



| Executive

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Mr Charlie McCreevy
European Commission Member for the
Internal Market and Services
European Commission
Rue de la Loi 200

B – 1049 Brussels

White paper on Private Equity Funds and Hedge Funds

Dear Commissioner McCreevy,

IG Metall is pleased to take this opportunity to take a stand on the reports of the Group of Experts on Non-Harmonized Funds.

But first, a comment on the procedure chosen by the EU Commission:

The composition of the expert groups – consisting exclusively of lobbyists from the industry concerned – is a design flaw. The same applies to the mandate given to the groups, which consists exclusively of eliminating obstacles to the efficient development of trans-boundary business in the industry in question. Neither the composition of the groups nor the restricted mandate assigned by the Commission take into account the now widely discussed risks and disadvantages of the private equity and particularly the hedge fund industry.

Private equity investments, and in future increasingly also hedge funds, have and will have a major influence on the employees of “portfolio enterprises” and often involve serious consequences for working men and women.

For that reason we consider it an inexplicable omission that the unions as the representatives of a substantial group of stakeholders were neither informed nor consulted about the appointment of the expert group. As far as we know, the Commission informed neither

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national unions nor the European Metalworkers' Federation, nor the European Trade Union Confederation (ETUC) of the Expert Group nor did it invite them to take part in it.

Decisions by the Expert Group are thus in no way socially representative and do not take into account the intensive debate in society concerning such financial investors.

Rather than merely a post-factum position paper, it would have been desirable if the Commission could have also given the other stakeholders, such as the unions, an opportunity to work together in a genuinely representative group of experts.

Having said that, our position on the framework conditions for private equity funds and hedge funds is as follows:

Development of a unified market for private equity (PE)

IG Metall does not oppose the development of a unified European market for private equity as such. Private equity can – particularly in the form of venture capital – contribute to the development of innovative enterprises and sustainable jobs. Private equity, through improved efficiency and an influx of capital, can help enterprises in trouble and even prepare them for the possibility of entering the stock market.

However, further promotion of the equity market as evidently pursued by the EU Commission is, in the view of IG Metall, not necessary. The existing financial resources of PE investors seeking investments already exceed the existing supply of holdings in companies. The excess demand raises the price of company shareholdings with the result that the expectations for returns from the portfolio companies rise higher and higher. Such high expectations are usually not consistent with economic reality.

IG Metall is afraid that the brunt will increasingly be borne by employees. But private equity should not become a synonym for layoffs, pay cuts and relocations.

We believe that private equity companies should not operate totally unregulated.

- Since PE funds are usually general partnerships or joint stock companies which are not subject to any right of supervision, it is all the more important to bind the institutional investors of these funds through legal regulations and strict investment limits for participation in PE funds. This applies particularly to pension funds and insurance companies, which because of their social responsibility should take smaller risks. Participation of pension funds and insurance companies in PE funds should be strictly limited, and within those limits they should be allowed to invest only in those PE funds which comply with mandatory standards of transparency and conduct.

Dangers of excessive credit financing with PE purchases

The main cause of problems for the acquired companies and their employees with PE funds is that PE funds pay for acquisitions with only a small part of the purchase price with equity capital, and finance the greater part with credit. The company is thus burdened with the cost of its own sale price in the form of interest and principal repayment. In many cases, that leads to an untenable rate of indebtedness for the company purchased. The problem for the company can be compounded when it is resold from one PE fund to another.

An excessive debt burden for the holding company also threatens stable long-term development and hence the jobs of the employees concerned. Often the enterprise is forced to divert resources to debt service that it urgently needs to invest in the future and to secure its market position through innovations. Experience has shown that the potential positive impact of an inflow of equity capital in such cases can actually have the opposite effect.

The widespread practice of excessive indebtedness, however, is a threat not only from an individual economic standpoint. There are also substantial threats to the capital market. When too many enterprises are destabilized through heavy debt, in the long run this is likely to affect for the banking system providing the credit. Recapitalizations have had harmful consequences which in the view of IG Metall are no longer tolerable.

- EU regulations should limit the portion of the purchase price of company holdings financed by credit to the level of the portion financed with equity capital. That would limit the leverage effect, and the potential risk of this business model would be reduced. In order to avoid unjustifiable risks in future to the company and the capital market, an equity capital rate of at least 30 percent is necessary.

Tax treatment of PE funds

Until now the member states have been exclusively responsible for tax matters. Accordingly, tax regulations for PE funds have varied. Nevertheless, the EU Commission is working to achieve a unified basis of assessment for corporate taxation in the EU. Within that framework, harmonized rules for taxing PE funds must also be established.

In Germany, profits from sales are in principle tax-free both for natural persons and corporations. In PE funds profits are made overwhelmingly from the sale of portfolio holdings. We believe that this constitutes unjustified preference for this type of income from profits and is inconsistent with the principle of taxation according to the ability to pay.

- With a view to better coordination and future harmonization of tax policy in the European Union, IG Metall considers that capital gains on the sale of assets should be fully included in the basis of assessment for income and profit taxation. Until final determination of the tax, a withholding tax of at least 25 percent should be charged on capital gains. This is provisional taxation, however, and is in no way a settlement tax.

One major concern of the Expert Group as regards taxation is that fund investors should only be taxed in their respective domiciles. IG Metall does not agree with that requirement. Double taxation agreements and domiciling of investors in tax havens often have the consequence that enormous profits from the activities of PE funds remain exempt from any taxation.

- In order to prevent that, capital gains and yields should be taxed when they occur with the domestic management company. Taxes incurred there can be credited to the tax owed by the investor.

External financing of the purchase of holdings enhances, sometimes substantially, the yield of PE funds through the leverage effect. Through recapitalizations, immense profits for investors are subsidized by the state with tax-free interest.

Exemption from taxes for interest on external capital leads to dysfunctional incentives which often result in excessive indebtedness of the holding companies.

- With a view to future harmonization of assessment bases in corporate taxation, IG Metall believes that interest on external capital should be considered part of taxable profit. The increase in interest on credit due to ending of tax-deductibility is the correct way to eliminate dysfunctional incentives which are harmful to companies. Tax policy in Germany is also presently moving in that direction.

Effects of PE holdings on employees

When the burden of interest and principal repayment must be compensated by savings elsewhere in the company, not only investors are affected. Just as often, employees are confronted with pay cuts.

Economy measures geared to the short term are implemented at the expense of jobs, pay and working conditions. As part of such shortsighted measures, jobs are often transferred to cheaper locations abroad. Thus the long-term condition of the company in the competition for innovation with quality products is sacrificed to a short-term, low-cost strategy. In such cases there is a clear contradiction between the PE fund's demand for short-term yield and the employees' interest in sustainable jobs.

Union experience has already shown that in the calculations of financial investors the legitimate interests of employees in preserving their jobs, collectively negotiated pay and working conditions, and co-determination, are often ignored.

It is therefore urgently necessary to protect established systems of industrial relations and collective bargaining in the EU member states from the harmful consequences which come with the appearance of financial investors and which constitute an increasing threat.

- IG Metall urges the EU commission to address this issue. We propose that the interests of employees be protected with a mandatory code of conduct for financial investors concerning employee rights in general and participation rights in particular.
- In addition, the EU commission should consider legal measures to protect jobs in sold enterprises for a specified period of time.

Regulation of hedge funds

IG Metall finds it incomprehensible that the EU Commission has to date hardly begun to address the substantial risks of hedge funds, a subject which has already been extensively debated in specialist circles and among the general public.

The risks of hedge funds are sufficiently well known from past crises in the financial markets. Recently even the European Central Bank warned that hedge funds pose a significant risk for global financial stability. The ECB sees as one of the causes the herd-like behaviour of the funds, which can lead to extensive upheavals in asset prices when several hedge funds simultaneously sell off certain holdings (cf. ECB, Financial Stability Review, June 2006).

In view of the risks posed by hedge funds, IG Metall calls for a ban on investments by pension funds and insurance companies in hedge funds. Existing involvement should be gradually phased out.

In addition, European regulation of these funds is urgently needed. The EU Commission and the member states should agree on the following regulatory steps as soon as possible:

- Registration of hedge funds
- Obligation to disclose asset structure and current transactions;
- Disclosure of owner structure;
- Stronger obligation to provide information on risks for investors, e.g. minimum transparency requirements, information on risk management, leverage in relation to investment strategies and liquidity risks of the fund;

- Prohibition of share lending;
- Introduction of a binding code of conduct;
- No access for hedge funds to the public market.

To prevent a threat to stability in the financial markets through excessive speculation, IG Metall also is in favour of the EU-wide introduction of a foreign exchange turnover tax and stock market turnover tax, as well as double voting rights for shareholders who have held their shares for at least two years.

Mr McCreevy,

In short, we would like to request the EU Commission in its consideration of financial investors and any future regulations not to be influenced exclusively by considerations of market efficiency and global competition.

Stability of the European financial markets, securing the achievements of a European social area, protecting small investors and above all the legitimate interests of the most important stakeholder group – employees – should be just as important a guide for the EU Commission.

Mr McCreevy,

We presume that you will take our views into account, and that the position of this union in favour of promoting a broader political discussion in the white paper on alternative investment funds will carry weight.

Sincerely yours,

Jürgen Peters
First Chairman

Wolfgang Rhode
Managing Member of the Executive