

AG/Brussels, 20 September 2006

**PES Group comments to the European Commission's report of the "Alternative investment expert group: Developing European Private Equity"**

Mr Commissioner Mc Creevy,

Please find herewith some preliminary comments to the report of the "Alternative investment expert group: Developing European Private Equity." The PES Group is currently working on this very important issue with the support of an expert group in order to deliver a Report by the end of the year that will be discussed more broadly in our political group. Seeing the deadline for consultation, we thought it to be appropriate to already give you some comments in this phase.

First of all I can ensure you on behalf of the PES Group that we criticize the way the report has been prepared. The report has been drafted by an expert group, which predominantly consisted of representatives from the private equity fund industry. Staff from the European Commission did, however, perform a secretariat function for the industry expert groups. We would have expected a more balanced composition of this group.

As to the content of the report our comments have not yet been discussed in the PES group, but we would like to share the concerns of our PES expert group with you already.

The report recommends that there is as little regulation of the fund businesses as possible. It is recommended that any EU initiatives in relation to their business model will not prevent the cross border investments of the private equity funds.

The report does not address a number of very relevant problems including:

- Many buyouts are financed through leverage (leveraged buyouts or LBO) and through the target company's equity.
- Because the majority of the private equity funds are organised as limited partnerships they are not subject to the EU rules and regulations on companies, including the rules on transparency.
- Since the majority of private equity funds are based in offshore centres they are not subject to the EU laws for companies and auditing rules on transparency.
- Because the buyout of target companies from private equity funds are followed by a delisting of the target company this leads to less transparency.
- Since the problems concerning the buyout through equity of the company is not discussed the following two points are also not properly reflected upon:

- The consequences of such buyouts for the future development of the target companies, including the future employment situation; and
- The considerable loss of fiscal income for the State because the tax payments from the target companies are falling drastically due to higher interest bearing debt.
- In relation to a buyout, special arrangements are often agreed with the management of the target company (including stock option programmes and other incentive structures). This can lead to a questioning of the loyalty of the management to the company and/or to the private equity funds. Although this is not a conclusive phenomenon, the fact that the loyalty of the management of a company can be questioned is in itself a serious problem for a company.
- There are considerable trading costs including fees for management consultancy and costs for the financial advice from the private equity funds. These costs are sent on to the target company although these costs should be covered by the private equity funds themselves.
- In some EU Member States, problems have arisen after the acquisition of companies by private equity funds, because the funds sought to obtain funds from the company pension funds.

You will find hereafter a more detailed comment from the PES expert group in view of further regulatory action, to be considered. These recommendations are preliminary and we will of course react to the White paper on asset management when it is released. The PES expert group will deliver a more detailed report by the end of the year. We will inform you in due time of the outcome of these activities.

Best regards

Ieke van den Burg, MEP  
PES Group  
ECON Coordinator

## *PES Group Recommendations*

As mentioned above, we will submit a more detailed report at a later stage. We will, however, raise a number of views of a principal nature related to this specific industry:

1. Since the report has been drafted mainly by industry, the views expressed are very one-sided.
2. We acknowledge that the development in the private equity funds industry has had a number of positive consequences for the development of capital markets. Especially the development of private equity venture activities has led to new opportunities for a number of companies, including the development of family-owned companies. Venture capital is a particular activity that is important to support and promote. We also recognize that private equity funds can have a role to play in terms of protecting family-owned companies from a break-up, which is the case for many SME's. Since this is described in the report, we will focus on other aspects, which are not discussed by the report.
3. The report does not recognize that many private equity funds are based in offshore centres, including many private equity funds active in the EU. The report does not see any problems related to the fact that many private equity funds are organised as limited partnerships. This is the company model where the EU company laws are the least developed, including requirements for financial reporting. Because of the offshore and limited partnership structure, the private equity funds are not subject to the same transparency requirements as other EU companies.
4. The report does not discuss the transparency problem that arises, when former listed companies that were covered by measures promoting transparency suddenly goes private after having been acquired by private equity funds. We believe that it is important that more transparency is created in the private equity funds. The same transparency measures should apply to private equity funds as to public companies based in the EU. It should be a requirement that the yearly reports are publicised and that there are supervisory disclosure demands related to these reports. The private equity funds should also report to the monetary authorities.
5. The report does not take into account the tax inspection problems that arise when an investor based in an EU Member States invest in private equity based in offshore centres. We believe that it should be investigated, whether the Council directive 2003/48/EC on taxation of savings income in the form of interest payment that have been implemented in a number of offshore centres also include investments in private equity funds. The directive imply that there is a supervisory disclosure to the investors' tax authority
6. The private equity funds justify their placement in offshore centres and legal organisation as limited partnerships with the existing rules on taxation. They refer to double taxation and tax at source issues. However, there is a paradox in the arguments of the private equity industry, because the parent/subsidiary directive (90/435/EEC and 2003/123/EC) has been implemented in the EU and the examples by the industry means that in reality the rules of this directive are circumvented by the private equity funds. We call on the European Commission to undertake a thorough study concerning this issue in order to clarify whether additional regulation is needed to ensure that private equity funds, if they are organised as a stock corporation based in an EU Member States (possibly organised as a European Company) could be exempt for unnecessary double taxation and tax at source. In this work it would be natural to include the private equity funds, but also other stakeholders should be represented.

7. We believe that it is very unfortunate that so many of the private equity funds operating in the EU are based in offshore centres. We would like to see concrete initiative from the Commission that would ensure that it is no longer favourable to be based in offshore centres.
  - a. It should be considered whether the MIFID directive should be amended so that the suppliers of investment products in private equity funds would have to adhere to the MIFID directive. In addition, special requirements should be made when the supplier is offering investments in private equity funds that are based outside the EU especially targeting funds based in offshore centres.
  - b. The Commission could consider specific requirements regarding the placement of funds by insurance companies and pension funds in private equity. This would in particular apply to investments in private equity based in offshore centres. The Commission should in this context consider whether a positive list of investment destinations could apply and/or whether a limitation of the capital invested could be relevant.
  - c. The rules regulating initial capital requirements for payment institutes should take into account the special structure and business that most private equity funds have. In the rules on initial capital requirements, there should be special provisions of placement of funds in private equity funds that are based outside the EU and especially if they are based in offshore centres.
8. The distribution from the target company is not limited to "free" assets in the company, but is often accompanied by a considerable increase of the company debt load. It is common that only 20% of the actual price of the company is paid with an equity check from the funds, while 80% are financed through equity in the target company and debt issued by the company after the takeover. Since this very important discussion has not been taken onboard by the expert group, we call on the Commission to thoroughly consider the consequences. This would include a study of existing regulation to assess whether it is sufficient and up to date to address this business model. We are particularly concerned about:
  - a. The rules on self-financing, i.e. that the target company in reality is acquiring itself through the buyout. One way to do this could be to restrict the degree of external financing to, for example, 70%. A clear definition on the threshold values and principles for the preservation of company capital post-acquisition could also be considered, including a definition of not acceptable models of "decapitalization" of the target company.
  - b. The rules for aconto distribution of dividend, including the aconto distribution of dividend to new shareholders immediately after a company have been acquired. A ban on extraordinary distributions to shareholders during the accounting year should also be taken into consideration.
9. The report does not discuss the consequences for public finances following the leveraged buyouts and the considerable decrease in tax proceeds following the deduction of the debt increase in the target company and in the holding companies. In many EU Member States the rules on joint taxation imply that the interest expenses are not included in the acquired company's tax base. One way to limit the debt increase could be to under certain circumstances to reduce the possibility to deduce the interest payments from the company's tax base.

10. The report does not discuss the substantial costs related to financial advisers following the private equity funds business and acquisitions. The acquired company pay the expenses of these fees, while these costs in reality should be paid by the private equity funds themselves. We call on the Commission to clarify the rules regulating this area, and whether there is any need for a tightening so that it no longer would be acceptable that the target company pays the expenses that in reality should be paid by the private equity funds. This would apply in particular when the management fees in reality are hidden distributions. One way to verify this would be through statements of the propriety of the fees and market comparisons.
11. The report does not discuss the incentive structures such as stock options that the private equity funds use to control the management of a company. Since these incentive structures can raise questions of loyalty of the company management, we call on the Commission to thoroughly study the implication of the use of these incentive structures.
12. The report does not discuss the problems relating to acquired companies pension funds. The Commission should thoroughly consider whether the current level of protection for the pension funds of an acquired company is sufficient.