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Direct EU regulation for Private Equity and Hedge funds  
The real economy comes first

Commission conference on private equity and hedge funds

*Poul Nyrup Rasmussen*  
President of PES, MEP, former PM

**- Check on delivery -**

At this hearing I'm not only speaking as president of the PES, but also in my capacity as the rapporteur of the European Parliament.

Someone outside the industry, dealing with the matter for years, presenting our report in March 2007 from the PES Group and the European Parliament, a critical analysis of hedge funds and private equity.

The European Parliament report on private equity and hedge funds were agreed overwhelmingly by all mainstream political groups, and calls for regulation covering all financial players, including private equity and hedge funds.

Long before the current financial crisis first emerged in August 2007 there have been growing concerns about the effects of the activities of highly leveraged investment vehicles such as hedge funds and private equity funds. These concerns have been voiced in Member States and by European and global financial institutions and by trade unions. Hedge funds and private equity are no longer a "niche" or 'alternative' industry, but important actors in the mainstream financial markets.

There are those who say hedge funds and private equity did not cause the crisis. But the crisis most definitely is the result of excessive debt – and hedge funds and private equity are responsible for a very sizeable amount of recent debt. In a sense all credit creating vehicles including hedge funds and private equity - all of them were in the same boat. Directly and indirectly they have all contributed to the financial bubble and the subsequent credit crunch.

We need investment for Europe to make our economies more competitive in the global economy. We need a well-functioning, transparent, cost-effective and stable financial market. Building on that premise, financial markets should be a tool, serving and enabling the real economy to be more productive and not an end in themselves.

One key question is - to what extent the growing sector of "alternative investment funds" - the hedge funds and private equity funds - conform and contribute to a positive, efficient and long-termist role for the capital markets in

financing the enormous amount of investment needed in the real economy? Unfortunately, we have seen some activities of the alternative investment industry undermining the wider social interest, extracting rather than creating value, and leaving others in the society to pick up the cost!

As this crisis has highlighted the financial system is now highly interconnected and highly geared. Distress in one institution leads to forced asset selling and because many financial institution assets are now “marked to market”, the resulting fall in asset prices can cause financial stress in other institutions through marked to market losses.

These institutions are then, in a bid to reduce risk and maintain capital ratios, forced to sell some of their liquid assets which can then trigger an asset price fall, forced de-leveraging and forced selling downward spiral which can result in a systemic breakdown.

Even if such systemic breakdown is prevented, any form of market stress imposes significant costs on a whole host of other financial institutions and often also the real economy. Importantly, this total cost to the system or to society is much higher than private cost to the institution where the financial stress originates.

So, financial disturbances in a hedge fund (or any other significant financial institution) have significant negative externalities. **Such potential negative externalities are perhaps the most important reason to regulate hedge funds and private equity.**

I, and I can speak on behalf here of the PES, strongly believe in a transparent, well-regulated market economy. Otherwise, as the actual financial crisis has shown us, we will simply weaken the future of our companies, industries and services, and weaken the capacity to be at the front of the added value chain, which requires constant high investment in knowledge, research and advanced employment - more and better jobs.

### **Why regulation is needed**

Therefore this two-day conference organized by the Commission should not be a step back to a discussion on whether regulation is needed or not. I'm simply astonished that this question is still open to the Commission - at least it seems so.

### **Lets be clear**

That discussion is long overdue and the answer is crystal clear. Yes, **we need sensible regulation of all important financial market actors and we need it urgently to restore confidence in the markets.**

I know that the industry representatives present here today will attempt one last push for self-regulation. I've seen their proposal:

Have they forgotten that we are in the deepest financial crisis since 1929, that this crisis has a recession that puts at jeopardy the jobs of millions of people? They say they are not part of systemic risks but we have seen numerous cases of pro- cyclical in their behavior. Recent LBO financing activity seems very similar to what happened in the subprime mortgage market. And there are a lot of other problems - over-leveraging of companies, extreme use of debt, greedy fee structures, the weakening of our companies' competitiveness.

To them my message today is straight-forward: **The moment for self-regulation has passed, if it has ever been there in the real world.**

I therefore welcome the statement by Commission president Barroso that *"No financial player should be exempt from regulation and oversight. That is a clear commitment on our part. It means that hedge funds and private equity must be covered."*

This commitment of universality was strongly echoed in the joint statement agreed by European leaders in Berlin this Saturday in preparation of the G20 summit: *"all financial markets, products and participants must be subject to appropriate oversight or regulation, without exception and regardless of their country of domicile. This is especially true for those private pools of capital, including hedge funds, that may present a systemic risk"*.

Commission President Barroso, EU Heads of Government, now Jean Claude Trichet, have all acknowledged that new regulation is needed. The collapse of the financial markets, has stripped the industry of the necessary credibility to self-regulate. When it did have the chance to self-regulate it failed to do so. Industry codes of practice were not supported by large parts of the private equity and hedge fund industry and did not install the public with the necessary faith that the industry is capable of responding on its own to the new climate. We need to create new trust and credibility and that is not going to come from the industry on its own.

Do the industries regulate themselves in an obligatory way covering every single actor:

- What they should pay in tax?
- How to limit excessive use of debt?
- How to limit excessive management fees?
- How to avoid pro-cyclical?
- How to ensure public authorities practice supervision to avoid bubbles?

They don't, and anyhow these fundamental questions can not be something to regulate on your free choice. It's about protecting our societies against repetition of financial defaults and abuse.

We note that when the Commission proposes regulation of other major actors such as Credit Rating Agencies, they reject the idea that self-regulatory codes of conduct are sufficient. Please Commissioner, be consistent - that goes for hedge fund and private equity too.

I have often heard it said recently that we need globally-harmonized regulation. People who only weeks ago rejected any new regulation now use this as a way to argue against EU-level regulation. Let's be serious – the US will regulate.

The EU and US will regulate – and for those who say industry will just go elsewhere I say the industry can't flourish outside the EU and US markets. The European Union is the world's largest economy and therefore has the necessary weight to implement the legislation effectively. PE cannot afford to abandon the European market so it will have to accept new regulation. In any case the benefits of lower systemic risk through better prudential norms would far exceed any potential costs in terms of a loss of competitive edge.

The EU has a leading role to play in promoting a certain convergence among regional regulatory and supervisory frameworks. This will be an important path of the basis for future global regulation.

### **What sort of regulation is needed?**

Let me now turn to the sort of regulation I believe should be the starting point in Europe. Let me just start by a few words addressing hedge funds.

We in the PES Party and the PES Group in the European Parliament along with a number of other organisations outside the hedge fund industry have responded to the Commission's hearing with comprehensive answers. We are very concrete in our proposals for new regulation.

Let me just highlight that the Commission should introduce risk-weighted capital adequacy requirements in respect of liquidity risk and the capital requirement of any institution providing prime brokerage services should be increased in line with the complexity and opacity of the structure or nature of the exposures, to which their dealings with hedge funds expose them.

Hedge funds and hedge fund management companies should also be subject to appropriate rules regarding bonuses and compensation, in order to limit pro-cyclical conduct and *moral hazard* resulting from a system providing for high bonuses in the event risky strategies succeed, and no reciprocal downside in the event of failure. These rules would be applicable when investors are EU pension funds, commercial banks, collective investment schemes or insurance companies

## **Private equity**

Let me turn now to private equity. I would like to address the conceptual framework in which private equity should be analyzed, the specific issues raised by private equity and the potential solutions.

I know private equity likes to portray itself as primarily venture capital but the reality is that the industry is dominated by LBO. I know that and you know that.

### **A) Addressing private equity in an appropriate conceptual framework**

Let's be immediately clear about *two major concerns* one may have with private equity.

First, private equity firms, just as hedge funds or asset managers, tend to see privately held companies as a "*class of assets*" – just as gold bullion, stamp collections or mansions on the Riviera. Well – I beg to differ. *Companies are much more than a "class of assets"*. Companies are made of people, working on projects, with appropriate equipment and finance, within a legal and social organization which is rooted in a local culture and community. No regulation relating to companies should ever forget this simple truth.

Second, private equity funds are a very specific type of shareholder. *Private equity funds hold companies with a view to resell them*. They have a strong control on management, but they have in reality a low commitment to the company's prospects and long term survival.

Both concerns are such that they are the source of a number of specific issues that we now need to address in more details.

### **B) Specific issues raised by private equity**

The two key aspects of private equity – viewing companies as a class of assets and acquiring companies with intent to resell them – have led to a widespread type of conduct fraught with potential dangers for the economy, social disruptions and regulatory concerns.

These dangers have been well identified for some time, but, as the current crisis has shed a harsh light on them, let's address them in some details.

#### **1 – Economic issues: negative externalities**

The returns for private equity firms may essentially come from three sources: a different management style of the company, the financial structure of the acquisition and a general increase in the value of assets. All three sources create potential negative externalities that should be appropriately addressed.

a) Optimization of the financial sources of return: overleveraging and asset stripping

In the years preceding the outburst of the financial crisis, all professionals in private equity could see that the average amount of leverage was increasing, transaction after transaction. Yet, market forces were the sovereign master of all, and nothing was done. When professionals acquire companies with a view to resell them, increasing shareholders' returns through optimization of financial structures is bound to happen. And we all know that the higher the debt is, the higher the risk of bankruptcy is. Leveraging has reached such a level that it is now part of the systemic risk faced by all our economies.

Asset stripping may happen in various contexts. It may be done for instance when the target company is performing well and the private equity fund wishes a quick reimbursement of its acquisition debt; or, on the contrary, it may be implemented when the target company is overloaded with the acquisition debt and its survival requires a quick sale of assets. In all cases, **the higher the debt, the higher the risk of asset stripping**. And with financial-based asset stripping comes an increased risk of bankruptcy, as useful assets may have been disposed of.

Thus, we have here our first negative externality: in order to produce ever higher returns, private equity firms have increased the risk of bankruptcy, which always generate public costs.

b) Optimization of the company sources of return: increased pressure on the company and short-termism

We know that acquisitions of target companies by private equity funds have, in many cases, a detrimental effect on employment, research & development and investment. This is due to the fact that companies are purchased with a view to being resold. In a bull market, where companies could be resold at a substantial profit without real improvements, short-term cost-cutting could provide private equity funds with higher interim financial distributions *and* a good sale price. It was the time where it was possible to have your pie and eat it.

With the end of easy financing and the beginning of a bear market for private companies, pressure on the target companies is likely to increase. Private equity funds are likely to look for extra returns through increased lay-offs and reduced investments. This is different from the search for efficiency, which may benefit the whole economy: the risk is to have undue wealth transfers from employees to shareholders, on the one hand, and short term decisions affecting long term value, on the other hand. Both would constitute negative externalities, which call for special attention.

c) Market sources of return: creation and burst of asset bubbles

Traditionally, the price of private companies evolved slowly. This increased stability and helped managers take long term decisions.

Cheap financing of LBOs has changed this: it has created a buoyant market for private companies, thus leading to instable prices for private companies. Just as the price of public companies is plagued with the creation and bursting of bubbles, the price of private companies is going up and down with no other rationale than financial decisions based on allocations of assets.

This is a social and economic problem. When prices go up unduly, industrial groups wishing to integrate new companies may be prevented from doing so. When prices crash, this is linked to a general financial crisis where all companies are in such a state that useful acquisitions may again be unduly postponed.

Economy needs more stability. Commoditisation of companies through private equity funds thus creates - again - negative externalities.

2 – Social issues: allocation of resources

Private equity also raises special concerns in the social area. *They relate to the capture by a few of wealth created by many.* This is linked to the resale of companies and to tax subsidies.

a) Allocation of resale price

Value created in a company comes from the work of the employees and the management. When, upon resale of a company, a significant profit has been made in a short period of time by private equity funds and firms, the issue of how the employees should all benefit from this is an appropriate question.

Management is already rewarded through significant packages. What should be the *employees' package* is now the question.

b) Tax subsidy for the carried interest, the leveraged structure

Private equity transactions receive a high amount of tax subsidies, though the channels of limited taxation of the carried interest and the deductibility of interest on the acquisition debt.

However, tax subsidies should be granted first to transactions that are economically efficient (*including* in respect of negative externalities) and

socially fair. We have seen that it is debatable whether these conditions are met. The question of tax subsidies should therefore be asked.

### 3 – Regulatory issues: lack of transparency

Appropriate regulation must be based on sound facts. This requires the ability for regulators to receive, on a regular basis, a comprehensive set of consistent and meaningful data from the industry.

One of the striking characteristics of private equity is its reluctance to provide required information. Private equity firms typically demand and obtain full transparency from target companies. It is only natural that private equity firms provide the same level of transparency than the one they get.

This is not only a question of symmetry and balance. It has to do with the ability of regulators to adopt appropriate regulations, to monitor systemic risks and to enforce sound principles.

### **C) Proposals for an enhanced regulatory package for private equity**

What we have described so far is well established and does not need further inquiries. It is now time for action.

So let's turn to serious matters. What should be an appropriate regulatory package for private equity activities? I see three areas where there could be major improvements.

#### 1) The single financial market

To ensure an effective and competitive single financial market in Europe, as proposed by the PES Group and the Danish Government and the Danish parliament, the European Commission should establish an EU framework for the registration and authorization of hedge funds and private equity funds and the entities that control the investment of such funds, i.e. management companies. They should function on a single entry point basis: once authorized, the entities concerned should have access to undertake business throughout the EU. It's interesting to see, that similar thinking is developing in the US.

Whatever the legal structure, an appropriate capital and liquidity requirements should be introduced at the level of the fund. This should cover all funds regardless of their place of registration. Appropriate capital and liquidity requirements should also be imposed to such EU institutional investors as pension funds, collective investments schemes, commercial banks or insurance companies when investing in hedge funds or private equity. Appropriate rules should make sure both that there is no loophole in the implementation of the requirements and that no double protection is unnecessarily imposed.

The introduction of strict reporting requirements on

- capital
- leverage
- investment strategy
- investment portfolio
- links with systemic financial institutions
- source of funds and
- risk management metrics is essential and overdue.

It is imperative that financial authorities have an accurate picture of the state of the financial system including aggregate amounts of capital, leverage and risk as well as inter-linkages amongst various actors.

## 2 - Reducing negative externalities

In order to reduce negative externalities, four reforms should be implemented:

- Limit excessive leveraging: funds acquiring companies with intent to resell should be constrained in their ability to leverage acquisitions. This may be achieved either through a limit on the leverage multiple (which may vary according to the industry where the target company operates) or, in a simpler and more flexible way, through a limit on the deductibility of interests paid by the target and the acquisition vehicle when such interests exceed a certain percentage – for instance 30% - of the target company's EBITDA.
- Controlling asset stripping: when asset stripping is motivated by the need to repay a portion of the acquisition debt, it should be appropriately controlled. To this effect, in the event a company under private equity control wishes to sell company assets in any material respect, the management of both the target company and the acquisition vehicles should issue a statement as to why the sale is implemented and certifying that the proposed sale is in the best interest of the target company. Second, in the event the proposed sale is connected to a repayment of the acquisition debt, the employees of the target company should be informed and consulted, through the workers' council when there is one. Third, in the event the company becomes insolvent after the asset stripping, the private equity firm should be held liable.
- Limiting the tax subsidy: the rules regarding taxation of the carried interest should be reviewed.

## 3 – Introducing more fairness and social cohesion

Fairness and social cohesion are key elements of a well functioning economy. Don't underestimate this. There is a lot of anger out there. People now associate financial markets with greed and hugely excessive pay and bonuses. Concerns about equality are coming back. The widening inequality

in recent years is a social and political timebomb. Some might say ethics and finance are two different things but this is a very, very dangerous attitude. In this respect, the following reforms should be implemented:

- Limiting management packages: in order to obtain an alignment of the management's interest on shareholders' interest, significant packages are offered to the management. There should be appropriate incentives to make sure that the benefit of these packages is substantially shared with all employees.

#### 4 – Transparency

Transparency is a very weak point of private equity. It should be substantially enhanced through the following reforms:

- Transparency towards prudential supervisors: prudential supervisors should be in a position to receive early signals of upcoming crises. To this effect, they should, on a regular basis, receive a set of key indicators regarding items such as indebtedness of private equity funds and the companies they hold, valuation of their participations, EBITDA, etc.
- Transparency towards employees: as employees are the ultimate source of any profit made by private equity firms and funds, they should be informed and consulted on the detailed structure of the acquisition of the company they work in, including fee arrangements, management packages, debt repayment plans, etc. If private equity transactions are good for employees, there should be no fear to communicate such information.
- Transparency towards the public: the true results of private equity investments in companies should be public knowledge. Private equity firms should collect standardized data on items such as acquisition and resale prices, employment, average compensation, investment, research and development and provide them to statistical offices for tabulation. Again, if there is nothing to hide, this should not be too difficult to implement.

#### ***Closing remarks***

The time for self regulation has passed. The time for sensible regulation is still here. Think for yourselves what might happen if we don't regulate very soon and decisively. Observe the lack of trust in and within the financial market. Financiers are not the masters of the universe anymore, if they ever thought they were. Politicians are watching – there is overwhelming political consensus for regulation. Trade unions are watching. Consumers and customers are watching. Pensioners and people with savings are watching.

The real economy comes first - it's time to ensure responsibilities at all levels among all actors on the financial markets. It's simply too costly to risk running in the future into new financial crisis of the kind we are in now.