part of the terms of the buyout which transfers heavy debt repayments to its balance sheet; and the limited time horizon of the private equity fund, which may make it less likely that the new owners will seek to invest in positive, long-term employment relationships, despite the mutual long-term benefits of this approach.

5.6 Recent studies have shown that private equity portfolio companies do indeed tend to carry out deep job cuts in the years after being bought. Two recent studies have used a control group of non-private equity owned companies in order to generate robust comparisons with private equity owned firms. A study carried out at Birmingham Business School and the University of Bologna, found that in comparison with a control group, job losses at UK private equity owned companies were 7% higher one year after the takeover, rose to 23% higher after four years and fell slightly to 21% after five years.[45] In a major study commissioned by the World Economic Forum and led by Josh Lerner of Harvard University, 300,000 US private equity-backed companies from 1980 and 2005 were examined. This research found that employment in private equity owned companies declined sharply in relation to the control group after a buyout, and was 7% lower after two years. Five years after the buyout, employment levels were over 10% lower in the private equity owned companies than they would have been had they developed like the control group.[46]

5.7 There is also evidence that workers' terms and conditions may be weakened by private equity buyouts. As well as anecdotal evidence, a study carried out by Centre for Management Buy Out Research and Nottingham University Business School found that buy-out firms had significantly lower annual wage growth than non-buyout firms. The downward pressure on wages was particularly great in management buy-ins (as opposed to management buy-outs). The study also indicates that the larger the company, the greater the downward pressure on wages.[47] Given the high returns that private equity funds earn from the firms they buy, a key question is why employees are not sharing in these financial benefits.

[45] Robert Cressy, Frederico Munari & Alessandro Malipiero, Creative Destruction? UK Evidence that buyouts cut jobs to raise returns, 30 October 2007.

[46] Josh Lerner *et al*, The Global Economic Impact of Private Equity Report 2008, Globalization of Alternative Investments Working Paper Volume 1, World Economic Forum, Jan 2008.

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

5.8 While the TUC supports extending TUPE to cover all takeovers by share transfer, there are aspects of the way in which private equity buyouts operate that make the case for extending TUPE in these cases particularly strong. When private equity funds buy a company, while nominally the employer remains the same, in practice employees and trade unions have frequently found that under new ownership, the management's approach to running the company so different that it is experienced to them as though there is an actual change of employer. Trade unions have complained of cases where management, despite having a previously positive relationship with the trade union, now refuses to meet them; in other cases, trade unions trying to represent their members' interests have been told by management that they are not in the driving seat in terms of making decisions that the union wishes to discuss. As shown in the research cited above, job losses and worse terms and conditions for employees are a likely consequence of private equity funded takeovers, again making the TUPE protections particularly relevant. In addition, as has been highlighted by commentators such as Paul Myners and FT journalist John Plender, the high leverage associated with private equity buyouts significantly increases risk for employees with no reward for that extra risk. This cannot be justified.

Information and consultation

5.9 As well as guaranteeing protection of terms and conditions and job security, it is essential that the information and consultation gap that currently exists for employees affected by mergers and takeovers is addressed. At present, employees frequently only find out that their company is being taken over and that their job is therefore potentially under threat when the deals are announced in the press. These "cornflake redundancies"—where workers learn that their company is to make significant numbers of redundancies on the radio over breakfast—have caused deep concern within the trade union movement for many years, and unions have called repeatedly for this information and consultation gap to be addressed.

5.10 There is existing regulation that should protect employees' right to be informed and consulted when a potential bid for their company is being considered. The Information and Consultation Regulations 2004 state that employers should consult employee representatives on matters that include:

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

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

These regulations have been in force for organisations with 150 or more employees since 2005 and will apply to organisations with 50 or more employees by April 2008. They are triggered by a formal request by employees or at the initiation of the employer.

5.11 In addition, the Collective Redundancies Directive 1975[48] requires information and consultation with employees and their representatives if 20 or more redundancies are proposed. This consultation must take place within 90 days and is triggered by the contemplation that redundancies might occur. Many private equity buyouts are followed by rapid job losses, as the studies quoted above have shown. The TUC believes it highly likely that in many cases private equity funds have already contemplated the possibility that redundancies may follow if their buyout is successful at the time of negotiating the buyout. Thus it would follow that this should be the trigger for consulting employees and their representatives about their proposals. However, currently this is not happening.

5.12 Company directors sometimes attribute this lack of information and consultation to the requirements of the takeover code. The general principles of the takeover code require that "all persons privy to confidential information, and particularly price-sensitive information, concerning an offer or contemplated offer must treat that information as secret and may only pass it to another person if it is necessary and if that person is made aware of the need for secrecy". This has been interpreted by boards and their advisors as preventing information about a proposed bid being shared with their employees and their representatives.

5.13 In fact, changes to the takeover code introduced in May 2006 means that far from preventing discussions with employees taking place, the takeover code now explicitly requires that employees are informed along with shareholders at the time that a firm bid is made. Rule 2.6 of the takeover code says:

"Promptly after the publication of an announcement made under Rule 2.5 [The announcement of a firm intention to make an offer]:

(i) the offeree company must send a copy of that announcement, or a circular summarising the terms and conditions of the offer, to its shareholders and to the [takeover] Panel; and

(ii) both the offeror and the offeree company must make that announcement, or a circular summarising the terms and conditions of the offer, readily available to their employee representatives, or, where there are no representatives, to the employees themselves".

[48] Implemented in the UK in the Trade Union and Labour Relations (Consolidation) Act 1992, Part IV, Chapter II, sections 188–198.

5.14 The bidder is also required to be explicit about its plans for employment if it acquires the target company. This is set out in Rule 24.1 Intentions regarding the Offeree Company, the Offeror Company and their Employees:

"An offeror will be required to cover the following points in the offer document:

(a) its intentions regarding the future business of the offeree company;

(b) its strategic plans for the offeree company, and their likely repercussions on employment and the locations of the offeree company's places of business; . . . and

(e) its intentions with regard to the continued employment of the employees and management of the offeree company and of its subsidiaries, including any material changes in the conditions of employment.

Where the offeror is a company and insofar as it is affected by the offer, the offeror must also cover (a), (b) and (e) with regard to itself".

5.15 If a bidder's intentions with regard to employment are being set out in its bid documents, and these intentions include options that would or could make 20 or more staff redundant, this should act as the trigger for consultations with employees and their representatives under requirements to consult on collective redundancies as set out above.

5.16 Far from preventing consultation, the takeover code appears to assume that consultation with employee representatives will take place, and requires that comments from employee representatives be included when the board circulates its opinion on the offer to shareholders. Rule 30.2 on the Offeree Board Circular requires that "the board of the offeree company must append to the circular containing its opinion a separate opinion from the representatives of its employees on the effects of the offer on employment, provided that such opinion is received in good time before publication of that circular". There is not, however, a requirement for directors to inform employee representatives of their right to make a submission to shareholders. The TUC has already raised this point with the Takeover Panel and plans further interventions to lobby for this omission to be addressed.

5.17 The takeover code further requires that the Board include its views on the employment implications in its opinion of the bid: "The board of the offeree company must circulate to the company's shareholders its opinion on the offer . . . [which] must include… the effects of implementation of the offer on all the company's interests, including, specifically, employment". These documents must also be made available to employee representatives or, in the absence of employee representatives, to the employees themselves.

5.18 Thus the takeover code, far from requiring secrecy from employees and trade unions, actually requires that the bidder company be specific in its bid about its plans regarding both condition of employment and numbers of employees; that the Board sets out its views on the employment implications of the bid in its comments to shareholders; that comments from employee representatives be included in the documents sent to shareholders; and that all the documents referred to above be made available to employees representatives or employees themselves.

5.19 The TUC is very concerned that these aspects of the takeover code are not currently being properly implemented, and is planning to conduct some urgent enquiries among affiliates to gather more detailed information on this. When this is completed, our concerns will be communicated to the Takeover Panel.

5.20 Just as there is a substantial gap in the reporting requirements between quoted and private companies, there is a similar gap in terms of the requirements surrounding takeovers of public and private companies. While listed companies and also unlisted plcs are covered by the takeover code, solely-owned private companies, including private equity-owned companies, are not covered. Private equity portfolio companies are often sold on from one private equity fund to another, and in these cases the information and consultation rights included in the takeover code do not apply. As set out above, other rights as set out in the Information and Consultation Directive and the Collective Redundancies Directive, are not being implemented in private equity buyout situations.

5.21 There is no justification for offering employees in certain companies information and consultation rights in a takeover situation and not others. This is an anomaly that needs urgently to be addressed. The TUC believes that TUPE should be extended to cover takeovers by share transfers. When the Acquired Rights Directive, from which the TUPE regulations stem, was originally introduced in 1977, the option of extending its protections to cover transfers by share ownership was considered, and the TUC does not believe that there are any technical barriers that would prevent this being implemented. As well as enshrining information and consultation rights, it would also prevent employment cuts being made solely as a result of the takeover and protect workers' existing terms and conditions.

5.22 If the Government is not minded to commit itself to this, it should at least commit itself to addressing the problems raised above in some other way. As a start, it should establish a working group to investigate the issue of employee interests, including information and consultation rights, in the context of mergers and takeovers, and draw up recommendations for reform. This working group should include representatives from unions, employers, investors and the takeover panel.

MARKET ABUSE AND CONFLICT OF INTEREST IN PRIVATE EQUITY TRANSACTIONS

6.1 There are three areas relating to conflicts of interest that are of concern to the TUC: potential conflicts of interest between existing shareholders and the bidder during the takeover process; conflicts of interest between limited and general partners; and, of particular concern to the TUC, conflicts of interest between private equity funds and their portfolio companies.

6.2 There is the potential for directors of target companies to face conflicts of interest as soon as a bid from a private equity fund is proposed, as company directors are often offered highly lucrative stakes in the company if the bid succeeds. In Denmark, the Government has recently passed legislation to address this issue. A new law forbids offering incentive programmes to the management of a company in connection with a takeover bid. In addition, the buyout fund is required to announce any dividends it wishes to pay out over the next 12 months in advance, thus making it easier for existing shareholders to judge the takeover offer. The TUC believes that the UK Government should implement similar legislation in the UK and urges the Treasury Committee to investigate options for this.

6.3 The FSA has warned of the potential for conflicts of interest between general partners and limited partners. For example, general partners are often able to over or under commit to specific company investments through "co-financing" deals. This could enable them to cherry pick the best deals for extra investment, while capping their exposure to more risky deals. Or, a fund manager may be managing investment funds at different stages of the investment cycle, both of which are invested in the same company. The interests of the two investment funds may diverge (for example, in terms of whether the private equity fund should sell to realise profit now or wait until later), while the fund manager has responsibilities to both groups. Or, if payment systems are in place that enable the fund manager to enrich its own staff and/or company directors without these payments going through the fund itself, it would be possible for the private equity fund to transfer significant value from the company to enrich its staff and company directors. If the value was transferred to the fund, the fund managers' staff would receive only a proportion of that value. The FSA argues that these are among scenarios that generate conflicts of interest between general and limited partners.[49]

6.4 The TUC is particularly concerned about the potential for conflicts of interest between private equity fund managers and the long-term success of the companies they own. The FSA has warned that the interests of fund managers, fund investors and the company are most likely to break down where:

— The fund invests in many different companies, with an individual spreading their attention across the portfolio, thus limiting the time that can be spent on each one; this is a particular problem if some of the companies are in the same sector and are thus competitors.

— The fund has already extracted profit through a re-financing and therefore considers that finite team resources would be better spent on another company.

— The fund manager is taking a portfolio approach to their investments and something that is in the interests of the portfolio as a whole is not in the interest of an individual company. Engineering a takeover of one company by another could be an example of this.

— Loans have been provided to company managers in order to allow them to buy an equity stake in the buyout. This could lead the company managers to act in the interests of the private equity fund manager, rather than the company they are responsible for.[50]

6.5 The FSA has also questioned the motives of the private equity fund managers and their commitment to the long-term sustainability of the company: "The entrance of new types of market participant with business models that may not favour the survival of distressed companies adds further complexities . . . which may create confusion which could damage the timeliness and effectiveness of work outs following credit events and could, in an extreme scenario, undermine an otherwise viable restructuring".[51]

6.6 Sir David Walker raised this issue in his consultation document of July 2007: "Where the equity providers have effectively lost the capital committed to a portfolio company, the general partner will be left with no direct financial interest to protect and could, if such interest were the sole criterion, feel little compunction about walking away from further engagement…But the rights of ownership should be seen to be complemented by a degree of obligation that would exclude abdication of responsibility by the general partners".[52] In his Guidelines published in October 2007, he included a recommendation on responsibility at a time of significant change: "In the event that a portfolio company encounters difficulties that leave the equity with little or no value, the private equity firm should be attentive not only to full discharge of its fiduciary obligation to the limited partners but also to facilitating the process of transition as far as it is practicable for it to do so".[53] The TUC believes that this exhortation is inadequate to address such a serious situation.

[49] FSA, Private equity: a discussion of risk and regulatory engagement, November 2006.
[50] ibid
[51] ibid
[52] Sir David Walker, Disclosure and Transparency in Private Equity A consultation document, July 2007.
[53] Sir David Walker, Guidelines for Disclosure and Transparency in Private Equity, October 2007.

6.7 If the interests of private equity fund manager and their portfolio companies can diverge, this has serious and detrimental implications for the portfolio company's stakeholders, including employees. It also raises major questions about whether the UK's corporate governance system is operating effectively to promote business success and protect the interests of those who contribute to that success.

6.8 The Companies Act 2006 enshrined what the Government has called "enlightened shareholder value" as the basis of UK company law. The duties of directors as set out in the new Act require directors to serve shareholder interests, and require that in so doing they have regard, among other matters, to the interests of employees, relationships with suppliers and customers, social and environmental impacts and the likely consequences of their decisions in the long-term. The thinking behind enlightened shareholder value was that in the long-term, the interests of different company stakeholders converge, thus making it unnecessary to put responsibilities to employees and other stakeholders on an equal footing to responsibilities to shareholders.[54]

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

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

Conclusion

The TUC welcomes this opportunity to submit evidence to the Treasury Committee's resumed inquiry into private equity. We believe that despite Sir David Walker's proposals on transparency and disclosure, significant problems surrounding private equity remain that need to be addressed by policy makers. These include conflicts of interest, taxation of general partners, tax relief on debt interest payments, the impact of private equity takeovers on the long-term performance of portfolio companies, and, most important of all to the TUC, the issue of how workers in portfolio companies are affected by private equity takeovers. The TUC believes that the current regulatory regime for private equity is inappropriate and should be strengthened to ensure that private equity funds and the companies they buy operate in the public interest. In particular, the TUC believes that measures are required as a matter of urgency to protect the interests of workers in mergers and takeovers.

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

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