HEDGE FUNDS AND PRIVATE EQUITY – A CRITICAL ANALYSIS

EXECUTIVE SUMMARY

PSE
Socialist Group in the European Parliament

Our Europe

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

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

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

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The question

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

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

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

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

The need for long-term investment

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

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

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

The need for long-term financing

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

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

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

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

No real answer from the Commission

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

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

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

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

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The PES Group report

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

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

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

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

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

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

The anatomy of hedge funds and private equity funds

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

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

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

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

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

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

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

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

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

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

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The pension funds

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

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

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

Investment strategies

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

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

The leverage and the consequences

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

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

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

In the HF industry the total debt including derivatives is something between 150% and

250% of HF single values, i.e. 2.0 - 3.3 trillion USD.

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

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

Extreme management fees and remunerations

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

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

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LBO: The target company - before and after

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

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

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

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

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

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

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

Their returns - better than others?

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

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

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

Tendency of crowding

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

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

Short-term versus long-term

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

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

- In 2004 the LBOs got 64% of their invested capital back just after 29 months.
- In 2005 PE LBOs got 27% of their invested capital back in just 20 months.
- In the first half of 2006 PE LBOs have got 86% of their investment back in just 24 months engagement in the target company.

Lack of transparency and disclosure

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

Societies' response - current national and European regulations

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

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

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Part II: Six concerns about our European social market economy

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

- The effects on the efficiency of capital markets. Lack of transparency, information asymmetry, insider trading - all contribute to inefficiency and imperfect markets.
- The effect on the productivity and long-term growth of the firms and industries in which HFs and LBOs invest. It increases financial risks, requires preoccupation with cash flow and reduces the capacity to invest and manage long-term efficiency, productivity and innovation.
- The effect on our public sector and the special public service obligations of industries like infrastructure sectors and public housing. It minimises or abandons the obligation and undermines the risks allocated by the authorities associated with the obligations through re-evaluation - this is the basis for additional cash withdrawals to the LBO funds.
- The lack of transparency. This is not a coincidental characteristic of HFs and LBOs. Unnecessary and costly, complex holding structures are created - and effectively make it impossible to lift the corporate veil to the detriment of all parties with an interest in the firm - regulators, tax authorities, trade unions and others.
- The incentives created for CEOs of the target company, such as special bonuses, stock options are all extremely high and threaten the efficient management of all potential target companies.

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

Economic viability of private companies

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

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

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

Decent work and workers participation

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

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

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

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

Public sector and universal provision of services

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

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

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

Pension fund investments and long-term real value

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

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

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

Stability of financial markets

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

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

Coherence, co-responsibility and ethics

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

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

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Part III: Lessons to be drawn for future regulation

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

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

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

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

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

1. Europe's single market is the world's biggest economy and enormously attractive for foreign investors.
2. "Creativity" and "financial engineering" to avoid the effects of regulators will always be an ongoing phenomenon - as regulation is also a permanent process.
3. We are aiming at appropriate and carefully targeted regulations, not disproportionate general prohibition or over-detailed regulations.

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

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

- Ensuring transparency and disclosure through regulations and incentives at the European and national levels.
- Protecting and ensuring dynamic long-term competitive decisions in companies through some protective regulations in company legislation.
- Protecting and promoting the real value and sustainability of wage earners' pension savings in pension funds through adequate, protective regulation of pension funds.
- Ensuring financial stability through adequate incentives, monitoring and regulations at the level of financial markets, nationally and within the European Union.

Transparency in practise

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

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

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

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

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

- New standards relating to the sale and promotion of alternative investment projects needs to be developed to protect consumers from mis-selling and mis-representation of risks. Funds that are eligible for marketing to retail investors should conform to a number of safeguards.
- A number of concerns have been raised about the valuation of assets within alternative investment funds including HFs. The European Commission should establish robust minimum standards.

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

- The regulatory step to be considered is to increase the transparency of the key funds by requiring reporting at regular intervals to an appropriate regulatory authority on (i) the investment strategy of the company, (ii) details of the assets held by the company, (iii) disclosure of the risk management model used, and (iv) the management's incentive structure.
- Direct supervision of LBO through the appropriate agencies should take place via guidelines and direct controls. It appears worth considering whether new tasks within the framework of supervision and regulation could be transferred to the ECB.
- At EU level one could at least argue for a directive defining minimum standards for disclosure.

Systemic risks and financial stability

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

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

Corporate governance

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

- Rules relating to the fair and the equitable treatment of different classes of share holders are needed to ensure that funds cannot use pricing policies to attract potential investors or dissuade potential sellers. The EU should establish rules to ensure this.
- The EU should create a framework to allow the HF industry and PEs to be rated according to investment strategy and risk.
- The EU Commission should also reflect on the "conduct of business rules" enacted by the financial community. These rules should include strong sanctions modelled after the City Code on Takeovers and Mergers of the LSE.
- Reporting requirements should include not only assessment of risks and returns but also a corporate responsibility report to allow investors to understand the impact on other stake holders in the investment chain (employees).

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

- Besides creating incentives for long-term investments, long-term investors should be rewarded by permitting weighting of voting rights according to duration of share holding and by means of differentiated taxation of income from shareholders.
- In order to prevent value extraction, limitations on the withdrawal of liquid assets from the target company should be introduced.
- One could also imagine restricting owners' freedom to set managers' remuneration packages (stock-options) autonomously.
- The desired character of investments could also be channelled in the right direction by capital-maintenance provisions which proscribe a limitation of the transfer of debts to companies that are the object of LBOs, through the restriction of credit financing.
- In order to ensure a better protection of pension funds investing in LBOs, we can consider relevant regulation at European level.

Ensuring more and better jobs

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

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

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

Tax policy

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

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

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

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

- Rules should be introduced limiting deductions for expenditure on interest in the target company, its holding companies and its subsidiary companies once the target company has been taking over through a leverage buy-out.
- The limitation could take the form of no deductions being allowed for interest expenditure by the local holding companies that have been established to carry out the takeover.

- The limitation could also take the form of removal of the deduction for interest expenditure by the target company, in respect of interest on the debt incurred in order to pay an extraordinary dividend after the company has been taken over by a LBO.
- There should be various protection rules to prevent the crass over-exploitation of tax saving opportunities.

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

- To introduce a fiscal discrimination, including FOHFs and all tax-exempt organisations, against offshore projects.
- To address the risks associated with offshore jurisdiction, consideration should be given to changing the tax rules, so that the location of the manager determines the tax position of hedge funds.

Our point of departure

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

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

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

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

HEDGE FUNDS AND PRIVATE EQUITY – A CRITICAL ANALYSIS

DRAFT REPORT MARCH 2007

Presented by
Ieke van den Burg, Socialist Group ECON coordinator
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PSE
Socialist Group in the European Parliament

FOREWORD

Since the 1980s the financial markets have undergone fundamental change. The impact of globalisation has not been so dramatic and far-reaching in any other part of our societies.

Hedge funds and private equity funds have existed for a long time - but their enormous growth is one of the most striking new developments with strong implications for the structures, the behaviours, and the transparencies of the financial markets, as well as business practice within them. The question is: does this new development bring down the cost of capital? Does it lead to higher efficiency on the capital markets? Or are we faced with new risks of financial stability, imperfections or abuse on the capital markets?

An even more fundamental issue is: Do we have today, with the increasing dominance of hedge funds and private equity funds, financial markets in Europe functioning with full transparency, financing the real economy on optimal conditions?

This precise question has given rise to much concern among progressive political parties including PES and the PES Group in the European Parliament, trade unions, corporate businesses, and employees.

Hedge funds and private equity funds cannot be analysed and discussed in a clear, fair and logical way without placing these capital funds in a broader context. And this context is our social Europe, in other words the Lisbon agenda.

In 2000 the European Council defined in Lisbon the objectives of the strategy as making Europe: “The most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth, more and better jobs and better social cohesion”.

In preparation for the Spring European Council 2005, the PES group presented on 1 February 20005 its report: “A Europe of excellence- the Lisbon strategy: Getting from declarations to results”. Europe’s choice is to base its competitive strategy on excellence, on the high quality of its infrastructure, its public services, its environment, its welfare systems, its workforce, its labour markets, and its companies. Europe has no future trying to compete as a low-cost producer in a global economy. We want to renew our welfare societies - our social Europe - so that it can survive in the global economy. The Lisbon idea is to recognise that by favouring investments - and creating an environment in which globally competitive companies can flourish. Europe’s social and environmental model is not an obstacle but an ally.

We clearly confirm our readiness for reforms in our welfare societies - from the labour market to the market in goods, to education policies, social policies etc. - but the right reforms! And reforms must go hand in hand with investment, growth and more and better jobs: investment in research and development, new technologies, education and improved qualifications, in public sectors as well as in private business. Investment - public and private - is the crucial agent of transformation.

We need investment to make our welfare societies more competitive in the global economy. The very basis for New Social Europe in the global economy is a pro-active European industrial policy, focusing on knowledge and information, and smart green growth. But, to achieve these objectives, long-term, patient investment is crucial.

We still believe in the market but it must be a “social market economy”, not a “market society”. This fundamental distinction was reiterated in the spring 2005 communication from the European Council, which quotes the draft vision for a European constitution of a “highly competitive social market economy”.

The decisive 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 to make a “Europe of Excellence” in the real economy? Alternatively - to what extent the activities of hedge funds and private equity funds are inimical to the wider social interest, extracting rather than creating value, and leaving others in the society to pick up the cost?

Answers could not be found in existing, actual information or analyses. Neither, unfortunately, can we expect answers from the European Commission.

In July 2005 the European Commission launched a public debate on possible ways to enhance the European framework for investment funds. The Commission established a couple of “Alternative Investment Expert Groups” to describe “how they see the future development of the hedge funds and private equity funds in Europe, and whether there are any European-level regulatory or other obstacles which hold back the efficient organisation of the business in Europe”. But the purpose of the reports as described seems to presuppose that the major problem is too much existing regulation. In July 2006, the result of this work was published in two reports titled “Developing European Private Equity” and “Managing Servicing and Marketing Hedge Funds in Europe”.

The PES-Group in the European Parliament welcomes that the European Commission has drawn attention to the alternative investment market in general and private equity funds and hedge funds in particular. However, the PES-Group is critical of the fact that the two reports have been drafted by expert groups, mostly consisting of representatives of organisations with a strong interest in the “light touch regulation” of alternative investment markets, which both reports duly proposed. Moreover, the PES-Group is deeply concerned by the strong bias in many of the analyses of the reports. A bias towards deregulation is even more striking in the policy proposals derived from these analyses and the reports fail to address a number of pivotal issues. This work - at the behest of Commissioner McCreevy - is in stark contrast to the very well documented worries expressed in reports from among others the ECB, and the World Bank. The PES-Group first voiced its criticism in preliminary comments to the European Commission’s two reports by the so-called “Alternative Investment Expert Groups”.

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At the same time the PES Group took full account of the present lack of coherent analysis and reflections on how to tackle the new trends on the financial markets - in the interest of our societies.

Therefore, we decided to establish our own group of experts (henceforth referred to as PES-Experts - Reiner Hoffmann, Christen Amby, Giovanni Di Corato, Jeppe Jørgensen, Michel Aglietta, Norbert Kluge, Pierre Bollon, Will Hutton, Paul Windolf, Andrew Watt, Lothar Kamp, Mick McAteer, Roland Köstler, Sam Ironside, William Melody, Norbert Wieczorek) and with them to analyse the situation and consider the need for regulation. The group has now finished "Capital funds in Europe - a critical analysis", reflecting discussions during the period July – February 2006/2007.

From the outset we insisted that this report should not be based on feelings or our perspective but on facts and a very clear commitment to the future of Europe - the "Europe of Excellence", the New Social Europe, the Lisbon Process.

Therefore, the report is based on a number of case studies from the real economy - to document the strategies and the pattern of reactions followed by most private equity funds.

Accessible studies, analyses, information and updates have been integrated into our work - supplemented by our own experts' analysis.

Our analyses have shown that some hedge funds and private equity funds contribute to making capital markets function more efficiently, to making some passive, corporate business managers more pro-active and ensuring returns to investors, pension funds etc.

However, overwhelming evidence and practical experience show that most of their activities raise serious concerns and problems in the real economy, e.g. the impact on long-term investment in R&D, new technology etc. in co-operative businesses, jobs and working conditions, investor protection and systemic risks to the stability of the financial markets.

Finally, this report considers a number of tentative proposals that should provoke discussions on the objectives and form of future regulatory issues - incentives, codes of conduct, monitoring, regulations - by member states as well as the European Union and other international bodies.

We deeply believe in a transparent, well-regulated market economy as the basis for the social economy in our welfare states and in the future global economy. But we also strongly believe that such regulatory measures have to be stronger than the "light touch regulation" proposed by the Alternative Investment Expert Group of the European Commission. Otherwise, we will simply weaken the future of our companies, industries and services, and the capability 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. And our Lisbon goal - "to become the most competitive and dynamic knowledge-driven economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion" - will surely be under threat. There is a better way.

Ieke van den Burg   Poul Nyrup Rasmussen

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PART I - The real economy is still there

If we were living in a perfect world, what we call the "real economy" - that is, not only businesses, resources, and the means of production but also the workforce, knowledge, development and innovation - would function perfectly well, all other elements of our societies being committed to its promotion and success. The financial markets and their various actors would, of course, contribute to the achievements of the overall real economy, providing easy access to funding.

But this perfection is not a reality since perfection does not exist as such. And the real economy as it stands nowadays suffers from more than simply imperfections. We are seeing new, strong actors on the financial markets dictating more and more of the rules, enforcing their time horizons and imposing their behaviours on the real economy. This trend is not only worrying as far as the actual functioning of the real economy of Europe is concerned – it risks preventing us reaching our common European goals for our societies and citizens. In Lisbon in 2000 the European Council defined its objective of making Europe: "The most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth, more and better jobs and better social cohesion".

In the preparations for the Spring European Council in 2005, the PES Group presented on 1st February its report "A Europe of Excellence - the Lisbon strategy: Getting from declarations to results". Europe's choice must be to base its competitive strategy on excellence, on the high quality of its infrastructure, its public services, its environment, its welfare systems, its workforce, its labour markets and its companies. Europe has no future in trying to compete as a low-cost producer in a global economy.

We must base ourselves on long-term investments to realise these common goals. Therefore, we need long-term financing - that is why the financial markets are so crucial for the real economy of today. We are still believers in the market but we insist on a "Social market economy", not on a "market society". The problem is that the main actors in the alternative investment industry do not see themselves as the "servants" or the instruments ensuring the smooth functioning of the real economy. On the contrary, they seem to gain all the advantages of the wealth created by the real economy without contributing either to its functioning or to its future.

We are facing a cycle in which the financial markets are not helping the real economy to flourish but increasing their gains to its detriment. There are, of course, exceptions to this trend, especially when looking at the venture capital industry, but overall developments in the financial markets are not promoting the New Social Europe. Very few people live off financial markets compared to the real economy. We cannot imagine a fully financed economy where financial capital determines the rhythm and returns expected from investments versus real capital, and where this investment is subordinated to the demands of the global finance markets.

The situation we are facing now is the result of a long historical evolution of capitalism, from family-owned capitalism, to manager capitalism, shareholder- value capitalism, and then “fund-driven” capitalism (or financial market capitalism) and reflects the transformation of the economic institutions of capitalism over time.

The first era of capitalism took the form of family-owned capitalism where large family not only owned companies but also had the funds to make the necessary investments into their business. This traditional form was characterised by very close relationships between the management and the employees despite a cruel lack of social rights. Although in retrospect it appeared to some analysts as the “good times”, this period also revealed a lack of dynamism, where the economy was closed and very local, with few perspectives for expansion. Since the financial markets were not well developed, the access to finance was limited. Growth was too weak and the decision-making in companies was too top/down.

This situation, described here in very broad terms, was the reality in Europe more or less until the 1950s.Then, an important decision taken after World War II, i.e. the convertibility of currencies into gold and the opening of trade at an international level, completely changed the face of capitalism.

We saw the rise of international markets, leading to the development of shareholder ownership. Managers controlled large public corporations, but they did not own them. Shareholders owned corporations but were unable to control them or coordinate their own actions due to their large numbers. They provided long-term capital on the condition that managers paid them a decent dividend. The separation of ownership and control kept the shareholders at arm’s length from managerial decision-making. The public corporation was not insulated from stock markets, but entrepreneurial decision-making was not directly influenced by the volatility of financial markets.

The immediate benefits from this change of international dimension were a boost for growth, an increase of productivity and the development of new technologies. A new type of company appeared: the so-called multinationals. While industry at the same time suffered from a poor capacity for renewal, there was a growing distance between owners of companies and their employees, and a slow-down in upgrading infrastructure. We witnessed the internationalisation of stock exchanges but not yet true international financial markets.

The 1970s were characterised by an acceleration of internationalisation. There was strong potential for economic growth until 1979, with increasing productivity. A phenomenon, called globalisation, became the new paradigm, going beyond the level of nation states and deep into the real economy. There was also a re-concentration of ownership in the large public corporation.

The last development of this evolution of capitalism had its roots in the USA. The shareholder value-concept has been increasingly influencing our societies, not only financial markets, but also managerial decision-making in companies in the real economy. Capital markets have changed fundamentally during the last decade. Today, financing capital is organised in relatively larger funds, compared to the traditional channel of bank financing. Today, pension funds and insurance companies re investing in up to 50% of all shares and

40% of other stocks and bonds. Another new phenomenon is hedge funds and private equity funds - both focusing on short-term profit and huge management fees.

This new type of ownership means in reality the predominance of institutional investors: banks, insurance companies, financial conglomerates, pension funds and other funds like private equity funds and, sometimes, hedge funds. Financial market capitalism may therefore be defined as a specific capitalist regime within which the real economy is more and more dominated by the operational principles of the financial markets. This is a quite recent phenomenon where, in addition to imposing their operational principles, funds are also the owners of the real economy, in one way or another. They may act in concert or not, they may exercise their voting rights or not, but in all cases, they are characterised by a damaging lack of transparency which affects both the market itself (in terms of price transparency, herd effect and volatility) and the end-investors (in terms of risk management and sound investment decision). In Germany, a political decision was taken in the late nineties, the magnitude of which was unforeseen. A law allowed the banks' ownership of companies to be passed to financial market ownership. This completely changed the philosophy of the German company model, which was based on the two-tier decision process - the supervisory board ensuring the influence of shareholders, and the management ensuring coherence of all stakeholders in the company. Hedge funds and private equity took full advantage of their new opportunity with substantial effect on German industry.

It is essential to view the private equity phenomenon as well as the hedge funds' growth within the context of the changed, "financialised" environment as a whole, because their impact is not limited to their target companies, but exerts a profound influence on the economy as a whole, including those companies which remain under traditional ownership, whether publicly listed or privately held.

The decisive question is to what extent the growing sector of "alternative investment funds" - the HF and PE funds - conform and contribute to a positive, efficient and long-term oriented role for the capital market in financing the enormous amount of investment needed to promote a Europe of excellence in the real economy?

Unfortunately, our worries are that they do not. Our analysis in this report indicates, that many activities of HF and PE funds are inimical to the wider social interest, and are simply about extracting rather than creating value in the companies.

The aim of Part I is to give a comprehensive description of the hedge fund and private equity fund industries in Europe as these are the fundamental part of the alternative investment industry. Both are to a large extent deregulated and both operate with short-term horizons to realise planned high returns. Although their effect on the real economy is similar they use financial markets in different ways, which is why we shall consider them separately.

Of course, there are huge differences to be found among the investment funds. Venture capital is invested in new and upcoming companies, often within high-tech industries. It generates real growth, supports good ideas and is a very important aspect of the investment market to promote the knowledge-economy of Europe. But our main topic in this report is HF and PE funds, especially the so-called leverage buy-out funds.

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It is highly important to underline again that the alternative investment industry is heavily deregulated and opacity is its general rule. Consequently it is not possible to gather public information concerning products and managers, as it is in the case of the UCITS industry. A full understanding of the current size and shape of the market, of its most relevant features and of its trend is necessarily influenced by these limitations. However, the report is based on industry sources, a whole range of important, new publicly accessible research and a set of concrete case studies (see annex).

1. Hedge funds

In the following pages we will try to offer an analytical and comprehensive picture of the hedge funds industry, focusing on its European segment.

Hedge funds are a recent development in Europe. The purpose of hedge funds has been twofold:

1. To create an opportunity to secure the overall development of an investor's active portfolio.
2. To create a profit by betting on different market developments between different actives/passives of the same type.

The achievement of the above was attained through varying long/short strategies in different areas. This could happen through buying and selling of assets, through futures, or through acquisition or issuance of options. It could also be through a combination of such contracts, including the conclusions of SWAP-deals[1].

In recent years the general fall in interest rates has led to a change of the business model of many hedge funds. Decreasing rates have on the one hand led to a large inflow of capital because the investors in hedge funds expected a higher return on investment than through traditional interest-rate-bearing products. On the other hand, the hedge funds have increasingly placed their investments in stocks instead of market-neutral, interest-rate-bearing assets. Many hedge funds have thereby become overexposed to investments in stocks, which can be seen from the fact that indices of share prices of investments in hedge funds have followed the developments of the international stock indices.

This in turn has made hedge funds look more like the stock-based investment funds where

[1] A swap is a derivative, where two counterparties exchange one stream of cash flows against another stream. These streams are called the *legs* of the swap. The cash flows are calculated over a notional principal amount. Swaps are often used to hedge certain risks, for instance interest rate risk. Another use is speculation.

the investment in stocks is complemented by some financial contracts. Lately the hedge funds have begun investing in more risk-prone interest-bearing products such as junk bonds, corporate bonds, and bonds from emerging markets.

Although there is a difference between hedge funds and private equity funds in the sense that traditionally hedge funds are investing short-term without exercising ownership authority, whereas private equity funds are more likely to exercise ownership authority, we have in recent years seen a development where the two types of alternative investment funds have become more closely related.

In a number of cases, hedge funds have been buying up stocks in publicly listed companies that have subsequently been bought by private equity funds. This is because hedge funds have been able to trace the specific companies most likely to be bought by private equity funds at a later stage. The placement of stocks in a hedge fund facilitates the acquisition by private equity funds, since the hedge funds is focusing on the short-term yield on stocks, and hence is more likely to sell to gain a quick return.

The relation between the two types of funds also occurs after private equity funds have acquired a target company. The leveraged buyout funds increase the debt of the company in order to finance the acquisition, and hedge funds have been buying the corporate bonds, junks bonds etc. issued by the acquired company. The hedge funds invest in these bonds because they have a relatively higher interest rate due to the higher risk.

1.1 The anatomy of hedge funds

The financial community and the regulatory bodies do not have a common definition of hedge funds. Someone defines hedge funds as a specific set of financial products, someone else as a group of investment strategies. Some commentators prefer to consider hedge funds as a specific business model, otherwise industry practitioners widely define hedge funds as an asset class (alternative, of course).

Among the above possible solutions we are drawn to definitions more related to the production side: the hedge funds are more a set of investment strategies and a specific business model than a set of products or a separate asset class.

- According to a recent occasional paper published by ECB the term hedge fund "denotes a fund whose managers receive performance-related fees and can freely use various active investment strategies to achieve positive absolute returns, involving any combination of leverage, long and short positions in securities or any other assets in a wide range of markets"[2].

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- Given the above production-related definition of the phenomenon we feel it right to stress the distinction between single strategy products and fund of (hedge) funds (FOHFs).

[2] ECB (8/2005), "Hedge funds and their implications for financial stability", Tomas Garbarivicius and Franck Dierick.

Our desire to separate the single strategy landscape from the FOHFs is due to the differences between the two categories as far as production techniques, investment skills, localisation of business operations and leverage are concerned.

The latter is focused on the selection of single strategy funds and so, generally speaking, is much less risky. It absorbs an incomparably lower level of leveraged capital (ideally zero), does not imply any kind of direct involvement in dealing financial instruments on the markets and mainly requires excellent relationship/networking inside the hedge fund community in order to have access to the best-performing and in-demand funds.

Table 1 Typical hedge fund characteristics

Investment strategies	Position-taking in a wide range of markets. Free to choose various investment techniques and instruments, including short-selling, leverage and derivatives.
Return objective	Positive absolute returns under all market conditions. Usually managers also commit their own money, because preservation of capital is important.
Incentive structure	Typically a 2% management fee. And a 20% performance fee, often conditioned of a certain hurdle rate which must be exceeded before managers receive any performance fees.
Subscription/Redemption	Predefined schedule with quarterly or monthly subscription and redemption. Lock-up periods for up to several years until first redemption.
Domicile	Offshore financial centres with low tax and a "light touch" regulatory regime, as well as some onshore financial centres.
Legal structure	Private investment partnership that provides pass-through tax treatment or offshore investment corporation.
Managers	May or may not be registered or regulated by financial supervisors. Managers serve as general partners in private partnership agreements.
Investor base	High net worth individuals and institutional investors (pension funds, insurance-institutions and others). Not widely available to the public. Securities issued take form of private placements.
Regulation	Generally minimal or no regulatory oversight due to their offshore residence or "light touch" approach by onshore regulators; exempted from many investor protection requirements.
Disclosure	Voluntary or very limited (in many cases no) disclosure.

Hedge funds have a structure similar to mutual funds in that they are both pooled investment vehicles that invest in publicly traded securities. There are, however, some important distinctions, when compared to Table 1:

- Mutual funds are highly regulated and restricted in the variety of investment options.
- Mutual funds are measured on relative performance such as a market index or other mutual funds. Hedge funds are expected to deliver absolute return.
- Mutual funds typically remunerate manager based on percent of assets under management. Hedge funds remunerate managers with very high fees that are geared to performance.
- Hedge funds make requirements on much larger minimum investments (average $1m) than mutual funds. Usually very little of the investment manager's own money is invested in mutual funds.

While mutual funds are available to the general public, hedge funds usually face many restrictions in selling their product[3]."

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One of the questions related to investor-protection is, whether a "retailisation" of hedge funds is under way? We can share the evidence recently highlighted by ECB researchers as follows:

"There is a trend towards the "retailisation" of hedge funds, and several European countries have recently permitted the distribution of hedge funds to retail investors, even though, compared to the traditional funds industry, retail investment in FOFH is still very small. Allowing hedge fund products to be distributed to retail investors raises specific investor protection concerns, such as inadequate disclosure, the risk of mis-buying and mis-selling, the lack of sufficient diversification, disproportionate management costs, etc. Some of these concerns can be addressed by only allowing certain variants of hedge funds to be commercialised, such as FOHFs or funds with capital protection.

… the United Kingdom's FSA concluded that there was no great desire on the part of the industry to produce and sell retail hedge fund products. However, more recently the FSA has indicated that it might re-examine the prohibition to sell hedge funds to retail investors. Germany, by contrast, adopted at the end of 2003 a new investment act that implemented a new legal framework for domestic hedge funds and the marketing of foreign funds in Germany. The new act explicitly distinguishes between single hedge funds and FOHFs. The former are hardly subject to any investment restrictions at all, whereas the latter are subject to more stringent restrictions, since they are the only hedge funds that can be distributed by public offer. For example, the latter are not allowed using leverage or short-selling, can only invest in single hedge funds, and are subject to certain diversification requirements."

The development of regulations in France and Italy will be further considered in part III of this paper.

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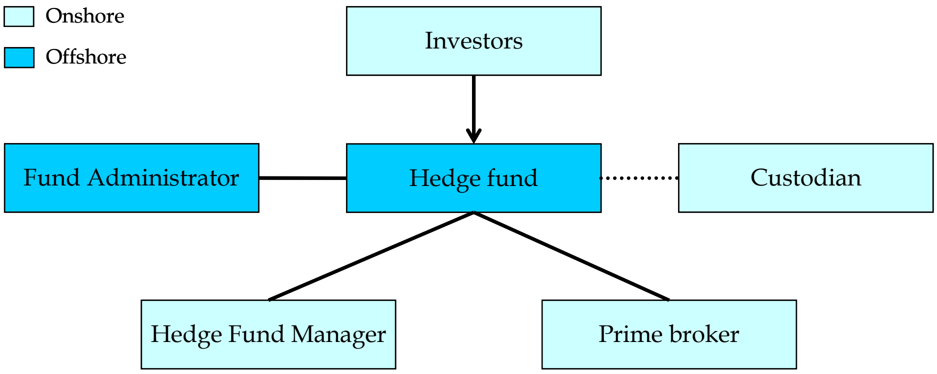
[3] Source "Hedge funds – City Business Series", march 2006.

Typically a single strategy HF operates though a very lean organisation. Apart from major players, managing a set of products or huge amount of money; it is rare to see an investment management organisation composed of more than 10 professionals. While the decision making, dealing in financial instruments' and risk management are retained in the hedge fund itself, operational tasks are done mainly by external providers (prime brokers and others).

Structure of a typical hedge fund



Note: Dashed line indicate optional relationships

Fund administrators (hedge fund managers). Some conduct all administration internally while others choose to outsource certain functions such as their accounting, investor services, risk analysis or performance measurement functions to third party administrators. Managers of offshore hedge funds typically rely on offshore administrators for various types of services and operational support.

Prime brokers are firms offering brokerage and other professional services to hedge funds and other large institutional customers. This is a major growth area for investment banks, which are typical providers of such services. Rather than providing particular niche services prime brokers try to offer a diverse range of services including: financing, clearing and settlement of trades, custodial services, risk management and operational support facilities. The bulk of prime brokers' income, however, comes from cash lending to support leverage and stock lending to facilitate short selling.

London is Europe's leading centre for prime brokerage services and accounts for more than 90% of its activity, as the largest investment banks are either headquartered or have a major office there. In Europe in January 2005, Morgan Stanley and Goldman Sachs were by far the largest prime brokers with 26% and 16% of the market. They were followed by CSFB, Deutsche Bank and Lehman Brothers. According to Tremont Tass the largest global providers of prime brokerage services include Morgan Stanley, Bear Stearns and Goldman Sachs. As can be seen, the European prime brokerage market is highly concentrated: The top six players control a 66% market share.

Custodians. Hedge fund assets are generally held with a custodian, including cash in the fund as well as the actual securities. Custodians may also control flow of capital to meet margin calls.

Auditors. Traditional investment funds are subject to auditing. By contrast most hedge funds are set up in a way that does not require them to have their financial statements audited. Some hedge funds however, may undergo annual audits if this is a part of the contract between the hedge fund

and its investors. In addition, some offshore locations such as Bahamas and the Cayman Islands require hedge funds to have their accounts audited[4].

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Hedge funds have flourished in a deregulated environment. In recent years, there has been increasing effort by regulators to try to, at least softly, regulate the industry nationally and – to a limited extend – internationally. So far national or domestic regulation of hedge funds has taken place at three levels: the level of the fund manager; the fund itself; and the distribution of funds. Based on domicile, hedge funds can be registered in offshore and onshore locations.

Offshore hedge funds are registered in jurisdictions allowing investors to minimise their tax liabilities. Thus, hedge funds often do not pay any fiscal charge on the financial returns at the fund level. In addition, the jurisdictions are characterised by a deregulated environment where there are short authorisation periods in connection with the establishment of funds and constraints regarding investment policies are very limited. Offshore hedge funds are usually structured as corporations although they may sometimes be limited partnerships. Generally the number of investors is not restricted. Onshore hedge funds often set up a complementary offshore fund to attract additional capital without exceeding limits on the number of investors.

According to HFR, as of 2005, 68% of single strategy products worldwide were domiciled offshore and only 32% onshore. According to data elaborated by the ECB (European Central Bank), the preferred off shore domicile was: Cayman Island 58%, BVI 20%, Bermuda 12% and Bahamas 4%.

Onshore or domestic hedge funds are investment companies registered in an onshore location. Here the most popular locations are the US and – within the EU – the UK. Within the US and UK investment managers are usually domiciled in the most important financial districts, mainly New York and London.

Historically, hedge fund managers in the US have not been subject to regular SEC (Securities and Exchange Commission) oversight. In October 2004, the SEC approved a rule change implemented in February 2006, which requires hedge fund advisers with more than 14 clients and $30 million in assets to register with the SEC as investment advisers under the Investment Advisers Act. Nearly 1,000 hedge fund managers had registered before February 2006. The measure, which requires hedge fund managers to disclose certain information about their operations, aims to protect investors and stabilise securities markets.

* * *

[4] The description of agents draws on “International Financial Services (2006): HFs, City Business Series, March.

In most European countries, fund managers are generally allowed to manage hedge fund products and both hedge fund and conventional fund managers operate under the same regulatory regime. Nonetheless, there are variations in the regulatory approach of EU member states.

The UK is the most popular location in Europe for hedge funds, with an estimated European market share of around 73% based on AUM (assets under management) and 62% based on number of managers.

One of the key drivers behind the growth of the hedge fund sector in the UK is the Investment Manager Exemption (IME). The IME essentially provides tax freedoms of funds based on a simple set of rules: A fund manager, based in the UK, will not bring a fund onshore for tax purposes, provided that overall policy and control of the fund rests outside the UK.

UK/London based fund managers provide services to hedge funds, including consulting services such as advice on investment strategy and are therefore regulated by the Financial Services Authority (FSA). The FSA specifies the restrictions on sales and marketing of hedge fund products. Hedge fund products cannot be, for example, marketed to the general public but UK investors can deal directly with offshore funds. Towards the end of 2005 the FSA created an internal team to supervise the management of 25 so-called high impact hedge funds doing business within the UK.

1.2. Fast growing, major actor in the financial market

Due to lack of transparency and almost non-existent obligations of disclosure, it is generally very difficult to gather information about the hedge fund industry, including the size of AUM. The best data available are provided by private institutions that manage and update proprietary databases[5]. This and the following sections use some of these data. With one exception, the data presented are global. The exception is section 2.9, where we distinguish between different regions as well as off- and onshore centres.

According to the TASS (Trading Advisors Selection System) database, the assets managed by hedge funds have jumped from approximately $ 100 bn in 1990 to $ 813 bn as of 2005. Within this period, the average growth rate of AUM has been around 15%, with a tendency towards acceleration in the later part of the period[6]. In the first half of 2006, this trend continued. Thus, the AUM increased by staggering $ 141 bn, i.e. by 17% within just six months.

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[5] One prominent HF database is the Trading Advisors Selection System (TASS) which is managed by Tremont Capital Management Ltd. The database business has recently been sold to Lipper a worldwide well known provider of data and metrics concerning traditional (long only) asset management. TASS database is used in order to calculate the CSFB/Tremont HF indices. TASS database covers almost 80% of the global single strategy HF industry. For a detailed analysis of the database issue in the HFs field it could be useful to refer at the already mentioned occasional paper published by the ECB (8/2005), “HFs and their implications for financial stability”, Tomas Garbarivicius and Franck Dierick.

[6] With the exception of 2005.

According to the HFR database[7] , hedge funds managed assets worth $ 1,105 bn in 2005. Since 1990, the average, annual growth rate has been around 25% - again with a tendency towards acceleration in the recent years.

The most common estimates are, that in 2006 hedge funds manage some $1.3 trillion, compared to $400 billions only six years ago. This extremely high growth was realised through a couple of mutually reinforcing factors:

- an enduring monetary policy of low interest rates, coupled with
- a deep-seated imbalance of world trade flows, which resulted in massive growth of liquidities seeking attractive yields,
- a massive expansion of the investments in HF: In Europe primarily from investors such as pension funds and life insurance companies

How significant is $ 1.3 trillion AUM? By comparison, the total gross domestic expenditure on R&D of the 25 member states of European Union amounted to around $ 275 bn in 2006, i.e. around 1/4-1/5 of the sum of assets under management by hedge funds world wide[8]. The financial needs of R&D in the coming years will increase sharply in accordance with the European Union's Lisbon goals. Therefore the hedge fund industry will be an important financial factor.

This view is confirmed if we relate hedge funds to traditional mutual funds (UCITS). As of 2005 traditional mutual funds (UCITS) globally managed $ 17.771 bn[9] with very modest or no growth. This compares to – then – $ $800-1.000 bn AUM of hedge funds growing rapidly (see above). In other words, hedge funds already manage assets amounting to at least 8-11% of the amount of capital managed by traditional mutual funds.

The European hedge fund industry is growing fast. To provide a rough picture it could be useful to refer to some 2004 UBS research:

- As of December 2003, 298 hedge fund managers domiciled in Europe were managing around $ 125 bn, i.e., around 15% of the global assets under management of $ 817 bn.
- The growth rate of the European hedge fund industry between 1995 and 2002 was around 50%, albeit from a very low base.
- The United Kingdom is the dominant location with market share of around 73% based on AUM and 62% based on number of managers.
- Strategies related to equity are dominant. European long/short equity had a market share of 36% based on managers and 30% based on AUM.
- The largest 10 managers have a 33% market shares.

[7] HF Research (HFR) is a prominent database managed by HF Research INC. The database stores the data concerning more than 6,400 HFs worldwide. HFR on a periodic base provides a wide range of HFs' performance indexes according with an internal classification along the different investment styles. For more information see www.hedgefundresearch.com.

[8] Our calculations based on Eurostat. The figures include expenditures on R&D financed by the industry, by governments and from abroad.

[9] Source FEFSI.

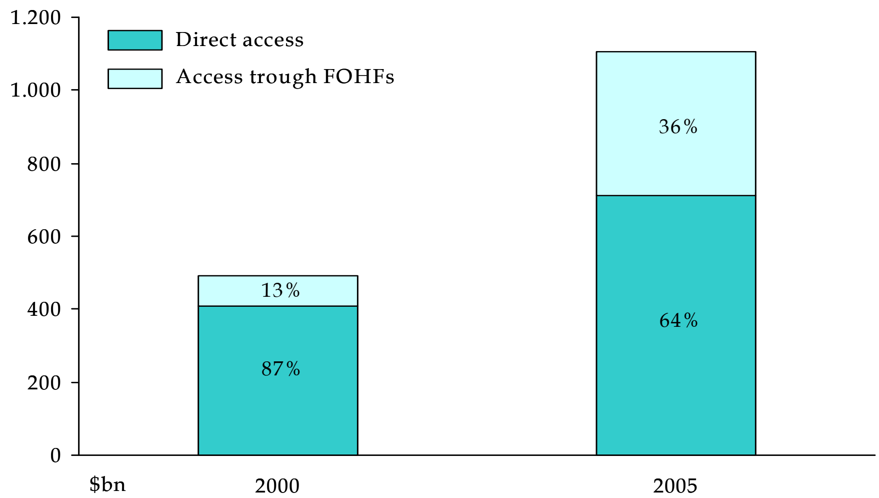
It should also be signalled that:

- since 2003 the growth of European single manager hedge funds has continued to reach $ 256 bn AUM, according to EuroHedge data as of 2005 BoY;
- the weight, on an AUM basis, of offshore domiciles in the case of European single strategy hedge funds managers is only slightly lower than that prevailing worldwide: 61% versus 65%;
- the preferred offshore domiciles for European single strategy hedge funds are: Cayman Island, BVI and Bermuda;
- the prime manager location is London, the next Paris: managers domiciled here drive more than 80% by AUM of the European hedge fund industry

* * *

It is important to note the increasing relevance of FOHFs, which hold a portfolio of other HFs rather than investing directly themselves. Historically investors, private and institutional, invested directly in HFs. But since 2000 FOHFs compound annual growth rate has been around 36%, compared to 11% growth in the direct access funds. Today FOHFs own almost one third of hedge funds' AUM, more than doubling its weight in the last 5 years.

An important reason for this dynamic is a growth in demand for FOHF products by smaller and medium sized investors, not least investors based in countries where the offering of such products to the public has only recently been permitted. Given the low amount of public information available, few retail investors have the capabilities to research the market, let alone the expertise to determine the blend of managers and strategies that will provide the risk-return profile they are looking for. Consequently, such investors are prone to channel investments through the intermediary FOHFs.



Source: HFR Industry Reports HFR Inc. 2005, www.hedgefundresearch.com

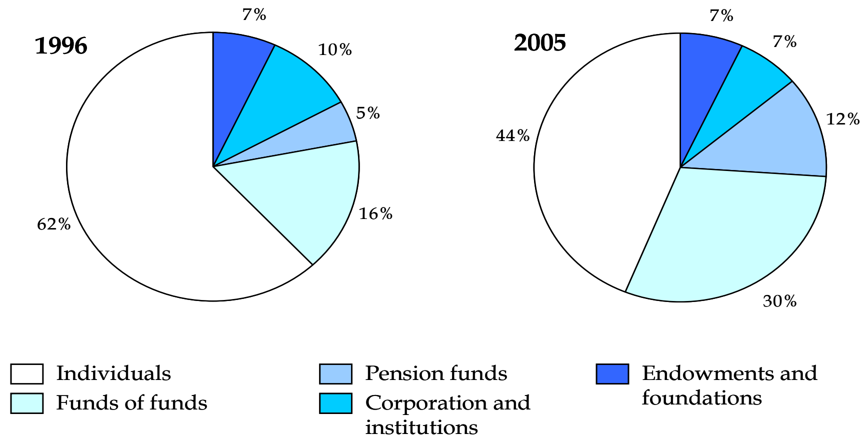
Europe's share of FOHFs total market is around 40% based on the location of FOHFs' managers, and 49% based on the location of the parent of FOHFs' managers.

1.3. Who invests in hedge funds? - the newcomers

Where does this money come from? In relative terms, investments by very wealthy individuals still retain a dominant position, making up 44% of hedge funds' AUM in 2005. Yet, since 1996 the relative weight of capital committed to HFs by individuals has decreased by approximately one third, from 62% to 44%. In the same period direct investments in the industry by institutional investors (pension funds, insurance, corporation and endowments) has grown by 26%. This means that by 2005 institutional investors had invested somewhere between $ 210 and 280 bn. in hedge funds.

The most significant change in both real and relative terms has been the impressive development of FOHFs. Their weight has almost doubled in a decade.. Thus, by 2005 FOFHs controlled almost one third of AUM, i.e. $ 240-330 bn. The nature of capital gathered by FOHFs is not easy to estimate given the lack of specific surveys. Nevertheless, the prevailing opinion is that small and medium-sized institutional investors - mainly pension funds and insurance - are among the main subscribers to these funds.

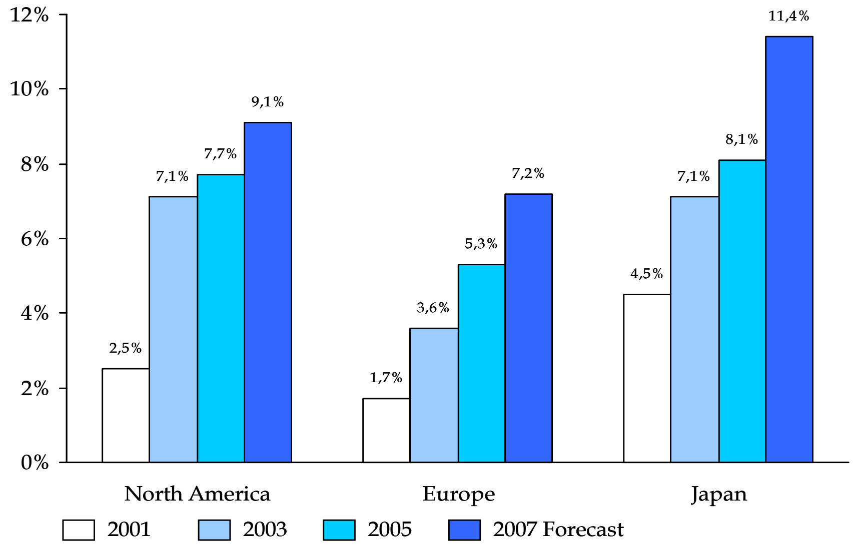
Global hedge funds by sources of capital



Source: Hennessee Group LLC, IFSL estimates

In combination, the figures on institutional investments and FOFHs are likely to reflect a growing readiness among institutional investors to consider non-traditional strategies of investments, using derivatives and leverage in order to achieve their investment targets. A study by State Street HF Research Study confirms this view. Thus, it finds that one-third of institutional investors surveyed in 2004 had at least 10% of their portfolios in hedge funds, while half intend to have 10% or more invested by 2007.

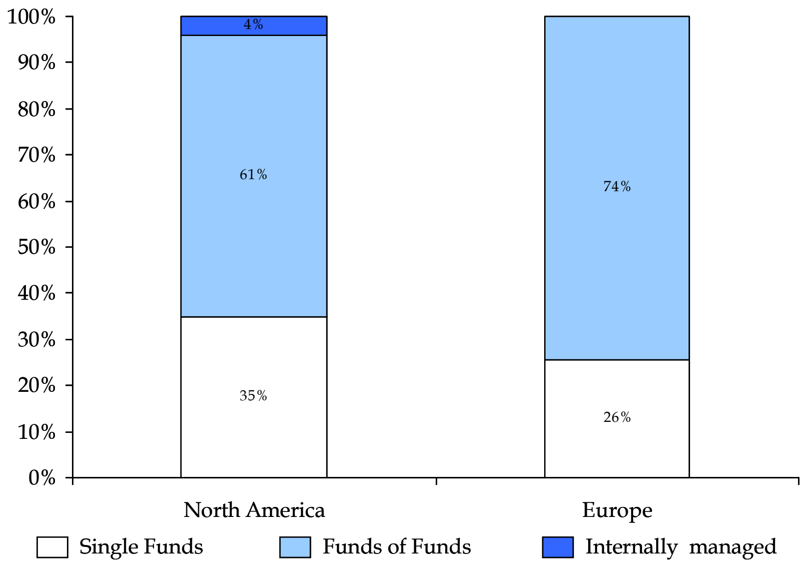
Institutional investors
Current and forecast mean strategic allocations to hedge funds



Source: Russell Research

Taking the 2005 Russell Survey on Alternative Investing as a proxy for institutional investors' behaviour we estimate the allocated capital to hedge funds ranges from 5% to 8%, with differences from country to country. This may be underestimating the real size, due to higher investments from pension funds in FOHF. European investors are currently the least exposed to hedge funds and Japanese the most. In all areas since 2001 the allocation has grown impressively at percentage increases ranging from +80% in Japan to +212% in Europe. The medium term trend is oriented toward a further exposure to hedge funds at growth rates ranging from +18% (Japan) to +40% (Europe) in three years time.

Institutional investors
Hedge Fund Investment Structure – % of Allocated Capital



Source: Russell Research

The Russell Survey also hints at the attitude of institutional investors towards FOHFs. In North America approximately 60% of institutional hedge investments are carried out through FOHFs, 74% in Europe. These figures confirm the assumption that nowadays FOHFs represent the preferred way of institutional investors, perhaps a specific cluster of them, to gain an access to the hedge industry. On this point the prevailing view is that institutional investors lacking investment and analysis skills and bounded by significant P&L constraints (particularly the smaller ones) prefer to outsource the hedge funds' selection to the specialised professional managers of FOHFs. It goes without saying, that in practice, there will be an upper limit for FOFH's share of allocated capital - by definition they cannot all be FOHF!

1.4. The investment strategies

Generally speaking the target of a hedge fund manager is to provide its investor base with an asymmetric risk return profile. This goal is usually achieved through extremely active management, a strong concentration of bets on single stocks or financial instruments. Although the approaches vary significantly from manager to manager it appears, generally speaking, that hedge funds rely heavily on short selling to structure a profitable strategy in value-driven investing, when they have identified undervalued and overvalued securities.

It is difficult to analyse hedge fund activities in detail due to complete lack of disclosure of their portfolio composition, owing to the prevailing deregulation of the sector and by managers strongly defending the proprietary character of trading strategies developed in-house. As we shall see, this is unsustainable.

In order to provide the investor base with data , it would be useful to compare the financial results of different funds and to track the behaviour of the industry as a whole, the contribution of data providers being a key.

In the absence of complete, transparent public statistics, the ECB has made a reasonable classification of four major groups of strategies[10] :

– **Directional hedge funds** generally try to anticipate market movements and offer returns commensurate to the high risks and leverage involved. Macro hedge funds are the most prominent example of this investment style. These funds follow a "top-down" approach and try to take advantage of major economic trends or events. By contrast, emerging markets and other directional hedge funds with a regional focus favour a "bottom-up" approach, i.e. they tend to be asset-pickers in certain markets and look for inefficiencies in developing markets.

– **Market neutral hedge funds** (also referred to as "arbitrage" or "relative value" funds) search for relative value or arbitrage opportunities to exploit various price discrepancies and try to avoid exposure to market-wide movements. Returns from such strategies usually exhibit lower volatility, but their implementation requires medium to high

[10] ECB, Financial Stability Review: December 2006, p.66

leverage in order to benefit from small pricing distortions, particularly in bond and other credit markets.

– **Event driven strategies** try to take advantage of "special situations" in a company's life, such as mergers and acquisitions, reorganisations or bankruptcies. These strategies lie somewhere in the middle of the volatility spectrum, with corresponding medium volatility and low to medium leverage. Some event driven hedge funds, specialising in securities of distressed companies, try to exploit the fact that it is difficult to value such securities and that institutional investors are prohibited from investing in them.

– **Funds of hedge funds (FOHFs)** invest in a number of other hedge funds and are expected to have lower volatility and attractive risk-adjusted returns due to diversification benefits.

On the grounds of the data provided by the TASS database, we can conclude that:

- The role of hedge funds in the corporate field is relevant and has increased throughout the last fifteen years. Long short equity, Event driven, Equity market neutral and Convertible Arbitrage are strategies exclusively focused on corporate financial instruments like ordinary shares, convertible bonds, corporate bonds and derivatives having the same instruments as underlying asset. In aggregate terms these strategies represent approximately 60% of the sector.
- By now pure futures trading, generally based on technical trading system and the top-down approach implemented by Global Macro, dealing with derivatives (option and futures on equity indices or government bond baskets) are only a minor, almost marginal, sub sector of the hedge funds industry.
- The most recent trend prevailing in the industry is the aggressive growth of Multi Strategy funds which try to diversify and swing dynamically, according to a direct disciplined risk management approach, among different strategies.

Despite the differences of the strategies presented above, some common concerns must be taken into account. There can be bandwagon effects due to the crowding of hedgee fund trades using similar strategies entailing higher correlations of hedge fund returns with the extensive use of leverage.

Also, some of the massive interventions of hedge funds on the market have clearly had a negative effect on its functioning, as they don't increase liquidity or contribute to price equilibrium, thereby denying their so-called market-efficiency promoter role.

A tendency becoming clearer during recent years is that the differences between the traditional fund management industry (incl. investment banks) and hedge funds seem to narrow. There is a tendency to start using investment techniques similar to hedge funds.

1.5 Hedge funds and the banks - independent or shared interests?

In the debate on transparency and need for regulations of hedge funds, it is sometimes argued that stronger demands on the banks over their credit analyses and demands on securities to accept leverage loans to hedge funds will be an effective instrument.

This argument is of uncertain validity. Close analyses of hedge funds using leverage spread debt look very similar to an investment bank.

A closer look at the importance of hedge funds for investment bank earnings confirms a further interdependence. Hedge funds are very important counter parties for the sales and trading desks in investment banking. The prime bookers of hedge funds are placed directly in investment banks, providing the hedge funds with a bundle of services including transaction execution, financing, securities lending etc.

Most importantly: The financial relationship between investment banks and hedge funds creates credit exposure to the hedge fund industry and similarly, the counterparty risk from derivative trading generates credit exposure to the investment banking sector.

Based on Greenwich Associates findings, we can assume that hedge funds pay approximately 30 per cent of all equity trading commissions in the US. This, and similar information on the European side, confirm our beliefs that hedge funds are important client groups for investment banks. But the lack of disclosure by the banks makes it difficult to quantify. Based on accessible reports and data estimates we can approximate the importance of hedge fund activities for the investment banks - they derive about 15-20 percent of their revenues from hedge fund activities. Similar, recent information confirms that investment banks are purchasing more hedge funds. Information from 2006 confirms, for example, that Morgan Stanley increased its minority positions and total acquisitions in hedge funds in 2006. There are several examples of this activity confirming that banks through their investments in direct hedge fund industry are snapping up managers of hedge funds to meet increasing demand for these types of investment.

Investment bank business with hedge funds is often first and foremost associated with prime brokerage. But the interrelations are much more complex - linked to other sources of revenue such as bid ask spreads from trading commissions etc. All in all, the tendency for the behaviour of hedge funds and investment banks to become increasingly similar, raises the question of regulation. When it comes to banks, the actual regulation and need for updating on a regular basis is not questioned. The central argument is the externalities. Ordinary banks are regulated to protect their depositors. The argument for regulating investment banks is to protect investors in securities markets. And the central argument for regulation is, after all, that any serious malfunction of the banking and securities market could create serious systematic consequences for the real economy, for jobs, for investments, for growth.

If there is a case for systemic risks connected to the hedge fund industry - and there seems to be, as we shall see later - it creates a further argument for claims of disclosure, transparency and regulations - as in the case of commercial banks and investment banks.

1.6 The costs, the management fees - the effects

In the hedge fund industry, calculations of fees are based on two components: A 2% management fee charged on an AUM basis plus a performance fee of 20%. The performance fee is typically determined as a share of the attained absolute return in excess of a hurdle rate, often subject to so-called “high-water marks” (i.e. performance fees are only paid if the value of AUM is above a previous high).

The level of management fee on average is currently around 1.5% of AUM in the case of single strategy products and reduced to 1% for FOHFs. As far as performance fees are concerned, those paid on single strategy products are higher than for FOHFs: 25% on average in the former and 10% in the latter.

According to a UBS top-down analysis:

- The global aggregated amount of fees generated by the hedge fund industry in 2004 has been in the region of $ 45 Bn.
- 90% ($ 41 bn) of the above amount rewarded single hedge fund managers and the last 10% ($ 4 bn) those of FOHFs.

As we can see, the fees are huge relative to other forms of asset management.

If we assume US mutual fund industry to be around $ 7.000 bn and the average management fee to be 0.60%, the aggregate gross fee income would be (simplifying to the extreme) around $ 42 bn. In other words, it is not entirely unthinkable that the global hedge funds industry is generating more fees than the much larger US mutual fund industry.

But this is not the total picture.

Some studies estimate that hedge funds pay:

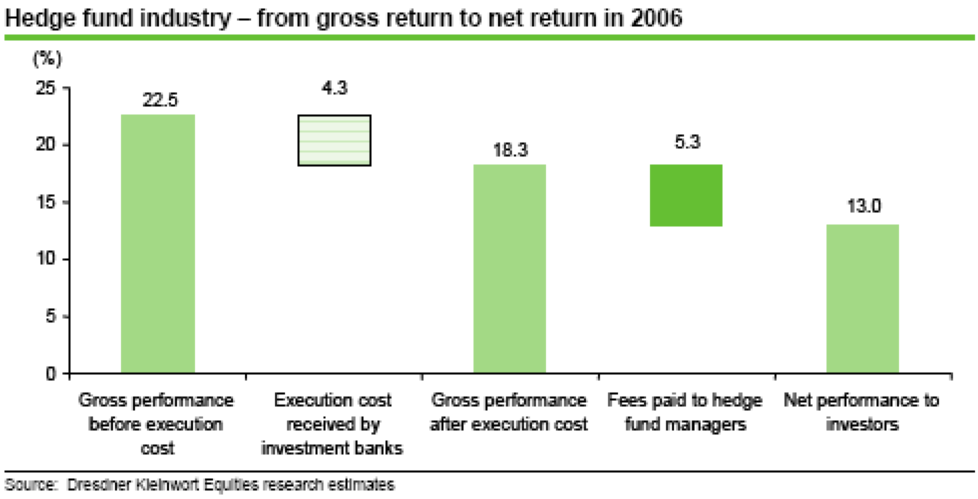
- 4-5 % of AUM to their managers (management fees plus performance)
- Around 4 % of AuM to the investment banking industry

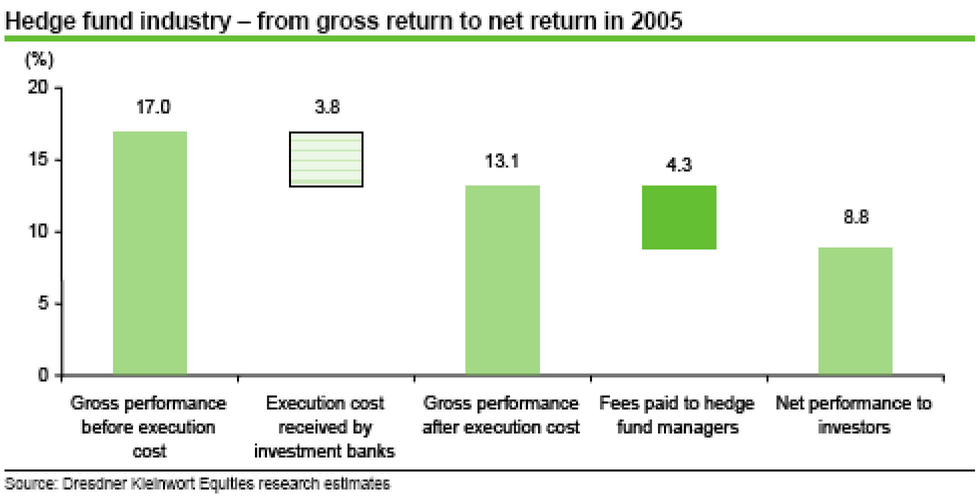
To maintain this pay-out and keep investors confident and satisfied, hedge funds need growth returns of around 20 %!

This fee structure and the level is not a “law of nature”. Neither is it market based. It simply seems to be a “characteristic” of the hedge fund industry and not questioned or challenged by anyone. We think it highly questionable because the pressure of hedge funds to create such huge gross returns is in itself having strong effects on the character and concrete content of hedge fund strategies.

The impact of fees and transaction costs to hedge funds, investment banks, prime brokers and trading counter parties is illustrated in a recent study (Dresdner/Kleinwort. Equity research. February 2007). As seen from the two charts, the “net return to investors” on the right hand side represents the HFR composite index return net of all fees. By adding the 2 % plus 20 % fee structure, the “gross performance after execution costs” is reached. If we then add the execution costs, we are having the “gross performance before execution costs”.

A recent paper from Dresdner Kleinwort illustrates this point[11] :





Whether or not these fees and transaction costs are sustainable in the middle or the longer run will depend critically on at least two factors:

- How can the industry sustain the necessary gross performance of around 20 %?
- Are investors confident and satisfied with the net return to them from the hedge fund industry?

The size and high growth of hedge funds are in themselves creating new problems for ensuring growth returns by ingenious stock picking or niche investment strategies. That is why we in our understanding of the hedge fund industry will make a link with the well-known, high leverage phenomenon. For many funds employ long/short strategies - removing market risks which are essentially spread or arbitrage bets with a relative low return. So the

[11] Dresdner Kleinwort, "Credit Suisse, Deutsche Bank, UBS - How important are hedge funds for the investment banking industry?", Equity Research 6. February 2007, p.16.

only remaining way to boost returns to the necessary growth returns of around 20 % is to employ extensive leverage.

1.7. Highly leveraged - the effects

One of the most frequently debated issues concerning hedge funds is leverage. The use of leverage varies a lot depending on strategy. Some of the strategies, like Managed Futures and Fixed Income Arbitrage, are highly leveraged.

A proxy to assess the entire leverage exposure of the industry is the ratio between the gross margin exposures of hedge funds (the global amount of owned financial assets) as a percent of AUM. According to Hennessee Group LLC this statistic is in the region of 125% at 2004 EoY and in the period 1995/04 never increased above the 160% reached in 1999. The growing role played by institutionalised investors, pension funds, insurance and selectors like FOHFs, more demanding than private investors on the risk management side, could be considered an important driver of the highlighted trend[12]. The high growth of the hedge fund industry puts extreme pressure on average performance. With $1.3 trn of AUM in hedge funds, this is an enormous pressure on strategies to ensure the necessary growth return. Logically it seems the hedge fund industry is bound to develop a performance problem when assets are traded primarily among hedge funds. Therefore, leverage is the only way to balance the equation.

Hedge funds are undoubtedly short-term investors - generally speaking they provide significant liquidity to the market, "however in certain cases, especially in small or medium – sized markets, their action can be destabilising[13] ".

Older hedge funds, perhaps managed by more experienced mangers, tend to be more leveraged than new ones and also the largest single hedge funds (greater than $ 1 bn) tend to exhibit higher levels of leverage.

It would be possible to argue that hedge funds could be on one side the object (as far as the growth of its AUM is concerned) and on the other side the drivers (as far as its performance and leverage size are concerned) of a possible virtuous / vicious circle related to the interest rate dynamic. As we have seen, the low interest rate in recent years has in itself been a driver to the expansion of the hedge fund industry.

In a very low interest rate landscape it is highly possible that:

- the appetite of investors for risk and performance is greater than those granted by the risk free instruments (cash and short term bonds). This would push towards an increase of the assets gathered by the hedge funds;
- the hedge funds themselves would benefit from comparatively better financing conditions, increasing leverage and the possibility to attain better financial returns.

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[12] IFSL 83/2006), "Hedge Funds – City Business Series".
[13] ECB (8/2005), "Hedge funds and their implications for financial stability", Tomas Garbarivicius and Franck Dierick.

Such a virtuous circle would be completely reversed in a justifiably higher interest rate scenario. Assuming the above hypothesis one could see a boom and bust cycle among hedge funds following major movements of the interest rate structure.

The recent increase of investors' appetite for hedge funds can be at least in part explained by the present extremely positive positioning of the interest rate structure. So, despite the boom and bust hypothesis to be verified, one has to consider the possible threat to the financial stability provided by the hedge funds in the case of a major, global increase of interest rates.

As we will see from the evaluation of the trend in hedge fund industry returns, there is evidence that it is downward. This is in itself creating further pressure on the leverage of the industry. Together with the continued growth of hedge funds, leverage will be increasingly important to continue squeezing high double-digit growth ROE (= Return On AUM) out of low-ROA investment strategies. An increasing dependency on leverage could pose serious challenges for absolute return investment and the risk of the vicious circle.

It is not easy to get an idea on the state of leveraged hedge funds owing to lack of disclosure. But estimates from different studies shed some light on the issue. Looking at the most used types of leverage relevant for hedge funds: margin loans, securities lending, reverse repos and derivatives, there seems to be basis for an estimate of the following magnitude:

- Margin loans: In 2005 - with all the necessary, reasonable assumptions given lack of disclosure - it is estimated that global margin debt of hedge funds could be roughly \$300 b.
- Securities lending: Assuming that hedge funds are probably the only customer group that has a structural demand for securities borrowing and taking a 40 % ratio as the representative for the industry, securities lending to hedge funds could amount to roughly \$500 b.
- Reverse repos: This leverage activity is not only used by hedge funds, but by many other customer groups as well. A reasonable guess would be that 20 % of all reverse repos are with hedge funds; this creates a volume of hedge funds at 120 b US dollars.
- Derivatives: This is, based on all accessible studies, the most important source of leverage. Leverage in a derivative comes from entering into a contract with a relatively large notional value - in that context there is only a need to have sufficient cash available to meet the initial collateral margin. The notional value of the derivatives book is likely to overstate its economic risk.

All in all, it could be estimated that total hedge fund industry debt including the derivatives is between 150 and 250 % of AUM, i.e. 2.0 - 3.3 trn US dollars.

Within this estimate extreme cases like LTCM are well known. According to the Financial Times (1.12.06) the balance sheet of Citadel's two main funds show that the leverage (=liabilities/shareholders funds) amounted to 11.5 times. This is an example of ground breaking ability to access capital markets for unsecured debt and thereby putting rising pressure on the collateralised lending of investment banks.

A majority of hedge funds have limited choices for boosting returns - and extensive leverage is one of those. Think LTCM!

1.8. Asset valuation - in complexities and derivatives

Recently studies by the World Bank and several national authorities have highlighted some problems of market integrity, i.e. mis-evaluation of complex instruments. This is of specific importance for investor protection, not least for pension funds.

Even if some of the considerations are general and not specific to hedge funds, there is an increasing risk of inadequate evaluations of illiquid and complex assets, careless evaluation and even miscalculations due to:

- The growth of hedge funds and their importance to the market
- The strong increase of complex instruments like derivatives.
- The extreme rewards offered to hedge fund managers
- Lack of clarity and/or independence of internal control and evaluation
- Total lack of transparency and disclosure. All trading is outside public exchanges.

All this is creating increased risk of miscalculations or even potential dishonesty of evaluations of assets. These new instruments, derivatives - including credit default swaps (DSS) and collateralised debt obligations (CDOS) - are as complex as their names suggest and some of their most important innovations are causing new challenges for regulators as well as the market.

Credit derivatives allow investors to buy or sell cover against default by borrowers. They are being pooled into collateralised debt obligations (CDOS) - this form of investment in particular is growing extremely fast. It is easy to see that these profits encourage liquidity and make it possible for banks to sell on the risk of loans turning bad - thereby enabling them to increase their lending capacity.

A derivative which has become very much used among hedge funds recently is the so-called variant swap. By using these instruments, hedge funds can place bets on the direction of stock markets' volatility in a leveraged way.

Recently (September 2006), the international swaps and directives association has made an estimate of the nominal amount of outstanding credit derivatives - rising in the first half of 2006 by more than 52 percent, indicating a rise in derivatives totaling 26 trillion US dollars.

The increasing use of complex instruments - typically derivatives, such as the ones described above - there seems to be a double problem:

- One dimension of a lack of competence. New "instruments" are developed so rapidly that there is an increasing risk of lack of competence. Who can validate the models? i.e. it must, of course, be an evaluation independent of financial engineering, using as well as creating the new instrument.
- Furthermore - where are the objective data for volatility in these complex derivatives?

From various studies one get the impression that hedge fund managers do not see the benefit of having a qualitative operating officer or chief financial officer - they believe this is taken care of and handled by the administrators and prime brokers.

- Another dimension of potential dishonesty is based on the fact that there is the possibility of collusion - between those who provide validation data and those with an interest in the concrete evaluation derived from that data. How can an independent evaluation be developed - and how can one avoid conflicts of interests regarding valuations and their links to management fees? It is a fact that some financial authorities recently have handed out fines to investment banks and hedge funds over market abuse. In particular with credit default swaps (CDSS) there are problems with the relevant information available to the administrators. From national financial authorities we can deduce that some managers have exerted pressure on administrators to manipulate evaluations, creating inflated returns and artificial fees. From the investor side it seems unclear as to who is responsible for providing market evaluation.

The impact of these problems and conflicts of interest has led to pricing errors. There are examples showing that investors are paying inflated prices on subscriptions - and later on finding out that funds have been making substantial losses, masked by inflated valuations.

For some investors this has created substantial losses - also connected to situations where office controls are weak and administrative mistakes are detected too late.

In recent years, where equity markets have been stable, combined with low interest rates, it has been relatively easy for the banks to manage these situations without exposing too high levels of risks. But now, stock markets are becoming more volatile again, pushing the banks to comply, to readjust their positions in accordance to the internal risk management rules. This process is further under pressure because the speed at which the banks need to adjust increases as the market becomes more volatile. As we can see - this is another example of the self-reinforcing nature of these trends, running the risk of market problems.

National and international financial authorities have become conscious of the necessity of closer monitoring - financial stability forum - FSA, MAF etc. Growing concerns focus on the risk of inadequate evaluation of illiquid and complex assets that are held in various proportions by hedge funds, as we have seen. As is stated by the French national authorities, in cases of bad performance or where bonuses are based on the managers' absolute performance, careless evaluation of the positions held may prove very, very tempting.

The difficulties in evaluating these assets and previous experience underlines the need for developing appropriate standard procedures in this area of hedge fund evaluation among all concerned parties: Prime brokers, depositaries, the auditor and the manager.

The use of derivatives and the enormous growth in these credit-oriented assets have also given rise to concerns in the European Central Bank. A recent paper by researchers says that these derivatives are used for speculation as well as hedging: "We have introduced a new product, "Insurance", which appears to be used by people not looking for insurance. It is not the instrument, which is causing liquidity concerns, but the way market participants may be using them".

Our analysis is that these concerns are well-founded.

1.9. Taxes and off shore/on shore

In a closed economy one can argue - from a theoretical point of view - that using tax deductions in one place and revenues in another for taxation would not imply great harm from societies' point of view because the closed economy will ensure that one day fair taxation will be the result. This is obviously not the case in an open economy in the globalised world. It poses the question of how to ensure tax revenues for the financing of our welfare states in Europe - when they are faced with increasing tax evasion due to hedge fund and private equity funds being registered in an offshore location.

The international financial authorities are not offering clear answers.

Anyhow, for the sake of clarity we must distinguish between taxation of the fund and taxation of the fund manager. The broad majority of funds are located outside the EU - chiefly for the reason of tax minimisation - with the consequence of tax losses for the EU region. This loss of income cannot be avoided by ensuring that managers pay the correct amount of tax for their on-shore activities.

It is a complex challenge to try to enhance efforts to protect tax revenues for Europe's welfare societies given the international character of hedge funds and private equity funds. It is not impossible - there can be a case for coordinated actions among member states. But a condition of a more efficient approach will be higher transparency and disclosure.

1.10 The return to investors - better than others?

The staggering growth of the hedge fund industry raises the obvious question: why are investors interested in hedge funds? The prevailing answer to this question is "financial performance". The "strong selling point" of both hedge funds and private equity funds is that they appear to offer the opportunity of superior investment returns (when compared to 'conventional' asset classes) plus reduced volatility. The data presented in the table below could be seen as a confirmation of this point. In the last thirteen years hedge funds have produced a 4.4% excess of return compared to US government bonds, the most popular low risk asset class among investors. This is marginally higher than the excess return of indexed investment in S&P 500 stocks and almost 2% more than indexed investments in NASDAQ stocks. Furthermore, this financial result has been achieved assuming a relative risk (tracking error) limited to 8.6% per year, versus a 15.6% and 27.4% in the case of a long-only investment in the stock market. Finally, the Information Ratio tells us that on average hedge funds' power to ameliorate investors' risk return profile has been double that granted by an equity investment and more than five times that of tech stocks.

CSFB/ Tremont indices, S&P and NASDAQ vs JP Morgan US bond
(December 1993 - September 2006)

Investment objective	Excess of Return	Tracking Error	Information Ratio
Convertible Arbitrage	2,8%	6,5%	0,42
Dedicated Short Bias	-7,3%	17,1%	-0,43
Emerging Markets	2,5%	17,3%	0,15
Equity Market Neutral	3,8%	5,3%	0,71
Event Driven	5,2%	7,7%	0,67
Fixed Income Arbitrage	0,3%	5,8%	0,06
Global Macro	7,0%	10,9%	0,64
Managed Futures	-0,1%	11,3%	0,00
Long Short Equity	5,4%	11,1%	0,49
Multi-Strategy	3,1%	6,9%	0,44
Hedge Fund	**4,4%**	**8,6%**	**0,51**
S&P 500	4,3%	15,6%	0,28
NASDAQ	2,6%	27,4%	0,09

These data notwithstanding, several commentators have criticised the claims made for hedge funds. Historically hedge funds have been a niche sector focused on specialised investment strategies that worked reasonably for a given limited amount of invested capital. The current growth of their AUM – sparked by low interest rates – could put at risk in the future ability to provide investors with the high financial returns promised in their marketing.

Other commentators argue that the performance of hedge funds is overestimated already. For example, the investment bank Barclays Capital put the typical level of overstatement of returns at 1 – 6 per cent a year, depending on the index[14]. A recent study by the renowned Princeton professor Berton Malkiel and Atanu Saha reached a similar conclusion[15]. The study identifies a number of biases that exist in the published indices of hedge fund returns, biases that lead claims about investment performance to be overstated. Analysis produced by Vanguard Investments, which adjusted the annual returns of the Tremont HF index for the biases identified in Malkiel and Saha's study, suggests that hedge funds produced returns well below those achieved by a simple portfolio of 50% bonds and 50% equities over the entire period, as well as when segmented into bull (1995-1999) and bear (2000-2002) equity markets[16].

[14] See HF returns 'are vastly overstated', Timesonline, 28/02/2006
[15] Malkiel, B. G./Saha, A. (2005): HFs: Risk and Return, Financial Analysts Journal, Volume 61, Number 6, CFA Institute. The study draws on the TASS database.
[16] HF index biases , Vanguard Investments, November 2004, http://www.vanguard.com.au/library/pdf/RL%20Hedge%20Fund%20Biases%20112004.pdf

Average annual returns

	1994-2003	**1995-1999**	**2000-2002**	**2003**
Tremont HF index: returns ***without*** Malkiel-Saha adjustment	11.11	18.16	4.09	15.47
Tremont HF index: returns ***with*** Malkiel-Saha adjustment	2.32	9.37	-4.66	6.72
50% Dow Jones Wilshire 5000/ 50% Lehman Aggregate	9.30	17.41	-2.10	17.93

What reasons may there be for such an overstatement of hedge fund performance? According to Malkiel and Saha the key reasons relate to biases that they call backfill, selection and survivorship bias. Furthermore, there are additional reasons related to the lack of persistence of returns and the relatively high attrition rates amongst hedge funds. Below we describe these reasons in greater detail.

Backfill and selection bias: hedge funds are often established with seed-capital and will begin reporting on their results at a later date. Yet, backfill and selection bias can occur because hedge fund managers are able to 'fill back' only the most favourable investment returns into an index. This can result in returns being overstated. According to the study by Malkiel and Saha backfilled returns significantly bias the returns upwards. The arithmetic mean of the backfilled returns over the period 1994-2003 was 11.69%, while the mean for the contemporaneously reported returns was 5.95% - a difference of 5.74%.

Survivorship bias can occur because the published indices may not include the returns from hedge funds no longer in existence (known as 'dead' funds), or funds that exist but no longer report their results ('defunct' funds). Malkiel and Saha examined the effect of this survivorship bias by comparing the annual returns achieved by 'live' funds with a universe of live and defunct funds over the period 1996-2003. They found that the arithmetic mean of the annual returns of the live funds was 13.74% for the period whereas the arithmetic mean for all the funds (live and defunct) was 9.32% - a difference of 4.42%. Naturally, all indices face problems with survivorship bias. However, Malkiel and Saha report that survivorship bias produced an overstatement of returns of 1.23% in mutual funds, compared to the 4.42% for hedge funds[17].

Risk, volatility and attrition rates: In the past, hedge funds tended to exhibit low standard deviations (volatility) and correlation with general equity indices offering significant potential for risk diversification. However, there appears to be a greater volatility in cross-sectional distribution of returns risk, i.e. a great risk of choosing a poor performing fund. Thus, Malkiel and Saha examined the cross-sectional standard deviation of different hedge fund categories over the period 1996-2003. They found that the standard deviation of their returns is considerably higher than it for mutual funds. In addition, Malkiel and Saha noted that the so called attrition rates – the proportion of funds that fail to survive – were three or four times higher than for mutual funds over the period 1994-2003. In other words, the range

[17] Op. cit. p. 83-84.

of returns is much wider so while investors may face high rewards for selecting top-performing funds, they also face a high risk of picking a bad performer or a failing one.

Assuming that hedge fund performance is overstated, what are factors in the current growth? We cannot ignore the fact that some hedge funds have delivered impressive investment returns. In addition, they do offer significant potential for risk diversification. However, we also believe that there are other important reasons for the current growth of AUM. Two relate to matters that we will deal with in greater detail in other parts of the report, so we will just briefly touch upon them here: the high performance fees paid to hedge fund managers and the likelihood of lower regulation and taxes.

In traditional investment funds, managers typically charge a management fee for their services but do not take any profits. Hedge fund managers, by contrast, generally charge two fees: management fees, averaging 1.5%, and performance fees, averaging 25% of the net profits (see section 2.10). The high performance fees make it attractive to set them up. In other words, explanations for the rapid growth in AUM by hedge funds should also be sought on the supply side. In addition, the performance fee issue underlines the importance of calculating returns by HFs net of the (often very high) performance fees – something that many publicly available statistics do not do.

Hitherto, low regulation and/or tax exemptions appear to have provided another important impetus to the growth of AUM by hedge funds, particularly the assets managed by offshore funds. Offshore funds are unregistered pooled investment funds domiciled in offshore centres like the Cayman Islands or the Virgin Islands. They are usually structured in a way that allows them to avoid various portfolio management restrictions that apply to registered funds. This might, for instance, be the case in terms of the use of leverage. In addition, offshore funds are likely to pay no tax, or much lower tax than both registered and unregistered domestic funds.

Above, we showed how traditional institutional investors allocate ever more funds to hedge funds. As a result hedge fund managers may be facing new choices: would they align themselves with the large asset managers, who act as a distribution channel to institutional money and therefore seek to comply with the institution's demands for transparency, strong governance and a robust operating environment? Or, would they choose to remain focused on the rich individuals and endowments, which allow more flexibility in the standards and often also the locality of operations? Given the size of traditional institutional investors, some managers are likely to choose the former option, thereby increasing the reach of existing regulations regarding traditional investment funds.

1.11. Tendency of crowding

Despite the differences of strategies among hedge funds, there are some common concerns to be taken into account. One key concern is related to similarities or correlations - even in cases of different strategies! Where funds are pursuing similar strategies there is an increasing risk that they will buy or sell their positions at the same time thereby disturbing liquidity. This so called herd behaviour could in turn leave hedge funds and third parties like banks and institutional investors highly vulnerable to adverse market dynamics. And even in cases of strategy-differences, there is still a strong correlation among hedge funds' actions on the financial markets.

In its 2006 Financial Stability Report the ECB highlights this crowding problem:
"The risks posed by the crowding of hedge fund trades were already highlighted in the June 2005 FSR, as well as by the Counterparty Risk Management Policy Group, which recently noted that "the concept of crowded trades [has] entered the lexicon as one of the most significant risks to be identified and mitigated". The fact that correlations are trending higher not only within some strategies, but also among strategies, raises concerns that a triggering event could lead to highly correlated exits across large parts of the hedge fund industry"[18].

In other words, the systemic risks result from the combination of leverage, trading activity and strategy correlation. We have shown that the hedge fund industry has to generate very high growth returns due to among others the generous pay-outs to the hedge fund managers themselves and the high execution costs linked to the investment banks. We have shown that only leverage can ensure the necessary return.

We know from several studies that around 60-70 percent of hedge funds' AUM use some kind of long/short strategies. The importance of hedge funds in trading flows is also substantial. The importance of hedge funds for asset pricing is thereby relatively higher than suggested by their share of financial assets. All these factors together with the confirmed high correlation of returns within many hedge fund strategies and among strategies confirm concerns about systemic risks. The capacity constraints and periods of diminishing returns, creating funds exploiting available arbitrage opportunities, are contributing to this risk.

We will return to this issue in the chapter on financial stability.

1.12. An imperfect market: Asymmetric information and no transparency or disclosure

Virtually all accessible report or analyses on hedge funds published in the past two years underline the lack of transparency and disclosure for the hedge fund industry.

At the G7 meeting for finance ministers in Essen, February 2007, it was decided to promote greater transparency in hedge fund industries. This theme has for long been an issue among national and international financial authority regulators. We have shown above that the vast majority of all hedge funds are established in offshore centres for tax reasons. But this does

[18] ECB: Financial Stability Report 2006, p.136.

not give the hedge funds any excuse or reason to imply that hedge funds should never have to be accountable to their constituents and to the markets in a transparent, precise, truthful manner and on a regular basis. Like other major actors on the public financial markets, they must comply as part of a common effort to tackle market imperfections and risks of market abuse. The work to limit or eradicate market imperfections is a never ending process. In the global economy, they can have far reaching consequences - not only for the financial market itself - but also for the real economy.

It goes without saying that effective monitoring of market abuse, asset assessment, accountability, early warning etc. is simply not possible without transparency.

In his prize lecture ("Information and the change in the paradigm economics", December 8, 2001) when receiving the Nobel prize in economics, Professor Joseph E. Stiglitz shows that information economics represents a fundamental change in the prevailing paradigm within economics.

As we know from our economic history, the micro and macro economic theories have for years focused much more on the functioning of perfect market mechanisms' than the imperfect markets, although we all know that in the real world, imperfect markets are more widespread.

As Stiglitz underlines, the world is, of course, more complicated than our simple - or even more complicated - models would suggest. In the past couple of decades many major economic political debates have centred on the question: "The efficiency of the market economy and the appropriate relationship between the market and the government". This debate has new importance considering the enormous influence on the financial markets of the hedge fund industry and private equity funds.

In his Nobel prize lecture Stiglitz makes observations highly relevant to our study of the development of the modern financial markets:

- In a section on "The theory of corporate finance", he says,

"Under the older, perfect information theory, it made no difference whether firms raised capital by debt or equity, in the absence of tax distortions. This was the central insight of the Modigliani-Miller theorem. We have noted how the willingness to hold (or to sell) shares conveys information, so that how firms raise capital does make a difference. Firms rely heavily on debt finance, and bankruptcy, resulting from the failure to meet debt obligations, matters. Both because of the cost of bankruptcies and limitations in the design of managerial incentive schemes, firms act in a risk averse manner - with the risk being more than just correlation with the business cycle.

Moreover, with credit rationing (or the potential of credit rationing) not only does the firm's net worth (the market value of its assets) matter, but so does its asset structure, including its liquidity. While there are many implications of the theory of the risk averse firm facing credit rationing, some of which are elaborated upon in the next section, one example should suffice to highlight the importance of these ideas."

- Corporate governance:

"In the traditional theory, firms simply maximised the expected present discounted value of profits (which equalled market value) and with perfect information, how that was to be done was simply an engineering problem. Disagreements about what the firm should do were of little moment. In that context, corporate governance - how firm decisions were made - mattered little as well. But again, in reality, corporate governance matters a great deal. There are disagreements about what the firm should do - partly motivated by differences in judgements, partly motivated by differences in objectives. Managers can take actions which advance their interests at the expense of that of shareholders, and majority shareholders can advance their interests at the expense of minority shareholders. The owners not only could not monitor their workers and managers, because of asymmetries of information, they typically did not even know what these people who were supposed to be acting on their behalf should do. That there were important consequences for the theory of the firm of the separation of ownership and control had earlier been noted by Berle and Means (1932)"

- Theory of money:

"In modern economies, however, credit, not money is required (and used) for most transactions, and most transactions are simply exchanges of assets, and therefore not directly related to GDP. Moreover, today, most money is interest bearing, with the difference between the interest rate paid, say on a money market account and T bill rates having little to do with monetary policy, and related solely to transactions costs. What is important is the availability of credit (and the terms at which it is available); this in turn is related to the certification of creditworthiness by banks and other institutions.

In short, information is at the heart of monetary economics. But banks are like other risk-averse firms: their ability and willingness to bear the risks associated with making loans depends on their net worth. Because of equity rationing, shocks to their net worth cannot be instantaneously undone, and the theory thus explains why such shocks can have large adverse macro-economic consequences. The theory shows how not only traditional monetary instruments (like reserve requirements) but regulatory instruments (like risk adjusted capital adequacy requirements) can be used to affect the supply of credit, interest rates charge, and the bank's risk portfolio. The analysis also showed how excessive reliance on capital adequacy requirements could be counterproductive."

"We also analysed the importance of credit interlinkages. Many firms receive credit from other firms, at the same time that they provide credit to still others. The dispersed nature of information in the economy provides an explanation of this phenomena, which has important consequences. As a result of these general interlinkages (in some ways, every bit as important as the commodity interlinkages stressed in standard general equilibrium analysis) a shock to one firm gets transmitted to others, and when there is a large enough shock, there can be a cascade of bankruptcies."

What does all this imply for growth and thereby wealth creation in our societies? What are - then - the implications of imperfections of credit markets arising out of information problems - asymmetric information - on growth?

Joseph Stiglitz gives the answer himself: "The importance of capital markets for growth has long been recognised; without capital markets firms have to rely on retained earnings.

But how firms raise capital is important for their growth”.

As we see it, this is in essence the set of theories showing how fundamental the interplay is between “the real economy” and the financial markets - and how important it is to enhance transparency to limit the negative effects of asymmetric information on the capital markets.

This is, as we see it, a fundamental - but not necessarily sufficient - part of a coherent new strategy to ensure the real economy and our European ambition as stated in the European Council, 2000 in Lisbon. It is about more and better jobs, it is about investment in research and development, it is about education and competence, it is about long-term strategies to guarantee the real economy as the precondition for our welfare societies in the age of globalisation.

1.13 Societies’ response - current national regulations

In the following tables we try to provide a picture of current regulation of the hedge fund industry prevailing in Europe, focusing on the five largest markets (UK, Germany, France Italy and Spain). We consider separately requirements of financial and fiscal authorities on FOHFs and single strategy products.

In the field of FOHFs Europe is taking an increasingly relaxed attitude to the marketability of such products. Only in Italy is there still a limitation to offering FOHFs to the public. In Germany, France and Spain the distribution on the mass market of FOHFs is allowed with almost no restriction. In UK a clear position on this issue has not yet emerged from the SFA, but the public offering of FOHFs wrapped as UK-listed companies is permitted. In any case, in our view the most relevant issue is the fiscal treatment of FOHFs. Local fiscal laws foresee a treatment of hedge funds analogous to that of UCITS investment schemes oriented to preserve the transparency of collective investment vehicles. Then FOHFs are substantially tax-exempt wherever they are based and instead their owners are taxed according to their fiscal status. In this general architecture it has to be signalled that the fiscal treatment of offshore funds, owned by onshore FOHFs, does not foresee any kind of tax discrimination against offshore domiciled funds.

Onshore FoHFs

Country	Manager authorization	Product regulation	Retail distribution	Minimum investment threshold	Fiscal treatment of the fund	Fiscal treatment of offshore underlying
United Kingdom	Not requested FSA authorization to manage or advice a UK-listed company investing in hedge funds	FSA (Listing Authority) There is no specific category of authorized onshore FOHFs, but such product have typically been structured as UK - listed companies	The public offer of UK – listed companies is allowed	Nil	Not relevant any comparison with UCITS schemes	
Germany	BaFin •Minimum capital equal to € 730,000 + a % of AUM	BaFin •Diversification limits (not more than 20% invested in a single product) •Investment manager and custodian bank are required to be located and regulated in Germany	Yes	Nil	Equal to UCITS fund, but in Germany both UCITS and Hedge funds to be tax transparent have to meet some transparency requirements	Transparency if the FOHFs is transparent according with German tax law
France	AMF Minimum capital requirement equal to the greater between •25% of annualized expenditure • € 125,000 + 0.02% of AUM > € 250 Mln	AMF • Max leverage (200%) • Diversification limits (Min 16 underlying funds) •Required the appointment of a depositary bank	Yes	€ 10,000 reduced to zero if it is forecasted capital protection	Equal to UCITS funds	Transparency
Italy	Bank of Italy •Specialized asset management company is required • Minimum capital requirement (€ 1 Mln)	Bank of Italy / CONSOB •No specific diversification limits •Required the appointment of a depositary bank	Only private placement to qualified investors	€ 500,000	Equal to UCITS funds	Transparency

Spain *Subject to the full introduction of the new regulatory framework*	CNMV •€ 300,000 + a % of AUM and income generated by investment activity	CNMV •Diversification limits to be qualified •Required the appointment of a depositary bank	Yes	Nil	Equal to UCITS funds	Transparency

Onshore Single Strategy Hedge Funds

Country	Manager authorization	Product regulation	Retail distribution	Minimum investment threshold	Fiscal treatment of the fund	Fiscal treatment for investors
United Kingdom	FSA •Own funds of£ 50,000 plus 3 months annualized expenditure	FSA •Qualified Investors Funds with no specific investment constraint	Only private placement to qualified investors	Ranging from £250 to £250,000	Equal to UCITS funds (transparency)	Favorable versus non resident offshore funds, but pension funds investors are tax exempt on both.
Germany	BaFin •Minimum capital equal to €730,000 + a % of AUM	BaFin •No specific investment constraint •Investment manager and custodian bank are required to be located and regulated in Germany	Only private placement to qualified investors. Possibility to distribute single strategy funds via wrapper products	Nil	Equal to UCITS funds, but in Germany both UCITS and Hedge funds to be tax transparent have to meet some transparency requirements	Favorable versus non resident offshore funds
France	AMF Minimum capital requirement equal to the greater between •25% of annualized expenditure • €125,000 + 0.02% of AUM > €250 Mln	AMF •Three different categories of products with different investment constraints, among them only contractual funds do not forecast any kind of investment constraint. •Required the appointment of a depositary bank	Allowed subject to a minimum investment threshold ranging from €125,000 to€ 250,000.	Ranging from €10,000 to €30,000 for qualified investors	Equal to UCITS funds (transparency)	Favorable versus non resident offshore funds

Italy	Bank of Italy •Specialized asset management company is required • Minimum capital requirement (€ 1 Mln)	Bank of Italy / CONSOB •No specific investment constraints •Required the appointment of a depositary bank	Only private placement to qualified investors	e 500,000	Equal to UCITS funds (semi-transparency, 12,5% on fund's return)	Favorable versus non resident offshore funds
Spain *Subject to the full introduction of the new regulatory framework*	CNMV •€300,000 + a % of AUM and income generated by investment activity	CNMV •No specific investment constraints •Required the appointment of a depositary bank	Only private placement to qualified investors	e 50,000	Equal to UCITS funds	Favorable versus non resident offshore funds

Considering single strategy products regulators in the main European countries seem oriented to substantially limit the distribution of such funds on the retail segment. As far as fiscal treatment is concerned, on one side, the common aim of fiscal Laws has been to inspire the taxation of domestic onshore vehicles to a principle of fiscal transparency and, on another one, to discriminate offshore vehicles domiciled in the main fiscal heavens. It has anyway to be signalled that the effectiveness of such policy is in part undermined by the tax exemption granted to some kind of institutional investors (for instance UK pension funds).

1.14 All in all: Hedge funds Industry for good or bad?

From the very start our ambition in this report has been to stick to the facts using accessible data and then our own analyses to guide us to conclusions.

Of course, one could not seriously blame hedge funds for all the ills that befall the international financial system.

And one can argue for possible, positive effects of hedge fund activities:

- They may contribute to market liquidity as they tend to be more willing to put their capital at risk on volatile market conditions, so that market shocks can be observed.
- It can also be argued that hedge funds - as active risk takers - may also contribute to spreading of risks among market participants.
- We know cases where the activity of hedge funds have been a wake-up call to sleepy managers of co-operative industries.
- It is argued that hedge funds - in their request for excess returns - arbitrage away price differences for the same risk across the market, which is beneficial for keeping capital costs down. One must add that these effects will be conditional on specific market circumstances.
- Finally, under certain conditions one could argue that hedge funds offer more possibility for diversifying portfolios thereby increasing the completeness of financial markets.

But the rapid growth of the hedge fund industry also raises important questions about the possible negative implications for financial stability and other risks. As we see it, we can summarise the risks in the following points:

- The systemic risks, ie. the risk of destabilisation of financial markets. Hedge funds can cause financial instability through their potential impact on financial markets and banks. The near collapse of LTCM in September 1998 provides the most vivid example of how hedge funds have the potential to disrupt the functioning of global financial markets.

- Market abuse i.e. potential market price manipulation and insider trading. The high pressure on production of extreme growth yields by managers and the use of out-performance commissions can create pressure on hedge funds to test the limits of certain rules of the market. The impact of such market abuse will be substantial in a market environment where speculative funds represent between one third and one half of the arbitrating volumes.

- The misbehaviour in shareholder activism. We are seeing too many examples of hedge funds exerting excessive influence on the strategy of some listed companies with a potential negative impact on all stakeholders. This is clearly because hedge fund activities favour a short-term approach of the target company strategy. The short-term approach is in direct contradiction to the long-term needs of companies to compete on investments in the global economy.

- Insufficient supervision of operational risks and insufficient internal control. This is the question of inadequate validation of illiquid and complex assets held by hedge funds.
- Mis-selling of the sale of inappropriate alternative projects to insufficiently informed clients.

Hedge funds have shown very impressive growth over recent years and have developed into a very important alternative investment instrument - for good and sadly also for the less good. The international character of the hedge fund industry and its unregulated nature, challenges our societies and authorities.

The possible implications of hedge funds for the stability of the financial systems are not only a problem for the hedge funds - the far-reaching consequences in case of a risk being realised will hit corporate industries, employment, and investments as well as pensioners' savings.

All in all, there is a central argument for reducing risks associated with the increasing role of hedge funds in the financial system. Given the case for regulating banks and investment banks and other financial actors - we must ask why should hedge funds and private equity be any exception? Given the readiness to reforms labour markets in all European macro economies as well as our goods markets - why should the new developments of the financial markets around hedge funds and private equity be exempted? We can summarise this part of our analysis by saying there is a strong case for demanding transparency and disclosure - and a strong case for some sort of incentives/regulations to ensure against systemic risks, market abuse, risk to the governance of listed companies, risk of poor asset evaluation, and protecting insufficiently informed investors.

1.14 Societies' response - current national regulations

In the following tables we try to provide a picture of current regulation of the hedge fund industry prevailing in Europe, focusing on the five largest markets (UK, Germany, France Italy and Spain). We consider separately requirements of financial and fiscal authorities on FOHFs and single strategy products.

In the field of FOHFs Europe is taking an increasingly relaxed attitude to the marketability of such products. Only in Italy is there still a limitation to offering FOHFs to the public. In Germany, France and Spain the distribution on the mass market of FOHFs is allowed with almost no restriction. In UK a clear position on this issue has not yet emerged from the SFA, but the public offering of FOHFs wrapped as UK-listed companies is permitted. In any case, in our view the most relevant issue is the fiscal treatment of FOHFs. Local fiscal laws foresee a treatment of hedge funds analogous to that of UCITS investment schemes oriented to preserve the transparency of collective investment vehicles. Then FOHFs are substantially tax-exempt wherever they are based and instead their owners are taxed according to their fiscal status. In this general architecture it has to be signalled that the fiscal treatment of offshore funds, owned by onshore FOHFs, does not foresee any kind of tax discrimination against offshore domiciled funds.

Regulators in the main European countries seem inclined to substantially limit the distribution of single strategy funds in the retail segment. As far as fiscal treatment is concerned, on the one hand, the common aim of fiscal laws has been to favour the taxation of domestic onshore vehicles applying the principle of fiscal transparency while discriminating against offshore vehicles domiciled in the main fiscal havens. It has, in any case, to be signalled that the effectiveness of such policy is in part undermined by the tax exemption granted to some types of institutional investors (for instance, UK pension funds).

2. Private Equity Funds

Private equity funds are similar to hedge funds in some respects. Both are lightly regulated, private pools of capital that invest in securities and pay their managers high fees as a share of a fund's profits. But there are also substantial differences. Most hedge funds invest in very liquid assets, and permit investors to enter or leave the fund reasonably easily. Private equity funds invest much more directly in relation to "the real economy", i.e. directly in companies. These are very illiquid assets such as early-stage companies and buy-outs of bigger, established companies. Consequently, investors are "locked in" for the entire term of the fund. There are, however, examples of hedge funds investing in private equity companies' acquisition funds.

When private equity capital is made available to companies, they are either de-listed or not yet quoted on a stock market.

Private equity funds are a sharply growing factor in financial markets, changing the environment quite rapidly. Private equity impact is not limited to the companies taken over by the buy-out funds. The funds exert a profound influence on the economy as whole, including on those companies which remain under traditional ownership whether privately held or publicly listed. As a consequence companies are directly competing on financial markets and this underlines a worrying tendency: the subordination of the real economy to the logic of financial markets.

2.1 Are private equity funds a single reality?

As in all other areas there are huge differences to be found among the investment funds. For example, venture capital funds typically invest in new and upcoming companies - often within high-tech industries. They generate real growth and support a good idea - there is a reason for venture capital often being called "business angels".

Private equity activity covers the process of collecting capital mainly from sophisticated investors - but also, in the form of specifically regulated investment funds, from retail investors - and pooling it in investment vehicles (usually called funds) and investing this capital in companies.

The phases of private equity activity are therefore fundraising and investment (as well as disinvestment, as the aim of private equity is to realise capital gains by leaving the invested company once its value has increased).

Classic equity financing is a way for a business to finance itself by acquiring funds from investors rather than self-financing, where the business builds up equity from profits which it retains. However, nowadays private equity companies generally only use equity to finance the acquisition of a business to a small extent, using borrowed capital to a much greater degree.

In contrast to public equity, there is no organised public market for private equity. The market is very opaque with no disclosure - this is especially the case for the so-called leverage buy-outs (LBOs)[19].

***

Let's look at different types of Private Equity:

- Venture capital is focused on young, entrepreneurial companies and is an essential part of value creation in the whole private equity financing cycle. It provides finance for start-ups- at their inception or shortly after their first technical or commercial developments. Much of this segment is technology-related e.g. new information and communication technologies, life sciences and healthcare, electronics and new materials industries.

[19] Cf. Special supplement to the Börsen-Zeitung of 27.4.2005, B 5.

Investments are often in individual minority shareholdings with a number of venture capital funds investing alongside each other in successive rounds of financing. The investors are closely involved in determining the investee company's strategy, hiring key employees, organising the search for further financial resources and negotiating partnerships with larger corporations. Venture capital includes:

- o Seed: financing provided to fund research, assess and develop an initial concept before a business has reached the start-up phase.
- o Start-up companies: financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or been in business for a short time, but have not sold their product commercially.
- o Early stage companies: financing to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales. They will not yet be generating a profit.

- In later stage expansion capital finance is provided to purchase holdings in existing, generally profitable companies by subscribing new capital (as equity or quasi-equity). Investee companies here have growth profiles that necessitate the consolidation of their financial structures e.g. to develop new products or services, set up a foreign subsidiary, make an acquisition or increase their capacity. Expansion capital includes:
  - o Expansion (as such): financing provided for the growth and expansion of an operating company, which may or may not be breaking even or trading profitably. Capital may be used to finance increased production capacity, marketing or product development.
  - o Bridge financing: financing made available to a company in the period of transition from being privately owned to being publicly quoted.
  - o Rescue/Turnaround: financing made available to existing businesses, which have experienced trading difficulties, with a view to re-establishing prosperity.

2.2. Leverage buy-out funds

Leverage buy-out funds are having a much more problematic effect on European companies and employees. It is the type of fund we are focusing on in this report - a private equity fund not registered on the stock market or stock exchanges. There is no transparency or disclosure.

The information we have on LBO activities is therefore limited, particularly the effects they have on the acquired companies. We have therefore made a set of case studies covering many European countries. Combining this picture of LBO activities in the past two to five years in Europe with public reports, we can begin to create a picture of the LBO phenomenon. In the vast majority of the cases studied, leverage buy-out funds seem to worsen working conditions for the employees and sometimes reduce their numbers. Another impact is on the company itself. There are too many examples of companies failing to prepare for globalisation after LBO take-overs, because they lack the capability to invest long-term.

Buy-outs are typically majority investments made in companies together with the existing management (a management buy-out or "MBO") or with a new management team (management buy-in or "MBI"). These normally use sophisticated financial techniques that involve bank financing and debt financing. Opportunities for buy-outs are created from the sale of family-owned businesses; the sale of a non-core subsidiary by a large corporation; taking a listed company private, typically a company underpriced by the stock market; and sale by financial shareholders. Buy-out funds do not focus on any one industry, though many managers have sector specialities. Buy-out capital includes:

- o Management buy-out: financing provided to enable current operating management and investors to acquire existing product line or business.
- o Management buy-in: financing provided to enable a manager or a group of managers from outside the company to buy-in to the company with the support of private equity investors.
- o Leverage buy-out: financing provided to acquire a company, by using a significant amount of borrowed money to meet the cost of acquisition.

None of these activities are transparent.

***

An LBO typically involves the following three steps:

- The investors form a company (often a limited company) which borrows the capital to acquire the shares in the target company; i.e. the acquiring company is typically heavily financed by borrowed capital.
- The investors acquire the target company.
- The target company is merged with the newly formed company.

The purpose of this multi-stage acquisition process is to give creditors security rights to the assets of the target company. Given the short-term nature of the commitment, the creditors are often willing to do without securities and/or to provide loans which rank below those of other creditors. Since there is greater risk attached to these secondary loans, they are often provided with debtor warrants. In a number of cases, where the merger is based on real economic concerns for the future of the company, there may be constructive results. However, as Part II of this report will detail, we often see a clear asset stripping of the company acquired, with major detriment not only to its debt level, but often also to its employees and investment capability including in R&D and long-term survival of the company.

Buyout funds purchase business divisions or a whole, big - eventually listed - company. Then they change the liquidity / capital structure immediately, with the aim of realising the added value created by selling the business on to an industrial buyer or to other financial investors[20]. Unfortunately this strategy of creating added value goes too often hand in hand with short-termism, and its negative consequences in terms of business management and competition. The buyer generally finances the purchase of the company with the company's own equity. The LBO only ever uses its own money to a small degree, if at all. In other words, the majority of the funding is borrowed. This enables it to make use of the so-called leverage effect: it is the difference between return on equity and return on capital

[20] Cf. Handelsblatt of 12.5.2005, p. 23.

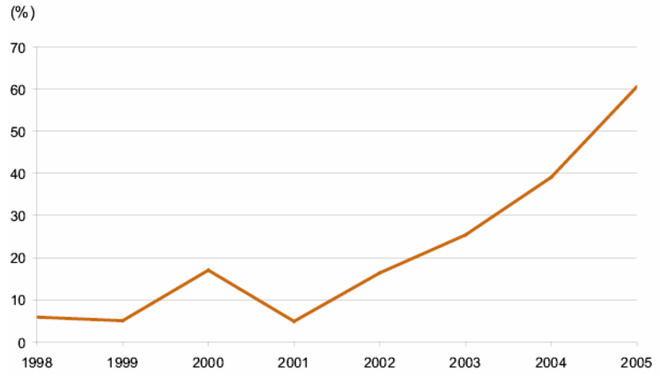
employed[21]. Leverage effect explains how it is possible for a company to deliver a return on equity exceeding the rate of return on all the capital invested in the business, i.e. its return on capital employed. However, there is also a risk of a loss if the cost of borrowing the capital outweighs the profit - but due to the LBOs' short-term investment profile, this is rare.

Since private equity firms also extract equity from the business they acquire in exchange for credit in order to satisfy their own investors and fund managers, there is a great risk that they may use up their equity on the business that they acquire. By the time refinancing has been completed, private equity companies will frequently have refinanced their equity, i.e. they will have got it back before reselling.

Furthermore, liquidity and earnings capability are used to service debts; the company is no longer available to invest in its further development. This risk rises further following reselling of the company, which is frequently also funded by borrowed capital; in this case, more of the cash flow is used to service debt.

In addition to the burden caused by servicing borrowed capital, the acquired business frequently has to mortgage its assets in order to secure loans. Banks providing money for credit-financed buyouts are increasingly allocating what are known as second-lien loans. These are secondary loans which, in the event of the business becoming bankrupt, are not repaid until the debts owing to other creditors have been. However, the creditors are offered higher rates of interest because of this. This means that the LBO company can achieve greater returns than first-rank creditors[22].

Evolution of recycled LBO (secondary + recap.) in total activity of LBO financing in Europe



Source : Standard & Poor's LCD

Private equity assumes unrestricted liability for losses. It is not repaid until the business's sources of borrowed capital (creditors) have been satisfied. Given the higher risk involved, private equity companies demand higher rates of return than creditors.

[21] For more details, see Glossary
[22] Cf. Handelsblatt of 12.5.2005, p. 23.

Capital providers generally have big influence on both strategic and the operational decisions taken by management. They request wide-ranging rights to inspect internal company data and to receive ongoing reports. In reality the LBO takes full control of not only the shareholder board of the company, but also the management of the company. This means in practice making all relevant decisions including job cuts, investments, dividends to shareholders, financial engineering etc.

2.3 The legal frame

The investment vehicle that is most often proposed to institutional investors in France is the Private Equity Fund (FCPR). This vehicle has also been adapted so that it can be used in the form of a Fund of Funds (see letter c below). The purpose of these investment structures is to foster investment in unlisted companies. They have different legal and regulatory operating procedures but comparable taxation systems for the institutional investor.

The Private Equity Investment Fund is differentiated from the European mutual fund (‘UCITS’) family by regulations that take into account the frequency, nature and risks of investments in unlisted companies. For instance in France, the FCPRs (Fonds Communs de Placement à Risque) must invest at least 50% of their assets in non-listed companies.

The FCPR is a co-ownership of securities with a limited life. It is owned by the investors or subscribers and is managed by a management company according to rules set out in the fund’s by-laws. The by-laws are a veritable contract between the investors and the management company. They set out the investment policy and the portfolio management rules and specify the commitments, rights and obligations between the parties. Their purpose is to provide investors in a long-term partnership with a guarantee that their interests will be protected and that the results and risks will be fairly shared.

There are two types of Private Equity Investment Fund: FCPR agréés, those authorized by the French Financial Markets Authority (Autorité des Marchés Financiers), and abridged procedure funds, FCPR à procédure allégée. The former can raise capital from all types of investors; the latter can only raise capital from “qualified” investors. Abridged procedure funds are not exempted from AMF control but have more freedom to set special terms and conditions for the fund’s management.

There are two successive periods during the life of a Private Equity Fund (ten to twelve years on average):

- During the first, typically 3-4 year period investment - the management company gradually calls on investors to provide the funds they have subscribed to. These calls are usually in tranches of 5% to 10% based on the needs of the management teams to carry out investment in the chosen companies
- During the second period, managers concentrate on raising the value of portfolio investments by actively monitoring them prior to preparing their sale.

Investments are sold off to other companies or are floated or sold off to other investment funds.

The proceeds from the sales are distributed to the subscribers as they are received. Such distributions are made primarily in cash or exceptionally, by allotting company shares after the initial public offering (IPO).

Depending on the pace of investment acquisitions during the investment stage and the management teams’ ability to sell them off during the realization stage, the profile of the financial flows – frequency of calls for funds and distributions – and the complete life of a fund may vary widely.

Limited Partnership (LP) : The Limited Partnership (LP) is an investment structure, fiscally transparent and mainly used by British, American and Scandinavian investors. It is very similar - but unlike LBOs it retains ownership and management in the company. But similar to a Private Equity Investment Fund it has a limited life-span, a capital call-up period of 3 to 5 years and a distribution of sales revenues throughout the life of the fund. The LP is managed by an independent management company, the General Partner (GP).

What is a fund of funds

The fund of funds is a structure for sharing investment across several private equity funds. The fund of funds is managed by a team of professionals offering investors the strategic construction of a diversified portfolio and the selection of management companies. These professionals manage the relationships with the various underlying funds, organize the review of valuations, transfer information and provide back office services for the funds.

2.4 How they get the money

How do LBOs organise the money for their activities? Equity financing for all the types of funds, including venture capital funds, typically involves the following steps:

- Launching a fund:

First, a private equity company generally launches several independent funds in which investors’ capital is combined. The typical legal form of funds in Germany is a GmbH & Co. KG; in the UK and the United States they are limited partnerships. The investors do not take any management decisions themselves; the operational aspects of the business are combined in a separate company, frequently in the form of a general partnership. This company, in turn, is frequently controlled by a (fund) parent company of the private equity company, which performs a role comparable to that of a holding company. The advantage of having a fund with the legal form of a GmbH & Co. KG is that the liability of its capital providers (limited partners) is limited to the level of their capital contribution. This means that individual investors are not additionally liable for losses through their private assets.

- Acquisition of an investment in a business or purchase of a business division:

In the second step the fund acquires the target business. Then they would typically use a blend of equity and borrowed capital to finance the purchase price, frequently at a ratio of

30% equity to 70% borrowed capital.

- Restructuring, merging or splitting the acquired business:

For some - typically venture funds - the aim here is to increase the value of the business by improving efficiency and productivity. But it can also mean that the sale of assets is made to provide cash to be paid out. Operating costs, e.g. through job cuts, are reduced mainly to increase cash flow. Cash flow may be used to borrow more debt in order to have cash for payments to the PE fund.

- Exiting the private equity company:

In the final phase the investor attempts to sell his investment at a profit. The LBOs frequently do this via an IPO. It is now also common practice to sell to another investor (a so-called secondary buyout).

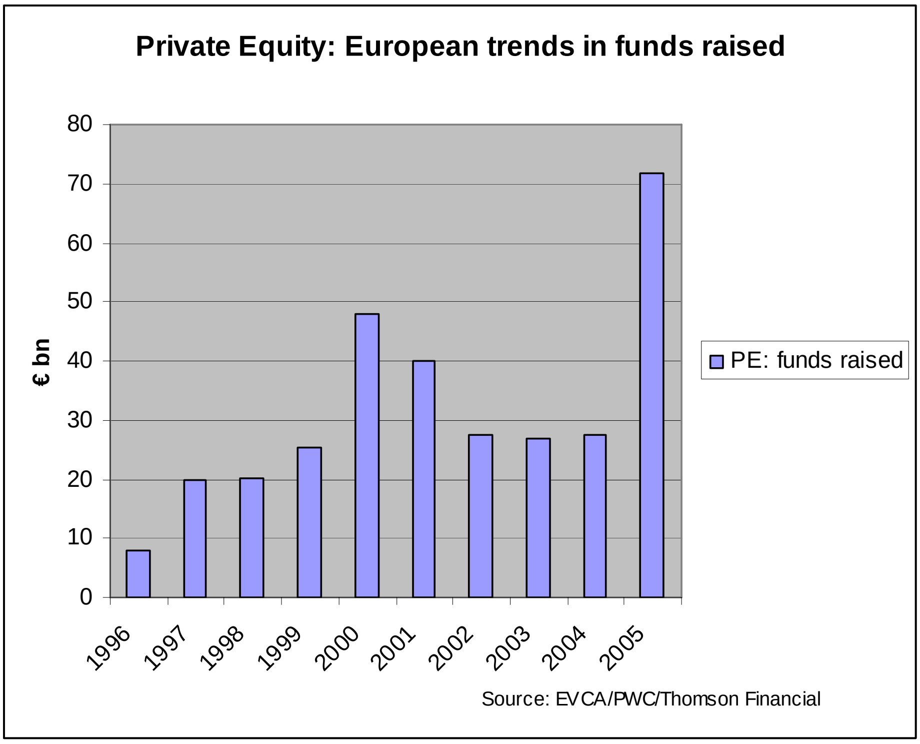
2.5 Private equity is big and growing fast

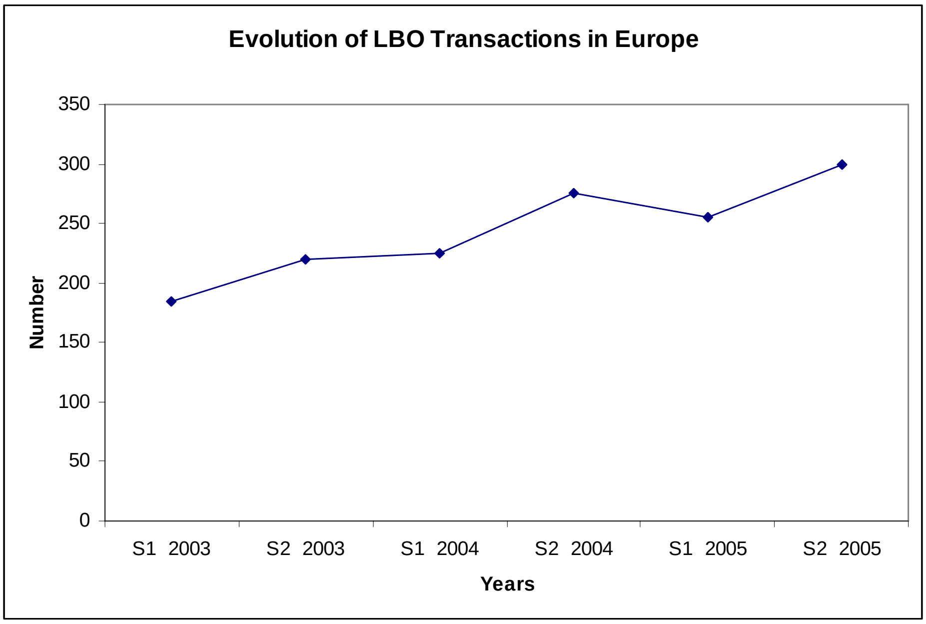
At worldwide level, the US market is still by far the most mature and developed and accounts for approximately 75% of the funds raised globally in the period 1983-2005 (€990bn).

However, Europe accounts for a large part of the remaining private equity transactions. European funds in the same period (1983-2005) raised €350bn. 55% of the global total (€550bn) has been raised in the last 5 years, with Europe seeing a new surge in fundraising in 2005 (€72bn) following a slow fundraising period from 2002 to 2004 (see chart below). The fund-raising i.e. the investor contributions to the PE-funds must, of course, also be seen in relation to the real economy, the general macro-economic environment, the saving / consumption ratio etc.

What could you do with 72billion euros? Well, with the right conditions it could significantly fund the enormous need for investment in R&D if we are to realise our Lisbon goals. Compared with funds raised in Europe in 2005 (€72bn), business enterprise R&D expenditure in Germany in 2005 was approximately 39 billion euros[23].

[23] http://epp.eurostat.ec.europa.eu/portal/page?_pageid=0,1136250,0_45572561&_dad=portal&_schema=PORTAL

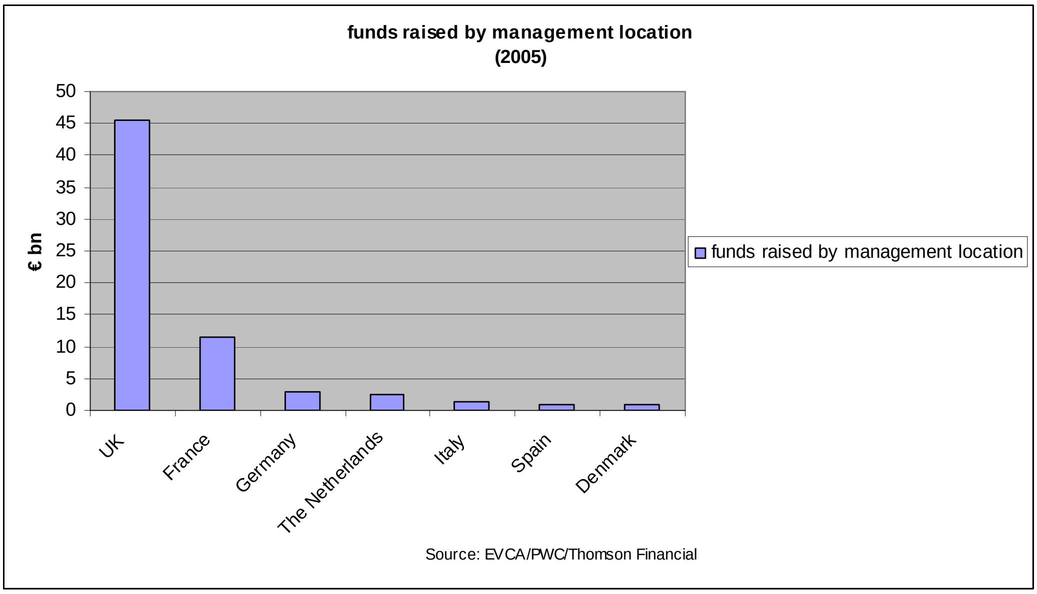




As mentioned earlier, PE-funds, in most cases LBOs, operate with heavy leverage of funds, according to David Bernard from Thomson Financial. To get the real picture of money/funds available for acquisitions from a LBO point of view, we must use a factor of 6, i.e. multiply the amount of funds raised by six. So in 2005the new funds available really amounted to 432 b Euros.

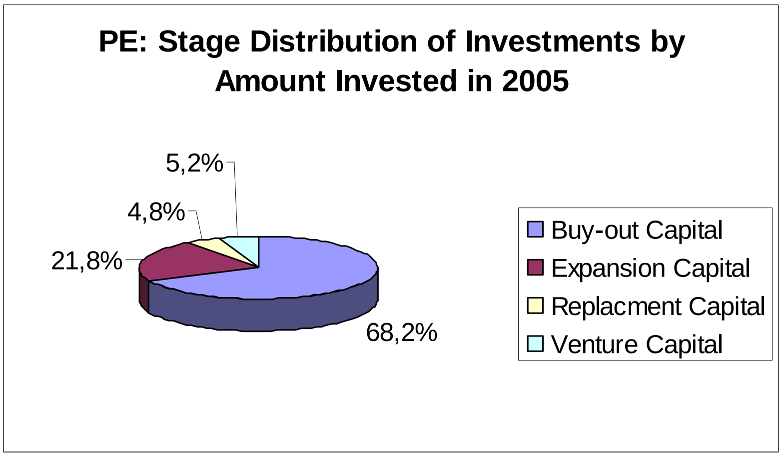
All indicators tell us that this trend will continue in Europe. For funds raised, UK is top with €46bn or 64% of the total. France accounts for the next largest percentage at 16%

(€12bn raised) and Germany is third with 4% (€3bn raised). Among the 7 biggest Member States in terms of funds raised by management location, the ranking is the following:



2.6 LBOs become dominant

Looking at the total funds raised for private equity funds it is striking to see the dominance of LBOs. In Europe the proportion of buy-out investment made has continued to increase in recent years, reaching over 68% of amounts invested in 2005. In contrast the amount of venture capital investments only represents 5 %. This is more worrying bearing in mind our need for long-term investments to realise the Lisbon goals.



And it highlights the comparatively difficult position of venture capital managers in recent years, caused by the 'bubble' of 2000, and the wider downturn in the EU economy at that time. Although the top European venture capital funds have performed at a similar level to their US counterparts (where the market is more mature), a wider recovery may take some time because of the longer holding periods necessary for venture investments.

Since the 2000 bubble, venture capital managers in Europe, in particular in Europe's smaller markets, have found it more difficult to raise funds as a result of historic underperformance. This situation is likely to persist until consistent performance is delivered. Taking into consideration the enormous growth in leverage buy-outs of European companies, it is striking at the same time to see the dominance of the US funds, especially their size. They are simply the most powerful funds in the world. Looking at US funds like Texas Pacific Group, Blackstone and KKR, they have together a capacity equalling more than 30 per cent of worldwide equity. Recently, a new study made public the total LBO take-overs worldwide as shown in the table.

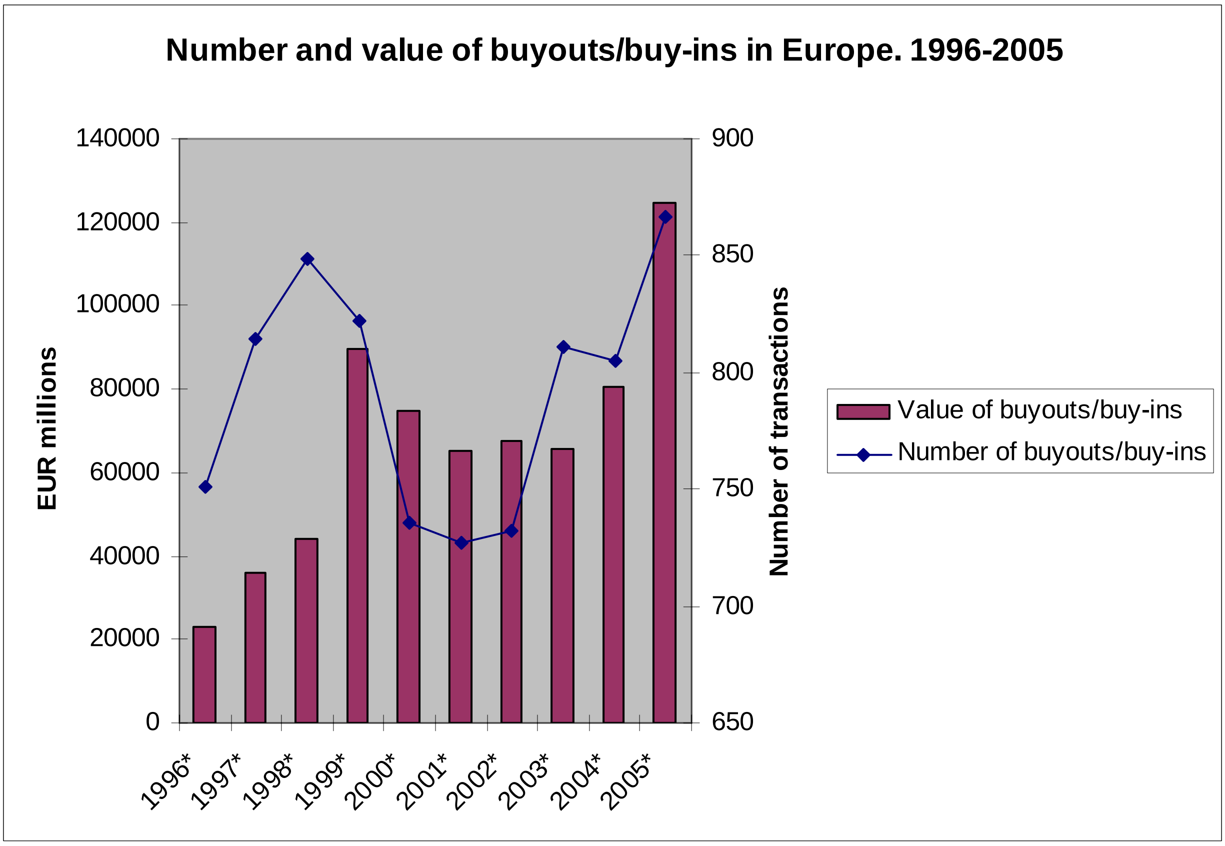
As the pie chart above shows, buyouts account for by far the largest part of the private equity investments. The buyout markets in Europe have developed substantially and aggressively over the past 25 years. The European market seems to be experiencing its third phase of significant growth, following the waves of buyouts during the latter halves of the 1980s and 1990s.

Records have been set in terms of both individual deal size and the total market value of transactions in recent years. From 1996 to 2005 the value of buyouts/buy-ins has experienced a tremendous rise of 445.4 percent points, as shown in the table.

Table. Development of LBOs - value of buyouts/buy-ins in EUR mil in Europe.

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Index figure	100	156,9	193,1	391,9	326,3	285,8	294,8	287,5	353,0	545,4

Source: CMBOR/Barclays Private Equity/Deloitte, figures taken from http://greywww.uvt.nl:2080/greyfiles/center/2006/doc/70.pdf



The illustration underlines the LBOs as the dominant financial actor. Together with the vast number of LBO take-overs of EU companies, this is the basis for our engagement in this report. The Private equity rankings below give us a sense of the major players:

Private equity rankings

By M&A deals (Year to Dec 20 2006)

US	Value $bn	Number	Europe	Value $bn	Number	Asia-Pacific	Value $bn	Number
Blackstone	85.3	12	Kohlberg Kravis Roberts	27.5	5	Texas Pacific	12.0	3
Texas Pacific	81.9	11	3i	25.9	25	Macquarie Bank	11.3	2

Bain Capital Partners	74.7	9	AlpInvest Partners	20.8	3	Allco Equity Partners	11.1	3
Thomas H. Lee Partners	53.4	6	Apax Partners	19.7	11	Onex	11.0	1
Goldman Sachs	51.2	5	Goldman Sachs International	17.3	3	Carlyle	8.0	6
Carlyle	50.0	14	Carlyle	14.9	8	CVC. Capital Partners	7.5	4
Apollo Management	44.9	7	Cinven	12.4	6	Kohlberg Kravis Roberts	5.2	4
Kohlberg Kravis Roberts	44.5	3	Hellman & Friedman	12.2	3	Goldman Sachs Capital Partners	4.0	2
Merrill Lynch	35.9	3	Contracted Services	11.3	1	Allianz Capital Partners	3.9	2
Cerberus Capital Management	28.6	4	Thomas H Lee Partners	11.3	1	MBK Partners	1.7	3
Industry total	402.6	1,157	**Industry tota**l	272.6	**1,564**	**Industry total**	**48.0**	**271**

Note: Financial Times December 27 2007.

The figures provide a substantial justification for the debate about the phenomenon of ever larger deals, a trend which is supported by banks' willingness to leverage transactions, as well as increasing institutional investor's appetite for the sector.

As illustrated in an annexe to this report our case studies document the need for change in society's strategies vis a vis the LBOs. Like its private equity counterpart, the leveraged finance market experienced a pause in activity in the 2001-2002 economic recessions, as institutional appetite for debt declined. According to Rating agency Standard & Poor's the leveraged loan market has increased significantly in 2006, posting record volumes and Europe's largest-ever buyout. In the first-quarter of 2006 leveraged loan volume was $44.4 billion. The comparable figure for first-quarter 2005 was $25.5 billion, and first-quarter 2004 volume totalled $20.0 billion. The prior record for first-quarter volume was $24.2 billion in 2001[24].

The increase in aggressive take-overs from LBOs is mirrored in the fact that leverage ratios also continue to rise. Pro forma average total debt to EBITDA for European leveraged loan borrowers was 5.9x in first-quarter 2006. The median was also 5.9x, but the third quartile

[24] Source: http://www.finfacts.com/irelandbusinessnews/publish/printer_1000article_10005973.shtml

threshold (25% of the “population” was greater than this level) was 6.7x. In 2005’s first quarter, these figures were generally a full turn lower, at 4.8x for the average, 4.7x for the median, and 5.9x for the third quartile. Even the fourth-quarter 2005 numbers are a half turn lower, at 5.3x for the average, 5.1x for the median, and 6.1x for the third quartile[25]. As we can see, the debt factor increased from average 4.7 to 6.7. In 2006 this development continued. Recent data of leverage buy-outs in Europe have shown that relaxed attitudes in the markets, or the banks’ need to get liquidity to work, are tempting borrowers to take on a lot of debt. The rising debt levels in companies owned by private equity funds have been fuelled by unprecedented demands for risky loans and bonds from hedge funds and other investors. Now, the average ratio of leverage rating is almost six times higher, according to Standard & Poor Leveraged Commentary and Data.

S&P is not denying that LBO activity is pushing up the average transaction size for loans. Fifteen percent of first-quarter transactions included $1 billion or more of senior debt, and nearly half of those deals were huge transactions, at $2 billion or more[26].

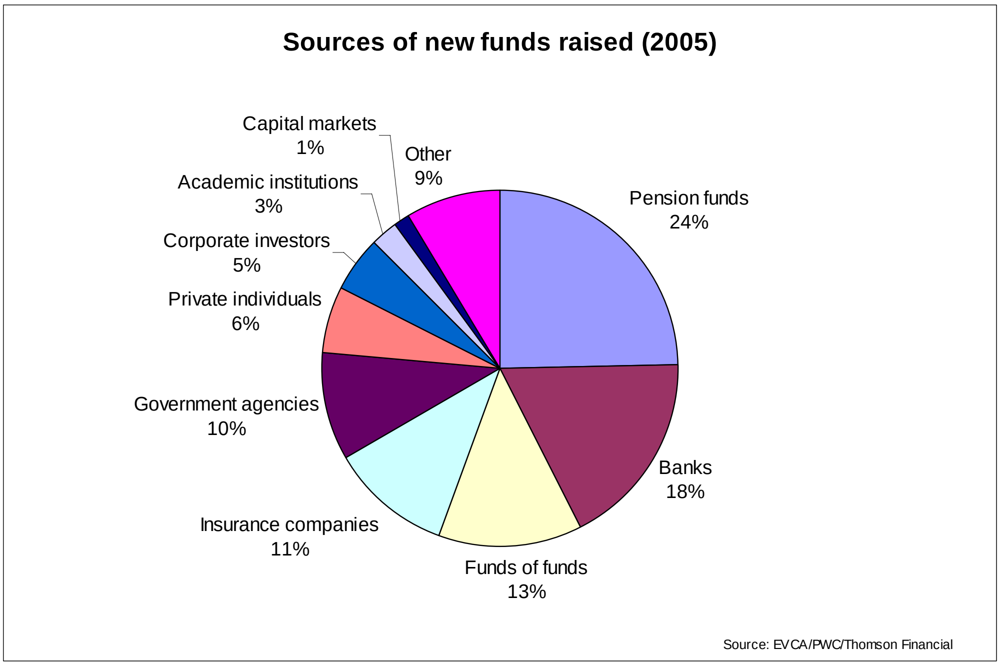
This huge amount of debt is in itself creating risks for financial systems, of which we should be aware.

According to The Economist the global private equity activity in the first half of 2006 took on cheap credit to buy companies for 300 billion dollars. This means that for the whole of 2006 they could in theory borrow enough money to buy a fifth of all listed on America’s NASDAQ, or nearly a quarter of Britain’s FTSE 100[27].

2.7 Who invest in LBOs?

It is pension funds and insurance companies who are the new investors in LBOs. As shown in the European Commission Expert Group Report on Private Equity in July 2006, funds raised from pension funds and insurance companies represented, in 2005, around one third of all funds raised in Private Equity in Europe.

[25] Source: http://www.finfacts.com/irelandbusinessnews/publish/printer_1000article_10005973.shtml
[26] Source: http://www.finfacts.com/irelandbusinessnews/publish/printer_1000article_10005973.shtml
[27] The Economist September 23rd 2006



One of the best surveys to demonstrate the involvement of the pension funds and insurance funds in the alternative field is the last Russell survey on Alternative Investing, dated 2005[28]. This survey analyses the investment habits of 327 organisations worldwide responsible for managing tax-exempt assets. The greater part of the sample is pension schemes (the minority are endowments and foundations). The evolution of such investment in Private Equity is shown in the table below.

Table. Current and Forecast Mean Strategic allocation to Private equity made by pension funds

	2001	2003	2005	2007
US	7.5 %	7.5%	7%	7.6%
Europe	3.6%	4.0%	4.5%	6.1%
Japan	N/A	1.8%	1.8%	4.5%

Analysing the above figures we can state:

- US players are leading the growth of the alternative investing among the institutional investors and mainly among pension funds.
- This investment practice seems more suitable to US investors, and anyway in this geographical area such investments are not in an expansion phase (from 2001 to 2005 they ranged from 7.5% to 7.0%). The catch up dynamic of European and Japanese investors to the US standards seems weak.
- At a first glance, the reported figures do not seem worrying in terms of the financial

[28] See under Executive Summary at:
http://www.russell.com/II/Research_and_Resources/Alternative_Investing/Alternative_Investments_Survey

safety of the subscribers (stakeholders) but as indicated, the high debt activities are creating financial market concerns.

2.8 When targeting a company

When targeting a company, LBOs are typically acting in accordance to a common set of patterns, as we can deduce when we look at their practical leverage buy-outs in our case studies and in accessible studies.

Extremely inexpensive loans have funded the acquisitions, because the funds usually only bring a small capital contribution and very large loans, which the companies afterwards have to pay back.

This means that the LBOs see as target companies:

- Who has stable cash flow so that the repayment is secured?
- Who is fundamentally sound with a strong internal economy, high internal capital? This means that the LBO as new majority shareholder can decide on an extra shareholder dividend.
- Who - in some cases can be acquired in the market at a price under the real market price?
- Who - in the case of stock market notifications - can be delisted immediately after an LBO acquisition?
- Who has a management amenable to “reasonable arguments”, as many LBOs put it, these being extraordinary bonuses, stock options to the company managements in the case of a realised acquisition?
- Who has a strong position within the specific market segment? Many infrastructure operators spanning the public sector and private market operations seem especially attractive to private equity funds. That is because the LBOs are looking for investment opportunities in highly imperfect markets, especially if the infrastructure operator is fully privatised and the management is “receptive” to a cooperative leverage buy-out.

It is worthwhile underlining that the LBOs increasingly look at companies as bundles of assets and liabilities to be traded and not as much as companies with employees, jobs, and economic potential to develop further in the globalised economy.

At the time investors - typically pension funds - buy into an LBO fund, they have no idea of what companies the fund will invest in.

As part of the fund’s investment policy, the manager will invest according to the business opportunities generated by him or her. There is no performance projection or guaranteed return. Although historical results secured by a management team are good indicators of its skills, they cannot be considered as a guarantee of future results. Accordingly, the relationship between investors and managers is based on a high degree of trust. The managers, limited only by their contract, have a great degree of freedom to choose, follow up and sell the portfolio investments during the life of the fund.

The private equity manager virtually always invests with a short term holding strategy. The typical stated holding period for a later stage investment is 3 to 5 years based on the team's strategy and business plan for extracting value in the business. In practice we can see that the holding period is even shorter in many cases, down to 1-2 years and thereafter reselling.

Unlike investors on the stock market who have access only to public information without being able to directly influence the behaviour of the companies in which they are shareholders, LBOs always go for direct management control. That is why LBOs nearly always go for majority shareholder positions.

Venture capital is investing in a technology start-up - this requires different skills from managers who deal with LBOs of companies. Performances between teams will vary based on their experience and the quality of their management. They will also vary according to the year and industry. The lack of a real benchmark index measuring the performances of various management teams makes the selection of a team particularly tricky. It is therefore necessary to use other means of analysis in accordance with the investment strategy. As a result, it will be easier, for instance, for a European investor to choose a team that invests in its own country than to choose a North American team.

It is time to engage in defending the public limited company, which separates management and ownership. Increasingly capital - in the hunt for higher returns to make vast personal fortunes - is going private to escape the demands of public accountability on stock markets. At the same time the LBOs acquiring a public limited company take full control of not only the financial management and the board. If this new trend is not corrected by better regulation in our societies, there will be serious long-term adverse consequences of privatisation of capital for our economy, society and democracy.

2.9. Extreme fees and costs

LBOs are typically compensated with a management fee, defined as a percentage of the fund's total equity capital. In addition, the general partner usually is entitled to "carried interest", effectively a performance fee, based on the profits generated by the fund. Typically, the general partner will receive an annual management fee of 2% of committed capital and carried interest of 20% of profits above some target rate of return (called "hurdle rate").

As for hedge fund managers, this in practice and in absolute terms means extremely high fees. These percentage rates are no "law of nature". We are instead talking about historical patterns, which at present are only questioned by us in this report. Nevertheless, these fees have - as has been shown in many public studies - far reaching consequences for the aggression of LBOs and therefore for the real economy.

One truth about private equity is it sends the wrong signal to the rest of our societies where governments often talk about the need to show responsibility and realistic wage claims, especially on the labour market: The extremely high management fees and annual "carry" (the share in profits) mean lifechanging fortunes. Researchers at the Manchester University ESRC Research Centre, recently published some information from the internal management account of a LBO fund with up to £8bn (12 billion euros) of funds under management. After five years 30 full partners in the LBO fund are expected to make between £25 million and £50 million each.

The first attraction of LBO funds is that financial engineering concentrates reward for the benefit of the minority of capital providers who provide equity and funds and not to the majority of capital providers who supply cheap debt.

2.10 Off-shore / on-shore and tax evasion

Two clear distinctions have to be made, first regarding the location of the fund, second regarding the location of the management company. The choice of location is clearly influenced by tax considerations.

- <u>Domicile of the fund</u>

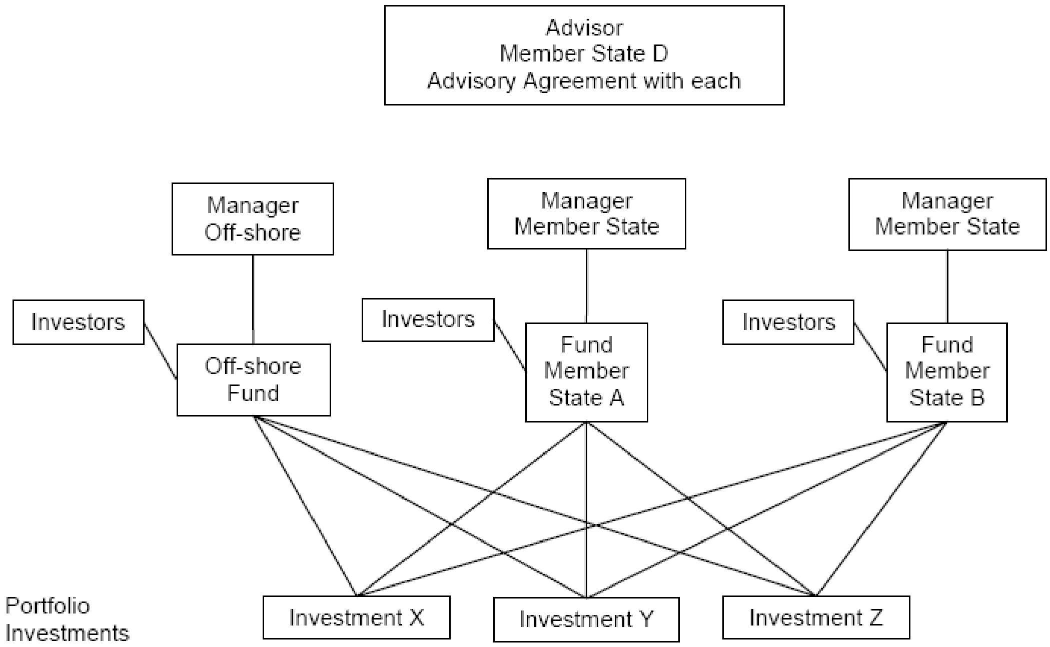
The choice of location (domicile) of the fund can be between different national regulated schemes (e.g. UK-based funds or French-based funds) – named ‘onshore’ funds - or between an ‘on-shore’ fund and an ‘offshore’ fund (e.g. Channel Islands, such as Guernsey or Jersey).

The choice of location between different national ‘onshore’ funds will be made on the basis of tax - usually onshore funds are mainly designed to reduce taxation for national investors.

The official reason for this practice is that by this method “double taxation” can be avoided. However, at the same time there is no control as to whether investors are getting taxed on the profit from the private equity funds. The lack of control relates both to the amount of the profit and the time of the taxation. This is due to the fact that there is no possibility of controlling how private equity funds distribute profit. It should be clearly recalled that in many off-shore centres, tax authorities are not as effective as in the major capitals of Europe.

When choosing between an onshore fund and an offshore fund, other reasons may appear. For instance, the advantage of the Channel Islands is that they have no significant domestic investors so there is no need for heavy domestic regulation and enforcement by the local securities regulator – unlike continental regulators. Therefore, a light regulatory regime for private equity funds in terms of product design and contract conditions allows their faster registration in those offshore centres than in onshore ones (so called ‘regulatory arbitrage’). We should recall that all LBOs without exception place their fund off-shore, precisely for these well-known tax reasons.

The fund structuring arrangements for EU private equity funds is typically like this[29]:



- <u>Domicile of the manager</u>

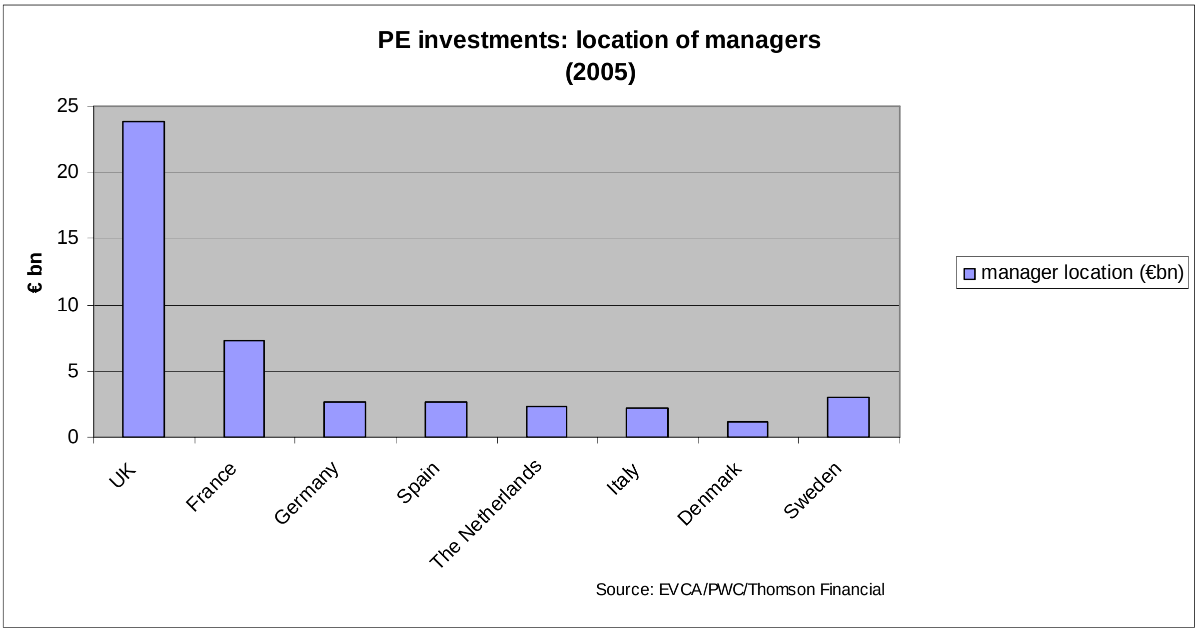
o For funds raised:

Many LBO managers are based in London, as the City marketplace is probably the most cosmopolitan location in Europe for finding a wide range of institutional investors, and specific taxation schemes are especially attractive for managers splitting location and placing funds off-shore. But other locations such as Paris are also booming.

o For investments:

A large number of LBO management companies wish to remain close to the companies they invest in, in order to keep a close eye on them, which means that many of private equity management companies investing largely in French companies remain in France, as long as they stay in the company (2-3 years) and the same applies to the other continental EU countries. Among the biggest 8 Member States in terms of private equity investments, the situation is the following

[29] European Commission: "Developing European Private Equity", Report of the Alternative Investment Expert Group, July 2006, p.26



2.11 LBOs' major strategies

Private equity as an asset class is subdivided into a number of sub-categories including:

- Venture capital
- Expansion (or growth) capital
- Buy-outs or buy-ins

Each market segment corresponds to specific company profiles or situations as described above.

Specific economic function of Venture capital: Venture capital investment involves risks, as capital is invested in new technologies and/or, unproven business strategies. Venture capital investment fosters innovation by financing young companies with innovative concepts and generates high-skilled jobs. Venture capital investment creates new employment and new wealth. The venture capital industry represents a transmission channel of privately available capital into sectors of the economy that have no access to the public capital markets.

Specific economic function of Expansion capital: Expansion stage investment involves in some ways less risk than venture capital, because investments are made in existing, generally profitable, companies. Expansion capital can provide capital for new premises, plant and equipment and product or service development needed for growth and in addition support the internationalisation process and the adoption of advanced governance and management skills.

Specific economic function of Buy-out capital: Buy-out investment involves less risks for the management companies and investors as investment is made in mature established companies where there is the possibility to create value, mainly through reorganising of businesses or restructuring operations. In the best cases, this is effectively what is taking place, where for example buy-outs help solving corporate succession situations or finance ownership transfers. But buyout capital looks mainly for significant stable cash flows, for example in the infrastructure based as their investors are looking for a stable long term return with regular dividends and reduced market risk.

In general, management companies do not invest in all segments. Most specialise in an industry or type of investment. They are also differentiated by the value of assets managed, which affects the size of their transactions and defines the profile of the targeted companies. Certain private equity investors have specialized in major shareholder transactions while others have focused on smaller investments to build a big portfolio of minority investments.

LBOs are investing in a wide range of industries. The analysis is based on full consideration of the cash flow opportunities on an industry-by-industry basis in the manufacturing sector and in consumer goods and services.

The LBOs buy companies and delist them from the stock exchange. This has the advantage that they do not have to inform the public about strategies, vital change etc. which are conducted in the boardroom or in the CEO office. It is only the investors who stand behind the LBO fund, who have access to this information while an eventual minority shareholder or the public are left outside.

The lack of transparency is a huge problem in a democratic society. European labour unions from all over Europe report examples of how LBO funds change the internal organisation and working conditions of the companies. This group of stakeholders therefore wants to unlock the mystery of the funds.

To build their portfolios, manager works at generating the cash flow corresponding to their investment strategies. After completing the analysis process, complemented by prospective studies, audits and negotiations, they choose the companies that offer the short-term outlooks that match the objectives set out in the LBO fund.

The manager insists on being close to the central, operational life of the companies. Management companies in the LBO fund will often be represented on boards to take part in crafting strategy to varying degrees. But there again, LBO funds generally insist on total control.

The manager’s ultimate objective is to maximise a return/cash flow - and develop revenue for its investors. There are several ways to assure these returns and fees: Extraordinary shareholder dividends, stepped increases in leverage, fees, cuts in jobs, sale or flotation. The LBO management picks the time and the exit method that will maximize the cash flow.

Every three to five years, managers must raise capital on the market or at the time of cementing an acquisition project. Faced with arbitrages between asset classes and competing projects, they meet investors to propose new fund investment opportunities and try to convince them on the basis of their past performance and their professional ability.

A distinguishing feature of LBO is that the financial reward of the investors, the investment management team and the investee company’s management will largely come in stages. Firstly, fees, shareholder dividends. Secondly, fees and value creation realised when exiting (by sale or flotation). An important part of the investment management team's/private equity manager's strategy is therefore the early identification of alternative routes for exiting their investments.

2.12 The returns to investors - better than others?

The supporters of LBOs constantly look for some kind of positive, general effect on financial returns or employment. They only differ from critics of LBOs as to whether it is positive or negative. The gains from operating and selling on an individual company within three to five years come, as we have seen, from several sources. And various events and decisions at the macro and company level will influence the net result. When there are so many factors and changing elements influencing the result, it seems quite unlikely that LBO funds will have any general positive effect regardless of sector, time period or the volume of the LBO activity.

There are only a limited number of academic studies. Studies on US LBO are especially interesting because they suggest that there are important differences of return within and between funds, with overall average levels of return which are far from decreasing. Like the recent study from CRESC - Centre, The University of Manchester, February 2007, Caplan and Schors US study found that average buyout returns over the period 1980-2001, after large fees have been deducted, are approximately equal to those of the big stock market companies from the S&P500 but with large "heterogeneity" in returns across funds and times. Or put another way: some funds produce high returns, but many others perform worse than publicly traded equity and even with successful funds, the overall performance will often depend on a small number of successful investments with losses on others.

In another CRECS Centre study from the University of Manchester Swenson finds that for funds formed between 1980 and 1997 both LBOs and venture capital in the US produce lower returns than public equity. These studies suggest that LBOs have not so far generated superior, average returns. These studies also show that these returns come with important warnings about variability and risks.

Mortgaging the future to capture gains for personal enrichment in the present is quite an easy activity. The task for a good manager in a public company is to resist it! Managers have to balance the interests of today's shareholders with tomorrow's shareholders and all other stakeholders including the employees. As seen in so many of our case studies, the one party unrewarded is the employees. In many cases they suffer an erosion of job security and a loss of benefits.

2.13 The societies' response - current national regulation

The legal, tax and operating environment in which a private equity industry may develop is determined largely at national/local level. Local fiduciary relationships and obligations differ widely in the various Member States. Most Member States regulate part or all of the private equity value chain. The main areas of regulation cover

- Management of funds
- Placement to eligible investors
- Tax incentives and restrictions
- Funds and product terms and conditions

Those in the industry who have developed specific products for retail consumers comply with a full range of different regulatory measures enforced by regulators with a strong mandate to protect retail investors.

As mentioned, the LBO industry would like to see less regulation and restrictions. In the EVCA report[30], one can see a list of criteria assessing the "friendliness" of the national environment for funds, managers, and investors. Among those criteria, the following are to be noted as they represent at the same time the points where possible regulatory changes would take place:

- no additional quantitative restrictions for pension funds to invest in private equity or venture capital on top of IORP directive 2003/41/EC requirements
- no geographical conditions for pension funds to invest outside EU countries
- no additional quantitative restrictions for insurance companies to invest in private equity or venture capital on top of Insurance Directive 2002/12/EC requirements
- no geographical conditions for insurance companies to invest outside EU countries
- existence of appropriate fund structure or investment vehicle to be used to invest in private equity and venture capital
- tax transparency[31] for domestic and non-domestic investors
- non-domestic investors are exempted from having a permanent establishment in the country when investing
- exemption of VAT on management fees[32]
- exemption of VAT on the carried interest[33]
- no investment restrictions
- tax incentives to encourage investment in private equity and venture capital
- the nominal company tax rate is below the EU average (26.23% including any local and municipal taxes and/or other charges on income)
- there is a special tax rate for SMEs
- there are specific fiscal scheme for supporting the creation and growth of young and innovative companies
- there are fiscal incentives on R&D
- the income tax for private individuals is below the EU average (43.03%)
- the taxation of stock options is made "upon sale" and not when they are granted, vested or exercised.

The country where all these conditions are met gets the best evaluation (1) and the worst get (3).

The table below gives an overview of the ranking of European countries according to the

[30] European Private Equity and Venture Capital association and KPMG: "Benchmarking Tax and legal environments", Dec 2006.

[31] See Glossary

[32] idem

[33] idem

EVCA findings for 2006, in comparison with previous years.

Table 1: Overview of results

■ Results tor 2006'		Results for 2004 (2)		Results for 2003(9)	
Country	Total	Country	Total Score	Country	Total Score
Ireland	1.27	United	1,25	United	1.20
France	1.36	Luxembourg	1,49	Ireland	1.58
United	1,4S	Ireland	1,53	Luxembourg	1.67
Belgium	1.51	Greece	1.75	Netherlands	1.79
Spain	1.52	Netherlands	1.75	Italy	1,96
Greece	1.55	Portugal	1.81	Greece	1,96
Netherlands	1.60	Belgium	1.82	**Total**	**2,03**
Luxembourg	1.62	Hungary	1.88	Belgium	2,0S
Portugal	1.71	Italy	1.86	France	2.09
Italy	1.72	France	1.89	Sweden	2,09
Austria	1.74	Switzerland	1.95	Spain	2.17
Denmark	1.75	Spain	1.96	Finland	2.25
Hungary	1,83	**Total Average**	**1.97**	Portugal	2.32
Switzerland	1.83	Norway	2.04	Denmark	2.S6
Total	**1.84**	Sweden	2.05	Germany	2.41
Finland	1.91	Czech	2,12	Austria	2,53
Estonia	2.08	Poland	2.13		
Norway	2.08	Finland	2.30		
Sweden	2.12	Germany	2.37		
Latvia	2,12	Austria	2,42		
Germany	2.15	Denmark	2.46		
Poland	2.1 6	Slovak	2.49		
Slovak	2.17				
Czech	2,21				
Slovenia	2.26				
Romania	2,35				

Source EVCA

Main conclusions:

- The total European average, at 1.84, indicates that the tax and legal environment create more and more incentives for private equity and venture capital in Europe.
- The gap between the best country average at 1.27 and the European average at 1.84 is smaller than the 2004 gap (1.26/1.97), However, the composite score of the lowest country in ranking (2.35) is not closer to the European average (1 .84) than the measured gap in 2004 (2.49/1.97). This means that, overall, a certain convergence is taking place in the upper part

of the table but that less mature countries still have a long way to go. This is how it looks unless we consider instead our common interest in protecting our welfare states including our tax revenues. Here, we are way off. But we have clear goals as defined by our Lisbon strategies.

On the European situation as a whole, the EVCA makes the following points as far as circumstances for LBO operations look:

- The European average for domestic fund structures is good, at 1.47. Most of the countries assessed have taken steps towards having an appropriate fund structure available in the country to attract capital from domestic and international limited partners.
- Also favourable are the environments for pension funds and insurance companies to invest in private equity and venture capital, with European averages of 1.55 and 1.42 respectively. Most countries allow those institutional investors to invest in the asset class and many of the previously existing obstacles have been abolished over the past four years.
- Very few countries are providing incentives to encourage investment in LBOs, leading to a European average of 2.04.
- As the LBO see it, Europe provides a very unfavourable environment for both company incentivisation and Fiscal R&D incentives, with European averages of 2.36 and 2.13 respectively.

From our point of view, societies' interest and our common interest in assuring a sustainable financing of the real economy, we lack:

- Adequate protection of pension funds as investors in LBOs
- Adequate incentives and rules which can ensure companies' comparative capability in the global economy through long-term investments.
- Sufficient regulations to ensure improved qualifications for employees
- The role of the social partners
- The financing of our welfare societies through taxation

The lack of coherence between different national regulations is a major problem considering the international nature of the phenomenon, but the lack of a common direction is even worse.

The Socialist Group in the European Parliament and the PES have recently, in our reports, "Europe of excellence" and "New Social Europe", underlined that Europe is not about competition among states, but among other things about assuring fair and transparent competition among companies within the single market. And Europe is about making progress for our common goals, the Lisbon goals. The main conclusions to be drawn form the trends described above is that there is on-going liberalisation and deregulation in order to attract funds and investments. And worse: without a corollary in terms of risks involved, social costs, innovation promotion and investor protection.

2.14 All in all: LBOs for good or bad?

The very rapid evolution of this private, opaque and unregulated financial industry, called LBO funds, poses a number of serious questions to the real economy in Europe and to European and national policy makers:

- The LBO effect on job creation
- The effects on investment in training and education of the labour force in the company, innovation etc. taking into account the company's investment capacity.
- Corporate governance and economics
- Protection of minority shareholders
- Management policy and shareholder activism as executed in LBOs: Stock option programs, effects on CEOs, fees for management
- Effects on public finances as a consequence of the fact that LBO funds are very often based in low - or no tax havens
- Evolution of stock markets and general market structure.
- Protection of investors - especially pension funds and insurance

These and other questions are central, when policymaking, in assuring an effective and smoothly functioning financing of the real economy.

As we have seen, the LBO industry itself is constantly trying to show its positive effects on job creation, returns etc. but this is contradicted by well-based studies and logical reflections.

First, society must, of course, consider how to avoid negative consequences on the financial markets of the heavy leverage activities from LBOs. But what our case studies show is that a substantial number of other questions are creating worries. Chief amongst them is that the social partners, representatives for employees, and their unions with a long-term stake in their companies - who are used to deal with company-minded managers - now have great difficulties in contacting or dealing with coalitions of investors whose only reference is a global financial market with an entirely new set of rules. Every investment is viewed as a portfolio of financial assets - not a place of employment.

The demand for change and better regulation seems to be growing.

3. The European response - current EU regulation

It's safe to say that there is a general legal - but not a coherent and comprehensive - basis for the regulation of alternative investment at European level. It's true that at present no tailor-made legislation exists for it. Although there is European legislation on institutional investors (see 85/611/EEC, the so-called UCITS directive), this does not as a rule apply to investors from the alternative sector - i.e. neither Hedge Funds nor Private Equity funds as such.

UCITS (Undertakings for Collective Investment in Transferable Securities) are specially constituted collective investment portfolios exclusively dedicated to the investment of assets raised from investors. Under the UCITS Directive, UCITS investment policy and its manager are authorised in accordance with specific requirements. UCITS' legislation aims to establish a defined level of investor protection. This is achieved through strict investment limits, capital and disclosure requirements, as well as asset safe-keeping and fund oversight provided by an independent depositary. UCITS benefit from a 'passport' allowing them, subject to notification, to be offered to retail investors in any EU jurisdiction once authorised in one Member State.

From the positive experience of the UCITS Directive, the UCITS funds developed very well after the adoption of the Directive in 1985 as it proved to be a very efficient way to develop a real Single Market for such a financial product while not harming investors' protection. Thanks to this Directive, UCITS benefit from a 'European label/brand', which is now a tool to export pan-European expertise at worldwide level (e.g. two thirds of funds currently registered in Hong-Kong are European UCITS).

However, there are several limits to the current framework of alternative investments in the EU. Currently onshore hedge funds/funds of hedge funds/private equity funds are fragmented through divergent national regulations. So, there is still a long way to go, in developing a Single Market for such onshore alternative investment vehicles.

No actual EU regulatory framework is provided for onshore alternative investments. A good next question is: what about offshore or non-EU regulated products?

The European Commission (Commissioner McCreevy) wishes clearly to develop the so-called 'Private Placement': i.e. the ability for a firm registered in the EU to sell any type of product (including offshore funds or non-EU regulated product) in the EU, to so-called 'qualified investors' (i.e. professional investors: insurance companies, pension funds, etc).

Our concern is that the final risk will be borne anyway by the end investor (e. g. retirees, retail investors) as unit-linked life insurance and 'defined contribution' retirement saving products develop. Therefore we think that it is necessary to provide a minimum safety net for alternative products to be sold in the EU.

In addition to giving increased investor protection, a EU regulatory frame for alternative investments (direct hedge funds/funds of hedge funds; private equity funds) could provide a success similar to the UCITS case. Within the EU, a regulated framework would help develop a Single Market for alternative investments, with the right level of investor protection and possible overseeing by regulators. Out of the EU, a 'non-UCITS fund' Directive would help develop a 'non-UCITS fund' brand which would be a serious competitor to offshore and non-EU hedge funds/private equity funds.

This proposal would take into account the fact that these funds are to be found largely outside EU sovereign territory and so are not accessible to direct EU-regulation. However, although the funds themselves are located offshore, the managers generally run their businesses in the large financial centres (especially London and New York). It would be then possible to make managers and their business partners – for example, prime brokers or hedge fund managers – the addressee of such regulation. In fact, they are already partly covered by some directives. Nevertheless, this does not deal with all the relevant potential consequences of alternative investment strategies. More has to be done.

Before giving an overview of what exists in terms of regulation at EU level, one should keep in mind the aims a regulation of alternative investment should pursue:

- It can and should protect investors. This is the principal consideration of the EU Commission and conventional regulatory methods. Rules serving this end are also directed towards the auditability of the investment products on offer.
- The object of the investment itself, in other words: how can we promote initiatives which can improve the basis upon which the employer together with his employees and creditors can sustain their legal environment, and thereby avoid negative eventualities (above all, leveraged buy-outs, 'asset stripping').
- It should be possible to register the investor or his business partner as a formal undertaking, which is subject to the usual corporate standards.
- The employees of the enterprise in question should be able to assert their social rights and have them respected by alternative investment actors.
- Typical risks pertaining to alternative investment should be framed in order to guarantee a sound functioning of financial markets in the common interest.

3.1 The single financial market - basic principles and common rules

Right of establishment, (Articles 43-48 of the EU Treaty); Freedom to provide services (Article 49)

The right of establishment, set out in Article 43 of the Treaty and the freedom to provide cross border services, set out in Article 49, are two of the "fundamental freedoms" which are central to the effective functioning of the EU Internal Market.

Article 43

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

Article 49

Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.

The Council may, acting by a qualified majority on a proposal from the Commission, extend the provisions of the Chapter to nationals of a third country who provide services and who are established within the Community.

The principle of freedom of establishment enables an economic operator (whether a person or a company) to carry on an economic activity in a stable and continuous way in one or more Member States. The principle of the freedom to provide services enables an economic operator providing services in one Member State to offer services on a temporary basis in another Member State, without having to be established.

The principles of freedom of establishment and free movement of services have been clarified and developed over the years through the case law of the European Court of Justice. In addition, important developments and progress in the field of services have been brought about through specific legislation in fields such as financial services, telecommunications, broadcasting, the recognition of professional qualifications and the services directive.

These provisions have direct effect. This means, in practice, that Member States must modify national laws that restrict freedom of establishment, or the freedom to provide services, and are therefore incompatible with these principles. This includes not only discriminatory national rules, but also any national rules which are universally applicable to domestic and foreign operators but which hinder or render less attractive the exercise of these "fundamental freedoms", in particular if they result in delays or additional costs. In these cases, Member States may only maintain such restrictions in specific circumstances where these are justified by overriding reasons of general interest, for instance on grounds of public policy, public security or public health; and where they are proportionate.

The Financial Services Action Plan 1999-2005 (FSAP) has laid the foundations of a financial market in the EU.

3.2 The Treaty

Free movement of capital, Articles 56-60 of EU Treaty

The treaty articles on free movement of capital intend to create the basis for regulations, assuring integrated, open, transparent, competitive and efficient European financial markets and services.

Article 56

1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries *shall be prohibited.*

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

Article 57

1. The provisions of Article 56 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment – including in real estate – establishment, the provision of financial services or the admission of securities to capital markets. In respect of restrictions existing under national law in Estonia and Hungary, the relevant date shall be 31 December 1999.

2. Whilst endeavouring to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to the other Chapters of this Treaty, the Council may, acting by a qualified majority on a proposal from the Commission, adopt measures on the movement of capital to or from third countries involving direct investment – including investment in real estate – establishment, the provision of financial services or the admission of securities to capital markets. Unanimity shall be required for measures under this paragraph as they constitute a step back in Community law as regards the liberalisation of the movement of capital to or from third countries.

For citizens it means the ability to do many things abroad, as diverse as opening bank accounts, buying shares in non-domestic companies and investing. For companies it principally means being able to invest in and own other European companies and take an active part in their management.

The liberalisation of capital movements in the EU was agreed in 1988 (Directive 88/361/EEC) and came into effect in 1990 for most Member States, while for the rest specific transitional periods were agreed.

There are exceptions to the free movement of capital both within the EU and with third countries. These are actually primarily linked to taxation, prudential supervision, public policy considerations, money laundering, and financial sanctions agreed under the Common Foreign and Security Policy.

3.3 Common rules

Abolishing national restrictions goes hand in hand with the necessity to intervene directly at the legislative level, in order to bring some coherence to different national systems and practises. The FSAP mentioned above has created the foundations for the financial services market with 42 texts adopted all soon to be in force. The Action Plan launched in 1999 suggested indicative priorities and time-scales for legislative and other measures to tackle three strategic objectives, namely ensuring a Single Market for wholesale financial services, open and secure retail markets and state-of-the-art prudential rules and supervision. Among the different texts adopted in the EU to achieve the single market for financial services, one could mention the following directives:

*Directive 2003/71/EC on “the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC” (Prospectus Directive).

The purpose of this Directive is to harmonise requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Member State.

*Directive 2004/109/EC on “the harmonisation of transparency requirements in relation to information bout issuers whose securities are admitted to trading on regulated market and amending Directive 2001/34/EC” (Transparency Directive).

The purpose of this directive is to establish requirements in relation to the disclosure of periodic and ongoing information about issuers whose securities are already admitted to trading on a regulated market situated or operating within a Member State. This directive sets out the rules governing the issue of annual and semi-annual financial reports for securities issuers.

*Directive 2003/6/EC on “on insider dealing and market manipulation (market abuse)”.

The directive prohibits any person who possesses inside information from using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates. This directive also sets out measures to combat market manipulation.

*Directive 2004/39/EC on “markets in financial instruments amending Directives 85/611/EEC, 93/6/EEC and 2000/12/EC and repealing Directive 93/22/EEC” (MiFID).

The directive addresses investment firms and regulated markets whereby the home Member State shall ensure that the authorisation specifies the investment services or activities the investment firm is authorised to provide. The authorisation shall be valid for the entire Community and shall allow an investment firm to provide the services or perform the activities, for which it has been authorised, throughout the Community, either through the establishment of a branch or the free provision of services.

*Directive 2001/65/EC “amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions” (4th & 7th Company Law Directives).

In order to maintain consistency between internationally recognised accounting standards and Directives 78/660/EEC, 83/349/EEC and 86/635/EEC, it was necessary to amend these Directives in order to allow for certain financial assets and liabilities to be valued at fair value. This will enable European companies to report in conformity with current international developments.

*Regulation (EC) 1606/2002 on the application of international accounting standards (IAS Regulation).
The Commission proposed that all EU companies listed on a regulated market (estimated at around 6,700) should be required to prepare consolidated accounts in accordance with IAS. Finally, this led to adoption of the IAS Regulation introducing the International Financial Reporting Standards (IAS/IFRS) for listed companies in the EU.

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As we can see from this partial list, EU competence covers a wide range of issues. The implementation question is now key. There is the need for safeguards and EU-initiatives to promote a forward looking, subordinate relationship between the financial market and the real economy.

3.4 Company law and corporate governance (shareholders rights)

In the fields of company law and corporate governance, the EU objectives include: providing equivalent protection for shareholders and other parties concerned with companies; ensuring freedom of establishment for companies throughout the EU; fostering efficiency and competitiveness of business; promoting cross-border cooperation between companies in different Member States; and stimulating discussions between Member States on the modernisation of company law and corporate governance.

Here a long list of directives has been adopted ranging from the formation of public limited liability companies and the maintenance and alteration of their capital (Directive 2006/68/EC) to cross-border mergers of limited liability companies (Directive 2005/56/EC), takeover bids (Directive 2004/25/EC), disclosure requirements in respect of certain types of companies (Directive 2003/58/EC), and Directive 2001/86/EC supplementing the Statute for a European company with regard to the involvement of employees. A Directive regulating shareholders voting rights is currently under scrutiny by both EU legislators and a debate is taking place on whether one share should mean one vote.

The Take-over Directive applies to takeover bids for the securities of a company governed by the law of a Member State if those securities are admitted to trading on a regulated market in one or more Member States. The scope of the companies and merger transactions covered by Directive is narrow. However, Member States can choose to regulate a wider range of companies and merger transactions if they want to.
The general principles in the Directive are:

- *All holders of the securities of an offeree company of the same class must be given equal treatment - in particular, if a person acquires control of a company, the other holders of securities must be protected.*
- *Holder of securities in an offeree company must have sufficient time and information to enable them to react a properly informed decision on the bid - the board of the*

offeree company must give its views on the effects of the bid on employment, conditions of employment and the company's business locations.

- *The board of the offeree company must act in the interest of the company as a whole, and must not deny the holders of securities the opportunity to decide on the merits of the bid.*
- *False markets must not be created in the securities of the offeree company, the offeror company or any other company concerned by the bid in such a way that rise or fall in the prices of the securities becomes artificial and the normal functioning of the market is distorted.*
- *An offeror may only announce after ensuring that it can fulfil in full any cash consideration it offers and after having taken all responsible measures to secure the implementation of any other type of consideration.*
- *Offeree companies must be hindered in the conduct of their affairs for longer than responsible by a bid for their securities.*

As far as the hedge fund and Private Equity industry is concerned, however, Art. 47 para 2 EC is a more obvious regulatory norm but its application must be considered on a case by case basis. Regulations in this area have the aim of coordinating legal and administrative provisions on the commencement of independent activities. A regulation could therefore apply in the case of investment companies themselves. Fundamental money market legal provisions are already founded on Art. 47 of the European Treaty: for example, the Markets in financial instruments directive (MiFiD). Particularly the Directive on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) is based on this regulation.

MIFID introduces more detailed requirements covering: the organisation and conduct of business of investment firms, and how regulated markets and MTFs (Market trading facilities) operate; new pre-and post-trade transparency requirements for equity markets; the creation of a new regime for 'systematic internalisers' of retail order flow in liquid equities; and more extensive transaction reporting requirements.
Types of firms to be regulated by the MiFID requirements are: investment banks; portfolio managers; stockbrokers and broker dealers; corporate finance firms; many futures and options firms; some commodities firms.
Most firms that fall within the scope of MiFID will also have to comply with the new Capital Requirements Directive (CRD), which is similar to Basel II, which will set requirements for the regulatory capital which a firm must hold.
MiFID will require transaction reports for any instrument admitted to trading on a regulated market including commodity instruments e.g electricity, oil and metals admitted to trading on exchange.

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Looking to the challenges of offshore activities, there is much work to do. In accordance with Article 56 of the European Treaty – free movement of capital and payments, there is in principle a comprehensive prohibition on restrictions also in relation to third countries, which may be limited only under the conditions laid down in the exceptional provisions of Art. 57–59.

Article 59
Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB, may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary.

For the regulation of offshore investors or their on-shore resident business partners the basis of authorisation of Art. 57 para 2 EC can be taken into consideration. According to that, only the EU, more precisely the Council at the proposal of the Commission, can enact new restrictions (which hasn't happened since 1993) on capital movements with third countries, in connection with direct investments, including real property, with the registered office, the furnishing of financial services, or the listing of securities on the capital markets. The aim is to ensure the EU's capacity to act in negotiations and dealings with third states. Direct investments in accordance with Art. 57 EC include the foundation, takeover or participation in an undertaking, long-term loans or re-investment of proceeds with the aim of creating or maintaining lasting business relations.

3.5 Employees rights, social governance of companies

Art.308 EC comes into consideration when the matter in hand is the closing of gaps in EU competences in the area of the single market while fulfilling the goals given by the EU Treaty without widening them. This provision was brought in for Directive 2001/86/EC to supplement the statute on the European company in relation to workers' participation, which remains contentious. Regardless of the fact that this provision can only come into consideration in the second degree this has limited value for shaping policy: the provision requires unanimity in the Council and requires merely only consultation of the European Parliament.

Article 308:
If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community, and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, take the appropriate measures.

In its Communication on worker information and consultation [COM(95) 547 final - not published in Official Journal], the Commission took stock of Community action in the field of information, consultation and participation of employees. Some directives have already been adopted in this area ("collective redundancies ", "transfers of undertakings" and " European Works Councils "), while other proposals have not yet been finalised (" European company ", " European association ", " European cooperative ", " European mutual society ").

Despite the existence of specific provisions on employee information and consultation, the Commission emphasised the need to redefine the Community legal framework in order to establish more binding rules and presented a proposal for a Directive, the objective of which was to establish a general framework for employee information and consultation in undertakings located in the European Community.

The Directive 2002/14/EC of the Council and the European Parliament of 11 March 2002 establishing a general framework for informing and consulting employees mentions that employee information and consultation cover three areas in relation to undertakings:

- economic, financial and strategic developments;
- structure and foreseeable development of employment and related measures;
- decisions likely to lead to substantial changes in work organisation or contractual relations.

Member States must establish the procedures for applying the principles set out in the Directive, with a view to ensuring the effective application of employee information and consultation. They also have the option of limiting the information and consultation obligations of undertakings with fewer than 50 or 20 employees according to the Member State's discretion.

The following are regarded as serious breaches of the obligations laid down in the Directive:

- total absence of information and/or consultation of the employees' representatives prior to a decision being taken or the public announcement of such decision;
- withholding of important information or provision of inaccurate information rendering ineffective the exercise of the right to information and consultation.

In the event of a serious breach with direct and immediate consequences in terms of substantial change or termination of employment contracts or relationships, the decisions taken have no legal effect. This situation continues until such time as the employer has fulfilled his information and consultation obligations. If this is no longer possible, the employer must establish adequate redress in accordance with the arrangements and procedures in place in the Member States.

Since economic trends are bringing in their wake, at both national and Community level, changes in the structure of undertakings, there is a need to provide for the protection of employees in the event of a change of employer, and in particular to ensure that their rights are safeguarded. To that end, the Council Directive 77/187/EEC on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of businesses foresees that the rights and obligations arising from a contract of employment or from an employment relationship existing at the time of the transfer are transferred to the new employer. Member States are required to adopt the necessary measures to protect the rights of employees and of persons no longer employed in the transferor's business.

The transfer does not constitute grounds for dismissal, which may only take place for economic, technical or organisational reasons or when Member States make exceptions in respect of certain specific categories of employees.

The status and function of employees' representatives are preserved unless, under the provisions or practice of a Member State, the conditions necessary for re-appointment of employees' representatives are fulfilled.

The former employer and the new employer are required to inform the representatives of their respective employees in good time of the reasons for the transfer, the legal, economic and social implications, and the measures envisaged in relation to the employees. This information must be given for the employees transferred before their transfer is carried out and in any event for all employees before they are directly affected as regards their conditions of work and employment. When the former employer or the new employer envisages measures in relation to their employees, they must consult the employees' representatives in good time with a view to seeking agreement.

It should be also underlined that referring to Art. 137 i lit. f of the EU treaty, the European Commission is provided with a power of initiative to create a European provision on obligatory employee involvement on boardrooms as a European wide standard.

Article 137

1. With a view to achieving the objectives of Article 136, the Community shall support and complement the activities of the Member States in the following fields:

a) improvement in particular of the working environment to protect workers' health and safety;

b) working conditions;

c) social security and social protection of workers;

d) protection of workers where their employment contract is terminated;

e) the information and consultation of workers;

f) representation and collective defence of the interests of workers and employers, including co-determination, subject to paragraph 5;

g) conditions of employment for third-country nationals legally residing in Community territory;

h) the integration of persons excluded from the labour market, without prejudice to Article 150;

i) equality between men and women with regard to labour market opportunities and treatment at

j) work;

k) the combating of social exclusion;

l) the modernisation of social protection systems without prejudice to point (c).

2. To this end, the Council:

a) may adopt measures designed to encourage cooperation between Member States through initiatives aimed at improving knowledge, developing exchanges of information and

best practices, promoting innovative approaches and evaluating experiences, excluding any harmonisation of the laws and regulations of the Member States;
b) may adopt, in the fields referred to in paragraph 1(a) to (i), by means of directives, minimum requirements for gradual implementation, having regard to the conditions and technical rules obtaining in each of the Member States. Such directives shall avoid imposing administrative, financial and legal constraints in a way which would hold back the creation and development of small and medium-sized undertakings. The Council shall act in accordance with the procedure referred to in Article 251 after consulting the Economic and Social Committee and the Committee of the Regions, except in the fields referred to in paragraph 1(c), (d), (f) and (g) of this article, where the Council shall act unanimously on a proposal from the Commission, after consulting the European Parliament and the said Committees. The Council, acting unanimously on a proposal from the Commission, after consulting the European Parliament, may decide to render the procedure referred to in Article 251 applicable to paragraph 1(d), (f) and (g) of this article.

3. A Member State may entrust management and labour, at their joint request, with the implementation of directives adopted pursuant to paragraph 2.

In this case, it shall ensure that, no later than the date on which a directive must be transposed in accordance with Article 249, management and labour have introduced the necessary measures by agreement, the Member State concerned being required to take any necessary measure enabling it at any time to be in a position to guarantee the results imposed by that directive.

4. The provisions adopted pursuant to this article:

— shall not affect the right of Member States to define the fundamental principles of their social security systems and must not significantly affect the financial equilibrium thereof,

— shall not prevent any Member State from maintaining or introducing more stringent protective measures compatible with this Treaty.

5. The provisions of this article shall not apply to pay, the right of association, the right to strike or the right to impose lock-outs.

3.6 Supervision

The Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate introduces group-wide supervision of financial conglomerates and requires closer co-operation and information sharing among supervisory authorities across sectors. The directive also introduces initial steps to align the rules for financial conglomerates with those for homogeneous financial groups (dealing in a single financial sector, such as banking) so as to ensure equivalence of treatment and a level playing field.

One can imagine using the framework of this Directive to supervise the activities of banks acting as intermediaries for the alternative investment industry. In that case, the Capital adequacy requirement directive (CRD) would be one tool. But in general, any thorough supervision of the funds themselves would require a specific regulatory framework because their characteristics differ from those of credit institutions or insurance companies. The national authorities would be the competent ones in this area, within the cooperation framework of CESR (Committee of European securities regulators).

The previous (1988) Basel Accord constitutes the international benchmark for capital adequacy and is agreed by the G-10 banking supervisors in the Committee on Banking Supervision of the Bank for International Settlements (known as the Basel Committee). Like the Basel Committee's rules, the new EU capital standards aim to align regulatory capital requirements more closely with underlying risks and to provide institutions with incentives to move to higher standards of risk management. The Directive (**CRD**), which is one of the outstanding measures required to complete the EU Financial Services Action Plan, will modernise the existing framework to make it more comprehensive and risk-sensitive and to foster enhanced risk management amongst financial institutions. This will maximise the effectiveness of the framework in ensuring continuing financial stability, maintaining confidence in financial institutions and protecting consumers. Improved risk-sensitivity in the capital requirements will facilitate more effective allocation of capital, contributing to boosting the competitiveness of the EU economy.

A key aspect of the new framework is its flexibility. This provides institutions with the opportunity to adopt the approaches most appropriate to their situation and to the sophistication of their risk management.

The new regime is also designed to ensure that the capital requirements for lending to small- and medium-sized enterprises (SMEs) are appropriate and proportionate.

CESR is an independent Committee of European Securities Regulators. The Committee was established under the terms of the European Commission's Decision of 6 June 2001. It is one of the two committees envisaged in the Final Report of the Committee of Wise Men on the regulation of European securities markets, chaired by Baron Alexandre Lamfalussy. The report itself was endorsed by Heads of State in the European Council (Stockholm Resolution of 23 March 2001) and the European Parliament (European Parliament Resolution of 5 February 2002).

In summary, the role of CESR is to:

- Improve co-ordination among securities regulators : developing effective operational network mechanisms to enhance day to day consistent supervision and enforcement of the Single Market for financial services; Having agreed a Multilateral Memorandum of Understanding (MoU) , CESR has made a significant contribution to greater surveillance and enforcement of securities activities;
- Act as an advisory group to assist the EU Commission: in particular in its preparation of draft implementing measures of EU framework directives in the field of securities;

- Work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States: this work is carried out by the Review Panel under the Chairmanship of CESR's Vice Chairman, and by the two operational groups: CESR-Pol and CESR-Fin.

3.7 Tax policy

The EU has at its disposal a legal basis for regulations relating to tax law only in the area of indirect taxes, with Art. 93 EC. If in the future an EU competence for a uniform basis of assessment for corporate taxes is introduced could further steps be envisaged for the taxation of alternative investment?

Article 93:
The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 14.

The directives on the taxation of savings income (2003/48/EC) and the Parent subsidiary directive (2003/123/EC) should be relevant for the alternative investment sector. The former has the aim of taxing interest earnings at the actual place of residence of the beneficiary. Here it is not the investment companies but the investors themselves who are subject to the tax.

The aim of the **Directive on the taxation of savings income** is to enable savings income, in the form of interest payments made in one Member State to "beneficial owners" who are individual residents for tax purposes in another Member State, to be made subject to effective taxation in accordance with the laws of the latter Member State. The automatic exchange of information between Member States concerning interest payments is the means chosen to achieve effective taxation of these "interest payments" in the Member State where the beneficial owner is resident for tax purposes. Member States must therefore take the necessary measures to ensure that the tasks necessary for the implementation of this Directive - cooperation and exchange of banking information - are carried out by paying agents established within their territory, irrespective of the place of establishment of the debtor of the debt claim producing the interest.

The **Council Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States** as amended by Directive 2003/123/EC, is applicable by each Member State: 1) to distributions of profits received by permanent establishments situated in that State of companies of other Member States which come from their subsidiaries of a Member State other than that where the permanent establishment is situated; 2) to distributions of profits by companies of that State to permanent establishments situated in another Member State of companies of the same Member State of which they are subsidiaries.

In summary: For the regulation of investors, Hedge Funds and Private Equity Funds, several legal bases are available, depending on the specific regulatory aim.

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4. Conclusion: New Social Europe and the financial markets - increasing contradictions!

In summarising our analyses in Part I, it is essential to understand that “the alternative investment industry” in the financial markets is not a phenomenon of marginal importance or just another time-limited “bubble” of interests, which will go away sooner or later.

The HF and PE funds are dominant and fast growing actors in the European and global capital markets.

Until recently, PE and HF only had real influence in the UK and Irish financial markets, as well as Luxembourg and Lichtenstein. This has changed fundamentally in the past ten years. The direction is clear. The big international funds, especially those based in the USA and the UK, have now really engaged in Europe, acquiring an increasing number of ever larger companies and projects on our continent.

The figures speak for themselves: in the period 2002-2005 the PE funds invested 165 billion Euros in companies in Europe. In the single year of 2006, the target volume was 270 bn Euros. In 2007 the PE industry is planning for 580 take-overs worth of 380 bn Euros. Given that the average leverage compared to acquisition price is 75%, we can estimate the total volume of potential buy-out capacity at around 1,500 bn Euros.

All the nuances of our analysis in part I suggest that the trends and developments of PE and HF have very clear common characteristics and implications.

The rapid growth of the hedge fund industry is also raising important questions about systemic risks ie. the risk of destabilisation of the financial markets, market abuse, i.e. potential market price manipulation and insider trading, and misbehaviour in shareholder activism.

Hedge funds have shown impressive growth to become a very important alternative investment instrument - for good and, unfortunately, also for bad – not only the risk of their destabilising the financial markets but also that its interests conflict with corporate business's need for long-term investment in the global economic competition. The international character of hedge fund industry and its de facto unregulated activities, challenge our societies and authorities.

The possible implications of hedge funds for financial stability are not only a problem for the hedge funds. If its risks are realised the consequences will be dire for corporate industries, employment, and other investment, well as pensioners' savings.

The PE industry, especially LBO funds, poses a number of serious questions to Europeans, their real economies and national policy makers. LBO activities have worrying implications for job creation, companies' investments in training and education of the labour force, innovation, and corporate governance. They also have disturbing implications for public finances, the evolution of stock markets and protection of wage earners money in pension funds. Of equal concern are extreme management fees and the LBOs' aggression towards target managements.

All in all, there is a straightforward argument for reducing the risks and negative implications associated with the increasing role of HF and PE funds in the financial system. There has always been a good case for regulating banks and investment banks and other financial actors - why should hedge funds and private equity be any exception?

Primarily, however, society must involve itself in how to avoid the negative consequences of the heavy leverage activities from LBOs. We can see from our case studies a substantial number of companies having serious difficulties after an LBO. Long-term investment in companies to strengthen global competitiveness becomes increasingly difficult to realise because of the desire for short-term financial gains. This is because every investment in the world of PE funds and LBOs is viewed as a portfolio of financial assets, not a place of employment.

In the introduction to this part I, we posed the question: "Does this new HF and PE industry respond to our investment needs for Europe's knowledge-economy?" After analysis the answer is that unfortunately, in far too many cases, there is a contradiction between the investment needs of the real economy, the way it works, and the cohesion between the different actors in the society - and the financial market. There is, therefore, an increasing need for change and better regulation.

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PART II - Six concerns about our European social market economy

Social Europe versus capital markets

The description and analysis in part I of the actual trends and functioning of the capital markets show that as far as Europe's Lisbon process towards a New Knowledge Economy is concerned, there is evidence of positive contributions, but first and foremost new risks and major contradictions from the capital markets. This especially applies to the activities of hedge funds and LBOs.

Let it be clear that the modern, real economy needs well-functioning, effective financial markets to ensure the implementation of long-term investment.

But it is also clear from our analyses in part I that the financial markets do not automatically respond in a subordinate and optimal way to the real economy - the social market economy of social Europe, as formed by our democratic societies.

Some managers or representatives from hedge funds and PE industries seem to argue on the basis of a well known but old-fashioned economic theory: The neo-classical model with perfect information, perfect capital markets and perfect competition is often their frame of reference. But that is a model that that does not accurately depict the modern economy in our part of the world.

Theoretical developments in imperfect capital markets over the past twenty years explain why total deregulation of capital markets may lead to instability and obstacles to growth. This development contradicts in many ways neo-classical market thinking, especially given the important role of imperfect information or asymmetric information leading to credit and equity rationing in modern finance.

These simplistic models, combined with the PE-industry's ideology and interests have too often played a dominant role in our discussion of globalisation. The argument is that free markets automatically must be welfare enhancing. But we have known for many years that when markets are imperfect, when information is limited or asymmetric, conditions cannot be optimal. And, as we have seen in Part I, the implications of this are giving cause for concern in our societies.

In a number of fields in our social market economy, we see subordination to the logic of financial markets: the declining rate of real investment as a percentage of cash flow; the steady increase of dividends and extreme executive salaries, stock options, and management fees - and even less income retained internally in companies as LBOs extract more value; the decline of capital stock relative to the gross profit; investment in R&D stagnating or declining as a percentage of expenditures; and deteriorating working conditions.

We are concerned about the financial effects of the LBOs and hedge fund industries on some of the most important issues:

- The effects on the efficiency of capital markets. Lack of transparency, information asymmetry, insider trading - all contribute to inefficiency and imperfect markets.
- Effects on the productivity and long-term growth of the firms and industries in which HF

& LBOs invest. It increases financial risks requiring preoccupation with cash flow and reduces capacities to invest and manage long-term efficiency, productivity and innovation.

- The effects on our public sector and the special public-service obligations of firms in the infrastructure and public housing sectors. It minimises or abandons those obligations and undermines the risks allocated by public bodies through re-evaluations - this is the basis for additional cash withdrawals to the LBO fund.
- The lack of transparency. This is not just an incidental characteristic of HF & LBOs. Unnecessary and costly complex holding structures are created - effectively making it impossible for anyone to lift the corporate veil. This again has detrimental effects on all parties with an interest in the firm - regulators, tax authorities, trade unions and others. One cannot rule out that it is a device LBOs use to weaken the negotiating position of everyone they deal with.
- The incentives created for CEOs of the target company are extremely high and threaten the efficient management of all potential target companies.

Our case studies confirm the risks and negative impacts for our social Europe.

The PES Group in the European Parliament has, in its report “Europe of Excellence”, highlighted our vision for a modern, coherent European knowledge economy in the globalisation era. The PES Group has also recently joined the roadmap for New Social Europe as decided at the PES Congress, in Porto December 2006.

That is the basis for our six concerns as outlined here in Part II of the report:

- The economic viability of our private companies in member states all over Europe. Their investment capability, employees, education and qualifications, innovation and global competitiveness.
- Decent work and workers’ participation.
- Our public sector and services
- Employees, pension funds, investments and long-term real value
- Stability of financial markets
- Coherence, co-responsibility and ethics

Our reflections on the implications on all of these six issues will also mirror our concerns for the social market economy as a whole, our social Europe.

These concerns must be met with a new offensive response as we will show in Part III

1. Economic viability of private companies

Private companies in Europe are faced by a huge competitive challenge from the global economy. To ensure Europe will be “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social coherence” - we must enhance our private companies and ensure great investment to promote innovation, technological renewables, permanent education and improved qualification of workforces in our social Europe.

Therefore, the interplay between our ambitions for social Europe, our firms and the financial markets are of fundamental importance.

1.1 Corporate governance

Concerns have been raised about the impact of hedge funds and LBOs on the governance of companies and the lack of transparency in their operations.

In the case study of **Deustche Börse** it is described how hedge funds managed to fire the CEO, Werner Seifert, as he wanted the company to move into another direction than the hedge funds.

In the case study of **Stork** it is described how the hedge funds have bought up a large amount of shares without disclosing this ownership to the public. The procedure used is under investigation.

As we have seen in Part I, the strategy of LBOs to take total corporate control after acquisitions creates a risk of deterioration in corporate governance. Funds tend to try to keep the conditions and form of their investments as opaque as possible with the justification that investors in such funds are professionals who are able to obtain the necessary information any time they want. The activities of such funds, however, are a matter of concern not only for the investors themselves but for the market and society as a whole since these activities can have wide-ranging effects. The approach to risk of investors and management alike, conditioned by the shareholder value approach, is further exacerbated by LBOs. As a result, management is increasingly frequently operating in grey areas. Regulatory measures are therefore also necessary in the interests of corporate governance and the stakeholders involved.

However, there is more to corporate governance, or good business management, than merely looking after shareholders' interests. It is a stakeholder-based approach and therefore widens the scope of a company. It cannot be evaluated purely in terms of performance or financial management, but must include the care of a company's human resources, employee participation and the pursuit of environmental and social goals.

The experience of our case studies and numerous reports shows that LBOs are not motivated to take sufficient account of such interests. LBOs' regular, brief interventions in management strategy and daily decision-making often do more harm than good in the quest for sustainable corporate development.

The impact of capital funds on the way that companies operate extends far beyond the – until now relatively limited – number of companies that have been bought out by private equity funds or suffered speculative attacks by hedge funds. Indeed it seems likely from theoretical considerations and some anecdotal evidence – even if difficult to prove with hard data – that the activities of such funds have affected the behaviour of a very large number of companies, both publicly-listed large and medium sized and family-owned SMEs. Indeed, in principle all but the smallest companies are affected, and thus the impact on the functioning of the economy as a whole can be expected to be substantial.

This indirect effect results essentially in the preventive measures taken by managers and owners to ward off unwanted approaches by private equity and hedge funds. In many cases the negative impacts are similar, if less pronounced, than those identified in those firms actually taken over.

In particular, incumbent managers of listed companies are expected to be increasingly concerned, if not obsessed, by the short run share price: a high share price is the best deterrent to a hostile takeover. A depressed share price – for whatever reason – will quickly attract the interest of capital funds looking for quick profits. This is likely to have a series of negative consequences. Large-scale investment projects, particularly those with a long payback period may be cancelled or postponed, as managerial planning horizons collapse to the demands of quarterly reporting deadlines and their priorities focus on the latest fad that, for a short period, is at the top of the likes or dislikes list of 'the market'. In particular, jobs may be axed to offer investors some 'good news'. Dividends are likely to be pushed up at the expense of real investment and the company's human capital. Some firms engage in macroeconomically irrational share buyback schemes. Others rush into mergers and takeovers that lack a genuine economic rationale merely to avoid an unwelcome takeover bid or speculative interest. Ultimately managers are forced into Enron-style false accounting. More generally the pressure on other stakeholders, and especially workers, as described in section 2, is likely to be ratcheted up.

1.2 Growth and financing

A 2005 study by PricewaterhouseCoopers (PwC), commissioned by the German organisation BVK, attempts to document the allegedly positive effects of the growth of private equity investments with figures from the companies they interviewed: over a five-year period from 2000 to 2004, the average turnover of German target enterprises grew by approximately 10 per cent with PE funds. The average growth of the German gross domestic product was only 1.6 per cent in this period. Moreover, the average growth in turnover of all German companies in the same period amounted to a mere 0.1 per cent. But on closer examination this illustration appears problematic. Numerous factors influence the gross domestic product and these do not make for a sensible comparison with LBO target enterprises.
There simply limits to what you can compare!
Even a comparison with all German companies is problematic. LBO funds deliberately select target enterprises that already promise success without their help and which are therefore already way above average. The turnover of these companies would have grown substantially as a rule without any influence from LBOs.

> In the case study of **DT Group** it is described how the number of employees has increased with 10% since the take over. However this is due to acquisitions of formerly privately owed building markets. Direct investment in property and equipment is lower than before the take over.

Here, too, the specific contribution of PE funds cannot really be proved - and one certain effect of LBO-operations is that internal debt in the targeted companies is heavily increased and the future investment capability correspondingly deteriorates.

Yet, even if it is assumed that the involvement of private equity investors - in some cases - can actually improve the efficiency of a business by breaking the managerial decision-making and supervisory monopoly, this statement frequently does not tell the whole story. In many instances, costs are not ultimately reduced but are merely offloaded by the company onto a third party. This means that, although the enterprise saves on labour costs by cutting jobs, it is not automatically strengthening the company's dynamics, qualifications and motivations. And it is effectively burdening society with the cost of the unemployment it creates.

Small and medium-sized enterprises are caught in a dilemma. Because of the tighter creditworthiness requirements to be imposed on companies by the new rules on capital adequacy for financial institutions (Basel II), there will be more cases in which businesses can no longer obtain any credit from their banks, or can only borrow at very expensive rates.

For such businesses equity investments - most constructively in the form of venture capital - often seem to be the only means of obtaining the capital they need to convert research findings or innovations into commercial products. It is also asserted that SMEs' preferred source of funding, namely bank loans, are not suited to this purpose, since the risk of failure is high, and small businesses cannot provide the requisite security. Since many small and medium-sized enterprises have no access to the capital market either, private equity, in the form of venture capital, is an ideal way to bridge the gap. Existing owners may even preserve their own entrepreneurial autonomy if contracts are so formulated[1]. Unfortunately, venture capital funds play very little part in the total of PE fund operations in Europe.

LBO investors, on acquisition of a listed company, generally have a short-term to medium-term stake meaning that the capital is not permanently available to the company. This creates comparative problems when long-term investment has to be decided and financed.

Moreover, current examples testify to the fact that LBO-managers have high expectations of a company's short-term growth and profit potential. LBO investments are not suitable as a bridging facility to deal with cash-flow problems, and certainly could not serve as a universal solution to the shortage of equity among small and medium-sized businesses.

Furthermore, acquired companies are themselves often dissatisfied with the contribution of LBO funds. This finding emerged from a study conducted by Wiesbaden University of Applied Sciences (Fachhochschule Wiesbaden) in 2003 on behalf of the private-equity firm Cornerstone Capital. The study examined the contribution of private-equity investors to increases in the value of companies. The researchers surveyed companies in which a LBO fund manager held shares and which had been sold within the previous four years.

The respondents confirmed that the main contributions made by LBO investors were in the domains of finance, accounting and reporting. By contrast, 70% stated that they had received no support for the improvement of processes and structures. Cornerstone managing partner Pieter van Halem summarised the findings of the study by saying it showed that most LBO investors still saw themselves as providers of capital but were unable to offer any genuine strategic benefits[2].

1.3 Asset extraction[3] and innovation

We have no interest in demonising PE funds. We are on the contrary insisting on a nuanced picture, based on our comprehensive analyses and case studies.

Private equity funds, especially venture capital funds, have been very helpful in providing investment in some innovative start-ups. Furthermore, they have sometimes paved the way for successful processes of corporate restructuring, i.e. processes improving governance and/or the

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1 See German Private Equity and Venture Capital Association (BVK), *Hintergrundinformation* No 2, March 2004.
2 See *Börsen-Zeitung* of 20 September 2003, p. 9.
3 Splitting up a business which has been taken over by selling off parts or individual assets

long-term competitiveness of the acquired companies, even saving some companies from insolvency. Finally, there are a number of examples where private equity funds have been genuinely helpful to some companies, particularly family firms with succession problems and companies with serious liquidity issues.

Nonetheless, there is a major trend in strategies of certain private equity funds - especially LBO funds -that has been detrimental to the long-term economic viability of companies. Financial investors pursuing leverage buy-outs are following a set of strategies that seem quite similar from our case studies, connected to this report (annex):

LBO funds frequently buy into businesses by acquiring the debts owing to creditors. The investor does not pay the seller the full amount of the debt, but rather a reduced price, such as 40 percent. The funds generate revenue by charging interest on the debts that they acquire and/or by selling the debts on at a higher price than they paid for them.

In another variant, buyers attempt to convert their amounts owed into participation, i.e. to become shareholders. The shares in the business are then sold on to third parties.

LBO funds known to fall into this category of investors, are US firms such as Cerberus, Citadel, Oaktree, Lone Star and Apollo. They are often supported in the restructuring process by banks specialising in this type of business[4].

LBO funds have a short investment horizon when compared with strategic investors. This has a negative impact on the sustainable and innovative development of target enterprises. Where technically complex or challenging products are concerned, the time for necessary research and development often exceeds the investment period of such funds. This bears the risk that LBO funds will limit or cut out altogether investment in innovations and development that are likely to bear fruit only after the end of the period of involvement of the fund, clawing back the money thus saved into the fund. PE funds are seduced into withdrawing from the enterprise financial resources held in reserve that could be used for future or unforeseen innovation. Such resources may include reserves for R&D, investment funds which are not required for the day-to-day running of the business or undervalued investment objects. Instead of investing in long-term effective innovation, LBO funds tend to engage in value extraction or asset stripping.

LBOs increasingly tend to recover their investment in a company not just by its sale after restructuring but by immediate special dividends out of new debt, recapitalisations and very high consulting fees. This has a negative effect on the capital base, the cashflow and the creditworthiness of the company. From this follows the danger of under investing in productive assets, markets and R & D undermining the long-term prospects of the company.

Today it is not unusual for a leverage buy-out to be financed by 20% share capital and 80% debt capital. Some part of the debt capital is very quickly paid back by dividends of the target company.

Here is a quite well known “flow” of decisions used by LBO funds to maximize their cash flow:

> In the case study of **Viterra** it is described how 90 % of the leverage buyout was financed by loans - an unusual high percentage for the purchase of stakes in a company.

- Normally the target company is bought by a series of local holding

4 Cf. Die ZEIT of 12.5.2005, p. 28.

companies. Each holding company is partly debt financed and owned by the next holding company, and the “upper” local holding company is owned by a Luxembourg holding company.

- The Luxembourg holding company is owned by the private equity fund, which is normally a limited partnership domiciled in an off shore centre. The limited partnership will distribute the profit of the investment to the participants in the partnership (the investors of the private equity fund).

- Soon after the acquisition of the target company, it is taken private and de-listed at the stock exchange. One of the purposes of this exercise is to avoid the disclosure regulations of a publicly listed company.

- Soon after the acquisition the balance sheet of the target company is pressed for liquidity, both in terms of assets and by new loans in the target company. All this money is distributed as dividend to the holding company, which is the direct owner of the target company. This holding company has often arranged bridge financing, and this bridge financing is redeemed. The direct holding company can also distributed the received dividend to the next holding company, which can redeem their financing or just pay the interest on its loan. By this the target company is in reality self-financing its own take-over.

- However, this type of financing is not only arranged through dividends. The takeover process included substantial expenses to financial advisers, lawyers and other consultants. Often the expenses of a take-over are about 5% of the sum of the acquisition of the target company. Traditionally such expenses should be paid by the buyer, but in cases of a leverage buy-out, the LBO manager decides that the target company will have to pay these expenses.

This type of financing, where the target company actually pays for its own take over, is of course not without consequences. The target company will be much more dependent on the general economic climate, and it will have problems financing necessary investment for new markets and new products, innovations and R&D.

1.4 The Effects of Debt Financing

As a rule, target enterprises are burdened with a high level of debt as a result of leveraged buyout financing and dividend recaps by private equity funds. Their own capital is transformed into debt through the dissolution of undisclosed reserves and the sale of investment objects, which the private equity funds deem to be unnecessarily tying up capital. The enterprise is thus stripped of assets that could serve as a buffer in the event of a market slump, marketing difficulties or management errors, or could be used for investment in the sustainable development of the enterprise and innovation or human resource management and training. The strategic and planning horizon of enterprises is shortened as a result of the influence of private equity funds. When the debt can no longer be serviced, the target enterprise can be pushed to the edge of bankruptcy.

The increased level of debt resulting from LBOs leads to large-scale tax avoidance and a concomitant loss of revenue for the state. This in turn results in a reduction in state investment in infrastructure and education.

It also leads to further weakening of the viability of state social security. LBO operations also require increased state expenditure due to job losses and reductions in purchasing power, placing additional burdens on government. If average job losses total 4% in a secondary buy-out, we will see further examples of the social and fiscal consequences of the growing number of tertiary buy-outs as the exit cycle speeds up.

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Advocates of these financing models defend the high leverage ratios of business acquisitions by arguing that loans make sound business sense. Interest paid on these funds can be claimed as business expenditure, which reduces a company's liability for corporation tax and municipal trade tax. Besides, the debt is not serviced from the company's hidden reserves but from its free cash flow[5].

But this is a very narrow-minded and fragmented LBO argument. The fact is that LBO burdens the companies with the cost of borrowing the funds and companies ultimately fund the acquisition themselves and are heavily indebted as a result.

According to the rating agency Fitch Ratings, the indebtedness of European companies acquired by private-equity firms has risen sharply. In the first quarter of 2005, Fitch Ratings assessed the liabilities assumed by companies at 5.5 times the value of their cash flow; this figure had peaked at 5.6 times cash flow in the fourth quarter of 2004.

Major damage to national economies cannot be ruled out, should the private equity sector overheat - many investment banks, rating agencies, central banks and even representatives of the sector itself could suffer. Risks could thus affect the banks involved in financing, or - if they securitise these loans - other capital market agents.

And suddenly, we see the hedge funds and LBOs enforcing each other in a very unhealthy way: To a certain extent, the latter are hedge funds which already operate in high-risk areas, which could cause more significant disturbances in the capital markets in the event of LBO investments failing to pay out.

2. Decent work and workers' participation

The role of alternative investment most often draws debate, both for and against, from a purely economic standpoint. When hedge funds or private equity come into contact with governments, it is often to debate regulatory or registration issues relating to ownership of companies. However, there have been much more profound and broad externalities, direct and indirect, from the recent boom in alternative investment.

Effects on jobs, wages and work organisation by LBOs and HFs have been substantial, if little understood by the general public or some policymakers apparently 'dealing' with this phenomenon. These same policymakers - with a traditionally uncritical attitude to LBOs and HFs

[5] See *Die Zeit* of 12 May 2005, p. 28.

- will also face increasing questions in the coming years as to the effect of alternative investment on national tax regimes, as former listed companies disappear from the markets.

2.1 Jobs

It is often alleged in the business news pages that PE funds have triggered considerable corporate growth and created many new jobs. However, we are not aware of any serious academic findings that would support this position. Academic studies carried out to date have for the most part been commissioned by groups of investors. They suffer from a lack of representation and are based on scientifically assailable methods and often they wrongly compare various sorts of PE, including venture capital funds. Similarly, they do not separate organic growth from cases of mergers or changes in the macro-economic environment in different reference periods.

The previously mentioned PwC study commissioned by the German organisation BVK is one example. The PwC management consultancy had a certain vested interest in the subject of the study, which differed from those of the independent universities. The study's methods were based on the evaluation of questionnaires sent to PE companies and their target enterprises. This raises doubts as to the reliability and objectivity of the answers and therefore the study as a whole. If the private equity market is broken down into the categories of seed, start-up, expansion/growth, turnaround and buyout, the examining institution concedes that in the instances of turnaround (the rescue of enterprises declared to be in critical difficulty), start-ups and buyouts (the most important segment), the rates of return are so low that no statistically valid statements are possible.

It can generally be said that studies of the effects of LBO investments involve uncertainties. Hence the variables which, together with private equity, affect companies' growth and the provision of jobs cannot really be checked. However, studies such as those referred to, for which many other examples can be given, have often been quoted in the press and used to support the ostensibly very positive effects of private equity. Representatives of the PE industry and institutions cooperating with them frequently give the impression that jobs are being created by the funds in PE funds' target enterprises. It should, however, be pointed out that these jobs are only being recreated - they were as a rule already in existence prior to the PE commitment.

> In the case study of **Friedrich Groh**e it is described how 770 jobs are to be cut.
>
> In the case study of **Viterra** it is described how the plan is to sack a total of 500 of employees - more than a quarter of the entire work force.

The case studies in this report show some negative effects on jobs. The example of the German company Grohe shows that in the private equity business a particular combination of various factors – in this instance a secondary sale (increased pressure on the rate of return), an exorbitant level of debt and market slumps – can lead to job losses.

Even with PE commitments in a relatively good market situation and a stable company (take the investor KKR's involvement in MTU Aero Engines in Germany), PE funds take job cuts immediately into account. Exceptional cases in the PE sectors include KKR's takeover of the Linde-owned forklift division Kion in the autumn of 2006, in which the investor is continuing with the guarantee of jobs previously negotiated up to 2011 between the management and works council.

If HFs and LBOs have brought uncertainty to the financial markets, their effect on jobs, while less documented, has been doubly severe. The stereotype of the private equity firm is not one that sits well with sustainable, decent employment. And the decisions on job cuts are made unilaterally - and absent from public reporting, absent from social dialogue and only looking to the short term.

The focus of the new LBO managers is commonly seen to be around the core business, resulting in the sale of saleable assets also in the group. This inevitably leads to even more job losses. On a more general level, the pressure exerted by private equity and particularly hedge funds, makes the collapse of a leveraged buy-out or a company with high alternative investment very likely. This is something that analysts have predicted for some time in connection to the debate on "systemic risks"[6]. The consequence for job losses would be serious. By making contingencies for and, in some cases, actively encouraging the falling share price, hedge fund managers are putting employment directly at risk.

The industry itself often claims value-adding or job creation effects from private equity. Unfortunately, this is a disingenuous claim in the most part. While it is true that in some private equity buy-outs, the LBO managers see the value of expanding the company in advance of their exit, in the majority of cases full-time, sustainable jobs are lost. Job growth figures are constructed from the plethora of advisers, assistants and consultants brought in by the new LBO managers as well as from the creation of low-skill, often temporary and sometimes precarious employment (customer-based operations).

2.2 Wages and working conditions

In most of the cases studied by the Hans-Böckler Foundation in Germany, PE investors have very quickly pursued a reduction of wage costs. The higher the levels of debt in the target enterprise, particularly with secondary sales, the stronger the attempt to cut wages.

The alternative investment model is inherently damaging for workers. As European Trade Union Confederation (ETUC) General Secretary John Monks put it recently, *"the drive for higher returns inevitably exerts downward pressure on wages and conditions"*[7]. Funds and backers that look for returns of up to 15% p.a. drive management to reduce head-count as a first port of call, and later global wage levels within the company. Coupled with restructuring, away from high-value jobs, to lower-skilled, often temporary, customer contact positions, the squeeze on wages is all too evident.

The pension funds of companies being taken over by LBO are at risk of a deterioration in value if through recaps, special dividends or high consulting fees the companies are no longer in a position to finance pension funds. This is even worse if the pension fund is already under funded.

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> In the case study of **Autoteile Unger** it is described how the working hours have been lengthened from 37½ to 40 hours per week as a result of the buy-out.

As a rule, LBO investors very quickly begin to trim working conditions after entry in order to achieve greater efficiency and productivity. Thus the financial

[6] See, for example, The Financial Times 'UK watchdog warns collapse of big buy-out is 'inevitable'' 7 November 2006 and 'FSA sounds alarm on private equity' 6 November 2006

[7] Monks, J 'The Challenge of the New Capitalism' Annual Bevan Lecture, Trade Union Congress, 14 November 2006

investor KKR announced, immediately after its entry into Kion, the forklift division formerly owned by Linde, in a case that was relatively positive for employees, that the latter had to work extra shifts each week in order to make greater use of the production lines.

In the vast majority of existing examples new owners have withdrawn from social dialogue and, in some cases, failed to honour existing collective agreements. LBOs - have little or no experience in dealing with organised labour unions or employee representatives and often fail to live up to even the most basic requirements on information and consultation and restructuring[8]. Trade unions often have great difficulty in establishing a negotiating relationship owing to the mystery of who is genuinely in charge of the company.

In the case study of **BTC** it is described how the UNI-Europa and the ETUC complained to the Bulgarian government due to BTC's failure to respect its commitments according to the Bulgarian Labour Code and European directives on information and consultation of workers.

One example of this lack of transparency from the commerce/retail sector, where alternative investment is already prevalent is Somerfield Stores. Following purchase by the Apax group and subsequent de-listing from the stock exchange, Somerfield decided to withdraw from the Ethical Trading Initiative (a multi-stakeholder alliance including retailers, NGOs and trade unions), in order to reconsider "short- and medium-term business priorities"[9].

Europe already faces growing skills and training shortages, something likely to be exacerbated by the increasing prominence of alternative investment. The European Commission has already highlighted certain areas where skills shortages are of the most concern, notably ICT.

Short-term approaches from equity groups threaten workers' commitment to their company and their willingness to upgrade their company-specific skills. The failure of equity-backed companies to consider the long-term makes inward investment in training and personal innovation highly unlikely. The same can be said for boards under hedge-fund pressure. Sadly, the long-term yield from skilling and training workers is all too often seen as expendable in these cases.

2.3 Co-determination and workers' participation

Employee co-determination is a practice whereby employees have a role in the management of a company. Co-determination rights are different in different legal environments. In some EU member-states, employees have virtually no role in management of companies. In other member-states, like Germany, co-determination plays a very important role, a role which is authorised by statutory law.

Co-determination usually refers to two distinct levels and forms of employee participation: co-determination at establishment level by the works council and co-determination above establishment level, i.e. on the supervisory (in two tier-board systems) or management (in one-tier systems) board of companies.

We believe that co-determination exercised at the board level is an important means of reducing some of the negative effects of private-equity funds on both the economic viability and

[8] For example, the European directives on collective redundancies (98/59/EC) and information and consultation (2002/14/EC)
[9] Schiller, B 'Trading down corporate responsibility' in Ethical Corporation 14 November 2006

the social responsibilities of companies. Experiences with board-level co-determination in Germany can serve to illustrate this point.

In Germany employee representatives of the supervisory boards, have access to information on the state and development of a company. In addition, they can gain access to information on planned acquisitions and take-overs by private equity funds. In both cases the level of information is considerably higher than the information provided to financial markets. Consequently, co-determination provides employees with an opportunity to open debates and take political or legal action before acquisition or takeovers are realised.

Co-determination also provides options after acquisitions or take-overs have taken place. For instance, employees are represented in the bodies making decisions about the level and structure of management remuneration. In this way, it might be possible to exert influence on the remuneration of CEOs and high-ranking managers. Such remuneration deals ought to serve two purposes. Firstly, they should create barriers against the current tendency towards a short-term, self-indulgent enrichment of managers and shareholders. Secondly, they ought to promote investments that secure the long-term economic viability of a company and hence its long-term ability to establish and maintain good jobs, proper salaries and decent working conditions.

In the cases of PE investments studied by the Hans-Böckler Foundation in Germany, the works councils interviewed consistently pointed out that the atmosphere between them and the management had become frostier owing to financial investors moving in. The status of information about enterprises' managerial events may have improved in part because of the introduction by investors of professional reporting. But this does not create a stronger investment in economic terms. In a succession of cases information is deliberately withheld from workers' representatives by investors. In many cases, investors put works councils under enormous pressure to agree to tough measures aimed at significantly increasing yield returns.

In the case study of **Gate Gourmet** it is described how workers' representatives have been let down by investors on a massive scale.

Recently, the fork lift division (Kion) of the German Linde Corporation was sold to a group of private equity funds. In this case co-determination had a notable effect on the deal that was struck. Various buyers – also under pressure from CEO Reitzle – were forced to present their business plan for Kion to employee representatives. Moreover, the KKR -consortium that finally bought Kion only won the deal because it agreed to sign a contract regarding investments and employment from 2006 to 2011.

Unfortunately the case of Kion appears to be an exception. Hedge funds and private equity funds often refuse to recognize their status as an employer, preferring to describe themselves as an "asset class" that is not bound by any of the legal obligations applicable to employers. Moreover, companies are portrayed as financial objects that are acquired to generate the maximum profit within a short (hedge funds) or medium (private equity funds) time horizon.

Because in many EU member states there is strong and obligatory employee involvement from the workplace up to the boardroom, an entire proven system of how to conduct businesses is at risk. In 19 out of 27 EU member states legal provisions on employee board level representation exist for companies with more than 25 employees, as in Sweden, up to those with more than 500 as in Slovenia, Luxembourg and Germany.

Having a voice and vote in the boardroom could be used to change the general orientation of decisions by new owners or, at least, to define conditions for a takeover by alternative investors in order to use the co-determination position to limit the worst excesses. Those conclusions were drawn recently (Dec 2006) from the examination of the German co-determination system by the academic members of the Biedenkopf-Commission, mandated officially by the German government. But the possibility of changing decisions on new ownership via intervention in boardrooms should not be overstated. One obstacle to using this more frequently might be that provisions on strong information and consultation, as well as board level representation, are limited to national borders. If a company's registration remains outside then those co-determination provisions do not apply or are blunted.

It appears that a great many hedge funds and private equity funds do not see themselves as long-term strategic investors. They have little interest in the relationship with stakeholders such as employee representatives. Instead, there are numerous examples of fund managers who talk and act as if employees were a threat to the creation of shareholder value.

This claim is supported by several of the cases presented in this report. In these cases employee representatives describe the relationship with hedge funds and private equity funds as non-existent, minimalist or adversarial (see for example the case studies of Friedrich Grohe and Mobilcom). The main interest of the latter tends to be financial key figures from which decisions about the production and employees can be deducted. The actual production processes, the human resources involved in them and the responsibilities towards employees and employee rights are considered secondary.

We believe that this approach is detrimental to the long-term economic viability of companies. Moreover, we believe that the approach conflicts with the idea that possession of companies involves both rights and duties, including duties towards employees. The latter are recognised as fundamental human rights and are set out in a variety of regulatory instruments, which both the EU and its member states are obliged to implement and defend.

2.4 Extraordinary dividends

In addition to the capital gain on leaving, the target enterprise's distributions to PE funds during the investment stage have achieved greater significance. In recent times there have been spectacular instances of super-dividends. The Danish telecommunications group TDC was taken over by the investors Blackstone, Apax, Permira, Providence and KKR for the sum of EUR 12 billion. Just a few months later the target enterprise was prompted to distribute an unusually high dividend of EUR 5.6 billion to investors.

This was the equivalent of EUR 29 per share. Until then the norm for the group had been 56 per cent per share[10]. PE funds have thus made it possible to refund one third of their input in an extremely short period of time.

> In the case study of the **DT Group** it is described how the company, at the time listed usually declared a dividend at 10 - 15 mill € pr year, while in the following two years after the take over the company declared a special dividend of 200 mill €.

The rating agency Fitch makes the criticism that many enterprises run into debt in problematic

[10] *Die Aktiengesellschaft* 16/2006, p. 579

areas after recapitalisation[11]. In the summer of 2006 the PE investor Terra Firma arranged for the equity invested in the German motorway services chain Tank & Rast to be repaid to the investor after only 18 months at one and a half times the amount with the help of a new loan, which had been imposed on the company.

The high rates of return of PE funds on buyouts are "justified" by the LBO industry because of the alleged risk they take owing to their capital being committed for longer in a target enterprise, the future prospects of which cannot be accurately calculated. The funds' risks, however, have actually been very low because of recapitalisations ('recaps'). According to a study by the Swiss business consultancy Strategic Capital Management (SCM), recapitalisations already provide 30 per cent of all backflows in the global PE sector[12]. Because of recapitalisations, funds' risks have shifted to the banks providing the loans. In recent years the banks have for their part switched over to securitising loans in tradable securities, thereby transferring the risks to other market participants. Those buying the securities are often hedge funds, in which once again institutional investors and wealthy individuals have a stake, with the latter two ultimately bearing the risk.

The rating agency Standard & Poor's (S&P) warns that the level of debt of enterprises run for special distributions of funds leads to greater risks of credit loss[13]. According to S&P data, the number of recapitalisations between 2002 and 2005 increased tenfold to more than US$ 40 billion[14].

Equity capital is turned into borrowed capital through recapitalisation. This increases the risks for the target enterprises concerned and results in a poorer rating and therefore higher loan costs. All in all, recapitalisation makes the situation of the enterprises concerned considerably worse.

2.5 Tax revenues

What typically happens when a capital fund buys up a company is that:

1. The indebtedness of the purchased company increases.
2. Extraordinary dividends are paid out, directly linked to the purchase.

The combination of increased indebtedness and the payment of extraordinary dividends mean that the capital fund does not need to find much money out of its own pocket to purchase the company. The company is to some extent bought with its own money. The reason why capital funds are able to increase the debt of the purchased company to this extent is that capital funds have the investment commitment of their investors behind them, which they can draw on if needed.

This combination of own-capital distribution and resulting increased indebtedness also has a major influence on the amount of tax paid by the company. This is illustrated by the example in box 1 below. In the example, the company's tax payments are brought down by 33%. This brings a double benefit for a capital fund: the fact that a company can practically be bought with its own

[11] *Financial Times Deutschland* 9.8.2006, p. 19
[12] *Financial Times Deutschland* 9.8.2006, p. 19
[13] *Financial Times Deutschland* 14.8.2006, p. 18
[14] *Handelsblatt* 15.8.2006, p. 23

money and save on tax makes well-cushioned companies a particularly attractive purchase for capital funds.

If this happened in a single closed economy, the company's interest expenditure would "pop up" as interest income in another place and be taxed there. But in a globalised world – where loans to companies most frequently come from foreign lenders – the state is very rarely able to benefit from this potential tax income. One possible source of tax income might also be from the capital fund and/or its beneficial owner. However, the capital funds themselves – or strictly speaking the management companies behind them – are often situated in low-tax countries. And the owners are often foreign pension funds.

> Box 1. Example of tax savings with increased indebtedness of company
>
> Company has a total balance of EUR 1 billion.
> Before purchase, this comprises 80% of own capital, while loans account for 20%.
>
> After purchase the ratio changes to 20-80 thanks to payment of an extraordinary dividend and increased borrowing.
> The economic result of the financial account amounts to EUR 100 million. Assuming that the interest rate is 5% p.a.:
>
> Corporation tax before purchase:
> Result according to financial account (100 - 1000 x (20% x 0.05))= EUR 90 million
> Corporation tax (90 x 0.28) = EUR 25.2 million
>
> Corporation tax after purchase:
> Result according to financial account (100-1000 x (80% x 0.05)) = EUR 60 million
> Corporation tax (60 x 0.28) = EUR 16.8 million
>
> Corporation tax saved after purchase (25.2 – 16.8) = EUR 8.4 million

This opportunity to save on tax by altering the company's capital structure is a result of the way in which corporation tax is constructed. Corporation tax taxes financial income and expenditure in line with the actual net increase in value – in other words, the net profit – generated by the commercial company in question.

The often highly aggressive yield targets of LBO funds mean that strategies to avoid paying tax to the government are used more intensively than by ordinary companies. The tax liability of the target enterprise is noticeably reduced by debt push-down and transfer of the acquisition debts of the fund's acquisition vehicle to the target enterprise, which usually takes place via a merger of the target enterprise with the acquisition vehicle. Furthermore, taxation is avoided through the establishment of the PE fund's intermediate holdings in countries with low or no tax liability, to which distributions and capital gains are transferred. Germany, for example, has concluded a double taxation agreement with fellow EU Member State Luxembourg. Dividends and capital gains are not taxed in Germany, since the intermediate holding is liable for tax in Luxembourg. And in Luxembourg this intermediate holding is usually exempt from tax.

> In the case study of **ISS** it is described how the joint taxation of the two Danish holding companies and the ISS Danish group company reduces the tax revenue. At the same time the interest of the loans are now deducted from the taxable income of ISS. Finally it is expected, that the ISS from 2006 onwards will no longer pay company tax in Denmark.

Furthermore, the funds in many cases avoid tax by forming tax groups between several enterprises in their portfolio, through which they exchange accumulated losses.

Therefore, LBO-fund activities should all in all lead to considerable tax deficits. It may also be noted that liquid assets flow out of Europe into the United States and are ploughed back by institutional investors there. The power to earmark these funds for investment purposes therefore drains away at the same time.

Despite the evidence showing a decline in tax revenue, it has been argued by the private equity industry that the interest is instead taxed from the recipients, which in this case are banks and other financial institutions. But this is incorrect. The bank will, of course, only increase their taxable profit by the interest margin, and a lot of interest goes to non-taxable institutions and to institutions in tax havens. Furthermore, as the private equity funds are organised as limited partnerships, no tax regulator can ensure that the profit of the private equity fund is taxed correctly. Of course, most of the investors in the equity funds pay tax according to the tax rules of the domicile country. But in reality the tax authorities have no power to control where and how the profit of the equity fund is taxed.

This situation is also very detrimental to the Welfare State in general. It is not just that companies after the buy-out are paying less in tax due to the level of debt but, in addition, dividends are paid mainly to foreign investors not subject to taxation. It is also that when the capital structure of companies is endangered and jobs are lost, the whole society is affected as unemployed people represent a burden for the State. The balanced role of the State in collecting taxes and redistributing wealth is in question in the long run and the issue of increased tax losses will certainly draw the attention of governments.

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The EU has in the past tried to combat tax evasion. Rules of investment in tax havens have been implemented but drafted in such a way that investments in hedge funds and private equity funds are not fully included.

The combination of a limited partnership, which is not a taxable body in itself and its domicile in an off shore financial centre, which is often a tax haven, means that the distribution of profit from the hedge fund and the private equity fund to the investors are normally out of the control of the tax authorities of the investor.

In nearly all member states of the EU, there is a system of joint taxation. Under the different joint taxation regimes, the members of a group will have the right to be taxed as a group. In practice this means that the holding company or holding companies of the target company will be taxed in a group with the target company.

According to EC directive a holding company is not taxed on the profit of the subsidiary when it holds 15 per cent of the subsidiary, and the subsidiary must not take withholding tax on the dividend to such holding companies.

If the investments in the subsidiary are financed by debts, the holding company will pay interest, and it will have a negative taxable income –a tax loss. But this tax loss will be part of the joint taxation with the target company and be offset in the taxable profit of the target company and it will by this means reduce the corporate tax burden of the target company. Because of the interest expenses of the target company and the interest expenses of the holding companies, which takes part in the group taxation, the corporate tax burden of the target company can be reduced significantly or even to zero.

> In the case study of **TDC** it is described how one conservative estimate suggests that the Danish government will lose some EUR 270m in tax revenue.

The target company, which is forced to pay for many of the costs of the take over, will try to deduct these expenses, in reality the expenses of the purchasing private equity funds, from its taxable income.

A holding company or an equity fund does not normally pay VAT. But some part of the expenses (adviser's fee etc) will be VAT-included. By letting the target company – which is normally paying VAT – pay the expenses of the take over, the target company will reduce its VAT obligation by the VAT paid on the expenses.

3. Public sector and universal provision of services of general interest

Recently the LBO funds have entered some traditional public utility industries that provide basic infrastructure services for the economy, in particular airports and telecommunications (telecom). Press reports indicate infrastructure operators in Europe will be high priority targets over the next few years.

The infrastructure industries – airports, ports, telecom, electricity, gas, water, and parts of public transport – differ from general industry in several important ways:

- the largest "incumbent" firms in the infrastructure sectors in any country typically have significant monopoly power in their respective sectors over the provision of essential public services;
- they also carry important public service responsibilities (e.g. universal service obligations);
- infrastructure providers are very capital-intensive, requiring significant and continuing long-term investments in physical infrastructure assets, their maintenance and expansion;
- they make extensive use of public rights-of-way and other public resources, the rights for which have been granted at minimal or no cost, not market value;
- they are subject to special government oversight with respect to their delivery of public services, often by industry-specific regulatory authorities. This regulation is directed only to certain services and markets of infrastructure operators, and does not extend to its financial structure or ownership.

Historically in Europe these infrastructure operators have been owned by governments and provided as public services. During the last 10-15 years many have been wholly or partly privatised with a view to stimulating a degree of competition in national markets and facilitating the development of European common markets (see table below). These infrastructure sectors are still at an early stage of the transformation process from government public service monopolies to private competitive markets, so that the services markets are still highly monopolized, requiring direct regulation to ensure that monopoly power is not exploited and public service objectives and standards are maintained.

Table. 1 Private equity funds have increased their investments tenfold in state-owned companies

YEAR	Europe: Millions in EUR[15]	Globally: Millions in EUR	Europe: Numbers of transactions	Globally: Numbers of transactions
2000	564	1129	14	17
2001	1623	1638	18	20
2002	1221	1473	11	14
2003	2088	2273	18	27
2004	7294	7650	18	30
2005	2336	2926	24	40
2006	5950	10671	22	46
TOTAL	**21706**	**27760**	**125**	**194**

Source: Published in Mandag Morgen the 22.nd of January based on figures from Thomson Financial

As infrastructure operators are typically conservatively managed and generate significant stable cash flows for reinvestment, they have characteristics that are especially attractive to LBO funds.

3.1 The attractiveness of public utilities

The transitional position of many infrastructure operators between public sector and private market operation makes many of them attractive to LBO funds looking for investment opportunities in highly imperfect markets, especially if the infrastructure operator is fully privatised and the management is receptive to a co-operative leverage buyout. The special considerations associated with the use of public resources such as rights-of-way, special rights such as the power of eminent domain and the provision of special obligations such as universal services raise a particular risk of possible political intervention with respect to hostile takeovers.

Typical characteristics of infrastructure operators that LBO funds find attractive are the following,

- significant stable cash flows from a customer base that considers the service a necessity

[15] The exchange rate used is 100 EUR = 745,41 DKR. (source the 25th of January: http://www.nationalbanken.dk/dndk/valuta.nsf/side/Valutakurser!OpenDocument)

and has few, and sometimes no alternatives;
- a significant degree of monopoly power in the primary market(s);
- infrastructure providers do not maximise short-run profits because primary considerations in decision making are given to long-term investment needs, stable financial structures and public service responsibilities;
- industry specific governance/regulation is limited to certain service performance objectives in basic services and does not extend to ownership, financial policies, pricing for most services, or profit control;
- infrastructure providers use significant public resources and special rights (e.g., land, rights-of-way, eminent domain, radio spectrum, etc.) that are undervalued, or even unvalued assets;
- financial structures and policies are geared to risk-optimisation for long term investments in capital intensive fixed assets; significant cash flows provide internally generated capital necessary to meet ongoing long term investment requirements in infrastructure assets;
- infrastructure operators are typically characterised by conservative management, often carried over from the prior government service model, and management policies and practices of largely untested and varying efficiency;
- public stockholders attracted to infrastructure providers have been investors looking for a stable long term return with regular dividends and reduced market risk.

The attraction to Private Equity Funds of each of these individual characteristics of infrastructure operators will vary depending on individual circumstances, but collectively they demonstrate that infrastructure operators are likely to become more significant targets in the future as the privatisation of publicly owned infrastructure continues and the scrutiny of infrastructure operators by Private Equity Funds deepens. For Private Equity Funds, the market risks of infrastructure operator takeovers are relatively small and the possibilities for enormous financial gains are great. Most infrastructure managers are likely to be receptive to bids given their custodial management style, the diversity and relative passivity of the public stock ownership, and the possibilities for large personal gains for the management. A more serious risk is whether the Private Equity Funds are likely to provoke political responses to their plans from concerns about the implications for the long-term development of public infrastructure services.

TDC case, Denmark

TDC was taken over by a group of five foreign private equity firm specialists - Apax Partners; Blackstone Group; Kohlberg Kravis Roberts; Permira; and Providence Equity - in the largest takeover in Europe to date. For about 10.5bn, they purchased 88.2% of TDC shares It was financed by slightly more than 80% debt. Capital management fees are not specified, but experience suggest they will be in the tens of million of euros. The 2005 Annual Report notes significant TDC credit rating downgradings by the Standard and Poor and Moody Investor services as a result of the leverage buyout. The acquisition increases TDC’s net debt to total assets ration from 18% to about 90% at interest rates substantially higher than those for the previously established debt. TDC’s debt ratio is now 97% of capitalization. The new owners have been deliberately vague about why they have taken over TDC and what their plans are, stating only that they expect to own TDC for about five years. The evidence to date suggests that the TDC takeover has nothing to do with improving the efficiency of TDC. The new owners have no expertise in telecom and are relying virtually entirely on the previous management. The diversified stockholders were long term investors that left the management of the company to the managers. The immediate cash payout of almost half TDC’s assets suggests a pretty clear case of asset stripping, and the offering of shares in NTCI to 41 senior executives of TDC provides a major benefit to TDC management for continuing efforts leading to further cash payouts. This is short-term disinvestment, not long-term investment. Observers can be thankful that the only reason all these details about the takeover activities are known is because the new owners were unsuccessful in their attempt to de-list TDC from the transparency requirements for public stock trading.

3.2 After an acquisition - conflict of interests

The effects of Private Equity Fund buyouts and restructuring on infrastructure operators are magnified because of the unique characteristics of infrastructure operators noted above. The most significant impact is on the capability to efficiently finance long-term investment programmes. This is where the short-term priorities of Private Equity Funds and the long-term priorities of infrastructure operators are in direct conflict. After the acquisition, the new owners have a powerful incentive to pay themselves the major portion of the large internally generated cash flow that would have been used for reinvestment. In addition, the infrastructure operators acquire the large debt borrowed by the PEF to acquire the operator. This dramatically increases the firm's debt-equity ratio and its annual interest obligations. It suffers a major decline in its credit ratings and the interest rates it must pay on its debt. Internally generated capital for re-investment is dramatically reduced, as is the firm's capability to borrow investment funds, even at higher interest costs. This means significant reductions in their investment programmess and/or increases in prices for consumers of their monopoly services.

Other areas where this conflict between the short-term priorities of the Private Equity Funds and the long term development focus of the infrastructure operators include,

- research and development, a long term priority where infrastructure operators traditionally have maintained activities, and Private Equity Funds typically have had no interest;
- quality of service where infrastructure operators traditionally have targeted a higher quality than Private Equity Funds are likely to find necessary to maximise short-term profits;
- fulfilment of public service responsibilities, where Private Equity Funds are likely to maximise their discretion to minimise expenditure on service delivery;
- staffing and training where the short-term requirements of Private Equity Funds require significantly fewer resources than traditional infrastructure operators long-term development programs;
- services pricing strategy, where the long-term market and services development associated with long-term investment strategy of infrastructure operators conflicts with short-term pricing and cash generating strategy of Private Equity Funds.

Given that infrastructure provision in some public utilities in some European countries is in need of significant improvement in managerial or operational efficiency, and that the degree of competition they face is relatively weak, one might expect Private Equity Fund take-overs to provide some unambiguous efficiency improvements. However, these same operators need dramatic increases in long-term investment to improve their relatively poor infrastructure networks. The distinctive characteristics and circumstances of infrastructure operators in Europe suggest that Private Equity Fund takeovers are likely to have negative effects on the longstanding public policy objectives for infrastructure operators, i.e., long term efficient infrastructure development in the public interest, and the provision of universal public services of a high quality, for the benefit of the economy and society.

The effect on public finances of the TDC purchase is, as yet, unclear. One conservative estimate, however, suggests that the Danish government will lose some E 2bn in tax revenue.

3.3 Impact on society

The infrastructure industries provide important foundations for economies and societies. They are priority factors for many industries making decisions on the location of investment. They are standard economic indicators of the differences between developed and developing countries. The effects of the efficiency and universality of a country's infrastructure services ripple throughout the economy and society in a manner that multiplies their impact many times. Because of their centrality to all economic and social life, infrastructure services always have been treated differently from industry in general. Public policy has been directed to ensuring to the greatest possible extent the universal availability of infrastructure services at a reasonable quality and price.

As state ownership and provision of infrastructure has begun to be privatised in line with market liberalisation policies in recent years, governments have sold shares to the public that are then traded on public stock exchanges. The infrastructure operators have retained their public interest obligations for long-term infrastructure development and their public service obligations. The entry of Private Equity Funds into the infrastructure industries raises serious new issues. By following their traditional practices and financial incentives to maximise short-term cash returns, Private Equity Funds can be expected to leave infrastructure operators in a condition where their capabilities for pursuing their long-term objectives have been severely weakened, if not jeopardised. There is a serious risk that investments in long term infrastructure development are likely to be significantly reduced both during the period of Private Equity Fund ownership (usually five years or less) and for a period afterward because of the debt mountain created, and the highly restricted possibilities and costs of renewing long term investment programs.

Eircom case, Ireland

Eircom is the former national operator in Ireland, provider of fixed-line telecom services with approximately 2.2 million fixed-lines. When eircom was privatised by the government in 1998, it was relatively inefficient in terms of comparison to incumbent operators in leading countries in Europe, and in need of significant investment. The shares were purchased by a wide cross-section of Irish citizens. The Valentia private equity consortium acquisition in late 2001 was mostly debt financed. After the acquisition eircom repaid Valentia debt by issuing bonds which increased debt from about 25% to 70% of its capital structure.
Eircom capital expenditures declined from E700m per annum in 2001 to 300m in 2002 and 200m in 2003 and 2004. In 2001 eircom invested its internally generated capital from depreciation allowances plus another E275m. Between 2002 and 2004, it invested more than E450m less than its internally generated capital from depreciation allowances. This enabled payment of a E400m

dividend to Valentia.
The second public stock offering was successfully floated in 2004 at a significant profit. And in 2006 Private Equity firm Babcock and Brown from Australia purchased eircom, again through debt finance. Eircom has now a debt ratio on the order of 117%. Although the new owners have announced their intention to invest in upgrading the eircom network to European broadband standards, eircom's capacity to invest significant amounts seems virtually straitjacketed. The new owners have petitioned the government to contribute funds to support universal service and indicated that pricing policies will need to be reviewed.

Investments in long-term staff development, research and development, upgrading the quality of service and restoring public service obligations are all likely to be necessary to return infrastructure operations to a level of preparedness for long-term development. Infrastructure operators with significant monopoly power may have to seek higher prices from consumers to help finance the restoring of infrastructure operator standards. In the circumstances of the public utilities, the entry of the Private Equity Funds is unlikely to bring strategies for long-term investment in infrastructure development. Rather it is likely to bring strategies for disinvestment through massive cash payouts. These in turn can be expected to have significant negative multiplier effects on economic growth for the economies dependent on the continued development of these infrastructure services.

3.4 Cases about Public Utility Sector: Telecommunication

The telecommunication (telecom) sector has been most subject to privatisation of incumbent national operators. Most of the EU's original 15 countries have privatised their national operators in whole or in part and are traded on public stock exchanges. The new EU member counties are at various stages of planning and implementing privatisation policies. The telecom sector is where there is the most actual experience with privatisation and where there have been a few instances of Private Equity takeovers.

Telecom is also important because the sector is growing rapidly as a result of the convergence of computing and information technologies with telecom infrastructure technologies and services. Long-term investments in new upgraded broadband telecom networks are now underway in order to provide the essential infrastructure for future Internet and electronic commerce services that will underpin Europe's information society.

The importance of Europe's transition to an information society is documented in the EU – *Lisbon Agenda i2010 Information Society initiative* launched in June 2006, which is a renewed commitment to the Lisbon reform agenda. It seeks to promote an open and competitive digital economy as well as an integrated approach to information society and audio media policies in the EU. This requires upgraded telecom networks across Europe that can provide the broadband capacity needed for information societies. There are three main priorities for Europe's information society and media policies: 1) the completion of a single European information space which promotes an open and competitive internal market for information society and media; 2) strengthening innovation and investment in ICT research to promote growth and more and better jobs; 3) achieving an inclusive European information society that promotes growth and jobs in a manner that is consistent with sustainable development and that prioritises better public services and quality of life[16]. It is difficult to see how private equity ownership of telecom infrastructure operators will promote these objectives, and experience suggests that in many cases they would be acting contrary to these objectives.

BTC case, Bulgaria

Set-up in 1992, the Bulgarian Telecommunications Company (BTC) is the former national operator in Bulgaria. The company provides 97% of fixed line services in the country as well as holding a substantial interest in the mobile market.
Following a lengthy two-year privatisation process, Advent International agreed the purchase, through the Austrian operation, Viva Ventures, of a 65% stake in BTC in June 2004 for E 230 million plus a E 50 million capital increase. In 2004 the owners took dividends of EUR 75m.

During this period, relations with BTC employees have deteriorated very badly. Employment has been reduced from 24.000 to less than 10,000 under conditions seen as secretive and arbitrary by the employees, and in violation of the BTC privatisation agreement. After local unions filed complaints with the Bulgarian government of BTC's failure to live up to its commitments in the Bulgarian Labour Code and European directives on information and consultation (98/59/EC and 2002/14/EC), a social partnership agreement was finally agreed with the company in July 2006. There is no confidence that BTC will be able to build a modern telecom network for Bulgaria in the near future.

Issues of the financial stability of some large infrastructure operators have risen, affecting their capabilities to invest in long term network development. To illustrate, in 1999 at the height of the dotcom stock market boom, British Telecom, France Telecom, Deutsch Telecom, KPN Netherlands, Vodafone and others all bid extraordinary sums for a limited supply of third generation (3G) mobile spectrum licenses. This raised their debt ratios and interest obligations to such a high level (the managements called them debt mountains) that they had to scale back their 3G investment programmes in major ways, significantly slowing economic growth in both the telecom services and equipment manufacturing sectors and delaying the introduction of new 3G mobile services for several years, until debt mountains were reduced to levels that would support sustained long term development. During this period Europe lost its global leadership in mobile telecom development to Asia, where operator investment plans were not constrained by debt mountains. As a result, investment in new European broadband telecom networks to provide enhanced Internet services for the future information economy, which was anticipated in the Lisbon Agenda targets for economic growth, have been slower than expected.

There are three countries where there is experience with PEF takeovers of incumbent telecom operators. Ireland historically has had a relatively inefficient telecom infrastructure and was hoping that privatisation would stimulate significant improvement. Denmark has always had one of Europe's leading telecom infrastructures. As a still developing country, Bulgaria's telecom infrastructure needs major investment in network development. More detailed information about developments in these countries is provided in the Annex of this report dedicated to Case studies.

[16] COM (2005) 229 "i2010 – A European Information Society for growth and employment." p. 4

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The three country case studies of private equity involvement in the infrastructure providers in the telecom sector in Europe suggest the following,

1) private equity ownership can be attracted to incumbent telecom operators that are efficient (Denmark), inefficient (Ireland), and still in need of fundamental reform and network development (Bulgaria);
2) private equity ownership is not likely to foster a demonstrable efficiency improvement in a relatively inefficient operator, the network modernisation and expansion needed in a still developing country, or the maintenance of the leadership of one of Europe's most efficient operators (Denmark);
3) long term investment in network development is not an evident priority of the private equity owners of the operators in any of the countries. Short-term gains from cash payouts and profitably turning around their investments are the priority;
4) the levels of debt left with the companies after the leverage buyout severely constrains long term investment capabilities for the future, and are incompatible with efficient long term investment;
5) private equity ownership is an exercise in disinvestment, the removal of capital, not new investment in growth and development;
6) the management of the utilities may be presented with a serious conflict of interest. Their personal rewards are greatest if they engage in inefficient practices to build cash and cashable assets that will invite private equity owners, facilitate the takeover and share in the very substantial payouts. In some circumstances, this could be a violation of their fiduciary responsibilities to the original public stockholders.

4. Employees, pension fund investments and long-term real value

Although we have seen earlier in the report that a certain "retailisation" is underway, the added value that hedge funds bring to retail consumers is questionable, while the development of the market introduces significant risks (see below). Although a strong consumer policy case could be made (based on the precautionary principle) for a prohibition on the distribution of hedge funds (and similar asset classes) to retail investors, it is probably not politically viable, given the current emphasis on market liberalisation within the EC. However, it is certainly reasonable to argue for a set of robust regulatory interventions to manage the potential detriment to retail consumers. The sentiments expressed in the Commission expert group report that further liberalisation would result in improved consumer welfare need to be challenged by objective commentators.

If the EC genuinely believes that hedge funds do have something to offer retail investors and is keen to see the market develop, then consumer confidence is paramount. It goes without saying that a hedge fund scandal similar to those seen in the US would undermine the limited potential for the sector and damage the reputation of EU policymakers.

To be fair to the Commission expert group, it does make some consumer protection recommendations: a minimum investment threshold of Euro 50,000 and for the enforcing of clear conduct of business requirements on the intermediaries and institutions who conclude sales contracts with end-investors.

These measures provide only limited protection – for example, the minimum investment threshold could easily be circumvented in cases of large pension transfers. However, the main flaw in these recommendations is that they do not sufficiently address the numerous key risks such as: legal and governance issues, prudential supervision, conflicts of interest within the hedge fund system, valuation risks, disclosure, promotion and marketing issues, intermediary competence, and risk classification.

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Alternative investment funds in the form of structured products have the potential to offer ordinary retail investors a product which offers a return on the risk spectrum between bonds and equities[17]. Alternative investments offer pension fund trustees opportunities for gaining exposure to alternative asset classes and diversifying risks. So there could be considerable potential benefits for consumers if the market operates properly and the present report does not aim to obstruct the development of functioning, efficient markets. The objective of this report is to ensure that the interests and structure of the market are aligned with the interests of consumers and wider society.

The main claims made by advocates of hedge funds are that: they can deliver superior returns and they offer enhanced opportunities for diversifying portfolio risk. These claims are open to challenge.

To begin with, a general point is that while hedge funds have developed a certain 'mystique' they are in practice simply another form of active investment management, which seeks to add value by taking a position in the market. There is no guarantee that a hedge fund strategy will deliver superior returns – as with any active management strategy it will depend on the skill but mostly the luck of the fund manager involved. And much of the available historical evidence suggests that past performance of a fund is of limited use as a predictive indicator of future performance.

Indeed, it may well be that much of the added value of hedge funds which seems to have been identified in the past (ie. the investment out performance of the early adopters) has now been competed away by rival firms entering the market. As with many innovations in asset management, the added value lasts only as long as the general market remains unaware of trends (previous examples have included small company investments, momentum and value investing etc). Once the information is disseminated to the rest of the market this value dissipates.

Moreover, there is some concern that the claims of out performance have been inflated because of survivorship bias within the universe of funds that have been used to measure performance.

For example, investment bank Barclays Capital puts the typical level of overstatement of returns at 1 – 6 per cent a year, depending on the index[18].

Analysis produced by Vanguard Investments[19], which adjusted the annual returns of the Tremont hedge fund index for the costs identified in Malkiel-Saha's work (see below), suggests that the actual returns achieved by hedge funds fall dramatically and seem to have produced

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[17] As a replacement for the with-profits type investments offered by insurance companies
[18] See Hedge fund returns 'are vastly overstated', *Timesonline*, 28/02/2006
[19] Hedge fund index biases , *Vanguard Investments*, November 2004, http://www.vanguard.com.au/library/pdf/RL%20Hedge%20Fund%20Biases%20112004.pdf

returns well below those achieved by a simple portfolio of 50% bonds and 50% equities (see Table 1).

Table 1 Hedge fund return comparison - Average annual returns

	1994-2003	**1995-1999**	**2000-2002**	**2003**
Tremont hedge fund index: returns ***without*** Malkiel-Saha adjustment	11.11	18.16	4.09	15.47
Tremont hedge fund index: returns ***with*** Malkiel-Saha adjustment	2.32	9.37	-4.66	6.72
50% Dow Jones Wilshire 5000/ 50% Lehman Aggregate	9.30	17.41	-2.10	17.93

It is interesting that the adjusted hedge fund index returns are lower than the mixed portfolio over the whole period ***and*** when segmented into bull and bear equity markets.

The key concerns relate to biases that exist in the published indices of hedge fund returns – these biases can lead to claims about investment performance being overstated.

The main biases are called backfill and selection bias and survivorship bias. Furthermore, there are additional concerns about the persistence of returns and the attrition rates amongst hedge funds.

Backfill and selection bias. Hedge funds are often established with seed-capital and will begin reporting on their results at a later date. But backfill and selection bias can occur because hedge fund managers are able to 'fill back' only the most favourable investment returns into an index. This can result in returns being overstated.

This effect was demonstrated in a study undertaken by Malkiel and Saha, which examined the hedge fund returns over the period 1995-2003[20]. Malkiel and Saha used the TASS database (a unit of Tremont Capital Management) to investigate the characteristics of hedge fund returns, and compared the backfilled returns with those that were contemporaneously reported to TASS.

They concluded that the use of backfilled returns significantly biases the returns upwards. The arithmetic mean of the backfilled returns over the period 1994-2003 was 11.69%, while the mean for the contemporaneously reported returns was 5.95% - a difference of 5.74%.

Survivorship bias: This can occur because the published indices may not include the returns from hedge funds that previously existed but are not currently in existence (known as 'dead' funds), or funds that do exist but no longer report their results ('defunct' funds).

In the study mentioned above, Malkiel and Saha examined the effect of this survivorship bias by comparing the annual returns achieved by 'live' funds with a universe of live and defunct funds over the period 1996-2003. The study found that the arithmetic mean of the annual returns of the live funds was 13.74% for the period whereas the arithmetic mean for all the funds (live

[20] Hedge Funds: Risk and Return, Burton G. Malkiel and Atanu Saha, *Financial Analysts Journa*l, Volume 61, Number 6, 2005, http://www.cfapubs.org/doi/pdfplus/10.2469/faj.v61.n6.2775

and defunct) was 9.32% - a difference of 4.42% over the period.[21]

All indices face problems with survivorship bias. However, Malkiel and Saha report that survivorship bias produced an overstatement of returns of 1.23% in mutual funds, compared to the 4.42% for hedge funds

Attrition rates – the proportion of funds that fail to survive – is another cause for concern. Malkiel and Saha found that hedge fund attrition rates are three or four times greater than the mutual fund rates over the period 1994-2003, and the differences are highly significant.

Risk and volatility: The other main perceived benefit of hedge funds relates to risk. Hedge funds tend to exhibit low standard deviations (volatility) and correlation with general equity indices offering significant potential for diversification.

However, the investors need to be concerned about the risk of choosing a poor performing fund (known as cross-sectional distribution of returns).Malkiel and Saha examined the cross-sectional standard deviation of different hedge fund categories over the period 1996-2003. They found that the standard deviation of hedge fund returns is considerably higher than it was for mutual funds. In other words, the range of returns is much higher so while investors face high rewards for selecting top-performing funds, they also face a high risk of picking a dismal performer.

Moreover, while the reported volatility of hedge fund returns appears to be comparatively low, care needs to be taken as concerns have been raised about valuation methodologies. These may result in the volatility of returns being understated.

Valuation of assets: Concerns have been raised about the plausibility of the investment returns claimed by hedge fund managers because of **the way assets are valued** within hedge fund portfolios[22]. 'Traditional' fund managers who invest in listed company shares do not face significant challenges when trying to obtain independent, fair value, and transparent portfolio valuations which reflect accurately the liquidity of the market in those shares. This may not necessarily be the case with hedge funds – a survey by the Alternative Investment Management Association (AIMA) conducted in Q4 2004 estimated that 20% of assets held by hedge funds are hard to value securities. This figure relates to the market generally. Many hedge funds offer strategies focusing on specialist markets such as emerging markets – so it would be possible for non-diversified hedge funds to be 100% exposed to hard-to-value securities. This raises issues in relation to governance, conflicts of interest, transparency and disclosure but also raises the possibility that investment performance may be artificially inflated by unrealistic portfolio valuations.

With regards to diversification benefits, it is not clear that hedge funds offer an intrinsic advantage over traditional asset management techniques that use diversification – although to be fair it may be that in some cases hedge funds can offer a more cost effective way of executing that diversification.

Therefore, overall it is not clear that hedge funds offer such added value potential for investors that it is imperative for EC policymakers to aggressively liberalise the market so that consumers can have access to these funds. After all, consumers are not exactly deprived of choice of retail

[21] See Table 3, p83 and Table 4, p84 of report published in *Financial Analysts Journal*, Volume 61, Number 6, 2005

[22] See Hedge Funds: Are their returns plausible. Speech by Dan Waters, Sector Leader Asset Management, Financial Services Authority, NAPF Conference, 16 March 2006

investment funds – in the UK alone there are 2,000 retail funds which invest solely or predominantly in UK shares yet only 800 shares in the main benchmark FTSE All Share Index which accounts for about 95% of the market capitalisation of the UK stock market.

Choice per se is not necessarily beneficial for consumers, quality of choice is more important than the number of choices available. In complex markets, proliferation of products leads to oversupply which actually leads to distribution costs being pushed up – unlike other consumer markets where oversupply leads to downward pressure on costs to consumers.

4.1 The risks posed to retail investors

The current system of regulation exposes consumers to a number of detriments and risks. If consumers are to be protected, resources allocated effectively, and confidence in the system justified, then it is self-evident that consumers and their representatives must have access to fair, accurate, and objective information to make informed decisions, and undertake due diligence.

The unique selling point of the alternative investment funds sector (especially hedge funds) is that they appear to offer the opportunity of superior investment returns (when compared to ‘conventional’ asset classes) plus reduced volatility. The industry seems to have been able to overturn conventional investment theory, which holds that higher returns are closely correlated with higher risk. But we have seen earlier that the expected returns are often not as high as claimed by the funds. While many hedge fund managers undoubtedly have delivered impressive investment returns, care needs to be taken when studying the performance claims made by hedge fund sector generally both in relation to superior investment returns and risk. There appear to major informational problems in the sector, and the claims about superior investment performance appear to have been overstated to a significant degree.

There are a number of major concerns about the potential **consumer detriments and market distortions** associated with hedge funds and alternative investments. These concerns can be categorised into the following areas:

- transparency and disclosure issues - there is a lack of transparency and disclosure about the basic operations of alternative investment funds;
- informational problems - such as absence of agreed minimum standards for independent valuation of assets or risk classification; In the US alone in 2005, valuation-related losses amounted to $1.6 billion. In some cases, poor valuation procedures and internal controls were exploited to misrepresent hedge fund valuations and to commit fraud.
- gaps in the reporting regime – in addition to disclosure problems relating to the basic operations of alternative investment funds, the reporting requirements relating to corporate social responsibility undermine accountability in the investment chain;
- product complexity - alternative investments are more complex than conventional investment products. A positive correlation between complex markets and consumer detriment is well established in consumer policy;
- contractual issues e.g. Lock-in periods;
- weak legal and governance structures, and conflicts of interest which compound disclosure problems;
- prudential and corporate risks;
- tax and jurisdiction issues;

- conduct of business issues e.g. marketing, promotional activities, investor communications;
- intermediary competence – complex investments require higher levels of intermediary competence and skills (intermediaries in this case being pension fund trustees, pension fund managers, collective investment scheme managers, financial advisers and sales staff);
- market distortions – conflicts of interest have always existed in capital markets. But the nature of alternative investment funds (e.g. the use of performance related investment fees and investment tactics such as short-selling) and the current operational environment means that these conflicts of interest are magnified - actions of the fund managers/ investors have the capacity to exert a major distorting effect on the investment chain.

If these concerns are not managed properly, they give rise to a number of potential detriments for consumers and other stakeholders in the investment chain:

- unforeseen or unrecognised prudential/ capital risks;
- unexpected fluctuations in capital, volatility issues;
- misselling risks such as unsuitable or inappropriate product sales, expectations with regard to risk and reward not being understood;
- access to capital may be restricted because contractual terms, product design and fund risks are not understood;
- informational problems undermine effective competition with the result that there is a huge proliferation of fund managers charging high fees (compared to conventional asset management fees);
- performance expectations not met which can have serious consequences for pension scheme funding;
- the existence of alternative investment funds adds another layer in the investment chain. The extent to which current alternative investment funds market adds value is not clear.
- the operation and behaviour of alternative investment funds can have a destabilising effect on company performance and employee futures. Investors (owners of capital) such as retail investors or pension scheme beneficiaries may be unaware of the consequences of fund manager behaviour because of gaps in the reporting regime;
- alternative investment funds undermine market accountability. It is more difficult for ordinary investors (in many cases the ultimate owners of investment capital) to exert influence on markets – investors have less say in decisions about how their investment capital is used.

This has implications for regulation particularly with regards to promotions and marketing. It suggests that EU regulators would need to intervene to ensure that the information presented to consumers and their representatives is fair, accurate and not misleading. Otherwise, this will undermine the objectives of: promoting an appropriate degree of consumer protection; effective allocation of resources; and promoting justified confidence in the financial system. However, many of the key issues relating to the operation and security of hedge funds are outside the control of EU policymakers and regulators. This raises concerns about the legal protection and redress available to investors in the event of a hedge fund failing.

4.2 The issue of pension funds

The privatisation of pension systems in many countries, ‘legitimised’ by increasing demographic pressures on public systems, means that workers are increasingly being called upon to save for their retirement through various forms of pre-funded schemes governed by private pension funds. In some countries these pension funds are major players on the capital markets. In the US, the UK and Canada, pension funds hold on average 20% of the stock market capitalisation.

Privatisation reforms have often been accompanied by de-regulation of pension funds’ investment policies to diversify – and hence mitigate - their market risks. Once bounded by strict quantitative restrictions (for example a 20% limit to investment in equity), in most jurisdictions pension funds are now free to determine the composition of their portfolio by asset classes as long as they respect value-based “prudent person” standards.

In the face of demographic pressures also squeezing such funds, rates of return on ‘safe’ investments, such as government bonds, that are very low and, in some cases, the severe losses that were incurred in the 2001 downturn, pension funds are increasingly looking to gain higher rates of return and to seek out ‘alpha returns’ in particular. Investment returns can be disaggregated into two parts: returns that are generated by generic market movements, known as beta, and residual returns that are attributed to the specific investment added-value, known as alpha. With lower market ‘beta’ returns, investors need to extract more ‘alpha’ to meet their funding targets, and for pension funds to match their liabilities. Alpha investment strategies are short horizon strategies using various tactical asset allocation techniques (such as delta-tilt, cross-market & overlay, flexible absolute returns, low liquidity & equity-tilt, long-only & long/short hedge funds, etc.)

As a result of the de-regulation of their investment policy and the search for ‘alpha’ returns, pension funds are diverting part of their assets away from traditional bonds and equity investments into new ‘alternative’, alpha-oriented investment vehicles such as hedge and private equity funds (including funds of funds).

This raises two main issues.

Pension funds aim to generate a long-term flow of income from their accumulated capital in order to meet their commitments - pay out pensions - also over the longer term. This suggests that investment in short-term and highly risky forms of investment should, at most, be a marginal activity for such funds, a little speculative froth on the top of a large cup of sustaining liquid. As shown elsewhere in this report, however, there are systemic pressures on fund managers pushing them to ‘go with the flow’ (herding) and not to let their returns fall significantly below the current best performers in the industry. Yet if these ‘best performers’ are merely so in the short term because of a favourable run of speculative successes, there will be a general pressure to take on higher risk. Moreover as pension fund money flows into alternative investments, which are by definition niche markets, it is increasingly unlikely that, as a whole, they will continue to be able to extract ‘alpha’ returns over and above the normal market rates of return.

A second concern is that of a division between the interests of retired (or elderly) workers whose pension funds are pushed to adopt alpha risk strategies, including investment in hedge funds and private equity and younger employed workers who are facing cuts in pay and conditions (threatening their own ability to save for their retirement) as a result of the self-same activity (such as the negative effects of leveraged buy-outs on wages, employment and working conditions). Such tensions are likely to exacerbate the already serious problem of achieving inter-generational equity in designing and reforming public pension systems.

As many jurisdictions require beneficiary representation on the governing body of pension funds – a representation that almost systematically falls on the shoulders of trade unions – the role of the labour movement in contributing to the needed regulatory responses is indispensable.

Part III sets out a series of proposals for regulating the alternative investment funds market to deal with these risks and detriments in a proportionate manner.

5. Stability of financial markets

The near-collapse of the hedge fund Long-Term Capital Management (LTCM) in 1998 raised concerns that the rapid growth of hedge fund business could have negative effects on the stability of financial markets (see box 1). Even though the collapse was prevented at the last minute, there was a significant reduction of 10-year government bond yields in many developed countries and a huge increase of the spreads between the 30-year and the 10-year maturities. In addition to this instability in the more liquid markets the crisis had extremely negative effects on emerging markets securities' prices, where the trading ranges, as far as equity markets were concerned, reached a width of almost 50% throughout 1998.

Financial instability and the related effects on counterparties and financial market confidence are important for many reasons. From a macro economic and social point of view two are particularly important. First, research has shown that financial instability is likely to slow down economic growth for several years after a crisis has occurred. Second, instability often has significant distributional consequences. This is especially the case in developing countries. Yet, even in the EU member-states lower income households are likely to bear a disproportional burden in terms of increasing unemployment and/or falling real-wages[23].

So far LTCM remains exceptional. Nonetheless, a number of more recent, smaller crises have prompted similar concerns about financial stability. This was for instance the case during the crisis of the hedge fund Amaranth (see box 2). Against this background, a Wall Street Journal survey among 50 renowned economists asked if "hedge funds pose a risk to the stability of financial markets?", 57% of the experts said yes[24]. Since June 2006 the European Central Bank (ECB) Financial Stability Review contains a special section on hedge funds. In a clear hint of rising concerns with the growing hedge fund business, the first of these sections described a number of significant threats to financial stability that "warrant close monitoring". In addition, the ECB stressed "the essential lack of any possible remedies" to deal with the threats[25].

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[23] Stiglitz, J. (2000): Capital market liberalization, economic growth, and instability, in World Development, Vol. 28, No. 6, pp. 1075-1086.

[24] Wall Street Journal (Phil Izzo) (2006, Oct. 13): Economic forecasting survey. Getting a grip on hedge fund risk, http://online.wsj.com/public/article/SB116058289284889490-P5gz1td28WJajNheo7gAUEzUtkY_20071012.html?mod=rss_free (16.11.2006).

[25] ECB (2006): Financial Stability Review, http://www.ecb.int/pub/pdf/other/financialstabilityreview200606en.pdf, p. 142 (12.11.2006)

One year earlier the British Financial Service Authorities (FSA) took a similar stance arguing that "significant distress of a large and highly exposed hedge fund – or, with greater probability, a cluster of medium sized hedge funds with significant and concentrated exposures – could cause serious market disruption." This is particularly likely to be the case in markets where hedge funds have taken large positions or when markets are relatively illiquid. The FSA furthermore emphasised that a crisis "… could also erode confidence in the financial strength of other hedge funds or of firms which are counterparties to hedge funds."[26]

The concerns of the ECB and the FSA stand in contrast to the relaxed attitude of the International Monetary Fund (IMF) and the Bank of England, both of which have stressed the positive effects of hedge funds while recognising minor dangers. Among the potentially positive effects mentioned are liquidity provision and the removal of perceived market inefficiencies by arbitraging away price differences for the same risk across markets.[27]

In its recent report the Alternative Investment Expert Group of the European Commission seems even more relaxed than the IMF and the Bank of England. Thus, the report devoted just one short paragraph to the issue of hedge funds and financial stability. In this paragraph it is stated that "there is little evidence to suggest that hedge funds threaten financial stability". Moreover, the Expert Group claims – with strikingly few references to empirical evidence – that the LTCM crisis has "prompted the tightening up of controls as investment banks have significantly improved the way in which they manage their exposures to hedge funds."[28]

Who is right? In the following we will argue that the crisis of LTCM and other hedge funds has proved to be only a temporary setback for the long-term growth of the hedge fund industry. In addition, several of the factors that played a central role in the LTCM crisis remain. Last but not least, regulators still find themselves in a situation with an enormous lack of transparency and reliable data on which to base informed decisions about threats. Consequently, it is difficult to take proportionate regulatory action to prevent or counter such treats. For these reasons, we side with those who believe that hedge funds have created substantial threats to global financial stability, threats for which there are currently too few remedies.

We will return to the remedies, i.e. recommendations for voluntary and regulatory action in Part III. Thus the focus of this chapter – and our fifth and last major concern – is on the threats that hedge funds pose to financial stability. To structure the analysis, it seems useful to distinguish between six factors explaining why hedge funds may pose threats to financial stability. These factors are often related, meaning that a financial crisis may be escalated through mutual links among several factors. For instance, market risk, liquidity risks and leverage may interact. Ideally, a risk assessment ought to analyse such potential patterns of interaction. Yet, this is beyond the scope of this chapter. Here we will have to deal with the factors separately. The factors that we will deal with are:

1. **Risk taking in the context of growing competition and high performance fees**
2. **Growing assets under management**
3. **Short selling**

[26] FSA (2005): Hedge funds: A discussion of risk and regulatory engagement, http://www.fsa.gov.uk/pages/library/policy/dp/2005/05_04.shtml, item 3.2/p. 19 (06.11.2006).
[27] E.g. speech by Sir John Gieve (Deputy Governor, Bank of England) at the 2006 Hedge Conference, http://www.bankofengland.co.uk/publications/speeches/2006/speech285.pdf (13.11.2006)
[28] European Commission (2006): Report of the Alternative Investment Expert Group: Managing, Servicing and Marketing Hedge funds in Europe, http://ec.europa.eu/internal_market/securities/docs/ucits/reports/hedgefunds_en.pdf, p. 12 (08.11.2006).

4. **Increasing correlations**
5. **Concentration on less liquid markets**
6. **High leverage and concentration in complex derivative products**

Before we turn to our analysis of these factors two points ought to be made. First, it should be emphasised that some of these factors apply to both hedge funds and private equity funds. Thus, private equity funds may also pose threats to financial stability. However, we believe that the most alarming threats stem from the hedge fund industry. Consequently, this industry is the sole focus of this chapter. Secondly, hedge fund size and strategies vary a lot (see also part I). This in turn means that the threats hedge funds pose to financial stability vary a lot. It is beyond the scope of this chapter to make detailed descriptions of these variations and assess their implications on financial stability. Instead, we are forced to deal with a more generalised model of hedge funds.

5.1 Risk taking in the context of growing competition and high performance fees

More regulated financial institutions are normally reluctant to be exposed to the kind of risk to which many hedge funds expose themselves. By contrast, hedge funds have always tended to be risk takers in a number of markets. This is particularly the case in complex markets, where risks are difficult to quantify and hedge funds have a competitive edge because of their often superior models. The credit derivatives market that we turn to further below is just one example of such a complex market. There are several reasons why hedge funds and their managers are more prone to take risks. In this section we will address two important ones: the extensive use of performance fees in the remuneration packages of hedge fund managers and increasing competition in the hedge fund industry.

The rising number of active hedge funds is due to rising demand for hedge fund products. Yet, explanations of this ought also to focus on the supply side. Here management fees often seem to be considerably higher than for instance the fees paid to mutual fund managers. In an ironic comment on this point, Financial Time journalist Stephen Schurr recently wrote that "It may take a genius to run a hedge fund successfully on the long haul but it does not take a genius to recognize that running a hedge fund with a 2 per cent management fee and a 20 percent performance fee is a better option than slugging it out at a mutual fund"[29].

Normally, the hedge fund manager will receive both a management fee and a performance fee, with the latter playing the predominant role. As with other investment funds, the management fee is computed as a percentage of assets under management. Management fees might typically be 2 per cent but may range from 0 to 5 per cent. The typical performance fee amounts to at least 20 per cent of the gains above a specified benchmark over a comparatively short period of 3 to 12 months.

Usually, the benchmark for the calculation of performance fees is the hedge fund's net asset value at the beginning of the measurement period. Yet, sometimes the performance fees are levied only after a so-called "performance hurdle" such as the short- term interest rate has been met. It is also not un-common to link the payment of performance fees to so called "high water marks". This means that a hedge fund manager does not receive incentive fees unless the value of

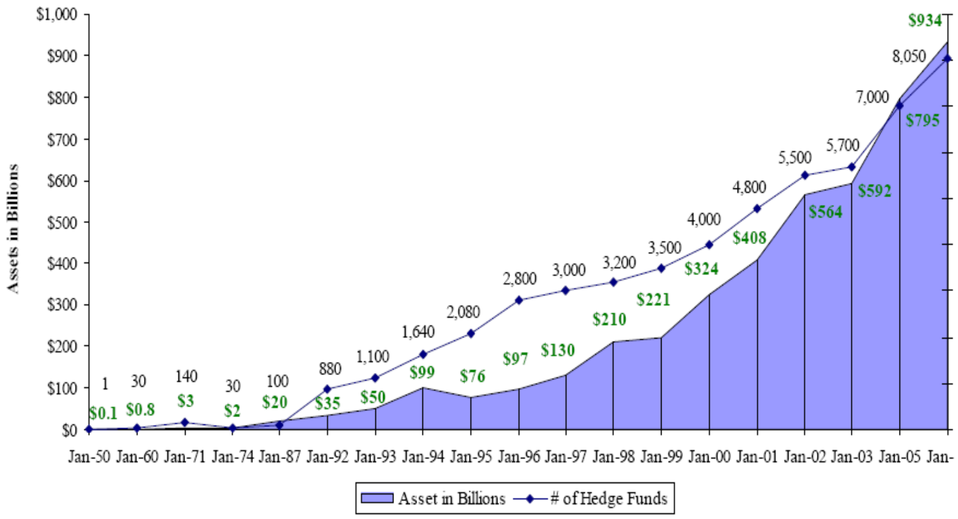
[29] *Financial Times* (Stephen Schurr) (2006): Hedge funds need to sober up soon, July 3, p. 6.

the fund exceeds the highest value it has previously achieved. From the point of view of investors, this measure is intended to link the manager's interests more closely to those of investors and to reduce the incentive for managers to seek volatile trades. Thus, if a high water mark is not used, a fund that ends alternate years at 100 and 110 would generate performance fees every other year, enriching the manager but not the investors

Performance fees of the types described here tend to encourage investment strategies that increase the probability of exceeding comparatively high return benchmarks. Such strategies are most likely to entail greater risk, risk that – in the advent of failure – could spark a crisis.

Risk taking is also likely to be closely linked with competition in the hedge fund industry. In the recent decade, the hedge fund market has grown at a staggering pace – in terms of the number of active hedge funds that we will turn to here and in terms of the assets under management, which we will return to further below (see table 1).

Table 1 : Hedge Fund Assets under Management and Number of Hedge Funds, 1950-2005[30]



The rising number of hedge funds appears to go hand in hand with increasing competition between hedge funds. The market for those hedge funds pursuing arbitrage strategies is but one example of this. Here, a massive inflow of money managed by a growing number of hedge funds appears to have competed away many arbitrage opportunities.

Due to increasing competition hedge fund managers have engaged in a search for alternative ways to maintain or increase yields in a market where average yields seem to be sloping downwards. In this context, many hedge fund managers are likely to consider investment opportunities involving more risk than was the case in the past. At least this is what has happened in the past, for instance in the early 1970s. In his recent book Hedge Hogging, the hedge fund and Wall Street veteran Barton Biggs describes the years from 1970 to 1973 as a period in which increasing competition led many hedge fund managers to take ever greater risks, with facile hedges. As a consequence "(…) many hedge funds crashed and burned because they were really just leveraged long funds and as a result suffered huge declines", Biggs writes, adding "Other funds had bought private equity-venture deals that turned out to be totally illiquid when things

30 Source: Hennessee Group and CISDM, http://www.magnum.com/hedgefunds/articles/2005/050101.pdf and http://cisdm.som.umass.edu/research/pdffiles/benefitsofhedgefunds.pdf (04.01.2007).

got tough."[31]

This process of rise and fall does not seem to be historically unique. For instance, the period between 1995 and 2002, a period characterised by first an upward and later a downward sloping market had a failure rate of 32% among funds with assets under management lower than $ 50 million. The same happened to around two thirds of funds of a size between $ 50 million and $ 150 million. This percentage decreases significantly to less than 4% in the case of funds with more than $ 150 million assets under management. The highest failure rates are found in the field of managed futures (derivatives) that we turn to further below. By contrast, convertible arbitrage and event driven strategies appear to have considerably lower failure rates.[32]

Since 2002 the market has been sloping gradually upward for developed markets and rapidly upward for emerging markets, e.g. South-East Asia. Yet, this process might stop once more and lead to large-scale failures. It is difficult to assess when this could happen. And in the absence of regulation it is most likely that the failures will repeat themselves. Moreover, the failures may have a much more profound impact on financial stability than we have seen in the past. This is not least due to some of the factors that will be addressed in the rest of this chapter, among them the growing amount of assets under management.

5.2 Growing assets under management

The crisis of LTCM and other hedge funds proved only to be a temporary setback for the long-term growth of the hedge fund industry According to conservative estimates, assets under management by single strategy hedge funds, and the so called funds of funds, have climbed from less than $100 billion in 1990 to more than $1,100 billion in 2005 (see Part I)]. Less conservative estimates suggest that the assets under management amount to more than $1,800 billion in 2005.[33] Currently, the staggering growth rates – a 16-year average of 15% p.a. – continue. Thus, some even predict that the assets under management could double again within the next three years. This growth increases the potential impact of a financial crisis.

Despite its rapid growth, the hedge fund market remains small compared to the size of the markets for non-alternative investments, such as the market for traditional mutual funds (UCITS). For instance, mutual funds globally managed $ 17,771 billion in 2005. In other words, hedge funds managed assets of between 6 and 10% of what mutual funds managed. This ratio has grown by around 0.7-1.0% since 2002 EoY (+12%).

Based on this observation, one could conclude that the potential impact of failing hedge funds remains small. By contrast, the FSA argues that a hedge fund with say $1 billion of assets under management may have a far greater market impact than a traditional investment fund with the same amount of assets under management.[34] Besides the absolute and relative growth in the assets under management, this is due to several of the factors that we turn to in the next subsections.

[31] Biggs, B. (2006): Hedge Hogging, Hoboken (NJ): Wiley & Sons.
[32] The President's Working Group on Financial Markets (1999): Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, http://www.ustreas.gov/press/releases/reports/hedgfund.pdf, p. viii (17.11.2006).
[33] *Wall Street Journal* (2006): Double trouble valuing the hedge-fund industry, July 8/9, 2006, p. B3.
[34] FSA (2005): ibid., item 3.29.

5.3 Short selling

Historically, hedge funds are often associated with “short selling”, i.e. the use of strategies allowing investors to gain from the decline in price of securities as well as currencies or raw materials. However, short selling has a longer history than the first hedge funds, which were set up after World War II. For instance, short sellers were blamed, in part, for the Wall Street Crash of 1929.

It is only a limited segment of hedge funds that is actually practicing short selling. Yet those who do are often charged of being trend-setters, i.e. of causing price depreciation independent of the underlying market fundamentals. This was for instance the case during the currency crisis of 1992, where some believed that the short selling strategies of the Soros-led Quantum hedge fund were the sole cause of the devaluation of the British Pound.

In the light of the current size of assets under management, there can be little doubt that some hedge funds – alone or through concerted action – can influence prices independent of fundamentals, thereby causing instability. This is especially the case in smaller illiquid markets. Yet, it is also not unlikely that it could happen in larger and more liquid markets.

In some cases there were suspicions that hedge funds – for instance by applying short selling strategies – have been engaging in manipulation, collusion or other possibly unfair trading practices. However, it is difficult to draw the line between seemingly manipulative trades and rational economic behaviour. Furthermore, it is even more difficult to obtain information about whether such a line has been crossed. For instance, the Financial Stability Forum has declined to conclude that hedge funds had compromised market integrity in the cases analysed in a report on highly leveraged institutions. Thus, the true motives were very difficult to prove. In addition, quite often it was traditional financial institutions and investors, and not hedge funds, which seemed to lead or precipitate market crisis and crashes.[35]

5.4 Increasing correlations

A key concern regarding hedge fund and financial market stability is related to increasing similarities or correlation among hedge fund strategies. Where hedge funds are pursuing similar strategies there is an increasing risk that they will buy or sell their positions at the same time thereby disturbing liquidity, i.e. the normal fundamentally driven supply and demand.[36] This could in turn leave hedge funds and third parties like banks and institutional investors highly vulnerable to adverse market dynamics.

The current empirical evidence as to whether hedge funds and institutional investors engage in such “copy-cat” behaviour is alarming. According to ECB calculations, the recent increasing competition in hedge fund markets has come along with increasing correlations among hedge fund strategies. In this connection, the ECB has stated that “... the correlations among hedge fund strategies tended to increase more or less continuously after mid-2003, reaching an all-time peak in 2005.” It is important to note the fact that correlations are rising not only within some

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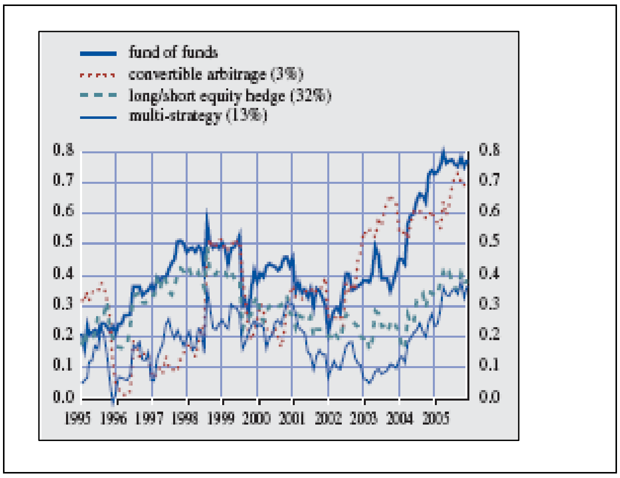
[35] Financial Stability Forum (2000): Report of the Working Group on Highly Leveraged Institutions, http://www.fsforum.org/publications/Rep_WG_HLI00.pdf (02.12.2006)

[36] E.g. Counterparty Risk Management Policy Group (2005): Toward greater financial stability: A private sector perspective, July, p. 48.

strategies, but also among strategies, raising concerns that some triggering event could lead to highly correlated exits. Furthermore, the ECB has stressed that "… the levels reached in late 2005 exceeded those that prevailed just before the near-collapse of the LTCM …"[37].

Table 2: Medians of pair wise correlation coefficients of monthly hedge fund returns within strategies

(Jan. 1995-Dec. 2005, monthly net of all returns in USD)



Sources: ECB Financial Stability Review, June 2006.

(Numbers in parentheses after strategy indicate the share of total capital under management (excluding FOHFs) at the end of 2005.)

There may be a number of reasons for high correlations. In the case of the LTCM crisis (see box 1) many of the virtual, statistical models used by hedge funds and other players in financial markets led to the same kind of behaviour. In the case of LTCM it also seems as if the brokers, who received order flow information through their dealings with LTCM, took similar positions alongside their client. In the more recent case of the hedge fund Amaranth (see box 2), the reason for its default does not appear to lie especially in excess of leverage but in an unsatisfactory management approach, which underestimated the correlation among different bets and the problematic concentration on a single thin market like the market for natural gas. Amaranth's position represented a significant share of the whole market. Consequently, it was difficult to unwind the fund's portfolio when things begun to get worse.

Despite the increasing correlations, the more recent default of the hedge fund Amaranth did not appear to have threatened or even influenced financial market stability (see box 2). Thus, there has been an absolute absence of contagion spreads over the other financial markets: No volatility spikes were registered during September 2006, neither on the stock markets, nor on the bond markets. Furthermore, the commodity market itself did not show any sign of fear as the ordinary price behaviour of the CRB index in September 2006 testifies. Nonetheless the absence of contagion spreads in the Amaranth case is no assurance that hedge funds have become any more robust. One of several important differences to the LTCM crisis of 1998 was the situation of

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[37] ECB (2006): ibid., p. 135.

global financial markets. In 1998 they were under extreme stress in the aftermath of the Russian crisis. In 2006 they were awash with cash after many years of loose monetary policy.

Box 1: **The LTCM case** (1998)

The near-default of Long-Term Capital Management (LTCM) in September 1998 and its fall-out on world financial markets brought hedge funds to the attention of the global financial community. LTCM was founded in early 1994 as a US limited liability partnership, and its main fund, Long-Term Capital Portfolio, was domiciled in the offshore centre of the Cayman Islands. Many prominent names from Wall Street and academia were present among its principals and investors, including Nobel Prize laureate Myron Scholes. At the beginning of 1998, LTCM managed approximately USD 4.8 billion of assets.

According to the TASS database, LTCM could be defined as a fixed income arbitrage fund. This means that LTCM used sophisticated relative value arbitrage strategies in global fixed income and equity index markets. These strategies relied heavily on quantitative models using past correlations between financial market variables. LTCM managers were taking market positions on the assumption that liquidity, credit and volatility spreads would narrow from their historically high levels. For a long time this strategy worked well. A favourable macroeconomic environment, the worldwide decline in inflation and a substantial convergence in interest rates associated with the prospect of Economic and Monetary Union (EMU) all led to a significant similarity of nominal yields and risk spreads in the industrial economies. These market positions were supported by extremely high leverage, with a leverage ratio, at one extreme stage, of over 50 to 1, and otherwise around 25 to 1. In other words balance sheet assets were at times more than 50 or 25 times higher than equity. Notwithstanding its limited disclosure, the fund's impressive track record and reputation of its principals ensured very favourable credit terms, while the large trading volume made the fund a very desirable counterparty.

The Russian debt crisis, however, caused global interest rate anomalies, as investors rushed into a "flight-to-quality" and spreads on riskier debt widened dramatically. Past correlations between financial markets broke down, LTCM investments began to lose value, and the fund was forced to unwind its positions at very unfavourable prices in order to meet margin calls and satisfy other liquidity demands. The problems were reinforced by the sheer size of the LTCM positions in certain markets, high-leverage and an imitation of LTCM trading strategies by other financial market agents, which switched to become a disastrously negative factor in the cause of the crisis.

At the end of August 1998, LTCM had already lost over 50% of its equity. What started as a pure liquidity crisis could have led to default, but a meltdown was avoided when the Federal Reserve coordinated a bailout by the consortium of the fund's 14 main bankers. Insolvency would have led to even larger losses to creditors and further disruptions in then already very fragile markets.

Sources:
- FSA (2005): ibid.
- Garbaravicius, T. and Dierick, F. (2005): Hedge funds and their implications for financial stability, European Central Bank, Occasional Paper Series, No. 34, August.
- MacKenzie, D. (2005): How a Superportfolio Emerges: Long-Term Capital Management and the Sociology of Arbitrage, in Knorr Cetina, K. and Preda, A. (ed.) (2005): The Sociology of Financial Markets, Oxford: Oxford University Press.

Box 2: **The Amaranth case** (2006)

In September 2006, the hedge fund Amaranth Advisors suffered, over the space of a few days, very heavy losses related to unhedged positions in the natural gas futures market: USD 6.4 billion, or almost 70% of its assets over the month. It was the greatest hedge fund industry debacle since the failure of LTCM in 1998, when losses totalled USD 5.75 billion. Created in 2000, Amaranth billed itself as a multi-strategy diversified hedge fund. In reality, its positions in the energy sector represented around half of its assets and generated around 75% of its gains before the crisis. Like many hedge funds, its strategy was based on exploiting statistical regularities relating to market prices, which although likely to reoccur, may not necessarily do so. By betting on seasonal variations in natural gas futures prices, Amaranth could have made massive profits in 2005, compounded by the effects of hurricane Katrina. That year, however, the strategy did not pay off. The magnitude of the losses sustained by Amaranth can be explained not only by price movements, but above all by the relative size of its positions on the natural gas futures market.

Despite its spectacular nature, the demise of Amaranth did not cause major or lasting upheavals on the markets. There may be a number of reasons for this. First, there was no large-scale withdrawal of investors thanks to clauses preventing them from doing so, which limited Amaranth’s liquidity needs. Furthermore, the fund was able to meet its margin calls as it could easily sell its leveraged loans (loans to speculative grade companies or firms undergoing leveraged buy-outs) and its convertible bonds, given the high demand in the current circumstances. The fund’s difficulties did not excessively affect its bank creditors or result in a rise in counterparty risk. It also appears that other market participants had been aware of the fund’s growing exposure to the natural gas futures market for a long time, which enabled them to take steps sufficiently early to avoid becoming enmeshed if Amaranth chose to suddenly close out its positions. Lastly, the way in which the fund resolved the crisis no doubt prevented it from spreading. In mid-September, the management of Amaranth decided to bring together a number of investment banks to organise the sale of its energy portfolio in an orderly manner. It was sold to JP Morgan Chase and the hedge fund Citadel on 20 September at a significant discount to market value, with no major impact on the natural gas market as a whole.

The Amaranth case illustrates first and foremost the seriousness of the risks related to over-concentration on markets as narrow as that of natural gas futures contracts. A simple examination of the notional value of Amaranth positions relative to its prevailing open positions in the futures market should have sent alarm bells ringing about the soundness of the strategy. Furthermore, it seems likely that a significant amount of the transactions were conducted on OTC markets via brokers and on electronic trading platforms such as Clearport and ICE (Intercontinental Exchange), which are not all regulated. The Amaranth affair therefore provides arguments to support projects calling for comprehensive transparency requirements in these markets. Lastly, the failure of Amaranth’s risk management system is a reminder that value-at-risk indicators are insufficient for assessing market liquidity risk and that it is dangerous to mechanically use tools that give a false sense of security.

Aside from the usefulness of the lessons learnt from the Amaranth debacle, the case has highlighted the importance of good co-ordination between market participants, without intervention by the public authorities, to avoid potential negative externalities and the systemic implications associated with the liquidation of Amaranth's assets. It is, however not at all certain, that such mechanisms would have worked if a number of hedge funds had experienced difficulties at the same time.

Sources:
- Banque de France, Financial Stability Review, No. 9, December 2006, p. 23. (Main source).
- Herald Tribune International (2006): Anatomy of a hedge funds $6.6 billion. Failure, December 7.
- Handelsblatt (2006): Milliardenverluste des Hedge-Fonds Amaranth schüren die Angst vor einer Finanzkrise, Oktober 20.

5.5 Concentration on less liquid markets

In addition to increasing correlations, the ECB has stressed that the liquidity of many hedge fund investments may be decreasing, "… as recently hedge funds have reportedly been acquiring less liquid assets." In this connection the ECB argues that "most strategies involving liquid assets have come under pressure due to higher competition and lower profitable trading opportunities across common strategies. Hence, more funds have been turning to increasingly exotic strategies and less liquid markets in order to earn the associated liquidity premium."[38]

The latter in turn increases the vulnerability to redemption risks in the advent of a crisis. Thus, in stressed times, a squeeze can arise especially in less liquid markets. When several hedge funds, that are pursuing the same strategies, rush for cover, liquidity evaporates suddenly in those market segments. Instead of bringing in liquidity, hedge funds generate major liquidity risks. The mix of credit and liquidity risks in investment styles using short selling-come-leverage can make hedge funds the weak links initiating a systemic event. If hedge funds are induced to withdraw together from the same markets under the constraint of a higher cost of financing or margin calls, the forced selling of assets could trigger the same behaviour among more traditional institutional investors. This could in turn spark a financial crisis.

From a geographic perspective, Asia currently seems to be a major growth area of hedge funds. In this area markets often tend to be less liquid[39]. The taking of positions in relatively illiquid OTC derivatives and the adoption of private equity-style investing are further examples of a trend towards decreasing liquidity. In addition to this, moves into illiquid assets have been complemented by changes in macro economic policies affecting the liquidity of existing positions. One example of this was when – in early 2006 – Japan ended its seemingly endless monetary easing policy, thereby taking around €190 billion out of the global financial markets.

5.6 High leverage and concentration in complex derivative products

A key characteristic of many hedge funds is a very high degree of leverage compared to traditional funds. In the aftermath of the LTCM crisis, the US President's Working Group on

[38] ECB (2006): ibid., p. 137.
[39] FSA (2005): ibid., item 3.21.

Financial Markets released a report on “Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management” in which the dangers of excessive leverage were portrayed as the main policy lesson to be learned.[40]

Despite all the criticism of this report its conclusion seems justified. Thus, LTCM operated with an extremely high leverage ratio, which at some stage was reported to be over 50 to 1 (see box 1). Leverage risk can, if it is not supported by adequate “emergency” borrowing capacity or reserves of liquid assets, force a hedge fund to default on its obligations to prime brokers and other financial institutions, thereby setting in motion a domino effect threatening financial stability.

In June 2005 the FSA stated that “currently, leverage at the aggregate level is not very high in historical terms.” Thus, the FSA found no evidence of a highly leveraged fund on the scale of LTCM.[41] However, the FSA also emphasised, that there are great variations among hedge funds. In August 2005, these views were confirmed by the ECB, which stated that “there is some support of the view that leverage across the hedge fund industry has probably declined and is presently lower than at the time of the near-failure of the LTCM”[42]. Drawing on data from the TASS database the ECB also suggests that leverage varies quite significantly depending on hedge fund strategies, size and age. For instance, it is worth noting that the hedge funds with the largest amount of assets under management also seem to operate with relatively high levels of leverage.

Contrary to the FSA and ECB, the German Bundesbank has warned against a growing use of leverage[43]. The latter view is supported by several observers of the financial markets. In a cautionary essay from April 2006 the renowned hedge fund manager Jonathan Bailey wrote that “hedge funds have rarely been longer, more levered and less hedged than they are today.”[44] In a comment from January 2007 Financial Times, editor Gillian Tett made a similar point. In addition, she suggested that much of the rising leverage and leverage risk remains undisclosed because hedge funds obtain leverage in ways that are difficult for outsiders to monitor and comprehend (see box 3).

Why is there such a significant difference in the assessments of the current levels of leverage and leverage risk in the hedge fund industry? Indeed, it might be – as Gillian Tett suggests – that we experience an unnoticed boom in leverage and risk without knowing it, because the boom is occurring in an area where there is little available information. In addition, there are a number of possible measures of, and methodological problems with the measurement of leverage.[45] To understand this argument it seems helpful to take a closer look at the concept and sources of leverage. Leverage (or gearing) can be defined as the use of given resources in such a way that the potential positive outcome of the use is magnified. Thus, leverage allows greater potential return to the investor than otherwise would have been available. However, the potential for loss is also greater because loans and other sources of leverage need to be repaid.

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[40] The President’s Working Group on Financial Markets (1999): Hedge Funds, leverage, and the lessons of Long-Term Capital Management, http://www.ustreas.gov/press/releases/reports/hedgfund.pdf, p. viii (17.11.2006). See also Krugman, P. (1999): The Return of Depression Economics, London: Allen Lane.

[41] FSA (2005): ibid., item 3.19 and 3.20.

[42] ECB (2005): Occasional Paper No. 34, August 2005, p. 32f. The conclusions made by the ECB have also been reached by McGuire et al. (2005) from the BIS.

[43] Deutsche Bundesbank (2006): Risiken im Finanzsystem. Herausforderungen für die Bankenaufsicht, in Festvortrag von Dr. h. c . Edgar Meister (Mitglied des Vorstandes der Deutschen Bundesbank) anlässlich der ordentlichen Generalversammlung der Österreichischen Bankwissenschaftlichen Gesellschaft in Wien am Montag, 16. Oktober 2006, http://www.bundesbank.de/download/presse/reden/2006/20061016_meister.pdf (05.01.2007).

[44] Bailey, J. (2006): Hedgehog, Wealth Management Survey (Spear Media), April Edition.

[45] ECB (2005): ibid., p. 30f.

The classic source of leverage is loans. Yet, there are also a number of other ways to obtain leverage. According to the ECB hedge funds tend to prefer, a) arrangements where positions are established by posting margins rather than the full value of a position, or b) derivatives. By contrast, direct credit in the form of loans is rather uncommon, although credit lines for liquidity purposes are widely used.[46] Generally, margin buying and derivatives offer the greatest possibility to capitalise on leverage. Yet, margin buying and derivatives are also likely to be associated with much greater risks. Moreover, the risks inherent in these activities may not be fully recognized. A look at derivatives and the market for credit derivatives can serve to illustrate this point.

Derivatives allow leverage without borrowing explicitly. However the risk of borrowing is implicit in the price of the derivative. Derivatives such as futures, options and swaps are financial instruments derived from some other asset. Rather than trading or exchanging an asset itself, market participants enter into an agreement to exchange or to have the possibility to exchange money, assets or some other value at some future date. A simple example is a futures contract, i.e. an agreement to exchange the underlying asset at a future date.

The markets for derivatives are generally growing at an extraordinary pace. This is not least the case with the market for credit derivatives. Credit derivatives allow default risk to be transferred without modifying the legal ownership of the underlying assets and without having to refinance the loan. As a result, this market is booming and notional amounts outstanding rose from less than $ 1,000 billion in 2001 to $ 26,000 billion at the end of June 2006.[47] Hedge funds are increasingly active in the markets for credit derivatives. Fitch Ratings estimates their share of derivatives trading at 25%. In addition, it is assumed that hedge funds trade mainly in the riskiest segments of the market.[48]

Generally credit derivatives serve the transfer risk from one party to another. One party gets rid of (or hedges) credit risk while the other party takes on the risk with the possibility of making a profit or a loss. The possibility of transferring risks has encouraged banks, in particular the largest ones, to change their behaviour substantially. Thus, they have started moving from strategies in which they kept credit risk on their balance sheets for several years, to strategies in which they trade with risk or pass it on to other players in the financial market. This allows them to shift to activities that generate fees and commissions (consultancy, intermediation and structured finance activities). At the same time risks are spread among more (new) players in financial markets, including hedge funds.

On the one hand, credit derivatives may make a significant contribution to the improvement of risk allocation. Greater risk dispersion among financial market players may also reduce the vulnerability of the financial system as a whole. The Banque de France for instance argues that the latter "… was corroborated by the fact that no systemic impact was observed on credit markets in the wake of the difficulties experienced in 2005 by large corporate issuers such as General Motors and Ford, whose ratings were downgraded and Delphi, which went bankrupt. These shocks were limited, admittedly, but no spill-over was observed, volatility remained in check and market"[49]. On the other hand, the trade of credit derivatives (and other derivatives) have generated a hitherto unseen opacity in the financial system.

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[46] ECB (2005): ibid., p. 28f.

[47] Banque de France, Financial Stability Review, No. 9, December 2006, p. 18.

[48] Fitch Ratings (2006): Global Credit Derivatives Survey: Risk Dispersion Accelerates, http://www.fitchratings.com/corporate/search/results.cfm (15.01.2007, subject to fee).

[49] Banque de France, Financial Stability Review, No. 9, December 2006, p. 22.

On the other hand, the trade of credit derivatives (and other derivatives) have generated an hitherto unseen opacity in the financial system. The opacity is first and foremost due to the fact that most transactions are conducted in so-called "over-the-counter" (OTC) derivatives. OTC-derivatives are traded (and privately negotiated) directly between two parties, without going through an exchange or other intermediary. Currently, the issuing and trade of OTC-derivatives is not recorded in a centralised manner. Moreover, risks are usually transferred by banks, which are regulated and transparent, to entities that are barely regulated or not regulated at all and are not required to disclose their positions. While risk from these transactions may appear to be widely distributed it is often impossible for regulators and market participants to ascertain the identity or situation of the ultimate risk holders. Finally, a number of additional factors makes it very difficult to analyse the sparse information available and – if required – to take timely action. The most important factors are the enormous size of the broader derivatives market and the more narrow market for credit derivatives, the high velocity with which derivatives are traded, the complexity of the derivatives issued and the opacity of the strategies pursued with the derivatives.

In sum, it is disputed that the use of leverage and the risk stemming from it has declined. We have argued that a boom in leverage and risk may go by unnoticed, because the boom is occurring in areas characterised by great opacity, e.g. the market for credit derivatives. If indeed the level of leverage has declined slightly, the potential for forced sales of hedge fund positions in the context of crisis may be lower today than it was at the time of the LTCM crisis. Yet, even with a lower level of leverage, there are situations where even more moderate price swings could force hedge funds to sell their leveraged positions to meet margin calls, potentially leading to a domino effect across markets. Moreover, much lending is short term, which in combination with high leverage, further decreases the ability to wait until a possible price recovery.

Box 3: **Complex leverage arrangements**

Last week I received an e-mail that made chilling reading. The author claimed to be a senior banker with strong feelings about a column I wrote last week, suggesting that the explosion in structured finance could be exacerbating the current exuberance of the credit markets, by creating additional leverage.

"Hi Gillian," the message went. "I have been working in the leveraged credit and distressed debt sector for 20 years . . . and I have never seen anything quite like what is currently going on. Market participants have lost all memory of what risk is and are behaving as if the so-called wall of liquidity will last indefinitely and that volatility is a thing of the past. I don't think there has ever been a time in history when such a large proportion of the riskiest credit assets have been owned by such financially weak institutions . . . with very limited capacity to withstand adverse credit events and market downturns. I am not sure what is worse, talking to market players who generally believe that 'this time it's different', or to more seasoned players who . . . privately acknowledge that there is a bubble waiting to burst but . . . hope problems will not arise until after the next bonus round."

He then relates the case of a typical hedge fund, two times levered. That looks modest until you realise it is partly backed by fund of funds' money (which is three times levered) and investing in deeply subordinated tranches of collateralised debt obligations, which are nine times levered. "Thus every €1m of CDO bonds acquired is effectively supported by less than €20,000 of end investors' capital - a 2% price decline in the CDO paper wipes out the capital supporting it. The degree of leverage at work . . . is quite frankly frightening," he concludes. "Very few hedge funds

I talk to have got a prayer in the next downturn. Even more worryingly, most of them don't even expect one."

Since this message arrived via an anonymous e-mail account, it might be a prank. But I doubt it. For, while I would not normally write an article about responses to an article (it is the journalist's equivalent of creating derivatives of derivatives) I am breaking this rule, since I have recently had numerous e-mails echoing the above points. And most of these come from named individuals, albeit ones who need to stay anonymous, since they work for institutions reaping profits from modern finance.

There is, for example, a credit analyst at a bulge-bracket bank who worries that rating agencies are stoking up the structured credit boom, with dangerously little oversight. "If you take away the three anointed interpreters of 'investment grade', that market folds up shop. I wonder if your readers understand that . . . and the non-trivial conflict of interest that these agencies sit on top of as publicly listed, for-profit companies?"

Then there is the (senior) asset manager who thinks leverage is proliferating because investors believe risk has been dispersed so well there will never be a crisis, though this proposition remains far from proven. "I have been involved in [these] markets since the early days," he writes. "But I wonder if those who are newer to the game truly understand the impact of a down cycle?"

To be fair, amid this wave of anxiety I also received a couple of "soothing" comments. An analyst at JP-Morgan, for example, kindly explained at length the benefits of the CDO boom: namely that these instruments help investors diversify portfolios; provide long-term financing for asset managers and reallocate risk. "Longer term, there may well be a re-pricing of assets as the economy slows and credit risk increases," he concludes. "But there is a very strong case to be made that the CDO market has played a major role in driving down economic and market volatility over the past 10 years." Let us hope so. And certainly investors are behaving as if volatility is disappearing: just look at yesterday's remarkable movements in credit default swaps. But if there is any moral from my inbox, it is how much unease - and leverage - is bubbling, largely unseen, in today's Brave New financial world. That is definitely worth shouting about, even amid the records now being set in the derivatives sector.

Source:
- Financial Times (2007) (Gillian Tett, Jan. 19): The unease bubbling in today's brave new financial world, http://www.ft.com/cms/s/92f7ee6a-a765-11db-83e4-0000779e2340.html (20.01.2007)

5.7 A case for systemic risks

How do hedge funds affect financial market stability? According to some the potential effects are minimal. Yet, since the near-collapse of LTCM in 1998 many scholars and institutions – among them the ECB – have pointed to potentially destabilising effects of hedge funds. In our view there are at least six factors explaining why hedge funds may pose threats to financial stability.

1) *Risk taking in the context of growing competition and high performance fees*: The crisis of LTCM and the failure of a great many smaller hedge funds have proved to be only a temporary set-back for the long-term growth of the hedge fund industry, in terms of both the number of hedge funds and the size of assets under management. Based on historical experience – and in the absence of regulation – the industry growth and the extensive use of performance fees is likely to go hand in hand with increasing competition and risk taking that could start another wave of failures among smaller, medium sized and – with lower probability – large hedge funds.

2) *Growing assets under management*: Currently hedge funds manage assets amounting to somewhere between 6 and 10% of what mutual funds manage. Against this background, it could be concluded that the potential impact of failing hedge funds remains small. We believe that this conclusion is wrong. The amount of assets under management has become quite significant, and it is constantly growing. Furthermore, the failure of a hedge fund may have a far greater market impact than the failure of a traditional investment fund managing the same amount of assets. In this respect, we point to factors 3-6.

3) *Short selling:* In the light of the current size of assets under management, there can be little doubt that some hedge funds – using strategies such as short selling – can influence prices independent of fundamentals and cause financial instability. This is especially the case in smaller illiquid markets. Yet, it is also not unlikely that it could happen in larger and more liquid markets.

4) *The increase in correlations*: A key concern regarding hedge fund and financial market stability is related to increasing similarities or correlation among hedge fund strategies. Where hedge funds are pursuing similar strategies there is an increasing risk that they will buy or sell their positions at the same time thereby disturbing liquidity. This could in turn leave hedge funds and third parties like banks and institutional investors highly vulnerable to adverse market dynamics.

5) *The tendency to concentrate investments in less liquid markets*: In addition to increasing correlations, observers have stressed that the liquidity of many hedge fund investments may be decreasing. Thus, ever more hedge funds have been turning to increasingly exotic strategies and less liquid markets in order to earn the associated liquidity premium. These strategies increase the vulnerability to redemption risks in the advent of a crisis.

6) *High leverage and the concentration in complex derivative products:* We have argued that a boom in leverage and risk may go unnoticed, because the boom is originating from markets characterised by great opacity, e.g. the market for credit derivatives. Leverage risk can, if it is not supported by adequate "emergency" borrowing capacity or reserves of liquid assets, force a hedge fund to default on its obligations to prime brokers and other financial institutions thereby setting in motion a domino effect threatening financial stability.

Having summarised the hedge fund related factors that we believe could pose a threat to financial market stability we would like to emphasise the great lack of information regarding many of these factors. Without transparency and reliable data it is difficult to take make informed conclusions about threats and to take proportionate regulatory action to prevent or counter those threats.

The main reason for the lack of information is the extra territoriality of many hedge funds. Another important reason is the fear that regulatory measures to improve the level and quality of information, could result in even more hedge funds going off-shore.

So far these problems and the work of a strong hedge fund lobby have led to a kind of regulatory nihilism, claiming that most regulation has negative results, so therefore the hedge funds are better off with no regulation at all. We believe that a cautionary regulatory stance is more appropriate – that hedge funds have created substantial threats to global financial stability, threats for which there are currently too few remedies.

6. Coherence, co-responsibility and ethics

Our welfare societies in Europe and our social market economy have for a century been built on a certain feeling of coherence, justice and shared responsibility. Our tax systems, public sector services, social policies, universal education etc. are based on that shared responsibility. Throughout the years the different actors have accepted this balanced interest including the social partners and their collective bargaining on the labour market.

Manager remuneration - coherence and justice

The relationship between LBO funds and incumbent management is a contradictory one, the nature of which can vary greatly depending on the attitudes of both sides, the attachment of management to the existing structures of the firms (including established systems of collective bargaining, worker participation, etc.) and the dependence of the fund on their specialised knowledge etc. In the worst cases the buyout firm enters into an unholy alliance with management: managers are enticed with a share of the spoils (stock options etc.) to participate in the looting of the firm by the fund. In others they are compensated for acquiescing to the takeover with generous – in some cases scandalous – golden handshakes. If their specialised technical or firm-specific know-how gives incumbent management a strong hand, the fund has to offer generous inducements for management to change its mode of operation. If not they may simply be replaced overnight (and can thus be expected to be interested in cooperating with employee representatives and other stakeholders in blocking takeovers). Of course, in genuine rescue and restructuring cases, the fund may be the mechanism by which the firm is able to shed incompetent management or disinterested and untalented owners.

The shareholder value approach, originating in the USA, has been spreading vigorously in the European economy. It follows the unilateral alignment of companies with the interests of shareholders who have their sights on the greatest possible increase in value of their company shares and the highest possible dividends. The private-equity industry consistently follows the shareholder value model. Such funds frequently replace the management if the latter does not actively support their goals. PE funds use a differentiated incentive scheme in order to induce management to adopt their short-term goals of increasing the value of the enterprise and freeing up liquidity including premiums, share options, participation in the enterprise, performance-based pay and bonuses for meeting PE-fund targets. For managers this can mean a significant increase in their income. For the company and its employees, this often has a detrimental effect.

Managers take greater risks that can produce excesses, such as falsifying balance sheets or backdating share options. Managers even change their attitude towards staff. According to statements made by the works councils, managerial obligations towards financial investors, incentive systems and shorter office hours, as an alternative to firing employees, create a purely numbers-based approach that takes less account of the practical operational business, as well as inducing a cold social climate and indifference towards the company and its staff.

Enterprises being run exclusively according to economic success indicators are becoming the norm, while management increasingly loses touch with actual production and the people involved in the target enterprise. What is remarkable is the increasing frequency with which takeovers are becoming more aggressive. Enterprises are increasingly being regarded as mere financial products and shareholders are becoming share traders. Sustainability and viability are losing their importance in the development of enterprises. Short-termism in business strategies is constantly on the rise.

Private equity - especially in the form of LBO - takes more and more clearly the form of a rearrangement of claims, which allow value capture and value extraction for a relatively small number of fund managers. The LBO industry emphasises the social benefits of private equity as well as the returns to investors from increasing leverage. But the real effects, as seen in many case studies, are rather helping to “normalise” a culture of value extractions (see study by CRESC, the University of Manchester, February 2007 that increasingly views companies as bundles of assets and liabilities to be traded.

The small elite of LBO managers are guaranteed extremely high fees and moreover they will be taken out not as income, but as capital gains. This has huge tax advantages when the rate of income tax is high as in the UK - 40%. The Financial Times reports rumours that leading British LBO partners pay taxes of no more than 4-5% on multi-million incomes.

These facts threaten coherence and co-responsibility among stakeholders and social partners in our societies. Given these extremely high fees, how can we seriously ask employees and wage earners to show responsibility for society as a whole during trade union are negotiations?

Fees and performance remuneration could take up to 50% of the cash-flow of a target company. This is giving rise to extremely high earnings. partners normally take 20% of the total yields (the so-called “carry”). One of the leading managers within the PE industry, Nicolas Ferguson, estimates that the PE managers in the period 1996-2006 have altogether picked up a yield/fee of around $430 bn.

This is creating new trends of inequality in our societies and threatening the coherence and co-responsibility. No one can defend such huge yields to such a small group.

It creates a moral dilemma: how can we argue for coherence and co-responsibility among all groups in our social Europe when fund mangers can make more money in an afternoon than ordinary workers can earn in several years?

This question is doubly important because it is cohesion and co-responsibility form the glue keeping together our societies in the global economy.

7. The need for change to ensure a sustainable New Social Europe

Companies are becoming crucial reaching our Lisbon goal of a European knowledge-economy (decided by the European Council in year 2000), and the new step forward in Europe’s tackling of energy and climate change (as decided in by the European Council in March 2007). We all have a fundamental responsibility to contribute - to ensure that the enormous cashflows in our financial markets are allocated in an optimal way to assure a stable financing of the long-term investment in companies. But there seems to be a clash of interests - especially in relation to the LBOs and HF short-term ambitions

The economic viability of private companies is affected by private equity- and hedge fund ownership in several aspects. In many cases transparency is lacking and public information is lost, especially when a private equity fund de-lists the target company from the stock exchange. This lost information is needed both for the market to function optimally and for society as a whole. Growth is another area where private equity ownership doesn’t seem to have any particular positive effect on the target company, contrary to the claim of the industry. As described, numerous factors like general macro economic conditions and the economic situation of the company before the take-over influence the future growth of a company. At present we are not aware of any serious study showing that private equity ownership alone improves the growth of the target company. Finally long-term investments are greatly in jeopardy, when the strategy of most LBOs is to withdraw huge amount of liquidity from the company. Through this exercise the company becomes deeply indebted, and from this point, it is unlikely that the company will make long-term investment - both because LBO operates with a short-term strategy and because the target company can no longer afford it.

The social living and working conditions in terms of employment levels, wages and training is also very much affected by private equity ownership. As already described it is very difficult to isolate the factor that influences growth in a company. This problem also applies to the factor that triggers job creation. Some studies show that private equity ownership results in job creation. But so far no serious evidence has been shown to confirm this statement. Several case studies in this report show both positive and negative effects on jobs. More clearly defined, though, is the assessment of the working conditions. PE investors very often quickly begin to downgrade working conditions after entry in order to achieve greater productivity and efficiency. In several of the case studies, new owners have withdrawn from social dialogue and even, in some instances, failed to respect existing collective agreements. Alternative investment funds have no or little experience in dealing with organised labour unions or employee representatives. They often fail to live up to even the most basic requirements on information and consultation and restructuring.

The public sector and the universal provision of services of general interest has been dealt with in a very specific way here by focusing on specific types of companies: those which provide services of general interest. These kinds of services are crucial for our societies and not just for the single consumer and this is why most of these service providers were historically state-owned. However during the last 10-15 years many companies have been privatised partly or wholly to stimulate competition in national markets and to develop European common markets. In recent years the private equity funds have entered some traditional public utility industries, because private equity funds find their characteristics, like significant stable cash flows and a significant degree of monopoly power in the primary market(s), very attractive. In the sector of services of general interest the effects of private equity fund buyouts and restructuring on infrastructure operators are magnified. The most severe impact is on the capability to efficiently finance infrastructure through long-term investment programmes. This is a clear example of how the short-term strategies of private equity funds and the long-term development of infrastructure operators are in direct conflict. Furthermore, it is to be expected that private equity funds leave infrastructure operators in a condition where their capabilities for pursuing their long-term objectives have been severely weakened.

Employees' pension fund investments are also major concerns. Investors in this sense are defined as being 'ordinary' retail investors such as collective investment scheme investors, pension scheme beneficiaries (and their agents such as trustees), and insurance fund policyholders. While the expert report from the European Commission argued that investors would gain added value by investing in hedge funds, alternative investment funds in the form of structured products have the potential to offer ordinary retail investors a product with a return that would be between bonds and equities on the risk spectrum. However, all in all it is not clear that hedge funds offer such added value potential for investors and therefore it is not clear why retail investors should have access to these funds. While it is difficult to identify the benefits of retail investors entering the market of hedge funds, it is easy to point to the problems. Lack of transparency and disclosure - even when it comes to basic operations of alternative investment funds, is just to mention one aspect.

Finally, the **stability of financial markets** is not the least of our concerns. Six factors have been presented as potentially impediments to the financial stability of the overall market. The industry's growth and the extensive use of performance fees are likely to go hand in hand with increased competition and risk taking. Sometimes the incentive is just too big, pushing hedge fund managers to take unnecessary risks. The amount of assets under management has become more significant, and a hedge fund failure with the same amount of assets under management as a traditional fund may have a far greater market impact. In the light of the current size of assets under management, there can be little doubt that some hedge funds – using strategies such as short selling – can influence prices independent of fundamentals and cause financial instability. A key concern regarding hedge fund and financial market stability is related to increasing similarities or correlation among hedge fund strategies. In addition to increasing correlations, observers have stressed that the liquidity of many hedge fund investments may be decreasing. We have argued that a boom in leverage and risk may go unnoticed, because the boom is originating from markets characterised by great opacity, e.g. the market for credit derivatives. Finally regulators are finding themselves in a vacuum where they are unable to react, as they are placed in a situation with an enormous lack of transparency and reliable data. This means that it is extremely difficult to make informed decisions about financial threats. So we believe that hedge funds create substantial threats to the global financial stability.

Coherence and co-responsibility are threatened by the extreme management fees and remuneration of partners within the HF and PE industry.

All the issues raised in this part of the report challenge the achievement of the Lisbon goals. More precisely, what are the perspectives in terms of innovation, Research and Development, new technologies, development of infrastructures and networks if the real economy is eaten, bite by bite, by financial market operative models? Our European economies need resources, brains and the means to function and develop in our globalised environment. How will we build on the future if the creation of wealth goes to very few, to the detriment of the many? We have to reconcile long-term needs of businesses and societies in general with the short-termism of more and more investors, prominently among them alternative funds. While promoting investments has always been a credo of the Lisbon agenda, not all investments are productive and those that are clearly destructive must be prevented.

There is enormous potential for all of us in Europe in bringing our New Social Europe and the global economy together in a new dynamic interplay. But there is also a need for change to ensure a sustainable New Social Europe in relation to the financial markets.

In Part III we deal with the regulation issues: What to do?

PART III - Lessons to be drawn for future regulation

1. The market cannot do it alone

In the introduction to this report, we have defined the future long-term investment ambitions for the European Union and its member states in the next decade:

The New Social Europe and connected, smart, green growth strategies

The need for long-term financing through efficient, low-cost, optimally functioning finance markets is obvious. We have in the report analysed the latest development of the financial market - especially the hedge funds (HF) and one part of the private equity (PE) industry, Leverage Buy Outs (LBO).

In part I we gave a comprehensive and thorough description of HF and PE-industries in Europe, based on the available facts and our case studies. It is a fast growing and increasingly dominant industry in the financial markets. While one can argue for some positive effect on the market and public companies, the activities of HF and - especially LBOs - do have substantial negative implications for financial risks, the leverage of public companies, the need for long-term financing of real investment, R&D and jobs, the protection of investors etc. All in all, there seem to be contradictions and negative implications for the real economy in a number of cases - especially in the light of the agreed Lisbon goals and the PES group vision for a New Social Europe.

In part two, we had a close look at the consequences of HFs and PEFs' (LBOs) have for some central issues in our real economies - and thereby for our Social Europe as a whole. It was shown that the financial markets do not automatically respond in a subordinate and optimal way to the financial needs of long-term investments. Our case studies confirm the risks and negative impacts on:

- The economic viability of our private companies in Europe. Limitations on investment capability, employment, education and qualifications - innovation and global competitiveness.
- The working conditions and participation of employees in the target company.
- The public sector, utilities
- The pension funds of employees and the long-term real value of their investments
- The stability of financial markets

These contradictions, negative implications and obstacles in progressing towards a New Social Europe will not automatically disappear. The problems will not be solved by natural changes on the financial markets. Unless the societies and the EU intervene, these market imperfections will stay and probably grow.

But if we in Europe - and hopefully globally - can regulate the financial markets to make them subordinate to the real economy, without negative implications, there are enormous real-economic opportunities ahead of us, for the future of the whole of Europe's of population.

That is why we need a new strategy for the financial markets in member states and the

European Union.

Part III is going to focus on possible legal instruments for responding to the impact of private equity fund and hedge fund ownership. The various consequences of their investment strategies range from declining tax revenues and offshore placement, lack of transparency and loss of information, reducing the capacity of target companies to invest, encouraging job cuts and worsening working conditions, an aggravated long-term investment situation and risks for financial stability.

Taking into account these negative consequences it is crucial to recognise that something has to be done in order to protect the European market economy and European society in general. But not only “to protect” - first and foremost in order to create the conditions for realising the enormous potential for smart, green growth and new, better jobs ahead of us.

In this part, legal instruments, incentives and proposals for regulation will be presented in connection with specific policy areas like taxation, corporate governance, social responsibility, supervision, etc. In addition, we want to underline that ideally each proposal should be examined for its national and EU-level implications. There is no single combination of regulations that can answer all the new challenges. Instead they need a coherent mix of over national, European and possibly global levels, as these funds are operating worldwide. Therefore where no competence is granted to the EU, we would encourage national action, based on common ground, to promote a common approach and avoid harmful competition. A successful concept designed at national level should serve as an example to other countries, whatever the policy area touched upon. The example of the US system should be kept in mind as regulation on such issues is centralised and quite efficiently implemented.

To play down any need for public inquiry the HF and PE industries claim: “*we are efficiency-enhancing*”. This contention is repeated *ad nauseam*. It is supposed to be self-evident and is thus brandished like a talisman against any attempt to discuss the opportunity of shedding some light on HF and PE for the sake of the lay investor.

But the *efficient market hypothesis* (EMH) is beyond the reach of any empirical evidence. So, if HFs and PEs enjoy the unique privilege of *always* being efficiency-enhancing, it follows that they should not be investigated, or transparent, or regulated.

In their investment strategies, hedge funds either make directional bets on futures markets or on the future values of macroeconomic variables, or exploit price inefficiencies, or exploit specific situations (event-driven, merger arbitrage, distressed securities). To support the contention that hedge funds are always efficiency-enhancing one must demonstrate that they always have incentives to act as *contrarians*. Therefore pro-HF and PE supporters go on repeating the following assertions:

- In their directional bets on future market trends, they take advantage of mean-reverting-processes and subsequently enforce adjustment to price equilibrium.
- In bridging the gaps between segments of markets that would be too shallow or even non-existent without them, they contribute to completeness in the whole set of markets.
- In bringing liquidity in corporate deals that are always beneficial for the economy as a whole, they not only contribute to market efficiency, but also to economic efficiency.

Furthermore, since their strategies cannot be deciphered because of their opacity, they must keep those stabilising processes rolling on *through their own market power, not through market discipline*. This is where the argument goes astray.

To insist that HFs and PEs enhance efficiency by themselves is a strange argument. If they can drive the market on their own, it is through sheer market power. Whenever a particular group has market power, it has the incentive to exploit the market in order to draw a quasi-rent at the expense of other market participants. How can it be beneficial for market efficiency and, further, for the whole economy? Market dominance should in theory be eliminated by competition between hedge funds and the outcome should always be equilibrium, just as it should if market transparency disseminated information to all market participants. (If the alternative investment industry is still of the same opinion, why are they against transparency and disclosure?)

The lesson of LTCM, for instance, is that it entailed the Fed's extraordinary lender-of-the-last-resort intervention to forestall the impending flight to quality. Observing that the same outcome was not needed in May 2005, in the turmoil provoked by the slump in GM and Ford derivative contracts after the downgrade in their rating, is no assurance that hedge funds have gotten more robust or "society responsible". The difference between 2005 and September 1998 was the situation of global financial markets. In 1998 they were under extreme stress in the aftermath of the Russian crisis. In 2005 they were awash with cash after many years of loose monetary policy.

While the investment industry keeps on repeating that maximum value should be returned to shareholders, because shareholder decisions are inevitably beneficial to society as a whole; and that taking companies private shields managers from the short-term pressures of financial markets **- all the evidence contained in this report suggests the contrary.**

The question of appropriate regulation basically depends on what kind of investment strategy is desired in Europe - and that is directly defined in our Lisbon goals and New Social Europe for the development of our societies in the next decade.

Some HFs and PEs would argue that regulations would "force them" to seek out other locations outside Europe. We think there are three answers to this attitude:

- Europe's single market is the world's largest economy (10% bigger than that of the US). This market is enormously attractive for foreign investors - and with the high growth rates of the new member states, its importance will increase in the coming years.
- "Creativity" and "financial engineering" to avoid the effect of regulators will always be a fact of life. As we have learned from national experience, regulation is an ongoing, permanent process during a changing environment.
- We are aiming for appropriate and carefully targeted regulations, not disproportionate, general prohibitions or over-detailed regulations.

The aim of regulation in this sector of the financial market should be to exclude certain characteristic risks and to compare results with preordained aims or have the ability to influence the development in the interest of society. No company should have substantially worse results due to LBO in its results, than before. No company that is the object of LBO should lose assets or sacrifice labour standards because its financial assets are plundered due to unwarranted charges and fees or predominantly debt-based financing.

Better investor protection, proper corporate governance, long-term investment and prospects of safe and decent jobs should be our road map for reforming the real economy as well as regulating the financial markets.

2. Market transparency - a common interest

We have seen from part I and part II that HF and PE industries are characterised by an extreme lack of transparency, information asymmetry and lack of disclosure on all essential activities.

In our modern European societies, this is in direct contradiction to the overall, general state of play of fundamental transparency in the real economy, as a basis for participation and responsibility of our people. The Nobel prize winner in economics, professor J. Stiglitz has shown how asymmetric information makes the market economy function ie inefficiently and certainly not optimally. Negative, systemic implications are created by HFs and PEs moving companies **from** transparency and disclosure in stock markets and public companies **to** opacity and lack of disclosure in the private part of market economy.

With the strong influence of LBO / PEF on financial markets and the adherent macro / micro risks, the demand for stricter information and transparency in these sectors is growing. Furthermore investors in LBO / PEF are no longer only very wealthy investors, but partly private retail investors (directly) or financial institutions who serve the general public or special public groups (Pension Funds, other public Funds, Insurance companies etc.).The main risks about which information and transparency are badly needed are: high or even sometimes extremely high leverage, market value risks, operational / managerial risk, correlation between several risk factors, or collusion between participants.

Until now there has been practically no direct regulation of LBOs (apart from exchange regulation and accounting rules) and very light indirect regulation through the banks / Investment Banks / Prime Brokers. This indirect approach seems increasingly insufficient, because Investment Banks as Prime Brokers are strongly dependent in their business volumes and profits on PEF / LBO firms. They are also increasingly active in proprietary HF and LBO business.

A necessary condition for EMH (efficient market hypothesis) to hold is that information is fully and equally disseminated to all market participants. The only way to get it is through full disclosure of positions and moves of the main market players. There are many circumstances where strategic agents have incentives to make short-run profit in playing a less than idealistic game. If their move is hidden, they may drive the market in a destabilising direction.

After the 1987 Stock market crash, several models showed that ignorance of the motivations that initiated the market decline had led to a huge magnification of the crash. One recommendation of the Brady inquiry[1] *was improving disclosure,* apparently to no avail. This question is more relevant than empirical studies showing that mean-reverting processes on equity, bond and foreign exchange markets have a longer time span than the horizon of market players like hedge funds. *Therefore the disclosure of proprietary trading of hedge funds would be nothing but setting the right conditions for market discipline.* Those who oppose it have other motivations than improving market efficiency.

As much as tougher competition between hedge funds crowds out standard market-neutral strategies increase efficiency and drive prices and HF-yields downwards, shifts to more exotic

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1 After the Stock market crash of October 1987, a US presidential task force on market mechanisms, chaired by Senator Nicholas Brady, was set up to investigate on what went wrong. It was known as the Brady Commission. Among other disturbing factors, the inquiry revealed the strength of bandwagon effects triggered by portfolio insurance.

styles arise in search for higher excess returns. HFs have become even more opaque while they have been holding assets with hazardous and infrequent valuation via the use of event-driven situations, the buying of distressed securities and the investment in private equity. Low-frequency skewed distributions of returns make the computation of volatility unreliable. Value-at-Risk models used by banks[2] to internally assess credit risk are not suited for hedge funds. *Running stress tests and disclosing results to market supervisors should be a minimal requirement.*

Transparency and disclosure are simply preconditions - but not sufficient conditions to ensure positive solutions to our concerns as explained in part II.

When considering - better – regulation of alternative investment it would help to answer the following questions in detail:

(1) How do we ensure long-term investments to promote our goals, the Lisbon strategy and New Social Europe?

(2) How do we avoid a clash between short-term financing and long-term investment needs in the real economy as a part of our efforts to make European companies compete globally on the basis of our common values?

(3) How can we ensure financial stability and eliminate systemic risk?

(4) How would European regulation reach investors, whether institutional or private, who have their company and business base outside the EU, as is often the case in the area of hedge funds and private equity? Is there a basis for an agreement encompassing the whole of Europe on how companies with this form of alternative investment can be handled?

The optimal solution would be to have regulation internationally, at the highest level possible. A case could be made for regulation of the risk management system through the Bank for

2 These are non-anticipated risk measurement models used by banks as supervisors require them capital adequacy provisions. More precisely, it is the value of losses that could be over passed only a certain % of time. For instance, the value of losses that could be over passed only 1% of working days.

International Settlements in Switzerland – the ‘Central Bank of the Central Banks’, under whose auspices the Basel Capital Adequacy Agreements were reached. The case could be made that, even though the alternative investment fund might be registered offshore, the manager is (i) raising money in and (ii) investing in Europe and (iii) therefore potentially posing a danger to the stability of the European financial system.

(5) To what extent can employees’ social rights be called into play for the socially acceptable regulation of alternative investment?

Considering the fact that a large proportion of capital in global financial markets is owned by workers, one could raise the question of whether this ownership could be organised, in particular, in the regulation of financial institutions and markets and within the framework of coordinated macroeconomic policies. We could rule at EU level to give labour a voice by ownership in supervisory bodies on the financial markets. In doing so you could refer to the example of the German BAF in (the Federal Financial Supervisory Authority) which has representatives of trade unions and (non-autonomous) pension funds on its general and insurance advisory councils, as well as employee representatives on its takeover council. Moreover, we have the example of the French AMF (Autorité des Marchés Financiers), which provides a seat on its board for a representative of the employee shareholders[3].

3. Hedge funds

We have seen from Part I and Part II that there are important concrete arguments for transparency and adequate regulations:

1. It is important to enhance the transparency of the hedge funds because of overall financial stability in the EU. This is important because it allows the monetary authorities to have a fair picture of the collective hedge funds investments and commitments, which in turn would allow the monetary authorities to assess the consequences to the financial markets of the hedge funds transactions and future transactions.
2. Transparency should be introduced in the hedge funds in order to protect investors.
3. Many of the hedge funds are in practice functioning more or less like traditional investment funds.
4. Many hedge funds are based in offshore jurisdictions, including hedge funds active in the EU. The problems relating to tax control, when investors based in EU Member States invest in hedge funds based in offshore centres, are crucial. The offshore centres often do not have tax control, nor are they obliged to provide information to the tax authorities concerning these investments.
5. Companies are not protected from short-term thinking of hedge funds and LBOs. This is creating problems for public companies competing globally as a part of our general promotion of New Social Europe.

[3] This idea goes back to Hans-Michael Trautwein, Oldenburg, as explained to the ETUC/SDA ‘Path to Progress’ project, forthcoming 2006, Brussels.

3.1 The fallacy of indirect regulation

Indirect regulation assumes that HFs counterparties are adequately regulated and supervised *in their business with hedge funds*. It assumes also that they have an incentive to comply.

HF counterparties are prime brokers who are big multinational banking groups, either American investment banks or investment arms of gigantic American financial conglomerates like City Group or Bank of America and European universal banks. For effective indirect regulation, bank supervisors must have a proper understanding of the risk exposure taken by banks on hedge funds, so that they can check if the risk is adequately accounted for in Basel II capital provision.

One may say that this is a very partial view of hedge funds' potential nuisance value. It is not only systemic risk from HF leverage that is of concern. That is, admittedly, the main concern of the Basel Committee of central bank governors. But it does not answer worries over consumer protection and market integrity related to HF trading.

Even the narrower view of indirect regulation is questionable. Banks do not simply lend money to hedge funds. This plain type of leverage is properly accounted for in computing bank leverage, at least in principle. But it is superseded by financial leverage through securities lending and derivatives that is less so. Financial leverage is due to exposures created by off-balance sheet positions ahead of the cost of derivative contracts. Prime brokers provide high leverage through reverse repos, using assets as collateral in non-tractable transactions that are not reported by the banks. At best, regulators can only know the total net exposure of a bank to all hedge funds. But they do not know the exposure of any hedge fund provided by all counterparties. Therefore the nature and the ever-changing size of HFs liabilities to their lenders make illusory the knowledge of the relevant indicator of leverage risk due to hedge funds, which is *potential future credit exposure*.

Furthermore investment banks are not under bank supervision at all. They are under SEC rules and only for their brokerage activities. All other business goes totally unsupervised. It ensues that the feasibility of indirect regulation via banks is dubious, at least debatable. In any case it cannot be taken for granted. And even if it were, banks have no incentives to be the regulators' scrutineers of hedge funds for two reasons:

- On the one hand, banks are busy acquiring or setting up hedge funds themselves. They are doing so to boost profits by all means, prodded as they are by shareholder value incentives.
- On the other hand, prime brokerage for hedge funds is sold with a whole bundle of services (clearing, settlement of transactions, custody of assets, research, legal advices and the like). This is a very profitable, risk-free fee business. Likewise, securities lending earns interest on the process of short selling by hedge funds. The more business volume they get the better.

There is a blatant conflict between banks' incentives and regulators' goals.

3.2 The main beneficiaries of regulation

In the last few years after the collapse of the “new economy” bubble, the structure of HF industry has changed in its source of capital and in types of strategies.

It has often been alleged that there is no need to regulate hedge funds because their clients are wealthy individuals who risk their own money and can take care of themselves. This assertion was roughly correct until the collapse of the equity bubble. But a dramatic change occurred in the early years of the present decade. As shown in Parts I and II, public saving invested via pension funds and funds of funds reached almost the same percentage in 2005. When corporations, insurance company endowments and foundations are included, it makes up 56 per cent of hedge funds. Collective saving into hedge funds is on a much faster track than any other source of capital. Therefore hedge funds put at risk as much of the public’s money as mutual funds.

The increasing exposure of private pension schemes to hedge investing must also be considered, and that the introduction of UCITS III principles in the different domestic regulations ruling mutual funds, will speed up growth of such products. So there is a clear and increasing need to regulate such a market.

The lack of investor protection and of disclosure requirement becomes intolerable.

Not only pension fund investors but also the entire real economy as such will benefit from appropriate regulation as reflected upon in Part II. i.e.:

- Financial stability
- The Lisbon goals and green growth
- The companies’ viability in the globalised economy
- The wage earners’ education and qualifications to match the new jobs
- The coherence in our societies and job creation
- The financing of our welfare states

As shown in Part II, hedge funds invest massively in risky strategies. Indeed the anti-regulation rhetoric for hedge funds has always been eager to point out that hedge funds specialise in arbitrage between market segments. Therefore they take no bet on the direction of markets. Having no correlation with market indexes, it goes without saying that they are suitable for portfolio diversification with few risks when they anticipate the narrowing of spreads. However as LTCM revealed, high returns on those strategies imply a large leverage and both legs of the investment are losing if spreads widen in disorderly market conditions. Even seemingly careful strategies might put HFs in jeopardy if they indulge in high leverage.

But arbitrage strategies have always made a modest proportion of HF investments and this proportion is shrinking for both structural and cyclical reasons. Directional bets are dominant and deliver mediocre results in adverse macroeconomic conditions. Nonetheless hedge funds developed massively after 2000 while rates of interests slipped downwards and equity markets plummeted. Institutional investors were looking for a dual strategy:

- A benchmarked passive portfolio to cover their costs
- An active management portfolio in the hope of boosting their overall return. To try to achieve their goal they invested both in funds of funds and in individual hedge funds. Controlling their active portfolios raises new problems of performance measurement (taking account of the

probability of extreme losses) and risk assessment.

It is quite plain that the opacity of hedge funds deprives institutional investors of any meaningful quantitative risk control.

The more hedge funds rely on fathomless investment strategies that increase markedly in weight according to table 2 (specifically multi strategies and event-driven), the more their institutional clients have to rely on the good faith of fund managers. The only control institutional investors can engineer is upstream. They should develop networks of acquaintances to facilitate reference checking in order to get a thorough understanding of the would-be fund manager's investment operations. It is awfully costly and time-consuming. Often pension fund trustees have neither the organisational resources nor the ability to run the investigation in-house. They must resort to counsellors biased towards getting more business for hedge funds.

It should be commonsense that a reasonable policy of market transparency would improve the principal agent relationship inherent in delegated management.

Hedge funds are going to manage more and more public money and a significant "retailisation" is under way. The call for some regulation will gain momentum. In the EU, as far as UCITS III allows mutual funds to indulge in hedge fund-type strategies, the need for a common regulation regime addressing hedge funds and their managers becomes pressing. Three motives for regulation are financial stability, investor protection and market integrity (against frauds, market abuse and money laundering).

Financial regulation is most effective when it targets the conflicts of interest between market participants, risks, and stress points within the financial services supply chain. The supply chain for the hedge fund market is particularly complex when compared to the 'traditional' asset management industry because of the use of various counterparties (often unknown to the investor) and due to anomalies such as fund managers and actual funds being regulated in on-shore and off-shore jurisdictions.

The supply chain approach to regulation allows policymakers to identify the areas in the market which are most likely to give rise to detriment, recognise the different levels of sophistication of various market participants, and deploy targeted, proportionate regulatory interventions.

3.3 Transparency and supervision in practice

One of the reasons given by EU and national regulators (eg. the FSA) for not introducing more robust regulation is the risk of a greater number of hedge fund managers relocating offshore. To counter this, an incentive structure through the regulatory system and enhanced disclosure needs to be created.

And once more: we must not forget that the European Single Market is the world's biggest economy - an enormous attraction for international hedge funds and private equity.

If regulators refuse to harmonise regulations to a higher level because of the fear of relocation then it will be necessary to distinguish between 'onshore' regulated schemes and offshore unregulated schemes so that market forces reward hedge fund operators and managers that reside within jurisdictions with enhanced regulatory standards.

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As a point of departure, our view is to fully harmonise European hedge funds (either single strategy, or FOHFs) in order to create a unitary category of onshore funds with a common minimum investment threshold, which could be lower in the case of FOHFs. By definition, it will never be possible to prohibit offshore funds at a worldwide level. So it seems more realistic to develop an onshore regime able to compete with offshore funds: it would obviously not prevent some investors keeping their activities secret in offshore funds but it would offer an alternative choice for the rest of investors, through a higher level of safety, a guaranteed level of professionalism of fund managers, an overseeing by regulators. Thus, such EU regulated products will be offered as a complement to offshore funds. And the features of such onshore products will reduce the size of the offshore market as compared to the onshore one. This EU regulated regime would not forbid Member States from keeping nationally regulated regimes. It should be mainly designed around the needs for regulation of the professionals involved in the 'value chain': the management company, and depositary/prime broker. It would focus on: registration of these professionals in the EU, requiring that they are 'fit and proper persons', minimum capital requirements and minimum rules on valuation of assets. However, contrary to UCITS, the features of any alternative investment product itself should not be covered by the EU regime.

The key issue here relates to the legal and governance arrangements of hedge funds as investment vehicles and the risks posed to retail investors. Most hedge fund managers located within the EU are subject to some kind of authorisation and supervision regime. However, for tax reasons most hedge funds or products are domiciled in offshore jurisdictions – as at the end of 2004, 64% of total hedge funds assets were registered offshore.

The offshore domicile for tax reasons raises concerns about the legal protection and redress available to consumers in the event of the failure of alternative investment funds. The EC should ensure that any alternative investment fund managers selling products to retail investors are part of a suitable compensation scheme.

A recurring problem linked with policymaking at EU level is the absence of pan-EU studies that compare and contrast regulatory approaches to managing those key risks within different member states. Therefore, it is not possible to assess the risk of regulatory arbitrage (where firms will seek to locate in jurisdictions which offer the lowest level of regulatory protection). This has been an issue in financial services policymaking generally but has a particular relevance for policymaking in complex areas such as hedge funds.

Beside the comparability of existing national regulatory frameworks, it would also be necessary to formalise a set of product clusters in order to enhance the scope for investors to compare different products' returns and to formalise a shared and comprehensive method of calculating hedge funds indices which could become the sector's benchmarks. This would provide basic information as far as investment strategies are concerned.

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The transparency and disclosure regime relating to alternative investments needs to be improved to enhance governance and accountability and ensure a high degree of **consumer protection**. As the PES group has pointed out, the recommendations of the hedge funds 'expert group' are intended to ease regulatory burdens on hedge funds and make the industry's products more widely available, in particular on cross-border marketing and portfolio construction. The expert group makes a number of claims such as: '*the hedge fund business is maturing in a way that does not give rise to any need for additional specific or targeted legislation of hedge fund participants or investment strategies at a European level'; 'the existing light touch regulatory approach has, in the view of the Group, served the industry, its investors and the wider market well'; 'additional regulation ……….is likely to fail and will do little to further protect investors compared with the status quo'*. The expert group report also urges regulators not to control sales and distribution of hedge funds through product regulation or registration but instead focus on regulating the intermediaries that sell investment products to investors. The report also says that many of the restrictions on insurance companies, pension funds and banks investing in hedge funds should be lifted.

These claims must be dealt with head-on if an appropriate and proportionate consumer protection regime is to be created. The recurring argument made by industry that further regulation would drive the business and its investors offshore must be challenged.

To this end, the EC should draw up minimum reporting standards covering:

- reporting frequency;
- investment strategies;
- full details of assets and investments held by the fund (or private equity firm);
- full disclosure of the risk management model adopted by the investment managers – this should include modelling of potential risks, management fees, stress testing of portfolios plus descriptions of contingency plans to contain risks;
- management's incentive structure to help investors better understand potential conflicts of interest;

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To detect **liquidity risk** the aggregate positions of all hedge funds in key markets should be made known to bank supervisors. Those data, indicatively not to be publicly disclosed, should be shared by prime brokers and bank supervisors.

Such a requirement would help central banks to implement monetary policy fully conscious of the hedge fund industry's exposure to main financial risks and, even more, allow prime brokers to have a full understanding of their operational activity and to drive their decision-making, limiting credit line extension to single funds, with multiple prime brokerage agreements, that show stressed or deteriorated financial health.

Recently in most European countries we have seen an effort by domestic supervisory bodies to regulate the hedge fund industry through the introduction, country by country, of new specific investment schemes. These domestic regulatory innovations provided final investors with financial products perceived as useful and effective by the market but only in the field of FOHFs. Effectively in this specific segment of the European onshore hedge funds industry we see, with some minor exceptions, a regulatory architecture really able to grant investor safety. Otherwise any attempt by local supervisory bodies to introduce regulated schemes in the field of the onshore single strategy products has been substantially unsuccessful as the persistent prevalence (in terms of aggregated AUM) of the offshore vehicles testifies.

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In our view, if we want to promote European sector regulation aiming to make the current offshore hedge fund industry an onshore one, it has to be assumed that single strategy funds are essentially the expression of a cross-border market, hardly possible to regulate at a national level. We are fully aware of the political difficulty of introducing a common supervision of such products undertaken by a unique Supervisory Body (for instance a dedicated division of the ECB). Nevertheless, we consider such a hypothesis as the only effective way of achieving such an aim. Therefore, our target would be the introduction of a specific family of registered European single strategy funds whose products and managers should be authorised and monitored by a unique, specialised and highly professionalised Authority, operating to reduce (and not to increase) the “regulatory arbitrage” provided by the main offshore locations (for instance in terms of length of the time to authorisation for new products or new investment companies). The second leg of this new European regulatory architecture should be the elimination of all the fiscal transparency incentives granted to the investment undertaken by institutional players (onshore FOHFs included), in vehicles not belonging to the above mentioned new family of European registered funds.

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As far as **investor protection** is concerned, the focus should be on information for institutional investors. They should be able to assess and compare financial returns and risks of the different types of management. Transparency requires more frequent disclosure of returns and risk characteristics, the storage of those data in a public database available to all investors, the computation of hedge fund indices and the disclosure of all management costs and fees charged on their clients. Information should be available about the appointment of a custodian bank, common and effective rules for management relating to portfolios’ market pricing, public communication and disclosure of attained financial returns.

Beside the information disclosed to the supervisors, the *disclosure of information to the public in general is in the common interest.* Therefore, hedge funds should be obliged to release general information about the inflow/outflow of money after their deals have been completed. This type of information would make the influence they have on financial markets more transparent and readable.

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New standards relating to the sale and promotion of alternative investment products need to be developed to protect consumers from mis-selling and misrepresentation of risk. These include:

- minimum investments for retail investors purchasing alternative investments directly without regulated advice. A minimum investment of Euro 100,000 is appropriate;
- rules should be developed to ensure that claims relating to investment performance and risks are honestly and clearly communicated to consumers. This means that promoters or intermediaries should not be allowed to be selective about the time periods used in promotions. Moreover, the use of independent benchmarks should be stipulated to prevent promoters selecting favourable investment universes to compare products;
- rules on the disclosure of total charges to retail investors should be agreed to allow for objective and accurate comparison of charges – especially where fund of hedge funds are involved. Illustrations and projections should be provided on a consistent basis to allow investors to compare the offerings of different fund managers – that is, funds with a similar investment strategy should be required to use the same projected investment growth rates net of actual total expenses and charges;

- the EC should ensure that the content and presentation of risk warnings in any marketing or promotional material should be clear, fair and conform to minimum standards.

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Funds that are eligible for marketing to retail investors should conform to a number of safeguards including:

- the need for an independent depositary;
- retail investors should have access to alternative investments only under certain conditions - for example, as part of a 'fund of hedge funds' or within a portfolio of conventional assets;
- even then restrictions should apply with regards to diversification, limits on exposure, and liquidity criteria.

Transparency alone does not guarantee high standards of governance and accountability (other measures such as rules on fair treatment of separation of duties and independent audits are needed). But greater transparency allows for other stakeholders in the investment chain to understand the risks involved and be more aware of the impact and consequences of investment decisions made on their behalf.

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A number of concerns have been raised about the valuation of assets within alternative investment funds (see elsewhere in the report). The plausibility of the investment returns (and therefore the validity of performance related fees) claimed by investment managers may be questioned as a result of incorrect valuations. In addition, inconsistent valuation methodologies undermine the ability of investors to assess risk, and can lead to differential treatment of classes of investors. It is all about avoiding market abuse and ensuring asset valuations as correct as possible.

In summary, these concerns relate to:

- the valuation methodologies used by investment managers;
- the need for clearly defined responsibilities when valuing assets to deal with potential conflicts of interest within fund management organisations;
- the availability of independent and reliable sources of market prices;
- independent and regular reviews of valuations;
- a number of process issues including: timing of closing prices, dealing with pricing errors, verification procedures.

The European Commission should establish robust minimum standards with respect to the following:

- rules on valuing hard-to-value, illiquid assets so that investors can be reassured that asset prices used in valuations are fair and independently obtained. These rules should apply to all internal and external parties in the valuation chain including fund managers, administrators, providers of market prices, verification staff, and auditors;
- the frequency and basis of valuations;
- the use of portfolio stress testing to establish valuation parameters;
- the relationship between internal and external parties involved in the valuation process to manage conflicts of interest and ensure a clear separation of duties between fund managers and those providing support services;
- the use of independent ratings and valuation agencies to communicate overall risk to

investors.

The EC should set up an independent expert working group consisting of consumer and public interest, representatives from corporate business, social partners and industry representatives to establish proposals for these minimum standards.

3.4 Systemic risks

As well as posing considerable potential risks to individual investors (or pension funds), concerns have been raised about wider market or **systemic risks –** in particular, financial stability, market disruption and disorderly markets (due to liquidity risks) and lack of transparency which can undermine regulatory effectiveness.

To promote better management of these systemic risks the EC should introduce new requirements for national regulators to **improve reporting procedures**. These should include:

- a requirement for national regulators to publish regular assessments and analysis of the concentration of hedge fund investments in sectors;
- detailed reporting requirements for individual firms. Firms should be required to report detailed information with regard to positions and investment strategies to their national regulator;
- The EC should create a centralised mechanism to allow for consolidated assessment of market positions and analysis of systemic risk.

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As far as **financial stability** is concerned, the link between credit and liquidity risk is the gist of the matter. To make indirect regulation of credit risk via banks workable, **monitoring the extensive use of derivatives is crucial**. The global hedge funds’ leverage is ruled by a very restricted number of prime brokers. So the first task of financial authorities should be to ask prime brokers for a periodic full disclosure of the exposure (fund by fund and then of the whole client base) to different categories of financial risks. *Potential future credit exposure should be measured and stress testing performed.*

In order to protect retail investors, promoters and intermediaries should be required to include scenarios in any promotions illustrating the impact of adverse market movements on investors’ portfolios. Possible minimum standards relating to product features and unfair contract terms for alternative investment products sold to retail investors should be envisaged. These standards should cover: investment fees, retail charging structures, and limit unreasonable and unfair lock-in periods so that consumers can have access to capital.

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To assess the **credit risk** of hedge funds an international credit register should track all counterparties’ exposure on individual hedge funds.

3.5 Corporate governance for hedge funds and their counterparts

The main difficulty is to define criteria or indicators in accordance with which investments and their capital movements would 'seriously disturb' the functioning of the European real economy. Once this definition is commonly agreed, then the EU could take preventive measures.

There are well-defined 'risk management' models that are extensively used in the banking world – by banks as well as regulators – and a special set of models also applied to leveraged hedge funds. The banking models estimate maximum 'value at risk', or maximum value of assets that could be lost, under rare but plausible occurrences ('2 or 3 standard deviation events').

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Furthermore, the correlation of different asset classes is taken into account by these models (for example, movement of the euro and the Swiss franc relative to the US dollar is highly correlated, and therefore would have to be counted as the same asset class for risk purposes). A prudent 'rule of thumb' used in the hedge fund world is that no more than 2 per cent of assets should be risked on any one uncorrelated 'bet' (that is, speculative investment). It is clear that many hedge funds are consistently violating this rule (Amaranth is a clear example of this, since such a large proportion of its equity was wiped out through a single 'wrong bet' on the direction of the price of natural gas). *Such limitations would help limit the size of bets taken by hedge funds*, and thus the danger to the stability of the system, (i) by increasing the stability of individual funds, and (ii) by putting a brake on the extent to which 'herding behaviour' can occur (that is, many funds taking large bets in the same direction).

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Rules relating to the fair and equitable treatment of different classes of shareholder are needed to ensure that funds cannot use pricing policies to attract potential investors or dissuade potential sellers. The EC should establish rules to ensure that:

- both investors and redeemers of capital are able to transact at a price which reflects the underlying fair value of assets;
- different generations of investors are treated consistently; and
- different classes of shareholder are treated fairly so that larger investors (or investors who have other commercial relationships with investment managers) do not receive preferential treatment over smaller investors whether in the form of favourable prices or information.

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The EC should also create a framework to allow alternative investment funds to be classified and rated according to investment strategy and risk. This would allow for improved evaluation of comparative risk and return, better communication to investors, and promote more efficient competition as performance fees could be challenged.

Precedents exist which allow for conventional investment funds to be classified according to portfolio asset allocation – for example, bond funds, equity funds, balanced funds and so on. The EC should establish an independent working group consisting of consumer and public interest groups to develop a classification system to encompass alternative investments.

Alternative investment fund managers should be required to have funds evaluated by an independent ratings agency.

Furthermore, to deal with additional risks relating to marketing and promotional practices, conduct of business rules, and risk assessment and disclosure consideration should be given to having the MiFID (Markets in Financial Instruments Directive) cover hedge funds. This Directive does not take into consideration the fact that many public financial institutions now invest in hedge funds and no clear rules exist regarding the information to be provided by these financial institutions to their investors or members about this type of investment.

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The European Commission should also reflect upon the '*conduct of business rules*' enacted by the financial community. These rules should include *strong sanctions* modelled on the *City Code on Takeovers and Mergers* of the London Stock Exchange. The EC could at least threaten to enact a *strong* regulatory regime within the Common Market if the financial community does not live up to its promises within precisely defined deadlines. The sanctions included in the *conduct of business rules* must be a 'credible threat'.

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Beside corporate governance requirements to be fulfilled by hedge funds themselves, their **counterparts and the companies** in which they invest could also be submitted to a set of rules:

- Knowing the aggregate exposure of hedge funds and knowing that their supervisors know, **prime brokers** should have the duty of **limiting credit line extension to any single fund** whose potential future credit exposure appears excessive.
- Constructing a suitable regulatory framework for managing the risks associated with alternative investments requires wider reforms to the way these investments are used by investors. Addressing the specific risks through UCITS or MiFID will be insufficient. Measures should be introduced through the insurance and occupational pension funds' regulatory framework to ensure that high standards of due diligence are undertaken when alternative investments are included in pension fund or insurance fund portfolios.
- Trustees and other intermediaries should ensure they have reporting and risk assessment systems in place to allow them to understand the consequences of investment decisions, and ensure they are accountable to end-investors. In particular, investor representatives should pay close attention to liquidity risks and lack of transparency associated with alternative investments.
- Reporting requirements should include not only a detailed assessment of risk and return but also a **corporate social responsibility** report to allow investors to understand the impact on other stakeholders in the investment chain (such as target companies and employees). As part of the due diligence framework, regulators should ensure that intermediaries such as trustees or sales advisers are trained to a sufficiently high standard to understand risks and make informed and responsible decisions on behalf of the clients/ investors they represent.
- There is a need to know about the outflow of money when it comes to institutional investors. One can ask this legitimate question: what are the institutional investors doing with "**other people's money**"[4]? Qualified investors (= institutional investors) do not need

[4] Cf. Louis Brandeis: Other People' Money and How the Bankers Use it. Boston 1995: St. Martin's Press (1st edition 1914).

protection. But they are not the ultimate investors in reality. They use "other people's money" when they buy high risk/highly leveraged products. Guidance relating to portfolio diversification is required to ensure that the end-investor is not exposed to undue risk.

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We can consider the introduction at European level of some regulatory quantitative or principle-based constraint to the alternative investments exposure of pension funds and other collective investment schemes such as mutual or insurance. But at this stage, before setting quantitative constraints, we should promote a reinforced "prudent person approach", especially when considering the growing size of investments made by pension funds in hedge funds. The EC should investigate the need for prescriptive limits because there are major informational problems which undermine the ability of investors to undertake due diligence within the prudent person framework.

If approved, it could be useful in the case of HF to introduce diversification/ low concentration constraints. For instance an option would be to limit the investments of the pension funds in single Hedge funds at 2.5% of the net asset value (NAV)[5] . This would go hand in hand with the promotion of onshore hedge funds in comparison to off shore ones. European pension funds would therefore be encouraged to invest only in onshore/regulated ones in order to have stronger guarantees.

In addition, all shareholdings of 1 percent or larger that institutional investors or private parties acquire in publicly listed firms should be disclosed to the appropriate national security exchange commission.

3.6 Tax policy

In the area of tax policy, there are 2 main proposals:

- To introduce a fiscal discrimination, to include FOHFs and all tax-exempt organisations, against offshore products (i.e. to confirm the principle that FOHFs and pension funds are fiscally transparent, but limiting such transparency to the treatment of onshore single strategy funds' holding.).
- To address the risks associated with offshore jurisdiction, consideration should be given to changing the tax rules so that the location of the manager determines the tax position of hedge funds.

4. Private Equity Funds - focusing on LBOs

The task of proposing regulations in the area of private equity is particularly difficult given the

[5] NAV: Net Asset Value: The value of a fund's investments.

widely differing impacts of PE activities. Such activities stretch from the scandalous and even criminal – asset stripping, the looting of pension funds and crass personal enrichment at the expense of workers and society at large – to the vital function of helping SMEs deal with succession issues and providing venture capital. In addition, the threat of LBOs also exerts pressures – some desirable but many not – on companies that are not actually taken over.

Our studies in Part II have shown that there is a need for response through adequate regulation to:

1. Many private equity funds are based in offshore centres, including many private equity funds active in the EU. 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.
2. A transparency problem arises, when former listed companies that were covered by measures promoting transparency suddenly go private after having been acquired by private equity funds.
3. Tax inspection problems arise when an investor based in an EU Member States invests in private equity based in offshore centres.
4. 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 cheque from the funds, while 80% is financed through equity in the target company and debt issued by the company after the takeover.
5. There are important 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.
6. There are substantial costs related to financial advisers following the private equity funds’ business and acquisitions. The acquired company pays this cost, while in reality they should be paid by the private equity funds themselves.
7. There are incentive structures such as stock options that the private equity funds use to control the management of a company, which raise questions of loyalty of the company management.
8. Pension funds invest more and more in private equity funds, then being indirect owners of private companies.

Our own case studies from leverage buy-outs have shown a clear picture confirming the above-mentioned 8 points. Reviews of LBO deals five years on, undertaken by the McKinsey consulting firm, have repeatedly pointed out that more than half of those deals have been industrial failures and have massively destroyed value. But they have been generously profitable for private equity funds and their prime brokers. The fees are so high that institutional investors dedicated to the long-run view get a lower-than-stock-market return with a higher level of risk. All the reward is captured by the investment funds that charge the acquired firm with debt to be redeemed by the sale of the firm’s strategic assets.

4.1 Market transparency and disclosure in practice

The first regulatory step to be taken is to increase the transparency of alternative investment funds by **requiring reporting at regular intervals to an appropriate regulatory authority** on (i) the investment strategy of the company, (ii) details of the assets held by the company, (iii) disclosure of the 'risk management' model used (this is especially important for leveraged companies, and is already used for banks by the banking regulators), and (iv) the management's incentive structure. Greater transparency is not enough by itself, but the premise here is that, due to inadequate transparency, many investors (including pension funds and so on) are not aware of the risks that alternative investment funds are taking in order to get a higher return. Many alternative investment companies would not be getting funding if investors were aware of these risks. Greater transparency is a requirement that persons from different ideological backgrounds (free market adherents included) must be able to agree on.

Direct supervision of LBO through the appropriate agencies should take place through guidelines and direct controls. It appears worth **considering whether new tasks within the framework of supervision and regulation could be transferred to the ECB**, based on the model of financial supervision in some EU member states. The ECB would be responsible for monitoring the risk of highly leveraged funds. This supervision could be linked with the responsibility of alternative investors to include in their reporting and disclosure of their investment strategies details on the social dimension of their businesses (CSR reporting). In addition, the setting up of an independent supervisory agency holding a register could be considered for all alternative investments at European level with public control, including employee involvement.

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At EU level one could at least argue for a directive defining **minimum standards for disclosure**, based on similar logic to the directive requiring disclosure of stock holdings of 5 per cent or more of a company's total shares. Under this scenario, countries would still maintain their distinctive regulatory systems, but the imposition of minimum standards would help to reach a 'level playing field'.

Registration and authorisation with supervisory agencies could be a way to cover PEF in creating a general obligation to register before they may do business. One way to do this is to include them explicitly in the UCITS framework. The SEC is currently envisaging this option[6]. The FSA is introducing a kind of observatory to examine 30 of the most important investment managers. So far it is not clear if one of these approaches could be used at EU level, but if the US decides to implement the obligation for registration, why shouldn't the EU too?

4.2 Corporate governance

It would be optimal, but difficult in practice, to write into the UCITS framework the requirement that alternative investment funds should contribute to the long-term increase of the value of an enterprise, except for a general statement about investing in a way that is compatible with the European Social Model.

The general way of regulating funds is to prohibit investment in specific asset classes or to

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6 http://www.sec.gov/news/press/2006/2006-208.htm

restrict investment to specific asset classes. Formally, both short-term and long-term investors are investing in the same vehicle (for example, company stock). The approach suggested is to try to create incentives for longer-term investment, with the hope that longer-term investors have more interests in common with employees than shorter-term investors:

- There must be an overall effort to ensure the further development of the Rhineland model of public companies. This model ensures engagement of all stakeholders - not only shareholders, but also management, employees, and other investors - in the interplay between the public company and corporation with the public sector on further education and qualification of employees etc.

- Beside creating incentives for long-term investments, the **long-term investors should be rewarded**. This can be done by permitting **weighting of voting rights** according to duration of shareholding and by means of differentiated taxation of (capital and dividend) income from shareholdings. Golden employee-owned shares are also an option to be further examined. Minimum holding periods eligible for tax exemption should be considered. Rules on better investor protection could include regulations on the limitation of voting rights or on dividend bonuses for shareholders who turn up and exercise their voting rights. Organised investors such as banks could be obliged to exercise their voting rights at general meetings in order to hinder minority shareholders from directly influencing the business policy of a company in their particular interests.

- In order to prevent value extraction, **limitations on the withdrawal of liquid assets from the target company** should be introduced. In particular, the financing of dividend payouts via the imposition of additional debt on the company's assets (leveraged recap) must be stopped. Most countries have rules here and we should propose a Moratorium on loosening of such rules. The Commission should undertake a comparative study of their effectiveness and propose EU-wide minimum standards.

- One could also imagine restricting owners' freedom to set **managers' remuneration** packages (stock-options) autonomously. At the very least an EU-wide code of good conduct should be drawn up to assure that managerial interests are best aligned with the long-term interests of the company. This could be a start for moving towards full disclosure on all kinds of management remuneration. It would be even better to have some sort of rating system/seal of approval of remuneration structures.

- The desired character of investment could also be channelled in the right direction by capital maintenance provisions which prescribe a **limitation on the transfer of debts** to companies that are the object of investment through the restriction of credit financing. What would be a sensible cap as a percentage of market value: 50%? Or would it be better to impose the minimum equity capital requirement at the level of the PEF? Here, one has to examine the tax deductibility of interest payments that 'subsidises' the use of debt over equity. The Commission should undertake a study to assess whether the need to tackle these issues should be considered on an EU basis or a national basis.

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In order to ensure better protection of pension funds investing in LBOs, we can consider some regulation at European level:

- regulatory quantitative or principle-based constraint to the alternative investments' exposure of pension funds. Such constraints in absolute terms could be meaningful especially in the case of the PE funds, given the low level of liquidity (scarcely considered as a major risk by the industry practitioners) of such financial instruments. (For instance, in Italy the pension funds' investments in closed-end funds, the PE funds, are subject to a 10% constraint). Anyway a regulation aimed to favour pension funds' investments in early stage / expansion PE funds should be seriously considered and the growing involvement of pension funds in the alternative field could help force increasing transparency of the alternative investment industry.

- These regulatory constraints should also apply to Banking, Insurance, and public funds and could take the form of:

- tolerable leverage
- stability of capital base
- risk assessment procedures
- information standards for investors
- safeguards against collusion and insider trading.

4.3 Ensuring more and better jobs and social responsibility

A supplementary way to make sure investment will contribute to the long-term increase of company value might be to adopt the approach used in the OECD Corporate Governance Code to define proper behaviour for companies and a complaints procedure for dealing with violations of this code. At present, experience with the CG code violation procedure has been mixed, depending in large part on the behaviour of the national authority. However, if this problem could somehow be dealt with (for example, by improving the willingness of the national authority to intervene on behalf of the workers), then perhaps a code could be developed for the conduct of alternative investment funds, using the OECD CG Code as a model.

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In order to strengthen the accountability of LBO-acquired companies, some accounting rules should be respected by LBOs after acquisition:

- Minimum capital standards, maximum levels of debt, fair advisory fees in relation to real advisory work, adequate funding of pension schemes, information about working conditions and wages of employees.

- Private equity managers distribute a high proportion of the firm's cash flow to the consulting industry (to which private equity managers are connected through strong networks). Therefore *consulting fees* paid out of the cash flow of the firm should be limited to a certain percentage (varying with the amount of the deal). Fees exceeding this upper limit should not be acknowledged as 'costs' for tax purposes[7].
- The ratings of private equity investment funds through rating agencies pertaining to capital ratios (leverage) and risk assessment processes on market risk, procedural and managerial risks, netting risks, stress tests, business plans and adherence to them would definitely improve information.

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[7] Consulting fees exceeding this ceiling may be paid by private equity managers, but they are taxed twice: Once as capital gains of the private equity fund, a second time as income of lawyers, consultants, etc.

Clearly the governance authorities for the **infrastructure industries** need to have their regulatory powers strengthened to govern effectively under conditions of Private Equity Funds ownership, since infrastructure governance mechanisms typically do not include powers relating to financing, ownership or management. The primary concern must be to **provide transparency with respect to all transactions affecting the implementation of existing public service responsibilities, including investment and expenditure activity**, as well as the periodic reporting of indicators of public service performance, and powers to act if the public service objectives of government policy are not being met. This regulation is not directed at the Private Equity Funds' financing activities, but rather at the implications of the complete range of Private Equity Fund managerial decisions upon the infrastructure operator's public service responsibilities.

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Regarding the financing activities of public utilities, industry-specific regulation will continue to be based on an assumption of effective financial governance of Private Equity Funds. In addition, governments may wish to consider whether they should retain a "golden share" of equity in all public utilities, including a seat on the board. Such shares were retained by many governments in the early stages of public utility privatisations, and some still hold them. This ensures government is informed of the utility's plans and major decisions, and reserves the power to veto decisions they believe are contrary to the public interest. This is justified because of the importance to the general public, the economy and society of the major decisions of public utility managers and owners.

However, a more effective approach may be to strengthen the industry-specific regulation in the infrastructure industries, establishing specific powers to regulate the financial as well as the operational activities of infrastructure providers. The initial requirement is to ensure full transparency to the regulator and the public with respect to all transactions that affect the implementation of the operator's public service responsibilities, including financial transactions. For all its **major financing activities**, the infrastructure operator could be required to obtain **advance approval from the regulator that they are in the public interest.** The regulator would need broad powers to require the operator to supply all the information necessary to make the necessary public interest judgments.

The strengthened regulator's powers suggested here are not without precedent. In the past, most regulatory agencies in the US and Canada had similar strong financial regulatory powers over public utilities precisely because they were businesses in which there was a public interest. Some of these regulators retain financial powers today. A leverage buyout of an incumbent public utility operator could not take place in the US today without advance approval from one or more industry regulatory authorities.

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To promote the Rhineland model of public companies, thereby ensuring co-responsibility of all stakeholders for the future performance of the company, we could propose further initiatives:

One other potential mechanism for regulating operations in the financial sector concerning employees' social rights is the Transfers of Undertakings Directive 77/187 of 1977 (ARD). The ARD incorporates two central principles of the *social acquis communautaire*: protection of individual employees and a role for collective labour representatives, and entitlement to information and consultation[8]. Enterprise restructuring driven by mergers and acquisitions following the transformation of capital markets and the invention of new mechanisms of corporate finance and credit instruments allowing for the financing of takeovers raises the question of whether the Transfers of Undertakings Directive 77/187 of 1977 (ARD) could be adapted to this new environment.

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The ARD covers only transfers *from one employer to another*, not where the undertaking is transferred through a share purchase. In light of the role of financial capital in restructuring operations, this loophole should be removed by a reinterpretation or revision so that transfers of undertakings achieved through transfers of shares are covered. These purely *financial dealings with a direct impact on workers could fall under the ARD and be subject to the requirements of prior disclosure of all relevant information to employee representatives, prior consultation with employee representatives, and protection of the individual employees affected: in other words, no transfer of risk to employees. It would mean defending and extending the existing national systems of co-determination and worker participation. In particular, issues of take-overs and leveraging should be incorporated in the substantive fields where workers' representatives already have information or consultation rights. The strengthening of trans-national workers' participation could take place through the revision of the European Working Council Directive.

Employee representatives of firms involved in (leveraged) buy-out deals should be informed about where the money comes from. Who are the ultimate investors? This change in the scope of the ARD would mean a foothold gained for worker involvement in share transfers on the stock market. This would be a first step in the participation of labour in financial operations.

However, it should be said that the directive only covers entities resident in the EU, while many alternative investment companies have their base outside the EU. To that extent direct regulation of investment companies will frequently fail to achieve its ends. Therefore this change in the scope of the ARD should be accompanied with the creation of a kind of "passporting procedure" to cover foreign alternative funds.

4.4 Tax policy

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

As previously indicated, many private equity funds are formally organised as limited partnerships and are domiciled in off-shore centres. This means that the EU holdings and subsidiaries directive and the EU directive on interest payments do not in actuality cover dividend and interest payments to private equity funds. Most EU countries allow deductions for interest

[8] The idea goes back to Brian Bercusson, London, as explained to the ETUC/SDA 'Path to Progress' project, forthcoming 2006, Brussels.

paid. There is therefore a need for rules ensuring that the recipients of interest are taxed on that interest.

Tax systems in most European countries are based on so-called double taxation of earnings of public limited companies. Firstly, company profit is taxed (by the country where the company conducts its business) and then the shareholder is taxed on the dividend he receives from the company. In most European countries taxation occurs in the shareholder's country of residence.

The rate of tax is adapted to take account of double taxation and the rate of corporation tax is therefore lower than the tax rate for individuals and individual shareholders are taxed less on share dividends than on other income. This is why when LBOs argue for placing their funds offshore, they cannot legitimately cite double taxation as a reason.

A number of European countries have in recent years lowered the percentage of corporation tax as part of internal tax competition. This has benefited private equity investors in particular, since they are not taxed on dividends.

Acquisitions by private equity funds in recent years have been accompanied by leverage. This means that both the acquired company and associated holding companies have contracted a considerable amount of interest-bearing debt. Since it is possible in most countries to establish joint taxation or tax consolidation, the acquired company is allowed to deduct the interest expenditure incurred and its tax base is eroded.

Common rules should therefore be introduced in the EU countries to **counteract such tax erosion**. This cannot be done by lowering the taxation of interest in some countries since this simply means that the interest expenditure is transferred to allied companies in other countries.

Rules should instead be introduced **limiting deductions for expenditure on interest in the target company, its holding companies and its subsidiary companies** once the target company has been taken over by one or more equity funds.

The limitation could take the form of no deductions being allowed for interest expenditure by the local holding companies that have been established to carry out the takeover and of removal of the deduction for interest expenditure by the target company in respect of interest on the debt incurred in order to pay an extraordinary dividend after the company has been taken over by equity funds.

This can in practice be achieved by calculating what has been allocated by way of dividend in excess of the current profit. This then becomes the apportionment of equity created prior to the takeover.

The entitlement to deduct interest expenditure by the target company should subsequently be limited so that overall interest expenditure is restricted in proportion to how great the apportionment of equity is in relation to total interest-bearing debt.

Example:

A company has acquired a target company for € 100 million. The company is purchased by an equity fund which not only establishes two holding companies that incur debts of € 40 million but also pays out € 40 million from the target company itself.

The interest expenditure on the borrowing by the holding company should not be deductible and the interest expenditure by the target company should be limited so that there is no deduction for interest on a borrowing of € 40 million.

The opportunity to save on tax by altering the company's capital structure is a result of the way in which corporation tax is constructed. Corporation tax taxes financial income and expenditure in line with the actual net increase in value – in other words, the net profit – generated by the commercial company in question (e.g. telecommunications services).

There are various protection **rules to prevent the crass over-exploitation of tax saving opportunities**. For example there are limits on how much one is allowed to lend a company (the rules on "thin capitalisation") and it is possible to set limits on how much of the company's money may be transferred abroad through exorbitant consultancy fees or exaggerated interest payments on the company's debt (the transfer pricing rules).

However, the fundamental reason these tax savings are possible lies in the very nature of corporation tax, which consists of deductions from financial expenditure – and conversely of taxes on financial income.

As described above one possible way to deal with the eroded tax base is to **limit the form of deductions allowed** for interest expenditure by the local holding companies established to carry out the takeover. Another possibility is to reduce the tax gains achieved through increased indebtedness. In practice this would be to reduce corporation tax while at the same time supplementing it with a tax on gross business capital. Such a tax would tax only the company's primary earnings, i.e. the financial account before taxation.

Introducing a new tax to stem tax 'profits' obtained through capital fund purchases may seem like using a sledgehammer to crack a nut. However, a tax on gross business capital has other features in its favour:

- It does not distort companies' investment decisions, which corporation tax does.

- It makes it possible to reduce the taxation of financial capital, which is becoming increasingly mobile and international

- It is easy to collect, since the tax basis consists of the VAT basis minus wage expenditure. The companies and the tax authorities thus already have the necessary information.

However, a tax on gross business capital is not entirely without its problems. Since it is founded on the VAT basis, and does not include financial income in its tax basis, finance companies and the VAT-exempt sector will be taxed at a lower rate if no compensatory taxation is imposed by other means.

5. Our immediate proposals

In the past two decades we have seen an increasing uncoupling of the well-known relationship between wage increases and productivity. Now productivity continues to grow without wages keeping pace. This is an expression of the changes connected to the new developments on the financial markets.

The increased subordination of real economic investments - to promote New Social Europe - to the global financial markets, is underlining the need for proper regulation.

Even more fundamentally, the efforts of the European Union to strengthen the role of the social partners is weakened through the shifting coalition of investors whose only reference is the financial markets. Many leveraged buy-outs imply that there is no longer any interest in improvements in production or services, increased sustainable productivity capacity, innovation and research, long-term viability of markets, consumer needs etc. On the contrary: every investment is viewed as a portfolio of financial assets, not a place of employment.

This situation has been developing slowly but steadily over decades, with private equity playing an increasing role, certainly in Europe. Into this environment have now been injected enormous funds offering rates of return unthinkable only recently. The buyout funds have grown so big and so active that virtually all companies, no matter how big themselves, are effectively functioning in a pre-bid environment. This not only means that they respond to the real threat of an actual takeover bid by typically resorting to mass layoffs, wage reductions, extensions of working hours, casualisation etc. to show shareholders that they are serious about "delivering value" but also means that there is **constant pressure** on all firms to deliver greater profits, while investing less in the future of the companies through expansion of the capital stock. The trend is most visible in North America, but Europe follows the same curve, as a result of which the social model and the financing of the long-term Lisbon-investments (ref. Lisbon-European Council 2000) are under pressure. The drain on resources away from productive investment to reward purely financial investors is one of the key elements in severing the link between wages, profits and productivity and fostering the growth of social inequality.

Viewed from the standpoint of the "financialisation" of the economy as a whole, and the regulation of "alternative investments" in particular, the goal of regulation should be to reverse this levy, discourage the rising distribution of profits to purely financial actors and *encourage long-term investments which contribute to the growth and development of sustainable employment.* Private equity is acting as a financial magnet taking investment capital in exactly the opposite direction. As such, it should clearly be identified as a menace to the European social model. This analysis is borne out by the case studies and the analysis in Part II, which is a devastating portrait of the impact of private equity and illustrates the ways in which private equity smashes the wages/productivity link.

EU-wide regulation of alternative investment should orient itself towards balancing the in principle desired financing of enterprises, in whatever form, between the three poles of free capital movement – 1)investor protection and freedom to choose and pursue a career, 2) corporate governance and 3) society's interest in maintaining or increasing the value of enterprises over the long term. Undesirable investment strategy, which aims at short-term leveraging of the investors' own capital as well as that of enterprises, should be hindered by European regulation.. So should very short-term investment with rapid 'exit', or the avoidance of standards of investor protection or which result in the lowering of social and labour standards as a direct consequence of the manner of financing. The door should clearly be left open to desirable investment strategies.

In the following section, priority proposals to be supported by the PES Group are set out.

5.1 Hedge Funds

Harmonisation of European HF and creation of a single supervisory body

Our view is to fully harmonise European hedge funds (either single strategy, or FOHFs) in order to create a unitary category of onshore funds with a common minimum investment threshold, which could be lower in the case of FOHFs. By definition, it will never be possible to prohibit offshore funds at a worldwide level. So it seems more realistic to develop an onshore regime able to compete with offshore funds: it would obviously not prevent some investors from keeping their activities secret in offshore funds but it would offer an alternative choice for the rest of investors, through a higher level of safety, a guaranteed level of professionalism of fund managers, and an overseeing by regulators. Such EU regulated products will be offered as complementary to offshore funds, but their very existence will reduce the relative size of the offshore market.

This EU regulated regime would not forbid Member States from retaining nationally regulated regimes. It should be primarily designed around the need for regulation of the professionals involved in the 'value chain': management company, and depositary/prime broker. It would focus on: registration of these professionals in the EU, a requirement for them to be fit and proper persons, minimum capital requirements and minimum rules on valuation of assets.

We are fully aware of the political difficulty of introducing a common supervision of such products undertaken by a unique Supervisory Body (for instance a dedicated division of the ECB). Nevertheless we consider this the only effective solution to achieve such an aim. Therefore our target would be the introduction of a specific family of registered European single strategy funds whose products and managers should be authorized and monitored by a unique specialised and highly professional Authority, operating to reduce (and not to increase) the "regulatory arbitrage" provided by the main offshore locations (for instance in terms of length of the time to authorisation for new products or new investment companies). The second leg of this new European regulatory architecture should be the elimination of all the fiscal transparency incentives granted to the investment undertaken by institutional players (onshore FOHFs included), in vehicles not belonging to the above mentioned new family of European registered funds.

New and better information standards

New standards relating to the sale and promotion of alternative investment products need to be developed to protect consumers from mis-selling and misrepresentation of risk. These include:

- minimum investments for retail investors purchasing alternative investments directly without regulated advice. A minimum investment of Euro 100,000 is appropriate;
- rules should be developed to ensure that claims relating to investment performance and

risks are honestly and clearly communicated to consumers. This means that promoters or intermediaries should not be allowed to be selective about the time periods used in promotions. Moreover, the use of independent benchmarks should be stipulated to prevent promoters selecting favourable investment universes to compare products;

- rules on the disclosure of total charges to retail investors should be agreed to allow for objective and accurate comparison of charges – especially where fund of hedge funds are involved. Illustrations and projections should be provided on a consistent basis to allow investors to compare the offerings of different fund managers – that is, funds with a similar investment strategy should be required to use the same projected investment growth rates net of actual total expenses and charges;
- the EC should ensure that the content and presentation of risk warnings in any marketing or promotional material should be clear, fair and conform to minimum standards.

Safeguarding pension funds

As far as investor protection is concerned, the focus should be on information for institutional investors. They should be able to assess and compare financial returns and risks of the different types of management. Transparency requires more frequent disclosure of returns and risk characteristics, the storage of those data in a public database available to all investors, the computation of hedge fund indices and the disclosure of all management costs and fees charged on their clients. Information should be available about the appointment of a custodian bank, and common and effective rules relating to market pricing, public communication and disclosure of attained financial returns.

Funds that are eligible for marketing to retail investors should conform to a number of safeguards including:

- the need for an independent depositary;
- retail investors should have access to alternative investments only under certain conditions - for example as part of a 'fund of hedge funds' or within a portfolio of conventional assets;
- even then restrictions should apply with regards to diversification, limits on exposure, and liquidity criteria.

Supervision and management of systemic risks

Financial authorities should ask prime brokers for a periodic full disclosure of the exposure (fund by fund and then of the whole client base) to different categories of financial risks.

To assess the credit risk of hedge funds an international credit register should track all counterparties' exposure on individual hedge funds.

A prudent 'rule of thumb' used in the hedge fund world is that no more than 2 per cent of assets should be risked on any one uncorrelated 'bet' (that is, speculative investment). Such limitation would help limit the size of bets taken by hedge funds, and thus the danger to the stability of the system, (i) by increasing the stability of individual funds, and (ii) by putting a brake on the extent to which 'herding behaviour' can occur.

The EC should also create a framework to allow alternative investment funds to be classified and rated according to investment strategy and risk. This would allow for improved evaluation of comparative risk and return, better communication to investors, and promote more efficient competition as performance fees could be challenged.

Prime brokers should have the duty to limit credit line extension to any single fund whose potential future credit exposure appears excessive.

Corporate governance provisions

Rules relating to the fair and equitable treatment of different classes of shareholder are needed to ensure that funds cannot use pricing policies to attract potential investors or dissuade potential sellers.

Measures should be introduced through the insurance and occupational pension funds regulatory framework to ensure that high standards of due diligence are undertaken when alternative investments are included in pension fund or insurance fund portfolios.

We can consider the introduction at European level of some regulatory quantitative or principle-based constraint on the alternative investments' exposure of pension funds and other collective investment schemes such as mutual or insurance.

Tax treatment

Introduce a fiscal discrimination, to including FOHFs and all tax-exempt organisations, against offshore products and change the tax rules so that the location of the manager determines the tax position of hedge funds.

5.2 Private Equity Funds

Improving transparency

The first regulatory step to be taken is to increase the transparency of alternative investment funds by requiring reporting at regular intervals to an appropriate regulatory authority on (i) the investment strategy of the company, (ii) details of the assets held by the company, (iii) disclosure of the 'risk management' model used (this is especially important for leveraged companies, and is already used for banks by the banking regulators), and (iv) the management's incentive structure. Greater transparency is not enough by itself, but the premise here is that, due to inadequate transparency, many investors (including pension funds and so on) are not aware of the risks that alternative investment funds are taking in order to get a higher return. Many alternative investment companies would not be getting funding if investors were aware of these risks. Greater transparency is a requirement that persons from different ideological backgrounds (free market adherents included) can agree on.

At EU level one could argue for a directive defining minimum standards for disclosure, based on a similar logic to the directive requiring disclosure of stock holdings of 5 per cent or more of a company's total shares. Under this scenario, countries would still maintain their distinctive regulatory systems, but the imposition of minimum standards would help to reach a 'level playing field'.

Corporate governance provisions

Long-term investors should be rewarded. This can be done by permitting weighting of voting rights according to duration of shareholding and by means of differentiated taxation of (capital and dividend) income from shareholdings. Golden employee-owned shares are also an option to be further examined. Minimum holding periods to be eligible for tax exemption should be considered.

In order to prevent value extraction, limitations on the withdrawal of liquid assets from the target company should be introduced. In particular the financing of dividend payouts via the imposition of additional debt on the company's assets (leveraged recap) must be stopped. Most countries have rules here and we should propose a Moratorium on loosening of such rules. The Commission should to undertake a comparative study of their effectiveness and propose EU-wide minimum standards.

One could also imagine restricting owners' freedom to set managers remuneration packages (stock-options) autonomously. At the very least an EU-wide code of good conduct should be drawn up to ensure that managerial interests are best aligned with the long-term interests of the company.

Capital maintenance provisions prescribing a limitation on the transfer of debts to companies that are the object of investments, through the restriction of credit financing, is a way of channelling investment in the right direction. In this regard one has to examine the tax deductibility of interest payments that 'subsidise' the use of debt over equity. The Commission should undertake a study to assess whether these issues should be tackled on an EU basis or a national basis.

We can consider the introduction at European level of some regulatory quantitative or principle-based constraint to the alternative investments exposure of pension funds. Such constraints in absolute terms could be meaningful especially in the case of the PE funds given the low level of liquidity (scarcely considered as a major risk by the industry practitioners) of such financial instruments.

Consulting fees paid out of the cash flow of the firm should be limited to a certain percentage (varying with the amount of the deal). Fees exceeding this upper limit should not be acknowledged as 'costs' for tax purposes.

Social rights

The Transfers of Undertakings Directive 77/187 of 1977 (ARD) should be revised so that transfers of undertakings achieved through transfers of shares were covered. These purely financial dealings with a direct impact on workers could fall under the ARD and be subject to the requirements of prior disclosure of all relevant information to employee representatives, prior consultation with employee representatives, and protection of the individual employees affected: in other words, no transfer of risk to employees. It would mean defending and extending the existing national systems of co-determination and worker participation. In particular, issues of take-overs and leveraging should be incorporated in the substantive fields where workers' representatives already have information or consultation rights.

Tax policy

A uniform progressive capital gains tax rate should be applied in *all* member states. The progressive rate should be very high for short-term arbitrage deals to discourage the short-term buying and selling of firms on the market for corporate control. Taxes should be paid in the country where the object of the transaction is located.

Rules should be introduced to limit deductions for expenditure on interest in the target company, its holding companies and its subsidiary companies once the target company has been taken over by one or more equity funds.

The limitation could take the form of no deductions being allowed for interest expenditure by the local holding companies that have been established to carry out the takeover, and removal of the deduction for interest expenditure by the target company in respect of interest on the debt incurred in order to pay an extraordinary dividend after the company has been taken over by equity funds.

In order to prevent the crass over-exploitation of tax saving opportunities, one can imagine, for example, putting limits on how much one is allowed to lend a company (the rules on "thin capitalisation") and it is possible to set limits on how much of the company's money may be transferred abroad through exorbitant consultancy fees or exaggerated interest payments on the company's debt (the transfer pricing rules).

Table 1. Sources of capital
(% of total)

	1996	**2005**
Individuals	62	44
Funds of funds	16	30
Pension funds	5	12
Corporations and financial institutions	10	7
Endowments and foundations	7	7

Hennesse Group LLC, IFSL estimates

Table 2. Assets under management by investment objective
(% of total)

Investment objectives	**June 2002**	**June 2005**
Long short equity	42.6	30.6
Global macro	9.3	9.7
Emerging markets	3.4	4.9
Managed Future	3.2	4.3
Dedicated short bias	0.3	0.2
Total directional	**58.8**	**49.7**
Fixed income arbitrage	**5.7**	**7.9**
Equity market neutral	**6.8**	**5.1**
Convertible arbitrage	**8.6**	**3.9**
Total arbitrage	**21.1**	**16.9**
Multi strategy	**0.8**	**13.3**
Event Driven	**19.4**	**20.1**

Source:TASS, Grail Partner's analysis

ANNEX 1 - Case studies

AA

1. Company description

The Automobile Association is the UK's largest motoring organisation going back to the start of the Twentieth Century. Formerly a member-driven association it was demutualised in 1999 and sold to the Centrica Group for GBP 1.1 bn. In 2004 it was sold on to two European PE funds, CVC and Permira for GBP 1.75 billion.

2. Economic and social effects

2.1 LBO description (offshore base, activity focus, etc.)

- Permira is a leading global private equity firm and acts as adviser to 18 Permira Funds totalling approximately EUR 11 billion. The firm, based in Frankfurt, London, Madrid, Milan, New York, Paris, Stockholm and Tokyo, focuses on large international transactions. Permira Europe III is a EUR 5.1 billion private equity fund. The investors in the fund are mostly pension funds and other institutional investors based primarily in Europe and the United States. The Permira Funds have since their inception had a strong focus on telecoms and technology investing over 30% of all investments in this sector.

- *"CVC is an independent buy-out group founded in 1981 and has raised over US$18 billion (€16.8 billion) in Europe and Asia. Of this total, US$15.5 billion has been raised in Europe and US$2.7 billion in Asia. Since 1981, CVC has acquired over 220 companies in Europe for a total consideration of more than €61.9 billion. CVC's current European portfolio of 38 companies has a combined transaction size of over €32.2 billion."* [1]

2.2 Effects on job creation, investments in training and education of labour force, investment in innovation

- Since CVC and Permira bought the AA for [pound]1.75bn from the utility giant Centrica in September 2004, the workforce has been trimmed by 3,000 to 7,000. Within that, the frontline workforce was cut from 3,500 to 3,000. The GMB, which accused the AA's owners of "asset-stripping", argued that the figures underestimated the cutbacks.
- Unprofitable service stations were closed with the loss of 1300 jobs
- Total job losses (including 500 front-line road mechanics staff) totalled 3-3400 out of a workforce of 10-11000. (GBP 100m in redundancy payments)

In an audiotape obtained by The Independent the chief executive of the AA, Tim Parker, admits that the amount of workers getting sacked was too many - or as he put it "You get a few of them (decisions) wrong and I think in the rush for the hills we probably reduced out patrol force more than we should have done."[2]

GMB general union said patrolmen currently applying to take leave were being told the "holiday book" was closed until March because of insufficient staff.

2.4 Corporate governance and economics

[1]Source: http://www.cvceurope.com/about/

[2] AA BOSS ADMITS CUTTING TOO MANY JOBS - INDEPENDENT 27TH NOVEMBER 2006

The new owners embarked on a radical restructuring program. The main features (there is some discrepancy in the figures give by different sources) were as follows:

- Fees to motorists were raised by up to 30%
- As a result profits doubled to 200m (2005 on 2003)
- The staff cuts led to problems delivering services and caused a consumer magazine to downgrade the AA from the best to the third-best in terms of response time.

2.5 Management policies and shareholder activism: stock option programmes, effects on board and CEO's, management fees, employee information

In the spring of 2006 a further GBP 500 m was to be raised in order to make a special dividend payout (I have not been able to confirm whether this actually took place).

Tim Parker, AA Chief executive, is reputed to have earned GBP 20 m in bonuses, with a further handsome payout when the AA is floated off. Mr Parker, who previously ran Kwik-Fit, also for CVC, is reckoned to have bagged [pound]20m after he cut the workforce there from 10,000 to 7,000 and sold the car repair business to French private equity house PAI. A sale of the AA would lead to another multi- million pound windfall for Mr Parker.[3](not the source, but the content is the same. You probably have to rewrite, as I cannot find the article. Perhaps it is in the canteen of Marie Odile)

3. LBO exit (secondary, LBO, listing)

There is considerable speculation that the AA will soon be sold on
(Sources: Media reports and GMB.)

[3] AA BOSS ADMITS CUTTING TOO MANY JOBS - INDEPENDENT 27TH NOVEMBER 2006

Autoteile Unger

1. Company description

The auto parts company A.T.U. operates a chain of accessory stores for motorists and car repair shops. In 2002 A.T.U. had 13 000 employees and a turnover of €1.2 billion. A.T.U. has 14 branches in Austria and intends to focus sharply on foreign markets in the future.

2. Economic and social effects

2.1 Private equity fund description

In 2002 the company’s founder, Peter Unger, sold his majority stake to the private equity fund manager Doughty Hanson & Co. There were two main reasons for the sale: Unger had no successor lined up and the planned establishment of a new distribution centre required a considerable volume of liquid assets, which private equity investor could provide. The share structure in 2002 was as follows: Doughty Hanson held 75% of the shares, Peter Unger retained a 19% holding, and the remaining 6% were in the hands of the company management team.

Only two years later, Doughty Hanson wanted to float A.T.U. on the stock market. When it became clear that the planned selling price of €1.3 billion could not be raised in the stock market, the plan to have the company listed was abandoned. The company was put up for sale to other investors. The private equity firm KKR secured the purchase with a bid of €1.45 billion. This price was considerably higher than the stock market target. The share distribution after this secondary buy-out was as follows: KKR held 77%, Doughty Hanson 17% and the company management 6%.

2.2 Debt structure, alteration of company capital management fees requested by LBO

The private equity investors have changed the accounting and financial structure of the company considerably. The activity of Doughty Hanson led to a sharp increase in the company’s leverage ratio to 88% of the balance sheet total. By the end of 2003, the group’s equity ratio was down to 6.8%. This was a result of the high percentage of borrowed funds in the purchase price that Doughty Hanson had paid. Because of fairly high operating profits and a good cash flow, Doughty Hanson was already in a position to repay many of its loans. One particular feature of its stewardship was a positive cash flow from investment activity, which is unusual. This came about because the company’s own cars were sold off and the vehicle pool was restocked with leased vehicles. This created a one-off liquidity boost, which was used to service the company’s borrowings.

Nothing is known of the precise motives for the acquisition of A.T.U. by the second private equity investor, KKR. It may be assumed that, even after the activity of Doughty Hanson, KKR considered that there was still scope for further growth and efficiency gains. After the buy-out, KKR undertook considerable restructuring of the company in terms of its legal status, which is common practice in leveraged buy-outs. KKR also financed the bulk of the purchase with borrowed funds. When KKR took over, all of the old borrowings were replaced with new loans or equity. The degree of leverage in the purchase price is not known, but it probably amounted to about 81%. KKR further increased the company’s debts by €500 million at the end of 2004, making a total of €1 327 million. Since there was a positive cash flow, KKR was able to deal with the planned debt servicing. The equity ratio was increased slightly to 9.8%. The number of branches, which currently stands at 525, is to be increased to 800 by 2014.

2.3 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

KKR has wielded considerably more influence than Doughty Hanson on the company’s internal organization. It has removed board members and introduced an extensive reporting system and now employs stringent targets to exert pressure at the operational level. Although the number of branches has been increased by 10%, the manpower ceiling has been maintained, which means that staff productivity has been considerably enhanced. The working week has been lengthened from 37½ to 40 hours. The feeling among the workforce is that the company has lost some of its corporate identity. KKR shows little willingness to share information with the works council.

3. Exit or secondary LBO, IPO, listing

KKR is seeking to make its exit by floating the company. Initially, this was planned for 2009 at the earliest. However, the investment firm is now talking about floating the company in 2007. If this launch takes place, it would trigger the third radical change in the company's shareholder structure within five years.

References: Finance 09/04, S. 28 f.; Wirtschaftwoche 02.09.04, S. 78; Börsenzeitung 14.10.04, S. 17; Frankfurter Allgemeine Zeitung 02.05.05, S. 13; Handelsblatt 06.05.05, S. 3

Bulgarian Telecommunications Company

1. Company description

Set-up in 1992, the Bulgarian Telecommunications Company (BTC) is the former national operator in Bulgaria and retains a dominant position in the market. The company provides 97% of fixed line services in the country as well as holding substantial mobile interests. Furthermore, BTC is the sole universal service provider.

2. Economic and social effects

2.1 Private equity fund description

Following a lengthy two-year privatisation process, Advent International agreed the purchase, through the Austrian operation, Viva Ventures, of a 65% stake in BTC in June 2004 for EUR 230 million plus a EUR 50 million capital increase.

In January 2005, the Bulgarian state initiated an IPO and offered a total of 2,869,573 shares (34.78% of BTC's capital) at the Bulgarian Stock Exchange. Current minority shareholders are Barclays (10%), Telecom Invest Holding (8%) and Bulbrokers (5%).

Advent International granted Novator Holdings, a company controlled by Thor Bjorgolfsson, an option to acquire Viva Ventures in December 2005. Under the original privatisation terms, Advent was obliged to retain control of BTC for a minimum of three years. It is fully expected that the turnaround buyout (transfer to Novator) will take place as soon as legally possible.

The transaction involves a payment that represents a successful refinancing of Viva Ventures and, thereby, an eventual exit for Advent's financial partners, including Enterprise Investors, the EBRD, NBG Venture Capital, the Abu Dhabi Investment Authority, Alpha Associates, the Dutch Development Bank (FMO), DEG and, as agent of the mezzanine tranche, Mezzanine Management. Novator's transaction has been financed in part by Citigroup and Landsbanki Island.

2.2 Debt structure, alteration of company capital management fees requested by LBO

Details on BTC's debt structure are difficult to attain but it is instructive that refinancing on the debt has already taken place. In March 2005 Bulgarian BTC refinanced its debt to one of the original backers in the equity deal, the European Bank for Reconstruction and Development (EBRD) by drawing a EUR 285m loan.

The original EUR 123m loan has, therefore, more than doubled. Putting up the new funds are: Bank Austria Creditanstalt; Citibank; EFG Telesis Finance; and ING.

In terms of fees recurred, again, figures are difficult to acquire. However, the advisers on the original privatisation deal were: Cameron McKenna (legal and tax) for Advent; Georgiev, Toderov & Co. and Lega Interconsult (legal); PA Consulting (commercial); PricewaterhouseCoopers (due diligence). The Bulgarian government was advised by Deutsche Bank (financial), Denton Wilde Sapte (legal) and Djingov, Goiuginski, Kyutchukov & Velichkov (legal).

Advisers on the Viva – Novator deal were: CMS Cameron McKenna for Advent; Linklaters for Novator; and Clifford Chance for Citigroup.

2.3 Effects on public finances

While BTC remains a publicly traded company, damaging effects on public finances have been minimised. However, the suspicion remains that on taking full control Novator will attempt to de-list the company.

2.4 Effects on job creation, investment and training

The BTC story has been a difficult one, particularly for the employees. Following a highly controversial and secretive privatisation agreement by the government, dogged by claims of graft, employee numbers have been slashed and social dialogue has broken down.

BTC employed 24,392 in 2002. In the first year of its transfer to equity ownership nearly 10,000 of these were retrenched. This is despite the fact that the privatisation agreement foresaw staffing levels of over 20,000 up to and including 2006. In 2004 the new owners took dividends of EUR 75m and net profits of EUR 125m.

2005 saw 3,500 workers forced out, under the guise of a voluntary agreement, which was far from ‘voluntary’. The complaints of the local unions at this stage fell upon deaf ears. Social dialogue had all but broken down and the company was even refusing to renegotiate collective agreements at due dates.

Projections for further voluntary redundancies in 2006 go as far as 5,000.

UNI-Europa and the ETUC have also complained to the Bulgarian government of BTC’s failure to live up to its commitments in the Bulgarian Labour Code and European directives on information and consultation (98/59/EC and 2002/14/EC). On the back of these complaints and sustained pressure form the local unions a social partnership agreement was finally agreed with the company in July 2006.

In terms of investment, it appears that the digitalisation and modernisation activities undertaken since privatisation are little more than the legal requirement from the privatisation agreement. This will have significant impacts on ICT’s capacity to act as a driver of growth when Bulgaria becomes a full EU Member State in 2007.

Deutsche Börse

1. Company description

Deutsche Börse AG is a marketplace organizer for the trading of shares and other securities. It also is a transaction services provider. Deutsche Börse AG operates the Frankfurt Stock Exchange, which is one of the world's largest trading centres for securities. With a share in turnover of around 90 percent, it is the largest of the eight German stock exchanges.

Deutsche Börse employs more than 3,200 people, that service customers in Europe, the U.S. and Asia. It has locations in Germany, Luxembourg, Switzerland and Spain, as well as representative offices in London, Paris, Chicago, New York, Hong Kong, and Dubai.

In 1993 Werner Seifert became the chief executive of Deutsche Börse. He focused the stock exchange sharply on growth. After creating the Xetra electronic trading system, which was displacing floor trading and the regional stock exchanges, he had amalgamated the local systems for securities clearing and settlement in the hands of a subsidiary, Clearstream, thereby carving out a monopoly in Germany. He also oversaw the merger of the Swiss and German futures exchanges to become Eurex, the world's largest derivatives market. After failing to take over the London Stock Exchange in the year 2000, Seifert tried a second time in 2005.

2. Economic and social effects

2.1 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

In 1993 80% of Deutsche Börse was owned by German commercial and savings banks. For them it is of importance, how the stock exchange works. Brokers and regional stock exchanges each held 10% of its shares. In 2001, when Seifert floated Deutsche Börse itself on the stock market, 68% of the shares were still owned by German investors. By 2005 93% of the company's shareholders were Foreigners, mainly interested in the yield on their shares. One of the reasons given by foreign investors for buying into the company was, that it represented a good business on offer at a low price.

American and British shareholders took a dim view of Seifert's practice of accumulating profits in the company's coffers instead of making payouts to its shareholders. In May 2005 they forced the chief executive of Deutsche Börse to step down. The reason for Seifert's overthrow was the planned purchase of the London Stock Exchange (LSE). The main dissenting voice was that of the English-based hedge fund TCI Fund Management, which opposed the purchase from the outset. The bid of £5.30 per share was described as excessive.

The managing partner of TCI, Christopher Hohn, also forced the resignation of Rolf Breuer, chairman of the supervisory board of Deutsche Börse AG and former chief executive of the Deutsche Bank. Breuer had supported Seifert´s strategy of expansion at all costs.

When the takeover bid for LSE was rejected, the fund companies demanded that the surplus capital be paid out to shareholders. The dissenting shareholders held a total stake of some 35% in the company (TCI had 7.9%, Atticus 5.1%, Capital Group Companies 5%, Capital Group International 4.7% and others 12.3%). At the general meeting in May 2005, the board of management and the supervisory board proposed that €78 million be paid out to shareholders and that €149 million be allocated to the reserves. Union Investment, one of the minority shareholders, tabled a counter-motion for a payout of €227 million.

The massive interference of shareholders in matters of firm strategy had so far been unusual and practically unheard of in Germany. In response to it the supervisory board brought legal action against the foreign fund companies, alleging that they had acted in concert. It was claimed, that these investors, whose combined stake in Deutsche Börse exceeded 30%, had coordinated their actions with a view to exerting jointly a controlling influence, that was not warranted by the size of their holding alone. Acting in concert is not permitted in Germany. If it nevertheless happens, the holders of the combined stake are required to make an offer to the remaining shareholders for the purchase of their shares. The supervisory board was unable to prove that the fund companies had acted in concert, since the fund companies had no need to strike any such deals, because their views largely coincided anyway.

The intervention of the hedge funds in the dealings of the German stock exchange had a very serious consequence: Now the stock market scenery in Europe was anew sorted without participation of Deutsche Börse AG. The prevention of the purchase of the LSE by the German stock exchange was one of the important reasons that subsequently now American stock exchanges received unchecked influence on the big European stock exchanges. Whether this was one of the destinations of the hedge funds beside the income return destinations, is not known.

3. LBO exit (secondary LBO, IPO, listing)

Many people were surprised not to see TCI and the other investment companies cash in their shares of Deutsche Börse, after they had successfully raised their value and gotten a big dividend on top of it. But many hedge funds have changed their strategy over the last few years. They used to adopt a hit-and-run-strategy, which means that they wanted to get in and out of an investment as fast as possible, while taking as much money as they could grab. Nowadays they are also looking for fairly long-term investments that can stretch even more than three to five years. To exert more control over their investments, hedge funds intervene in the business policy of firms, which shifts the balance of power.

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DIS

1. Company description

The DIS Deutscher Industrie Service AG is one of the five largest providers on the German market for temporary employment. Through its specialization in the qualified segment DIS AG is clearly differentiated from the rest of the market. DIS is based in Duesseldorf and it has 161 branches in 73 cities and 7 300 employees.

The strategy of DIS AG is based on the concentration on the German market, increasing market share, the provision of qualified personnel services in five clearly separated business divisions and the performance-oriented remuneration of employees.

2. Economic and social effects

2. 1 Hedge fund description

In 2006 the Swiss recruitment agency group Adecco launched a takeover bid for DIS. Two hedge funds, led by Elliott International, intervened in the process. The actions of DIS and Adecco were unusual by German standards. Adecco's chief executive and major shareholder Klaus Jacobs acquired a 29% stake in DIS from Dieter Paulmann, former chief executive of DIS and its main shareholder. Jacobs then made a public offer to buy the other shareholders' stakes in the company. The chief executive of DIS, Dieter Scheiff, initially resisted the takeover. Jacobs won him over by promising to appoint him chief executive of Adecco after the takeover.

Adecco subsequently acquired 83% of the shares in DIS. In the meantime, two hedge funds had bought into DIS, Elliott International having acquired a 10% stake and the Liverpool Limited Partnership a 3% stake. Adecco planned to acquire more than 95% of DIS by squeezing out the remaining shareholders with a cash settlement. Adecco also intended to delist DIS and to slash dividends by 80% from the levels of previous years. Delisting would effectively compel shareholders to sell their stakes in the company since the shares would scarcely be freely negotiable any more. The hostile dividend policy also served to drive out shareholders.

2.2 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

At the general meeting of 8 June 2006, DIS wanted its shareholders to take decisions to delist the company and cut its dividends. Small investors employed stratagems involving the tabling of numerous motions to ensure that these main items of business could not be discussed on the day of the meeting. The decisions in question were not taken until the early hours of 9 June, whereas the general meeting had been scheduled for 8 June. The Higher Regional Court in Düsseldorf ruled in favour of the litigants who challenged the validity of these decisions, and DIS had to remain a listed company. At the general meeting, Elliott International managed to secure the appointment of a 'special representative' to examine claims for damages. Allegations were raised that DIS chief executive Dieter Scheiff and his head of finance, Dominik de Daniel, who also switched to Adecco, may have divulged trade secrets to DIS's competitor. Adecco had not yet consolidated its position as majority shareholder in the group by means of a control agreement. DIS commissioned a specialists' report, which valued the company at €51.82 per share. The offer made to the minority shareholders amounted to €58.50 per share. On 7 June 2006, the day before the general meeting, however, DIS shares had a stock exchange value of €74. The big difference between the two sums is the reason the hedge funds kept their shares with hopes of making a higher profit from their investment.

3. LBO exit (secondary LBO, IPO, listing)

The preliminary conclusion is, that DIS AG is still listed on the stock exchange. The Adecco Germany Holding GmbH as biggest shareholder holds 82.6 percent of the shares. Followed by the Elliot Group which holds 10.0 percent of the shares. The remaining shares of 5 percent are largely held by foreign institutional investors.

An analysis of the case would result in two contrasting assessments of the actions of the hedge funds. On the one hand, the strategy of the hedge funds was designed to ensure that Adecco bought off their resistance with a considerably higher settlement offer, so that the funds could make a substantial profit on the purchase price of the shares; on the other hand, the hedge funds exposed a very dubious lack of transparency in the actions of the two recruitment firms.

DT-GROUP

1. *Company description*

DT Group A/S imports wood and trades building materials (special wood products) and runs chains of building markets. It provided building materials and tools etc to professionals and private in Denmark and Sweden. Turn over is 2½ bn € and numbers of employed 8.000. DT Group was in many years listened at the Copenhagen Stock Exchange under the name Det Danske Trælastkompani (Danish Wood traders). The DT Group A/S was listened at the Copenhagen Exchange

2. Economic and social effects

2.1 Private equity fund description

In 2003 the DT group was bought by the private equity group CVC Capital Partners (90%) and a holding company formed by the management group in the DT Group A/S (10%). Price: 0, 9 bn €

The profit of DT Group A/S has increased very must the last 3 years, thanks to the very positive conjuncture in Denmark special for the housing and building industry.

When the company was listened, it usual declared a dividend at 10 - 15 mill € pr year, which was a ratio of 30 % of the profit of the year, the company to times declared a special dividend at 200 mill € two times (2004/05 and 2005/06). The holding companies used in the LBO used the dividend to pay back the financing of LBO.

The increased dividend was financed by better cash flow of the company, which – among other initiatives – pressed its supplier to give a longer credit.

2.2 Social effect

The numbers of employees have increased with 10%, but this is only because of acquisitions of formerly private owed building markets.

The direct investment in property and equipment is lower than the yearly deprecations.

The effective tax rate of the profit of the company was decreased because of joint taxation with the holding companies, which were the direct owners, and had taxable negative profit because of interest of the financing of the LBO.

3. Exit of the private equity

In 2006 the CVC and the management team sold the DT-Group to the British building materials provider Wolsely plc. for the price of 2 bn €.

eircom

1. Company description

Eircom is the former national operator in Ireland. In 1983-84 it was set up as a semi state enterprise. Eircom is the principal provider of fixed-line telecommunications services in Ireland with approximately 2.2 million fixed-lines. Eircom is, further to this, the designated universal service provider in the country.
The mobile division, Meteor is the third largest mobile operator in Ireland. Meteor has approximately 683,000 mobile subscribers, which includes approximately 5,000 eircom customers.

2. Economic and social effects

2.1 Private equity fund description

In 1999 the government decided to sell the business by way of an IPO (Initial Public Offering). A large proportion of citizens bought shares in the company only to see the value of the shares dramatically drop and many lost money on their investment. The unions negotiated an Employee Share Ownership Plan (ESOP) for its members under the deal, where 5% was put up by the government in exchange for an agreed programme of change. The union coalition bought a 9.9% stake bringing their stockholding to 14.9%.

The Employee Share Ownership Trust (ESOT) and the related eircom Approved Profit Sharing Scheme (the APSS) together with the ESOP were established on 31st March 1999 to encourage and facilitate the acquisition and holding of shares in eircom by and for the benefit of the employees and certain former employees of eircom and participating companies within the eircom group. The ESOP Trustee is the Trustee of the ESOT and the APSS. The vast majority of current ESOP participants joined the ESOP upon its establishment.

Due to the poor performance of the share price, the board announced in 2000 that it intended selling Eircell (the mobile telephony arm). This transaction signalled to the business community that the rest of the company could be saleable. In 2001, a consortium headed by Valentia was successful in buying the company and taking it private. The ESOT (Employee Share Ownership Trust) raised their stake to 29.9% of the company under this transaction.
Valentia decided to exit in 2004 and a 2nd IPO was issued. This brought the company back on to the Irish stock exchange.

In July 2005 the board announced that it had signed a conditional agreement for the acquisition of WWII, the holding company of Meteor (Ireland's third largest mobile telephony provider), which valued the Meteor business at €420m on a debt free basis. The board announced that it would fund this transaction through a rights issue. This deal went ahead on the 1st January 2006.
Meanwhile, in November 2005, Swisscom confirmed that it had entered into discussions with eircom in preparation of a bid for eircom. Eventually the Swisscom Federal Council instructed its representatives on the Swisscom board to vote against the proposed acquisition. Consequently, Swisscom announced that it would not be proceeding with an offer for eircom.

In October 2005, Babcock & Brown (BCM) announced that it had acquired a long term, strategic holding in eircom of 12.5% and by March 2006 it had increased its stake to 27.1%. Following this BCM and the ESOT made a joint approach for eircom with an offer of €2.20 per ordinary share together with the right to receive a dividend of 0.052 per ordinary share and a preference share alternative. At that time the ESOT beneficiary held 21.4% of the ordinary shares. The bid was successful and today the ESOT holds a 35% stake in the company with Babcock & Brown controlling the rest.

The sale of eircom was conducted on the terms of a recommended offer under which Babcock & Brown and the eircom Employee Share Ownership Trust jointly making the offer. BCM is an Australian based investment fund that is listed on the Australian stock exchange.
BCM is permitted to invest in both Australian and overseas companies and in both listed and private entities. The focus of BCM is on a concentrated portfolio with a flexible investment horizon.
For the financial year 2006 results, shared revenue for the period of €1,693m (2005 figure was €1,598m) and EBITA before restructuring pay costs, non cash pension charges and profit on disposal of property and investments of €601m

(2005 €610m) resulting in an EBITA margin on the same basis of 35%. Eircom’s basic earnings per share was €0.08 and net debt as of March 2006 was €2,111m euros.

2.2 Debt structure

The new ownership structure (BCMIH) will be financed by equity/contributions from the BCM group and the ESOT and debt financing underwritten by Barclay’s Capital, Credit Suisse, Deutsche Bank, Dresdner Kleinoort Wasserstein and JP Morgan. The total transaction value including the eircom debt and transaction costs is expected to be approximately €4.8bn of which 80% (approximately €3.8bn) will be funded through debt finance with the balance from equity finance.

2.3 Effects on job creation, investment and training

The eircom/union relationship has been characterised by a partnership model created when the union coalition received its initial stockholding in 1999. In the seven years since there has been a huge reduction in the workforce, achieved by the company offering (on an ongoing basis) voluntary redundancy and early retirement schemes. Increased automation and competition balanced with a reduction in revenues and a challenging regulatory regime have set the pace of the agenda.

The average employee age profile is now approximately 50 years old. Recruitment is a priority in certain areas of the business if eircom is to prosper. Investment and training are always difficult, however, in the higher technical areas. For example, IP and NGN training is provided in a structured manner. More complex still are the external aspects, although existing health and safety legislation is of benefit to the workers in these employment areas. Investment in training (and, investment more generally) has been difficult to secure from the new owners who espouse merely a short-term vision.

2.4 Corporate governance

The ESOP, with its 35% stockholding, has the right to nominate two directors (one being the Vice Chairperson) to the main board of eircom, consisting of six directors. Guarantees were sought and given to the union during the sale that existing employment conditions, including pension rights of the employees of eircom would be fully safeguarded. All agreements will also be honoured in accordance with existing industrial relation provisions. The new management appears ready to work within the partnership framework, which currently exists between eircom and its workforce.

The ESOT was a key aspect of the agreement entered into in 1999 between eircom and the union coalition. This agreement was the blueprint for transforming the state owned company into an entity capable of prospering in the emerging competitive telecommunications market in Ireland.

The union coalition is entitled to appoint a majority of the directors to the board of the ESOT. This is a board of seven, four union coalition members, one independent director and two company representatives. The ESOT will have a significantly enhanced ability to influence the business following the most recent purchase. This will be particularly valuable against the unprecedented challenges arising from technological and regulatory developments. Each change recognises that such significant and rapid change requires considerable support from the workforce.

2.5 Protection of minority shareholders

In eircom’s case the union coalition, which started with 14.9% in the original IPO, moved to 29.9% when it was taken private. Dropped to 21% during the second IPO, ESOT now owns 35% of eircom. This must be also viewed on the basis that ESOP members have to date received approximately €35k to €40k tax free in distributions. Negotiated under the latest deal the ESOT, which owned 100% of the issued Convertible Preference Shares (CPS), allowed BCMIH to acquire them for €144.2m. The ESOP intends to distribute this to members in transactions over the next three years.

2.6 Management policies and shareholders activism

Owing to the high number of transactions that has occurred at eircom a disturbing amount of money has been paid to an elite group at the top of the company. At the original sale the CEO left with millions gained in the deal. When Valentia took the company private this pattern was repeated among top management. The same can be said of the second IPO and the subsequent BCMIH purchase. The amount paid to advisors acting for the management and the equity fund on these corporate deals is also very difficult, if not impossible, to explain to the ordinary worker. During all this, of course, the company's debt level only increases. Currently this stands at €3.8billion.

In summary these transactions have not brought stability to the business. High dividends and, particularly, management fees are to the detriment of the long-term financial health of the company. They affect the investment portfolio and the commitment is usually short term. The workers and unions have keenly felt these changes but the ESOP has enabled certain financial returns as well as some level of control of the changing environment.

FRANS BONHOMME

1. Company description

Frans Bonhomme was founded as a family owned business in 1935 when the first shop was open. In 1989 the company became almost completely owned by the Bollore Group. In 1994 the company became by private equity owned, and has since undergone four LBOs.

Frans Bonhomme, with more than 120,000 customers in France and more than 30,000 items in its catalogues, is the leader in the distribution of plastic pipes and their accessories destined to construction and public works professionals as well as plumbing tradesmen. Frans Bonhomme is the only specialist player in its field and has a strong position throughout the French territory due to its network of 284 points of sale. The company had a turnover of €538 million in 2004.

2. Economic and social effects

2.1 LBO description (offshore base, activity focus, etc.)

Frans Bonhomme was originally the subject of a buyout in December 1994 when Fonds Partenaires (Lazard) led a FFr 950m transaction in which a syndicate of private equity investors committed a total of FFr 300m. The syndicate comprised Fonds Partenaires, Apax Partners, l'Union d'Etudes et d'Investissement, IPO, LCF Edmond de Rothschild and Socadif. Later, in February 2000, Frans Bonhomme was acquired in a FFr 2.5bn secondary buyout by a consortium of institutional investors comprising Cinven, PAI and Astorg Partners. Each of Cinven and PAI acquired a 33.4% stakes in the company while Astorg Partners acquired a 17.9% stake.
In June 2003 Apax Partners, alongside Goldman Sachs private equity funds, announced the Euro 520m tertiary buyout of Frans Bonhomme, and accompanied the change of generation at the CEO level.
The Fourth LBO took place in October 2005, when Cinven in conjunction with the newly appointed management team acquired Frans Bonhomme from Apax Partners.

2.2 Debt structure, alteration of company capital management fees requested by LBO

Royal Bank of Scotland provided the debt of the latest LBO.

2.3 Effects on job creation, investments in training and education of labour force, investment in innovation

Thanks to changes in strategy implemented by private equity investors and consequently a renewed management team, Frans Bonhomme has succeeded in achieving its development programme of outlet openings in France and in launching an international expansion. It has now a network of 300 shops compared to 145 in 1998. Geographic expansion was followed by a significant increase in employment level.

2.4 Corporate governance and economics

Financial sponsors have been actively involved in the process of building a strong management team. During the second LBO a new Financial Director and Development Director were introduced in order to reinforce the team.
In the third LBO there was a change of CEO as the historic CEO retired.

2.5 Protection of minority shareholders

Not applicable. In the case of Frans Bonhomme there is no minority shareholders at risk as the only owners are professional financial investors, and the Management team.

2.6 Management policies and shareholder activism: stock option programmes, effects on board and CEO's, management fees, employee information

With the fourth LBO the number of employees participating in the transaction has been increased from 500 to 800.

2.7 Effects on public finances

Those of a growing business, i.e. more employment, more consumption and thus more income for the state.

3. LBO exit (secondary, LBO, listing)

Depending on market conditions BC Partners may envisage a third LBO but the company could also be eligible for a trade sale (as was the case in 1994) or, given the growth profile, an IPO.

Friedrich Grohe AG

1. Company description

The Friedrich Grohe company is a manufacturer of sanitary and kitchen fittings with a 10% share of the world market. In 1968 Friedrich Grohe sold 51% of his shares to the American group ITT. This sale improved the international position of the company. In 1983 Friedrich Grohe’s sons bought back the shares from ITT. In 1991 Grohe was converted into a joint stock company, and in the same year it was floated on the stock exchange. At the end of 2004 the company had 5 800 employees.

2. Economic and social effects

2.1 Private equity fund description

Grohe triggered a highly critical debate about the activities of private equity investment firms in Germany. In 2005 Franz Müntefering the chairman of the Social Democratic Party of Germany at that time described investment firms as ‘swarms of locusts’.

In 1999 the members of the Grohe family sold their majority stake to an investment group headed by the British private equity fund BC Partners. Two thirds of the purchase price of €900 million were leveraged by means of bank loans and high-yield bonds. In the period of BC Partners’ investment, from 1999 to 2004, the value of its stake, including recapitalization exceeding €350 million, more than doubled, which was equivalent to an annual return of about 20%.
BC Partners initially intended to sell the company by floating it on the stock market. This plan was abandoned, presumably because the expected profit from the sale seemed too low. Instead, the company was the subject of a secondary sale in May 2004 to two private equity investment firms, Texas Pacific Group (TPG) and Credit Swiss First Boston (CSFB). Experts estimate that the new investors paid between €1.5 billion and €1.8 billion for the company.

2.2 Debt structure, alteration of company capital management fees requested by LBO

Before the private equity investment firms took it over, the Grohe company had a rather high equity ratio, which averaged 50% in the years from 1994 to 1998. The free cash flow was also high. The company had been profitable for a long time before the investors moved in. When the first private equity fund made its investment, the equity ratio fell to 6.2% by 2003. There even was a negative leverage effect; in other words, the overall return on investment fell below the interest payable on the borrowed capital. The reason for this was the high leverage ratio and the consequent interest burden. There was no option for the fund but to reduce its investment. In 2003 not even the curtailed investment could be funded from the cash flow. Although turnover increased considerably from €769 million in 1999 to €911 million in 2004, and the company’s performance in terms of earnings before interest, tax, depreciation and amortisation improved from €126 million to a record high of €185 million, record losses of €100 million were nevertheless posted under the management of the second private equity investors in 2004 because of the heavy interest burden.

Industry experts believe that the purchase price paid by the second group of investors was far too high. The following reasons were probably crucial in their decision to buy out the company: They sensed, that there was good growth potential in the company, which enjoyed an international reputation. Also they saw good prospects for further expansion in what was considered to be a lucrative German market, and they hoped to find further hidden reserves in the company, but these no longer existed, having been unlocked long before by BC Partners. Along with the negative leverage effect, returns on equity also slipped into minus figures. Because of the high purchase price that TPG and CSFB paid BC Partners, Grohe’s level of debt, which had already been high, underwent another steep increase. That caused the rating agency Moody´s to reduce Grohe´s credit rating. Moody´s finds fault in the high interest and restructuring costs and claims, that they will probably continue to absorb a significant part of the operative cashflow.

The turnover in the third quarter in 2006 rose by 15.3% on 900 Mil. EUR, the EBITDA on the basis of reorganisation expenses only about 14%.

In January, 2007 a variably bearing interest loan (floating rate note) was brought in the volume of 800 Mil. EUR by Grohe to the capital market. Together with a new credit line of 150 Mil. EUR the whole bank debts were replaced with it. Already in 2004 a loan of the same sort was transferred. Both loans have together a volume of 1,135 Bn. EUR and are payable in 2014. An analyst from S&P means, the new loan will improve Grohe's liquidity position significantly. 80 Mil. EUR of credit line and 30 Mil. EUR of liquid means would be available with it to the company. Besides, the credit conditions are less strict than with bank loan.

2.3 Effects on job creation, investments in training and education of labour force, investments in innovation

Under the first private equity investor, BC Partners, there were very encouraging developments: further progress was made in internationalising the company, its organisational structure was modernised, new products were put on the market more quickly, the product range was diversified, and expenditure on research and development was increased.

2.4 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

In respect to its rising level of debt the company was close to saturation point. This was to have serious repercussions at a time when commodity prices were rising, the industry was entering a difficult period, and competition in general was becoming tougher. One of the company's responses was to shift a large part of its production to low-wage countries. In the view of industry experts, that was a strategic error. They believe it could damage the prestigious Grohe brand, which might lead to a sharp fall in sales. By now this danger has also been recognised by Grohe´s management. The brand Grohe is to be maintained as a premium brand. That's why the chairman of the board, Haines, does not plan to cut back any more jobs in Germany.

In the course of their restructuring drive, the second set of private equity investors have constantly sought to play off the company's various locations and their workforces against each other. The workforces in the company's plants and their works councils concede that they have not cooperated as closely with each other as they might have done. The works councils interviewed describe the representatives of the private equity investors as people who have no emotional bond with the Grohe brand and the company's products. They do not identify with the company and its staff but regard Grohe as nothing more than a financial asset. While the works councils were still able to cooperate in a professional manner with BC Partners, they describe their relations with TPG and CSFB as adversarial and say that cooperation between management and labour has deteriorated dramatically. TPG and CSFB were now intervening heavily in the operational and strategic management of the company. Major changes have been made at senior management level.

When the company dropped into the red, the private equity investors brought in McKinsey management consultants to identify 'non-essential' expenditure. The consultants proposed an accelerated internationalisation drive, relocation of numerous production facilities to other countries, a tighter purchasing policy, a smaller range of products and a slimmer administration. The main brunt of restructuring was to be borne by the staff in Germany, most of whom would lose their jobs. The plants at Lahr in the Black Forest, Herzberg and Porta Westfalica would be closed down, leaving only the Hemer and Ludwigsfelde factories in Germany. More than half of the jobs in Germany, totalling 2 700, would be axed. The works council commissioned its own specialists' report, which proposed the preservation of the plants in Hemer, Lahr and Porta Westfalica. The report also proposed that there should only be 842 job cuts. It recommended a considerably smaller degree of relocation abroad than McKinsey had proposed.

In June 2005, the works council and the company management reached an agreement whereby 943 employees would be made redundant by the end of 2006. Natural wastage would account for another 290 jobs. The company would continue to operate at all of its locations except Herzberg. In August of 2006 it became known, that due to good going business Grohe will lay off less employees than agreed. Instead of 943 workers only 770 will have to leave the company. Nevertheless the dubious actions of the private equity investors had serious repercussions for the company's workforce, which has been suffering for years from the uncertainty of becoming redundant.

3. LBO exit (secondary LBO, IPO, listing)

It is assumed that the new investors, TPG and CSFB, intend to make their exit by floating the company on the stock market. They are targeting an annual 28% return on the equity they have invested, which is considerably higher than the target set by BC Partners, who had the advantage of taking over a company that had not yet been plundered.

Overview
Equity ratio average years 1994 – 1998: 50 %
Return on assets average years 1994 – 1998: 16-17%
Return on sales average years 1994 – 1998: 12 %

1999 sale to BC Partners – price of sale 900 mill € - 2/3 loans
increase equity ratio from 32 % in 1999 to 44 % in 2000
EBITDA 1999: 769 mill. €
Increase debt capital ratio from 50 % before 1999 to 94 % in 2003
negative leverage effect in 2003: return on assets less than debt capital ratio
Recapitalisation by BC Partners until sale 350 mill. €
Average return BC Partners 20 % per year

„Secondary sale“ to Texas Pacific Group (TPG) / CSFB / 1.8 bio. €
EBITDA in 2004: 911 mill. €
loss 100 mill. € in 2004 due to debited interest
restructuring program McKinsey: loss of 1200 working places in Germany out of 5000

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Gate Gourmet

1. Company description

For a long time Gate Gourmet was considered SwissAir's "Crown Jewel". The company was worth roughly 6 billion Swiss Francs before the bankruptcy of Swissair and the 9/11 impact on the aviation sector. Gate Gourmet, was bought by Texas Pacific Group in 2002 for around CHF 1 billion. Gate Gourmet's then CEO welcomed the sale with these words: "Through a combination of strategic acquisitions and organic growth, Gate Gourmet should experience continued success." At the time of its acquisition by Texas Pacific Group, Gate Gourmet employed over 26,000 workers in 33 countries with 144 flight kitchens.

As Gate Gourmet was formerly the wholly-owned airline catering division of SwissAir, Gate Gourmet were publicly listed. After the Texas Pacific Group acquisition Gate Gourmet is now a privately held company. In practice this means that almost none financial details concerning the company are disclosed.

2. Economic and social effects

2.1 LBO description (offshore base, activity focus, etc.)

Texas Pacific Group (TPG) is a leading global private investment firm with over $30 billion of capital under management. TPG manage several types of funds including private equity, venture capital and public equity and debt investing. The firm was founded in 1992. Holdings have included stakes in technology (Seagate Technology, ON Semiconductor), consumer franchises/products (Burger King, Ducati), retailers (J. Crew, Petco), airlines (Continental, America West), and entertainment (Metro-Goldwyn-Mayer). In 2006 Texas Pacific Group raised a $15 billion sized buyout fund.

2.2 Effects on job creation, investments in training and education of labour force, investment in innovation

From 2002 to 2005 workers of Gate Gourmet have experienced severe job cuts: From 26.000 to 22.000 workers and from 144 to 109 flight kitchens. Especially one round of job cuts has caught the attention of the media and public:

In August 2005 some 800 workers were sacked by the airline caterer Gate Gourmet. The Transport and General Workers Union (T&G) had been in negotiations with Gate Gourmet since February over measures to deal with a massive projected operating loss at Heathrow. A rescue package was put forward in June, but when it became clear that management was excluded from the cost-cutting measures, the workforce rejected the package. In August, Gate Gourmet announced their intention to hire 120 temporary workers - while permanent staff continued to work under the threat of being made redundant. The company ignored calls for discussions and brought in the temporary workers. Workers on sick leave and holiday were informed by letter that they had been sacked.

In addition Gate Gourmet also found themselves in a bitter labour dispute in the United States in the summer of 2005. Unions presenting Gate Gourmet employees successfully sued to get their health benefits after the company tried to eliminate them.

2.3 Corporate governance and economics

Gate Gourmet reported making losses in each of the four years leading up to the 2005 dispute, losing some £22 million in 2004-05. The path to "organic growth" at Gate Gourmet began with a meticulously planned assault on trade unions beginning with the struggle at Heathrow Airport in the UK. The offensive then moved to Germany's Düsseldorf airport, where members of the IUF-affiliated Food and Allied Workers' Union NGG have been on strikeover the company's refusal to negotiate wages and compensatory measures for increasingly arduous working conditions.

In a clear challenge to Germany's established collective bargaining framework, the company has been demanding enterprise-level concessions on working hours, holiday leave and shift pay despite the fact that these are negotiated at industrial sector level. A compromise negotiated between the union and local company management in early December 2005 was unilaterally scrapped by Gate Gourmet corporate headquarters, leaving the workers no alternative to continuing with their strike. The strike continued until a settlement was reached in April 2006.

Gate Gourmet continues to operate at Dusseldorf airport with a minority of strike-breaking workers from the site supported by strike-breakers from a non-unionised Gate Gourmet kitchen near Frankfurt airport and from labour-hire agencies.

2.4 Management policies and shareholder activism: stock option programmes, effects on board and CEO's, management fees, employee information

Gate Gourmet, which has sought concessions on wages and benefits averaging from 25-35% at all its operations since being acquired by TPG in 2002, illustrates well the heightened aggressiveness and willingness to attack established industrial relations norms by corporate managements imposing radical restructuring programs to meet the demands of the new private equity owners. EU legislation on information and consultation were of no help in curbing management aggression either in the UK or in Germany.

Workers reported that relations with managers had deteriorated in the months preceding the disputes. In order to make cost savings, Gate Gourmet management reportedly cut sick pay entitlement, intensified work, by requiring workers to service a greater number of flights, and reduced overtime rates.

ISS Denmark

1. Company description

The ISS-group is an international service group, which provides different services, primarily cleaning.
The group operate in many countries, and have 370.000 employees, mostly unskilled and often people of foreign origin.
The turn over was 7 bn € and the profit nearly 6% of turnover before the LBO.

The group have an important and comprehensive internal education program (The International Cleaning academy) and have little turnover of employees compared with other service groups.
The ISS group is known for its important social responsibility for the employees and their families.
The ISS was listened at the Copenhagen Stock Exchange up to the take-over.

2. Economic and social effects

2.1 Private equity fund description

It was bought in 2005 by the 2 private equity funds: EQT (55%) and Goldman Sachs Capital Partners (45%). Price: 5 bn. €.
The acquisition was made through 2 holdings companies (S.a.r.l.) in Luxembourg and 2 Danish holding companies: FS Equity A/S and FS Funding A/S.
The ISS and the two Danish holding companies has obtained 4 bn. € in different sort of loans and bridge financing, so the investment of the private equity groups is only 1 bn €.

The management team of ISS supported the take over by the equity funds and was granted big bonus and had a big profit of the shares in the listened ISS and the warrant and options program in the listened ISS.
But in September 2006 the management team has left ISS because of disagreement with the new board of ISS (the representatives of the equity groups.

Many of the core employees in Denmark had shares in the company from general employee share program, and because of the share price in the LBO, they supported this because of the - often tax free – gain on the shares by the LBO.

2.2 Social impact

Because of joint taxation of the two Danish holding companies and the ISS Danish group companies, the interest of the loans are now deducted in the taxable income of ISS, and it is expected, that the ISS will from 2006 and forward not pay company tax in Denmark.

It is not possible now to see the exact impact of the LBO.
It is expected, the growth strategy by buying other smaller service companies will be slower, because of the lower liquidity in the company.

Linde

1. Company description

Linde is a traditional conglomerate, which was founded in 1879. Its four business areas until 2003 were: industrial gases, materials-handling (fork lift trucks and pallet trucks), engineering and refrigeration (refrigeration equipment for food retailers). Linde took over AGA the largest Swedish industrial gases producer in 2000, making it one of the top five companies in this sector.

The post-war period saw the company emerge as a potential take-over target on a number of occasions. At this time board chairmen persuaded large German financial institutions to take substantial shareholdings in the company. The result was that about 25 years ago Deutsche Bank and Commerzbank each acquired 10% of the shares and Allianz-Versicherung 12.5%.[4]

In the more recent period analysts and representatives of capital markets repeatedly called on the company to concentrate on its strongest business area – industrial gases – and to sell the other parts of the group. They calculated that the conglomerate status of the company reduced its stock market value by about 30%. As the large financial institutions of the old Germany AG have been making efforts to sell their holdings in industrial companies, it became clear that Linde would sooner or later come under pressure. Institutional investors in the USA and the UK built up their holdings in the German company from 14% to a total of 24%. US investors accounted for one-third of the total holdings of the institutions.

At the start of 2003 Wolfgang Reitzle became the new CEO. He responded to the capital market pressure and stated that he wanted the group to concentrate solely on industrial gases.

2. Economic and social effects

2.1 Private equity fund description

Reitzle sold the refrigeration business to the US group Carrier in 2003. The British industrial gas producer BOC indicated that it had identified Linde as a potential take-over target. From this point on, Reitzle pursued a strategy of turning the tables and taking over BOC – succeeding in spring 2006. Following hard bargaining over the take-over price, BOC´s management finally recommended the offer to the company’s shareholders. The shareholders themselves had, for their part, encouraged BOC management to open the company to offers. Both BOC´s management and shareholders seemed to be more interested in getting the highest possible price for the shares than in the company itself. The agreed price was €12 billion – a 40% premium on the previous stock market valuation. The substantial holdings of the three large German finance groups provided protection against the possibility of BOC launching its own counter-bid (the Pac-Man defence). In total the take-over cost Linde €15 billion, as the German company also took on BOC’s debt and its pension obligations.

The new group will be represented in 70 countries and will have a turnover of some €12 million. As the world market for industrial gases is dominated by the five largest groups, who control over 60% of the total – potential competition concerns mean that further concentration in the industry is not to be expected. This gives Linde/BOC some degree of protection against take-overs and tough stock market challenges, even if the three German finance groups sell their holdings – something which will probably occur shortly.

2.2 Debt structure, alteration of company capital management fees requested by LBO

Linde took on €3.4 billion debt to pay for the take-over of the Swedish company AGA, which has largely been paid off. It planned to finance the take-over of BOC from a range of sources: first, through a €1.8 billion increase in capital through the issue of new shares; second, through a hybrid bond worth €1 billion; third by taking on €9 billion debt; and fourthly by selling parts of the group, in particular the materials-handling business (now renamed the “Kion

[4] This pattern, with German financial groups holding substantial stakes in German industrial companies, was at one time a key feature of the country’s corporate structure – “old Germany AG”.

Group"), as well as some smaller parts of BOC. In addition the competition authorities have required Linde and BOC to dispose of businesses in specific regions of the world where previously both companies were represented. Linde and BOC are in very good shape, with both sales and profits rising sharply recently. Operating income in the new company will be approximately €1.8 billion, so the debt could be paid off in around five years. Linde is behaving in a way which is very similar to that of a private equity fund and is using almost the same leveraged buyout (LBO) methods. A large number of private equity funds are already interested in the materials-handling business, as the constantly high cash flow provides them with a good basis to take on a high level of debt for an LBO. The risks for both company and shareholders are relatively low.

During the take-over period, funds investing on a short-term basis are estimated to have held some 30% of the shares. This repeatedly spurred on market excitement, keeping the share price of both BOC and Linde at high levels.[5]

In November 2006 Linde AG sold its forklift section to KKR and Goldman Sachs. In the bidder's fight had also taken part: Permira/alliance Capital, partner / Apax BC and CVC. In the purchase price of 4 Bn. euros 400 Mil. net finance debts which covered pension and leasing liabilities were included. The purchase was financed to three quarters with debts. The repayment of the debt admission for Kion was arranged final-due. In the hold phase by the financial investors only the interest is to be paid. This should permit more flexibility and higher investments. There should not be a refinancing about special dividends with Kion according to KKR.

2.3 Effects on job creation, investments in training and education of labour force, investments in innovation

Following the sale of the refrigeration business to the US group Carrier, there were massive job cuts in this area in Germany, as large parts of the production were transferred abroad. The new CEO has introduced programmes in all areas to improve effectiveness. Organisation has been improved and earnings have been reduced and in part linked to company performance. Working time has been lengthened and made more flexible and more shifts have been introduced to improve the utilisation of the company's assets.

Reitzle has emphasised that the merger with BOC will not lead to the loss of any jobs in either Germany or the UK. However, the sale of individual parts of the business means that these jobs will be located in other companies or will become the responsibility of financial investors. And it is impossible to predict how employment in these areas may develop in the future. Reitzle promised the German works council that Kion, the materials-handling business, would not be broken up before it was sold; in addition there is an agreement between the management and the works council – the "employment guarantee" – under which there can be no dismissals for economic grounds until 2011. This agreement is initially also valid for any purchaser of the business – something which could be a barrier for financial investors.

Some difficulties can be expected over the next two years because of friction between cultures as the two companies merge. However, planned innovations and investments seem likely to be continued. For example, a new plant near Munich, producing pure gases for the semi-conductor industry, has recently been brought into operation.

2.4 Corporate governance and economics

Although it was Linde that took over BOC, Reitzle emphasised that it is virtually a merger of equals. At the time of the take-over he was already cultivating the idea of it being a "friendly take-over". He has brought two English managers from BOC onto the main board of the new company, which is being enlarged from four to five. Additionally it is rumoured, that BOC-director Tony Isaacs will be moving onto the supervisory board in 2007.

The company will keep its headquarters in Germany and will remain an AG governed by German law. It will also continue to be subject to the German system of employee board-level representation – with 50% of the places on the supervisory board going to employee representatives – despite the fact that Reitzle had the possibility of moving to a company structure in which the German system would no longer have applied.

[5] Börsen-Zeitung 21.02.2006

2.5 Protection of minority shareholders

A take-over offer of 1,600p per share was made to all shareholders.

2.6 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

Under Reitzle the board of Linde has fostered good contacts with the representatives of the workforce and given them extensive information. This will be the same in the new company.

2.7 Effects on public finances

Linde/BOC will continue to pay taxes to the German state. However, the company's high level of debt will result in a reduced tax bill.

3. LBO exit (secondary LBO, IPO, listing)

Linde had been considering two ways to sell the materials-handling division ("Kion"): flotation on the stock exchange or a sale to a group of financial investors. On the 5th of November 2006 Kion has been sold to a consortium comprising the private equity funds Kohlberg Kravis Roberts & Co. (KKR) and Goldman Sachs at a price of € 4 billion. The competition authorities approved the deal.

KKR/Goldman Sachs say that they will honour all the agreements on safeguarding locations made by the Linde executive board with employee representatives. They want to pursue a strategy of growth to achieve sustainable increases in Kion´s value. The new owners plan to float Kion on the stock exchange in about 5 years in order to cash in on their investment.

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Märklin

1. Company description

Märklin is the world's largest manufacturer of model railways. It bought up Trix, which used to be the second-largest model railway manufacturer. At the present time, Märklin has 1 000 employees in Germany and another 300 in a plant in Hungary. The company has production facilities at three locations in Germany. In 2005 Märklin's turnover fell to €123 million, compared with €148.5 million in 2004 and €164.4 million in 2003. Group losses amounted to €6.8 million in 2005. The company had a credit line of €60 million with several banks. Having taken up €55 million of this facility, it had almost exhausted its credit.

2. Economic and social effects

2.1 Private equity fund description

The sale to private equity investors was made under pressure from the banks to which the company owed money. In the middle of 2005, the creditor banks demanded the intervention of an investor. As the company put off its decision, two banks lost patience and sold their loans to Goldmann Sachs. The company's shares were in the hands of 22 family members. Three of them blocked the sale to private equity investors until the very end. They wanted to keep their holdings, which totalled 23% of the company's shares, even if an investor bought out the company, a condition that prospective investors could not accept. The company was finally sold to the British private equity firm Kingsbridge for a price reputed to be about €30 million. A total of €13 million was to be made available immediately and a sum of two million euros was to be tied up to deal with any unforeseen problems. The remainder was not to be paid until the investor withdrew from the company.

The works councils and the relevant trade union, IG Metall, wholeheartedly supported the sale of the company by the family to the private equity investor, since all the jobs at Märklin would otherwise have been at risk. The banks had given the company an ultimatum to agree a sale with the private equity investor by 15 May 2006 or have their loans called in, which would have made the company insolvent.

2.2 Effects on job creation, investments in training and education of labour force, investments in innovation

Before the acquisition by Kingsbridge Capital 340 employees had been dismissed in 2004. Directly after the acquisition the financial investors made at first no statements about activity changes. In January, 2007 the company for the current year announced a planned place reduction of 310 of a total of 1340 employees. After the turnover would be stabilised, now one goes to the cost structures, said the manager anew named in September, 2006 Jan Kantowsky. The most important measure is the reorganisation of the manufacture with the reduction on two of four locations up to now. The plants in Thuringian Sonneberg with 220 employees and in Nürnberg with 60 employees are closed down, other 60 colleagues in the home office Göppingen will lose their workplace. The more slender manufacturing processes and the allocation of works on supplier should provide from now on also for higher efficiency like new machines.

2.3 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

The investor has appointed two new members to the board: a new financial director and a director responsible for the restructuring process. The chairman of the board, Paul Adams, has left the company half a year later, after helping them to develop a capital spending plan.

The investor's strategy involves trying to rekindle interest in model railways among the young generation. This is likely to prove difficult. Children and young people prefer to devote their leisure time to the use of technological products – computer games and mobile phones being the current favourites. The investor also wants to improve marketing outside Germany and to boost sales in numerous European countries. Production and marketing are to be rationalized.

Also the corporate management contemplates opening an amusement park around the theme of model railways. It is to be opened in 2009, when Märklin celebrates its 150th birthday. Many workers oppose the idea, because they believe, that it is meant as a distraction from cuts in production. Adding to that, one earns less selling candy in an amusement park than being a skilled worker in production. Besides there are already two amusement parks in the area and they don't operate profitably.

The first destination after the acquisition by the investor is the stabilization of the turnovers. The production and the distribution should become more effective. As the first measure the sales were strongly upgraded at own account about an online shop in the Internet and in the factory-owned museum loading. This led to strong criticism of the specialist suppliers who saw own position weak. After a clearing discussion the dealers from the single point-of-sales should be incorporated in the Internet business. The toy turnover could be increased in 2006 by about 4%. Nevertheless, 2006 was closed again with a loss.
In total the investments are increased in 2007 towards in 2006 by 50% on 15 Mil. EUR.

3. LBO exit (secondary LBO, IPO, listing)

The investor now intends to turn the company around. The result of operations has improved already. In the first half of this year the turnover increased by 4 % to nearly € 50 million. The orders received are 6 % higher than last year. Kingsbridge plans to keep the company for four to six years before making its exit.

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Mobilcom

1. Company description

Mobilcom is a listed mobile communications company. It does not have its own network but buys blocks of airtime from other carriers and resells them to its own customers. Its subsidiary freenet.de is an Internet service provider. In 2000 the company took part in the Federal Government's auction of UMTS licenses (Mobile broadband network) and obtained an operating license for €8 billion. Its turnover in the past few years has amounted to some €2 billion.

2. Economic and social effects

2.1 Private equity fund description

In 2000 France Télécom (FT) acquired a 28.5% stake in the company. FT gave a contractual undertaking to fund the establishment of a UMTS service. At the same time, FT negotiated an option to acquire a majority stake in Mobilcom in 2003. In 2000 Mobilcom's losses amounted to €89 million. These increased to €205 million in 2001. In 1997 Mobilcom had employed 220 people. By 2002 the workforce had grown to 5 500. At that time, France Télécom itself was in debt to the tune of €70 billion. In 2001 Mobilcom began to establish its own mobile network. In mid-2001 it had 5.2 million customers. Its debts amounted to five billion euros, and its debt-to-equity ratio was considerably higher than that of its competitors.
The funding pledges made to Mobilcom applied only to the establishment of a UMTS network. By this time, however, all the experts agreed that Mobilcom would not make a profit from its UMTS operations, not even in the long term.

In 2002 the government stepped in to save the company from insolvency. France Télécom now tried to do all in its power to withdraw from its financial commitments to Mobilcom. An infringement of the code of business practice by Gerhard Schmid, chief executive of Mobilcom, gave France Télécom the opportunity to declare that it no longer felt bound by its existing contracts and to go back on its pledge to finance the establishment of a UMTS network. After a lengthy dispute, France Télécom and Mobilcom reached a compromise, whereby FT took over debts amounting to €7 billion. The compromise deal was approved at an extraordinary general meeting at the beginning of 2003. The costly license secured by Mobilcom in the UMTS auction had to be returned unused to the Federal Government. At a general meeting in April 2005, Mobilcom's shareholders voted by a large majority to bring an action for damages against FT for having pulled out of the funding agreements.

In May 2005 France Télécom sold 27.3% of the shares in Mobilcom to the US private equity investment combine Texas Pacific Group (TPG) and retained a 1% share for itself. TPG obtained three out of twelve seats on the supervisory board.

2.2 Debt structure, alteration of company capital management fees requested by LBO

Before the planned merger with Freenet, Mobilcom once more had a high liquidity ratio as a result of the disposal of its debts. Mobilcom's routine business yielded steady operating profits. This aroused the interest of the private equity investor, as did the fact that the book values of Mobilcom's assets were set very low in relation to their real current value. A merger with Freenet would offer the opportunity to convert the balance sheet from book values to current values. This would have unlocked hidden reserves of 800 to 1 000 million euros, providing an opportunity to pay special dividends or to raise the leverage ratio by means of new borrowing.

TPG was firmly resolved to pay out several hundred million euros to shareholders in the form of special dividends. The dividends have yet to be paid, perhaps because TPG is marking time in the face of the wide publicity given to its aggressive recapitalization plans. Thorsten Grenz, chief executive of Mobilcom, wanted nothing to do with this windfall and resigned his post.

2.3 Effects on job creation, investments in training and education of labour force, investments in innovation

In the merger agreement between Mobilcom and Freenet it was laid down that there were to be no merger-related job cuts. This arrangement would probably be respected in the initial stages if Mobilcom and Freenet actually merged. Nothing is known of any other effects on the workforce.

2.4 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

In July 2005 a merger agreement was concluded between Mobilcom and Freenet and ratified by a general meeting. Numerous shareholders brought legal actions in a bid to stop the merger. The opponents of the merger stated that the special dividends on which TPG was particularly insistent were the main bone of contention. They wanted a contractual guarantee that special dividends could not be paid before 2010. They doubted TPG’s declarations of its intent to foster the growth of Mobilcom. Eckhard Spoerr, head of Mobilcom, offered a binding embargo on special dividends for the period from 2006 to 2008, but only if the payment of such dividends would prevent acquisitions.

The legal disputes over Mobilcom are obstructing all the major activities of the mobile telecommunications company and its ISP subsidiary. Major acquisitions are rendered impossible, and all for want of access to the pooled finances of the two companies – this in 2006, at a time when Mobilcom has a high liquidity ratio. Due to the judicial problems Mobilcom has lost the strategic scope of one year. That's why analysts and shareholders ask themselves the question, which advantage the fusion of Freenet and Mobilcom will bring in the face of current market conditions. In this situation a notably smaller company put Mobilcom on the spot.

In October of 2006 the mobile radiotelephone service provider Drillisch has surprisingly taken over a 10.37% share of Mobilcom. Drillisch wants to create one mega-provider out of the four biggest service providers in Germany. The goal is to get the competitors Debitel and Talkline as well as the own company to operate under the name of Mobilcom. Therefore the CEO of Drillisch wants the fusion of Freenet and Mobilcom to fail, so that Freenet can be sold to the highest bidding. Regardless of the wishes of Drillisch, as Mobilcom´s supervisory board stated on the 6th of November, management is to stay focused on a fusion with its subsidiary company Freenet.

The sale of the stake held by France Télécom was linked with the shareholders’ claims for damages against the French telecommunications group. As a party to the dispute, FT was unable to take part in the vote in April 2004. At the extraordinary general meeting in October 2005, the new owner of its former block of shares, TPG, was not bound by this restriction since it was not a party to the dispute. TPG moved that the decision taken in April 2005 to press claims for €3.7 billion in damages against FT be overturned. The shareholder structure at the time of the October EGM was as follows: 60% of the shares were spread among numerous smaller investors, TPG held 28.7%, Henderson Global Investors held 6%, and Hermes Focus Management held 5.3%.

The second main item on the agenda of the EGM in October 2005 was a motion for approval of the merger of Mobilcom and Freenet. The motion was carried. Shareholding staff members at Mobilcom now brought court actions against the merger too. Despite statements to the contrary from the company management, they feared that the merger would lead to substantial job cuts.

In December 2005 a court ruled that the decision taken by the general meeting in 2003 approving the compromise deal with France Télécom had been invalid. Although the deal remained in effect, the board of Mobilcom was ruled to have been solely responsible for the situation leading to the withdrawal of FT. This meant that shareholders were now able to claim damages against the Mobilcom board. The *Schutzvereinigung der Kleinaktionäre* (SdK), a group dedicated to the protection of small shareholders, exercised this right and brought an action for damages against the board of Mobilcom.

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Peguform

1. Company description

The history of Peguform started in 1959 with the Baden-Plastic Werke in Bôtzingen which produced plastic products (films and household goods). However, it was first in 1978 that the company name "Peguform-Werke AG“ was introduced. At the same time the company entered the automotive market (bumpers, exterior systems, cockpits and instrument panels and interiors), which is today the single focus of Peguform. In 1999 Venture Industries, an American auto supplier, took over the Peguform Group. In May 2002 the management of the German companies applied for preliminary insolvency. In October 2002 the insolvency procedure was opened. After reorganization, which was possible due to participation by employees and financial guarantees provided by customers, the American private equity fund Cerberus took over the Peguform Group (Germany, Spain, Mexico, and Brazil).

2. Economic and social effects

2.1 LBO description (offshore base, activity focus, etc.)

Cerberus Capital Management LP is a large privately owned investment fund. The firm is based in New York. The fund was founded in 1992, and Cerberus invests primarily in companies which are near bankruptcy and hopes to make the businesses it acquires profitable.

Cerberus' financial contributors are mainly US pension funds and wealthy individuals. Cerberus invests capital in real estate and financing corporate takeovers. In addition, the US investor has specialized in the purchase and use of loans in default. The company has been a voracious acquirer of businesses over the past several years and includes sizeable investments in sportswear, paper products, military services, real estate, energy, retail, glassmaking, transportation, and building products. Its holdings amounted to $16 billion in 2005. Cerberus currently has significant investments in companies around the world.

2.2 Effects on job creation, investments in training and education of labour force, investment in innovation

After filing for insolvency in 2002, the well-known insolvency administrator Dr. Jobst Wellensiek together with the Rothschild Investment Bank drew up a list of potential buyers. Three financial investors and three strategic investors made offers and the offer of Cerberus was accepted. All potential buyers required a reduction of operating costs. They all required from employees a reduction in personnel costs of 40 million euros, which represented approximately one sixth of the total personal cost of 260 million euros. This was agreed in a reorganization collective contract together by the IG BCE employees and Cerberus. For the most part, an increase in working time to 39 hours per week without an increase in salary, and an income reduction of 4 percent was established. Also agreed was a reduction of Christmas and holiday pay. Thus the burden was around 10 percent per employee, including those not covered by the collective contract and senior managers. The contract is valid for five years. Collective pay raises will only be implemented by half. Lay offs are possibly only with the consent of the works council. For reductions in capacity due to the evolution of the auto industry, personnel adoptions are possible in accordance with an opening clause.

Restructurings at the expense of employees were part of the sale agreements. In the first round, 500 jobs were eliminated. A second wave of layoffs will soon take place. However, the employees do not blame the job cutback only on the financial investor. Rather they are to a greater extent economically determined by a slump in sales among the auto manufacturers. For that reason there is a fundamental understanding of the need to back jobs.

2.3 Corporate governance and economics

Since the entry of Cerberus there have as yet been no major changes in the finance structure. Investments have been carried out according to plan. However, Peguform invest cyclically. Major investments are only made when there are new orders. At present, the situation is assured until the end of 2007. Developing new products takes approximately one to two years and Peguform is unsaleable without assured orders. Only in the case of new orders, major investments would be made again in 2007.

While Venture Industries was considered to be geared to the market, Cerberus' attitude seems to be geared to finance. Cerberus appointed two managers sent from headquarters in New York. The chairman of the Supervisory Board, also a Cerberus representative, has been very active. The two managers were characterized as his agents. The investor was said to have expertise on the industry when it comes to production, but not as regards marketing. Employees are observing with increase unease that no progress is being made with new products (auto models).

With the entry of Cerberus, the representatives on the Supervisory Board were replaced. All the members representing the owners now came from the entourage of the financial investor. Through the chairman of the Supervisory Board they influence the company management. The situation as regards information and communication in the Supervisory Board is described as unchanged and good. When the company was sold to Cerberus, the works council and the union were present at the table. The economic committee continues to have access to internal reporting. The data are also evaluated centrally the committee.

2.4 Management policies and shareholder activism: stock option programmes, effects on board and CEO's, management fees, employee information

In the Supervisory Board and the works council there have been cultivated a culture of consensus which have stood the test of time. This is based on the understanding that the Peguform plants should not be played off against each other. Problems at individual plans have been and are quickly discussed at the company-wide level. The prevailing belief is that problems of profitability at individual locations must be solved together by all plants.

3. LBO exit (secondary, LBO, listing)

Despite the good information situation, the various bodies are unclear about the goals, strategies and long-term plans of the financial investor. Only general information has hitherto been available. No precise exit is known. Sale on the stock market is a part of the deliberations on exit, but there are no concrete plans or information concerning that. With Cerberus, Peguform should become a successful company in the long term, whose yield and market share should increase. This has so far been true of the yield.

PICARD

1. Company description

Picard was created in 1973 by Armand Decelle who acquired a small home delivery business based in Fontainbleau. In 1994 the company was sold by Carrefour and in 2001 bought out by management and members of the founding family backed by the private equity investors being Candover, Chevrillon, Montagu and Astorg. In 2004 a second LBO took place, it was led by BC Partners and management still headed by a member of the Decelle family.

The company now has a market share of more than 16% and is the major frozen food retailer in France. Its sales network consists of 640 stores and over 20 home delivery centers in France and 42 shops in Italy. Picard also offers a home delivery service in London. The pace of organic growth in France is of 40 stores per year. Picard offers a range of more than 1,000 basic and ready-made products. Five warehouses, two of which are directly managed by Picard, ensure the stores' supply.

2. Economic and social effects

2.1 LBO description (offshore base, activity focus, etc.)

In the first LBO in 2001 Candover, together with Chevrillon & Associes, Astorg Partners and Montagu PE, has led the €920m buyout transaction. This consortium of four funds alongside Picard's management committed a total equity ticket of €320 million. 79% of this amount was provided by private equity 21% was subscribed by management. Total debt was of€600m.

In 2004 the four funds exited their investment as part of the normal active management of their portfolio. The second LBO of 2004 was led by BC Partners who alongside the Decelle family and management, acquired all of the capital of Picard for an enterprise value of €1,308 million. Own financing totaled €465 and the remaining part is senior debt and mezzanine financing.

2.2 Debt structure, alteration of company capital management fees requested by LBO

Calyon and RBS provided the debt of the second LBO.

2.3 Effects on job creation, investments in training and education of labour force, investment in innovation

Since the first buyout Picard has developed its network from 441 shops in 2002 to 640 in 2006 which represents a 45% growth and has a clear impact on the employment level. In 2002 firm's headcount was of 2200 which has increased by 59% and totaled 3500 in 2006. With 40 new shops every year, Picard is a constantly developing enterprise that still retains a human dimension.

Picard invest more than 2.5% of its total payroll in training to enable the employees to develop skills either in the sales network (shops and home services) or in relation to backup roles (human resources, expansion, communication, purchasing, logistics, IT).

From the beginning of LBO ownership, Picard has increased its market share and strengthen its brand thanks to the quality products resulting from its large focus on innovation.

2.4 Corporate governance and economics

Picard's management represents stable continuity. The CEO- Xavier Decelle, represents the founding family which remains a large shareholder in Picard. Financial sponsors working alongside management lead the company in a successful way which is represented by the following numbers:

- Since under LBO ownership Picard's turnover has increased systematically year-on-year at a rate in the 8.3% to 10.5% range.
- 2005 sales of €884m represented a growth of over 40% from the 2001 level of €624m.

- Picard's market share increased as well. In 2002 the firm had 13.2% of the market which increased by 3.2 points by the year 2005.

2.5 Protection of minority shareholders

Not applicable. In the case of Picard as in most LBO transactions there is no minority shareholders at risk, as the only owners are professional financial investors, management and the founding family.

2.6 Effects on public finances

Those of a growing business, i.e. more employment, more consumption and thus more income for the state.

3. LBO exit (secondary, LBO, listing)

Depending on market conditions BC Partners may envisage a third LBO but the company could also be eligible for a trade sale (as was the case in 1994) or, given the growth profile, an IPO.

STORK

1. Company description

The industrial firm Stork consists of three divisions: Aerospace, Food and Prints. Stork is planning to sell the Prints division, but because of the high prices of nickel (an important input), the selling is until now not successful.
In the past years, Stork made excellent returns. Nowadays however, the company is faced with more difficult market circumstances, because of the very small profit margins in the Food and Aerospace industries. Moreover, there's uncertainty about delays with Airbus and the development of the European transport chopper NH90.

2. Economic and social effects

2.1 Description (offshore base, activity focus etc.)

Two hedge funds, Paulson & Co. Inc. and Centaurus Capital Ltd. together own 32% of Stork's equity. The hedge funds want Stork to be divided into three separate firms. Their main criticism on Stork is that the company is good in the businesses it is in, but isn't top of the bill in any. Moreover, Stork missed some important business opportunities, such as the development of the Airbus A320 and A330, nor does it deliver products for the new Boeing 787 Dreamliner.

The hedge funds think that Stork will have more value when it is split up. Their only purpose is now to force the board of directors to decide according their strategy.
Whether Paulson and Centaurus will sell their stakes immediate after a split up isn't known, but seems likely.

Chairman Vollebregt of the board of directors of Stork doesn't agree with the hedge funds. He claims the hedge funds have wrong market-expectations. There is a reason for Stork to concentrate on three businesses. The three divisions need each other to secure their existence. They complement each other very well in sensitivity to market fluctuations, risk of capital and investments. Precisely because the Aerospace division is very dependent on the world economy, Stork needs diversification.
According to Stork, the cooperation between these divisions is necessary to play a part in the world economy.

2.2 Debt structure, alteration of company capital management fees requested by LBO

At this moment, Stork is in good financial health. How this will change after a possible splitting up, is not known.

2.3 Effects on job creation, investments in training and education of labour force, investments in innovation

The comment of the Dutch labour union (FNV Bondgenoten) is as follows: "Centaurus and Paulson have imperceptible increased their shares in Stork. They were able to do that without publicity, because they bought their shares by means of sorts of Ltd.'s. As long as one Ltd. has no more than 5% of total shares in a company, you are not obliged to report your ownership to the authorities. By now, the hedge funds own rather 30% of the shares and use their shareholder power to have Stork splitted up. They want the divisions Food and Technological Services (Prints) to be sold; Stork should specialize on Aerospace. When this happens, FNV Bondgenoten fears that employment will disappear."

Moreover, Dutch labour unions investigate whether Dutch pension funds have shares in Paulson and Centaurus. The pension fund of the metal industry is not willing to sell of their investments in Paulson.

2.4 Corporate governance and economics

On the shareholders' meeting Centaurus and Paulson proposed a motion with the proposal to split up Stork within one year. This motion was supported by 86% of the shares present during the meeting, who represent 40% of total shareholders. Paulson and Centaurus own totally 32% of the shares. The firm Marel owns 8% of Stork-shares and supports the intentions of the hedge funds because Marel wants to buy the Food division. 52% of the shares was represented at the shareholders' meeting. Therefore, 40% supported the motion, and 12% rejected. This means that 40 / 52 = 86% of the present shareholders at the meeting voted in favour of the splitting up. But in reality, probably only 40% of the shareholders supports the splitting up.

2.5 Management policies and shareholder activism: stock option programmes, effects on board and CEO´s, management fees, employee information.

Stork asked for some time for reflection to think about the motion. But everyone knew that the board of directors does not see any prospect in the proposed splitting up. The board of directors indeed rejected the motion. As reaction to this, Paulson and Centaurus asked for a third extraordinary shareholders meeting in which they ask for two measures: 1) To abandon the confidence in the board of commissioners; 2) To have all spendings above 100 million euro approved of by the shareholders.

In the meantime, the board of directors of Stork asked the law court of Amsterdam to start an investigation whether the hedge funds complied with the duty to report about their shareholdings. They may have been broken the law. On December 21 and January 17 witness hearings will take place.
Also, the board of directors planned to use a so-called poisson pill: Stork would offer new shares to the 'Stichting Stork', a organization that has only one goal: protecting Stork from a violent bid. Stichting Stork would then have a majority vote on the shareholders meeting.

Dutch judge president Willems of the Law Court decided the following to overcome the impasse: Stork is not allowed to emit new shares to Stichting Stork. The hedge funds are not allowed to send off the board of commissioners. Instead, the Law Court appointed three men to become special members of the board of commissioners: former president of Akzo Kees van de Lede, former prime-minister Wim Kok and former cfo of Philips Dudley Eustace. They have to find a solution for the conflict.

Both Stork and the hedgefunds were happy with this judgement. Also the labor unions were happy. On the one hand, a firm as Stork is not allowed to make use of some protection construction; this means more power to (hostile) shareholders. On the other hand, shareholders *have* to consider also the interests of employees.

On this moment, the three special commissioners are doing their job. The final result is not known yet. In the meantime, Stork announced to do some small and big takeovers this year.

TDC

1. Company description

TDC is the former national operator in Denmark. As well as continuing dominance of the Danish market, the company has expanded its portfolio to include significant holdings in Switzerland and Central Europe. In 2005 TDC employed some 20,000 staff, 2/3 of which are based in the domestic business and 1/3 internationally. Revenue in 2005 stood at EUR 6,245m while net income was just under EUR 1,000m. TDC is organized as six main business lines: TDC Solutions, TDC Mobile International, TDC Switzerland, TDC Cable TV, TDC Directories, and TDC Services. TDC was partly privatised in 1994 and fully privatised in 1998.

2. Economic and social effects

2.1 Private equity fund description

In December 2005 the Nordic Telephone Company made a public offering for TDC. The offer valued TDC’s shares at EUR 29, a premium of nearly 40% on the market price. The Nordic Telephone Company is a conglomerate of five international equity funds: Apax Partners; Blackstone Group; Kohlberg Kravis Roberts; Permira; and Providence Equity. The new owners intend to remain at the helm for five years before exiting.

- Apax Partners is a leading private equity investment advisory group, with offices in London, Madrid, Menlo Park, Milan, Munich, New York, Paris, Stockholm and Tel Aviv. Apax Partners manages or advises funds totalling USD 20bn globally. Headquartered in London, Apax has expertise in the following industry sectors: telecommunications, information technology, healthcare, media, financial services and retail/consumer.

- Blackstone was founded in 1985 and is headquartered in New York. The firm raised its first private equity fund in 1987 and since then has invested USD 11.3bn in equity in 89 transactions with an aggregate transaction value of approximately USD 115bn. In 2000, Blackstone raised BCOM, a USD 2bn fund dedicated to investments in the communication and media sector. At that time, BCOM was the largest fund of its kind ever raised. Since 2000, Blackstone has increased its focus on Europe by growing its team to 45 European professionals and allocating 33% of funds to European investments representing approximately USD 2.8bn of capital. Blackstone invested USD 2.6bn of equity on European deals over the last four years in 16 transactions.

- KKR is one of the world's oldest and most experienced private equity firms specializing in management buyouts. The firm is currently managing approximately USD11.5 billion in funds, including its USD 6.0 billion KKR Millennium Fund L.P. and its EUR 4.5 billion European II Fund. KKR made its first investment in Europe in 1996, and in aggregate has invested USD 4.8 billion of equity in 17 European companies through a wide range of transactions. These include the largest leveraged buyouts to date in the Netherlands and France and nine European transactions with a value of USD 1 billion or greater.

- Permira is a leading global private equity firm and acts as adviser to 18 Permira Funds totalling approximately EUR 11 billion. The firm, based in Frankfurt, London, Madrid, Milan, New York, Paris, Stockholm and Tokyo, focuses on large international transactions. Permira Europe III is a EUR 5.1 billion private equity fund. The investors in the fund are mostly pension funds and other institutional investors based primarily in Europe and the United States. The Permira Funds have since their inception had a strong focus on telecoms and technology investing over 30% of all investments in this sector.

- Providence is a global private investment firm specializing in equity investments in media, communications and information companies around the world. The principals of Providence Equity manage funds with over USD 9.0 billion in equity commitments, including Providence Equity Partners V, a USD 4.25 billion private equity fund, and have invested in more than 80 companies operating in over 20 countries since the firm’s inception in 1990.

2.2 Debt structure, alteration of company capital management fees requested by LBO

TDC's purchase, for just under EUR 12bn, at the time the largest LBO ever seen in Europe, was based on slightly more than 80% leverage (just over EUR 9bn) and 20% equity from the five purchasers. Capital management fees are still unclear at this stage but will be in the tens of million of euros area.

According to the prospect of the LBO the cost for legal and financial advisers will be 524 mill €.
Probably some part of the fees will go to the 5 equity funds and the managing partners in the funds.

2.3 Effects on job creation, investment in training and education of labour force, investment in innovation.

Already before the LBO, the TDC have stated a planned reduction of the workforce. This plan will be carried on, and it seemed that the new management will speed up the plan.
It seemed, that the TDC will now stop investment in minority interests in foreign mobile telephone companies, and will sell the actual portfolio of minority interests I different European mobile telephone companies.

2.4 Protection of minority shareholders

In contrast to many other equity operations, the Nordic Telephone Company has failed to de-list TDC. This is due, in large part, to the activism of the pension fund that retains minority shares in the company. The Dansk Metal trade union has been instrumental in this effort, in order to retain corporate transparency, which would be lost were the company de-listed. The Danish courts have confirmed the status quo. Currently the new owners hold 88.2% of the stock, falling just below the required 90% threshold to take full control.

Now the new owners, who control the TDC via 2 holding companies in Denmark and 2 in Luxembourg, try to reach the 90% ownership mark by increasing the share capital in TDC with new shares issued to the members of the management board.

2.5 Management policies and shareholder activism: stock option programs, effects on Board and CEOs, management fees, employee information

The TDC management and board, which had espoused the sound financial position of the company before the takeover, have seen significant personal returns on their holdings in the company while TDC has seen debt, interest rates and risk exposure rocket and investment capacity crumble. Following the takeover, TDC's new owners were awarded an immediate cash dividend four times annual earnings already paid. The April 2006 dividend was worth some EUR 5.9bn to the new owners.

2.6 Effects on public finances

Once again, the actual effect on public finances of the purchase is, as yet, unclear. One conservative estimate, however, suggests that the Danish government will lose some EUR 270m in tax revenue.

Because of joint taxation of the two Danish holding companies and the TDC- companies the interest of the loans for the LBO are now deducted in the taxable income of TDC, and it is expected, that the TDC will from 2006 and forward not pay company tax to the Danish state.

2.7 Pension fund

The TDC- which originally was 3 local telephone companies owned by the Danish state and local municipalities - has its own pension funds for the employees funded by the telephone company. The TDC now try to persuade the government to allowed that ½ bn € of "surplus capital" in the pensions funds are contributed to the TDC.

TELECOM ITALIA GROUP

1. Company description

Telecom Italia is a business which operates in every sector of advanced communications. Its activities range from fixed-line to mobile telephony, from the Internet to media. The group operates both in Italy and abroad, through well-known brands such as Telecom Italia, Alice, TIM, Olivetti, La7 and APCom.
The Telecom Italia Group is a leading force in fixed-line and mobile telephony, the Internet, the media sector and office & systems solutions, and is currently investing heavily with the aim of expanding broadband and opening the way for a new generation of interactive and multimedia services, systems and advanced solutions for both families and the business world.
Cabling, extensive network infrastructure and leading-edge technologies also underpin the Group's international presence. In Europe, Telecom Italia is currently expanding broadband in France and Germany, and carries 60% of all traffic between major Mediterranean basin countries. In South America, TIM Brasil has become the country's leading nationwide GSM line provider, and is the country's number two carrier overall.
Where turnover is concerned, revenue in the first nine months of 2006 was € 23 104 million, a 5.2% increase compared with the first nine months of 2005.
This very positive revenue picture is offset, however, by a high level of debt. The Group's net borrowings as at 30 September 2006 were € 39 504 m, € 1 811 m less than the position as at 30 June 2006 (€ 41 315 m); this was attributable to cash generation in the third quarter. Even given this substantial improvement, Telecom Italia still carries a mountain of debt. This is the result of a series of events which led to the explosive growth of a level of debt which was modest until 10 years ago. The reasons are to be found in a particularly turbulent decade in which there were many changes both in the ownership structure and at the head of the Group.

Chronologically, the most recent change goes back to September 2006, when Marco Tronchetti Provera, the then Chairman and leading shareholder in Telecom Italia, through Pirelli, resigned from the board of directors following the Government's outright rejection of his reorganisation plan. He handed over to the lawyer, Guido Rossi, who returned to head Telecom Italia, as he had for a few months in 1997.
But what are the reasons for the explosion in the Group's indebtedness? To understand this, we need to go back to the time when the business, having been a public undertaking, moved into private ownership.

2. Economic and social effects

2.1 Description of LBO (offshore base, activity focus, etc.)

It was in 1997, during the Prodi Government, that the need arose to privatise Telecom Italia, a State-owned giant which at that time boasted a turnover equivalent to more than € 22 million, a workforce of 124 000 and holdings in various companies throughout the world, and was the first mobile telephony operator in Italy and the country's first Internet service provider. It was no easy matter to privatise such a huge group, but the Treasury Minister and the Minister of Industry, in conjunction with the Minister of Telecommunications, had a specific political idea, namely that Telecom Italia would become the first Italian public company to bring together small savers and the capital market, which at that point was under-developed by comparison with its European partners. There were two types of ownership structure which could be used as a basis: the Anglo-Saxon public company and the typically French 'hard core' structure. While the first would ensure widespread share ownership with good protection for minority shareholders, it would also have made the Telecom Italia Group excessively vulnerable, exposing it to acquisitions by foreign companies (something that the Government did not welcome in such a strategic sector). The public company model also had many negative aspects with regard to corporate governance, such as the agency costs associated with the marked separation between ownership and control, which could lead to opportunistic behaviour on the part of management. Adoption of the 'hard core' structure, on the other hand, would undoubtedly have brought about greater involvement of a stable shareholder base in the company's performance, but would have run counter to the principle underlying privatisation itself.

Although the privatisation of Telecom Italia was adjudged a success from the purely technical point of view, given the large number of savers who bought into it, the same cannot be said about the choice of ownership structure. Negative signs of instability, unmanageability, and the lack of a leading shareholder with experience of the industry who would pursue a clear, agreed goal all emerged in short order.

In October 1998, although the company still actually benefited from a monopoly position and high cash flow, it was valued at a multiple of only 1.9 times its net worth, compared with a figure of 3 for Deutsche Telekom (DT) and more than 4 for France Télécom (FT) and British Telecom (BT). The P/E ratio[6] was 19, compared with 22 for BT and 28 for FT and DT. Franco Bernabè took the helm at the Telecom Italia Group in January 1999; he was a manager whom the market appeared to favour, given his previous success with restructuring ENI. However, international investors criticised the Group's financial structure, which carried too little debt by comparison with what could be regarded as the optimum level. The Group's low level of debt, together with its high and stable cash flow (from TIM, especially), were the factors which opened up the possibility of a stock market raid, using high financial leverage.
This situation thus made Telecom Italia a potential target. Towards the end of November 1998 it attracted the attention of Roberto Colaninno, the Managing Director of Olivetti; in February 1999, following a series of rumours of a possible stock market raid, he launched a hostile takeover bid.

2.2 Debt structure, alteration of company capital management fees required by LBO

The operation envisaged the involvement of a new company (Tecnost), to be used as vehicle to take on the debts generated by the operation, which would then be transferred to Telecom Italia through a future merger, which then never took place.
In theory the acquisition should have been followed by the merger between Tecnost and Telecom Italia, resulting in the latter shouldering the debt used to acquire it. According to the analyses carried out by the advisers the debt taken on by 'new Telecom' was supposed to be € 38 billion (€ 5.5 inherited from the pre-acquisition situation, and €32.5 bn from the bank loans and bonds constituting the Tecnost 'dowry'). Net borrowings are now close to € 40 000 m.

2.3 Management policies and shareholder activism

Bernabè deployed a range of counter-measures to fight off the takeover bid. The first was a public exchange share offer between Telecom Italia ordinary shares and TIM ordinary and savings shares. The official aim was to carry out a merger by incorporation, so as to speed up implementation of the strategy of integrating fixed-line and mobile telephony, the primary objective of Bernabè's strategic plan. The actual aim was to make Telecom Italia too big a mouthful to swallow. If TIM had been incorporated into Telecom Italia this would actually have produced a bigger company than its predecessor, with more capitalisation, which would then be more difficult to bid for.

Colaninno resumed the attack by increasing the offer price (from € 10 per share to € 11.50), and the shareholders' meeting convened by Bernabè for the purpose of rejecting the bid, since it failed to achieve the quorum of 30% of the capital being represented there, broke up having come to nothing. The Government, which did not support the defence being deployed by Bernabè, consequently supported Colaninno's operation. The Treasury Ministry was actually the biggest shareholder and, as such, nominated two members of the Board of Directors. The key point was that Government approval was needed for shareholdings of more than 3%; that approval was one of a series of 'special rights' which are usually referred to as golden shares. The final defensive measure attempted by Bernabè, namely a merger between Telecom Italia and Deutsche Telekom, was simply dismissed by the market. The operation, which was, in fact, a leveraged buy-out of Telecom Italia by Olivetti, was successfully completed and became the biggest takeover ever carried out in Europe, and is still one of the biggest in the world in terms of value. However, the price paid has been a high one, namely net borrowings of nearly €40 000 m.

2.4 Effects on job creation, labour force

Telecom Italia remains one of the biggest businesses in Italy in terms of both the size of its workforce and its turnover. However, where jobs are concerned, whereas Telecom Italia Group employed 124 000 people in 1997, by 31 December 2005 the workforce had shrunk to 86 531. More than 84% of the Group's workforce is employed in Italy.

[6] Price/earnings ratio: derives from the ratio between the stock market capitalisation and net profit. Indicates the level at which the market values earnings.

2.5 Corporate governance and economics

Currently, 82% of Telecom Italia's shares are placed on the market, with the remaining 18% belonging to Olimpia, which is controlled by Pirelli & C.

Where turnover is concerned, revenue in the first nine months of 2006 was € 23 104 m, a 5.2% increase compared with the first nine months of 2005. EBITDA was € 9786 m, a 0.8% increase compared with the first nine months of 2005. Consolidated net profit for the first nine months of 2006 was € 2376 m. Industrial investment in the first nine months of 2006, amounting to € 3299 m, was € 97 m higher than the figure for the first nine months of 2005; this was accounted for by heavier investment by Wireline and Domestic Mobile in connection, in particular, with the development of solutions to support new services and the expansion of the European broadband project, this being offset by the downturn in the Brazil Mobile business unit.

TUI AG

1. Company description

TUI AG is Europe's largest travel group, with its main offices in Hanover and Berlin. It employs 63,000 people worldwide, and in 2005 it had a turnover of €19,610 million and profits of €495 million.

The company emerged from the former steel group Preussag AG, an industrial conglomerate with a number of holdings. Under the leadership of management board chairman Michael Frenzel, the company was transformed in just under ten years into an integrated travel group, able to offer all the services in the tourism value chain – travel agencies, airlines, hotels – from a single source.

In order to diversify risk, TUI has a two-pillar business strategy: it focuses its activities on the core areas of tourism (providing 72% of turnover and 57% of earnings before tax in 2005, with around 50,000 employees) and shipping (19.5% of turnover and 44% of earnings before tax).

With seven airlines in six countries and 116 aircraft, TUI is among Europe's largest airline companies. Among others, it owns the airline Hapagfly (HLF) and low-cost airline Hapag-Lloyd-Express (HLX). The two areas of the shipping business – container ships and cruise liners – are brought together as Hapag-Lloyd AG, based in Hamburg, with around 7,000 employees.

2. Economic and social effects

2.1 Hedge fund description

The company first became a victim of hedge funds in August 2004 when they tried to speculate against the company's share price by short selling. At this point TUI AG was planning to float its shipping subsidiary, Hapag-Lloyd AG, on the stock exchange. The aim of the hedge funds was to reduce the overall market capitalisation of TUI AG (the total value of its traded shares) and so force the company out of the DAX index (the main German stock exchange index). This in turn would probably have produced a further fall in the company's share price. The hedge funds were speculating that, after such a fall, they would be able to repurchase shares in the company at a lower price and would make their profits in the spread between the buying and selling price.

TUI feared that as a result it could fall victim to a takeover, where the predator, once it had acquired a majority of TUI AG shares, would separate the profitable shipping business Hapag-Lloyd AG from the rest of the company and sell it at a profit. The company was able to fight off the hedge funds' attack as a result of a number of factors including the close co-operation between the management and supervisory boards, a range of defensive measures, and the early publication of positive company results. The flotation of Hapag-Lloyd was abandoned, in part because the overall stock exchange environment was bad, but also to protect the shipping subsidiary – and with it the whole group – from further capital market attacks.

TUI came under pressure again in summer 2006. Representatives of several investment groups holding minority stakes made a call at the Annual General Meeting (AGM) for the company to be broken up into its two divisions, tourism and shipping. They argued that there were no synergy effects between the two areas, so separation would increase the value of business. The strategy of the company up to this point had been to compensate for the variations in income from the tourism business, which is closely linked to the business cycle, with better results from shipping. However, as Hapag-Lloyd had moved into loss owing to higher fuel cost and lower freight prices, this strategy was now questioned by the investment funds.

The employee representatives on the supervisory board produced a statement in September 2006, expressing their support for the concept of an integrated tourism business and the two-pillar strategy. In addition, trade union representatives have already sought a meeting with the mayor of Hamburg and further measures are being prepared.

In January, 2007 Richard Mayer, an infamous private investor, as a TUI stockholder appeared. This had provided in the past at numerous companies as an uncomfortable and critical stockholder for headlines. Mayer demands in the

same way like some institutional investors, among them DWS and Hermes, the splitting off and the sales of Hapag-Lloyd.
At the beginning of February the press for 2006 announced an expected loss of the TUI AG of about 900 Mil. EUR. In 2005 TUI had achieved one more profit of 495 Mil. EUR. Following causes were responsible for the high loss: An "Impairment test" to IFRS, the international balance standard, proved goodwill depreciations at the rate of 700 Mil. EUR. The biggest interest (500 Mil. EUR) of the depreciations arises by the goodwill depreciations on the British Thomson Travel Group assumed in 2000. Other 60 Mil. EUR came at by goodwill depreciation of the French subsidiary firm Nouvelles Frontieres. In addition, the result is loaded by high expenditures of 100 Mil. EUR for the reorganisation of the tourism business and 110 Mil. EUR for the integration of the Canadian CP Ships assumed in 2005. The company capital rate thereby falls on approx. 20%.

2.2 Debt structure, alteration of company capital management fees requested by LBO

The transformation of the steel company Preussag AG into the tourism business TUI AG resulted in a sharp increase in the company's level of debt, in which a substantial proportion of the external capital provided was refinanced through bonds issued on the capital market. After a period in which the company consistently reduced its level of debt, with the aim of obtaining as positive a credit rating as possible, in 2005 it issued further bonds to finance the purchase of the Canadian shipping company CP Ships, for which it paid approximately €2 billion. On 31 December 2005 the level of debt was about 64%.

2.3 Effects on job creation, investments in training and education of labour force, investments in innovation

The aim of the management board chairman, Michael Frenzel, is to double operating earnings to €1.3 billion, something which cannot be achieved with the tourist business alone, given its low margins. Under the pressure of the capital markets, the company has for years implemented cost reduction and restructuring programmes. Its current programme "One Company" is intended to save around €50 million. The plans include slimming down and providing a new organisation for the travel business, particularly in the main market, Germany. Since 2002 some 6,000 jobs have already gone in the tourism division. A further 2,000 jobs are to be lost worldwide as a result of the takeover of the Canadian shipping company at the end of 2005, although 100 additional jobs are to be created in the Hamburg headquarters.

Executives have also been affected by the cost-cutting reorganisation. The plans foresee up to 400 of them losing their jobs, while others are to be demoted or will have to accept reductions in salary.

2.4 Corporate governance and economics

Because of pressure from the capital markets – or, to be more precise, investment funds at the last AGM – as well as increasing competition in the airline industry, TUI management is planning to integrate the two airlines (HLF and HLX) into a single brand. The two companies will remain independent legal entities and HLX will deal with marketing while HLF takes responsibility for flying operations. However, it is not yet clear where the employees will fit into the new structure. In addition, the productivity of the aircraft fleet is to be improved, and sales and marketing are to be brought together to cut costs further.

As a result of the restructuring there have been a number of personnel changes at management board level in different parts of the company, as well as changes in the supervisory board.

2.5 Management policies and shareholder activism: stock option programs, effects on Board and CEOs, management fees, employee information;

In October of 2006 several investors wrote an open letter, in which they challenged the chairman of the board Michael Frenzel to split up the TUI group. They wanted management to officially announce a timetable for the split up of the tourism and shipping divisions within the next 6 to 18 months. Furthermore they already discussed their strategy proposal with the head of the supervisory board Jürgen Krumnow. In their meeting with Krumnow the shareholders demanded a stop of acquisitions and the election of new members for the supervisory board, who are experts for shipping and tourism.

Author of the open letter is the British asset manager Hermes, who has invested in shares of TUI for the pension funds of British Telecom. Supposedly the British have got the backup of DWS, a subsidiary company of the Deutsche Bank and the leading provider of collective investment schemes in Germany.

The step they have taken is a form of escalation in matters of firm-shareholder-relations, that is virtually unheard of in Germany. Usually investors discuss their ideas with the operative management. If they are very displeased, they then seek the publicity of a general meeting to enforce their arguments. The open letter raises the pressure for Frenzel to take action until the next general meeting in May of 2007. Statements several investors have made, seem to indicate, that a significant part of the shareholders will try to force the dismissal of Frenzel, if he doesn't act as they wish.

2.6 Effects on public finances

At the end of 2005, some 16,000 of TUI's approximately 63,000 employees were employed in Germany. The company is a particularly important employer in Hanover, where it has its headquarters, and in Hamburg, where the head office of its shipping subsidiary Hapag-Lloyd is located. It is extremely likely that breaking it up would have a negative impact on employment in the tourism business – indeed it is questionable whether TUI as a company would survive long-term in its current form, without its second supporting leg of shipping.

The consequences for jobs in Hamburg if Hapag-Lloyd were to be sold are also unclear. There are several possible purchasers, including the Oetker group in Bielefeld, which owns the shipping company Hamburg Süd, and the Danish shipping group AP Møller-Maersk, although the latter company has denied any intention of buying.

The TUI group calculates its current tax liability on its consolidated earnings for 2005 at €87 million. TUI AG on its own shows a tax liability of around €10 million in its profit and loss accounts. The consequences for the public finances of a break-up of the company cannot be estimated at this stage – or, to be more precise, they depend on the future location of current operations.

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Viterra

1. Company description

Viterra is a residential property company that was owned by E.on and had a stock of 150 000 housing units. E.on is Germany's largest energy group. Its areas of activity are electricity generation and distribution and the sale of natural gas to households and businesses. In recent years, E.on had been tidying up its portfolio of companies, hiving off the parts of the group that were not in the energy business, including Viterra.

2. Economic and social effects

2.1 Private equity fund description

Deutsche Annington, a subsidiary of the British private equity investment firm Terra Firma, acquired E.on's property subsidiary Viterra with its entire stock of 150 000 dwellings for seven billion Euros in May 2005. At that time the deal was the biggest ever residential property transaction in Europe. The purchase made Viterra the largest German property company at a stroke. By now it has 230 000 housing units in Germany.

E.on made a profit of €2.4 billion from the sale. The purchase price included €3 billion for the assumption of net liabilities and reserves; the remaining amount of €4 billion was for the acquisition of equity.

2.2 Debt structure, alteration of company capital management fees requested by LBO

According to the German edition of the *Financial Times*, 90% of the purchase was made with debt capital – an unusually high percentage for purchases of stakes in companies. The fact that interest rates were at one of their lowest points ever was conducive to the high leverage ratio. The loans were made available by the Citigroup financial services company. As part of the deal, it acquired a minority stake of about 17.5% in Annington through its subsidiary Citigroup Property Investors. According to official statements, Citigroup intended to support the growth of Annington in collabouration with Terra Firma.

The private equity firms Fortress and Cerberus had been interested in acquiring Viterra but had bid only €6 billion. The reason why Terra Firma and Deutsche Annington were able to make such a high offer was evidently that the Citigroup investment bank had arranged debt financing on quite reasonable terms.

2.3 Effects on job creation, investments in training and education of labour force, investments in innovation

Before the deal, Deutsche Annington had 400 employees. The purchase of Viterra added a further 1 500. The plan is now to offload a total of 500 of these employees, in other words more than a quarter of the entire staff. Annington and E.on had not negotiated any employment guarantees for the Viterra workforce.

2.4 Corporate governance and economics

E.on's shareholders want to benefit from the successful sale in the form of a special dividend. Wulf Bernotat, chairman of the E.on board, on the other hand, wants to use the billions for investment purposes. Observers assume, however, that the board will bow to the wishes of its investors. As in the case of Deutsche Börse AG, the trading name of the Frankfurt Stock Exchange, this clearly illustrates that German managers will need to learn to live with the fact that shareholders will exert far more influence on corporate strategies than has been customary in the past.

2.5 Management policies and shareholder activism: stock option programs, effects on board and CEO´s, management fees, employee information

The strategy of investment companies like Terra Firma, which specialize in the acquisition of residential property, consists in reselling the purchased dwellings singly or in smallish packages. Deutsche Annington gave assurances that it would offer to sell its dwellings in the first instance to tenants living in the vicinity of the dwellings in question. Where third parties purchased dwellings, the tenants were to be protected for ten years from termination of the lease on grounds of the owners' wish to use the properties themselves. If a tenant had already reached the age of 65, he or she would apparently enjoy lifelong security of tenure. These contractually agreed conditions are largely in line with the tenants' minimum rights enshrined in German housing legislation.

3. LBO exit (secondary LBO, IPO, listing)

The purchase of Viterra was a high-risk deal. Because of the high leverage ratio, the investor has to find €300 million a year merely to service the company's debts. Many of the dwellings are located in structurally disadvantaged areas of Dortmund, Bochum, Witten and Essen. Experts say that tenants have been extremely reluctant to buy homes that may prove impossible to sell at a later date. The sale of housing to tenants, however, is the main pillar of Terra Firma's business strategy. For the investment firm, the purchase price of €7 billion represents a cost of €700 per square metre of floor space. Housing prices in the Ruhr Valley, however, are low. Experts doubt whether a 20 to 25% return on equity will ever be possible in these conditions. They estimate the costs arising from the purchase of a dwelling alone at €150 to €200 per square meter. The investor would therefore have to charge €900 per square meter, which is a very high price by Ruhr Valley standards. The investor will certainly be targeting rent increases, but these will not prove attainable to any great extent. Terra Firma has no option but to sell the maximum number of dwellings as quickly as possible.

Terra Firma is proceeding on the optimistic assumption of a large circle of prospective buyers on the basis that investment in property is inflation-proof and that Germany, with a home ownership rate of 43%, still has a lot of catching up to do on countries like France, where home ownership stands at 57%, or Spain, where the rate is 85%.

The Deutsche Bank considers, that the firm's portfolio contains many unsaleable properties and sees a danger that, once it has sold its best stock, the firm will be left holding a residue of unattractive properties. The Bank also predicts, that the targeted clientele will be very reluctant to buy in the present economic climate. There are already some salutary examples. In the Eving district of Dortmund, for instance, a third of all the flats in a set of eight-storey blocks were empty. Viterra sold them on to the private equity investment firm Mira. Since then there have been no more investments in the area. Nor have the private equity investors done anything to improve the residential environment. Even in the smaller blocks on the same estate, many dwellings have proved unsaleable.

References

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Glossary[1]

Absolute returns: *The return that an asset achieves over a period of time. This measure simply looks at the appreciation or depreciation (expressed as a percentage) that an asset - usually a stock or a mutual fund - faces over a period of time. Absolute return differs from relative return because it is concerned with the return of the asset being looked at and does not compare it to any other measure. Absolute return funds look to make positive returns whether the overall market is up or down, while index tracking funds try to beat the index they are tracking.*

Alternative investments: *Usually refers to investments in hedge funds. Many hedge funds pursue strategies that are uncommon relative to mutual funds. Examples of alternative investment strategies are: long--short equity, event driven, statistical arbitrage, fixed income arbitrage, convertible arbitrage, short bias, global macro, and equity market neutral.*

AMF: Autorité des marchés financiers, French Securities supervisor

Asset stripping: *Asset stripping is the practice of buying a company in order to sell its assets individually at a profit.*

Attrition: *The reduction in staff and employees in a company through normal means, such as retirement and resignation. This is natural in any business and industry.*

Bafin: German securities supervisor

Basel Committee: *The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year.*

Its membership is now composed of senior representatives of bank supervisory authorities and central banks from the G-10 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States), and representatives from Luxembourg and Spain. It usually meets at the Bank for International Settlements in Basel, where its 12 member permanent Secretariat is located.

*The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision (see bank regulation or Basel II, for example) in the expectation that member authorities and other nation's authorities will take steps to implement them through their own national systems, whether in statutory form or otherwis*e.

Bond: *A debt investment with which the investor loans money to an entity (company or government) that borrows the funds for a defined period of time at a specified interest rate.*

Carried interest: *A bonus entitlement accruing to an investment fund manager company or individual members of the fund management team. Carried interest (typically up to 20% of the profits of the fund) are payable once the investor have achieved repayment of their original investment in the fund plus a defined hurdle rate.*

[1] Most of definitions are taken from: http://financial-dictionary.thefreedictionary.com/

CESR: *Committee of European Securities Regulators*

Derivatives: *Security, such as an option or futures contract, whose value depends on the performance of an underlying security or asset. Futures contracts, forward contracts, options, and swaps are the most common types of derivatives. Derivatives are generally used by institutional investors to increase overall portfolio return or to hedge portfolio risk.*

Dividend: *Distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. The amount of a dividend is quoted in the amount each share receives or in other words dividends per share.*

ECB: *European Central Bank*

Emerging markets: *The financial markets of developing economies or industries.*

Equities: *A type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings.*

There are two main types of stock: common and preferred. Common stock usually entitles the owner the right to vote at shareholder meetings and to receive dividends that the company has declared. Preferred stock generally does not have voting rights, but has a higher claim on assets and earnings than the common shares. For example, owners of preferred stock receive dividends before common shareholders and have priority in the event a company goes bankrupt and is liquidated.

FED (also the Federal Reserve; informally The Fed): *The FED is the central banking system of the United States. The Federal Reserve System is a quasi-governmental banking system composed of (1) a presidentially-appointed Board of Governors of the Federal Reserve System in Washington, D.C.; (2) the Federal Open Market Committee; (3) twelve regional Federal Reserve Banks located in major cities throughout the nation; and (4) numerous private member banks, which own varying amounts of stock in the regional Federal Reserve Banks.*

Futures: *A financial contract that obligates the buyer (seller) to purchase (sell and deliver) financial instruments or physical commodities at a future date, unless the holder's position is closed prior to expiration.*

Futures are often used by mutual funds and large institutions to hedge their positions when the markets are rocky, preventing large losses in value.

The primary difference between options and futures is that options provide the holder the right to buy or sell the underlying asset at expiration, while futures contracts holders are obligated to fulfil the terms of their contract.

FSA: *Financial Services Authority, UK*

Hedge fund: F*und whose manager receive performance-related fees and can freely use various active investment strategies to achieve positive absolute returns, involving any combination of leverage, long and short positions in securities or any other assets in a wide range of markets.*

Hurdle rate: *A rate of return that must be achieved before the manager becomes entitled to carried interest payments from a fund*

Hostile takeover: *A takeover attempt that is strongly resisted by the target firm.*

Info ratio statistics:

Institutional investors: *A non-bank person or organization that trades securities in large enough share quantities or dollar amounts that they qualify for preferential treatment and lower commissions. Institutional investors face less protective regulations because it is assumed that they are more knowledgeable and better able to protect themselves.*

Investment vehicle: *This term is used very broadly. It refers to anyplace you can put your money. For example: stocks, bonds, mutual funds, options, futures, etc. You'll often hear it used in sentences like this: Mutual funds are a good investment vehicle for beginning investors who aren't confident enough to pick stocks themselves.*

IOSCO: *The International Organization of Securities Commissions*

IPO (initial public offering): *A company's first sale of stock to the public. Securities offered in an IPO are often, but not always, those of young, small companies seeking outside equity capital and a public market for their stock. Investors purchasing stock in IPOs generally must be prepared to accept considerable risks for the possibility of large gains. IPOs by investment companies (closed-end funds) usually include underwriting fees that represent a load to buyers.*

Leverage: *leverage is generally considered to exist when: (a) an institution's financial assets exceed its capital; (b) an institution is exposed to the change in value of a position beyond the amount, if any, initially paid for the position; (c) an institution owns a position with "embedded leverage", i.e. a position with a price volatility exceeding that of the underlying market factor.*

Leverage effect: *The leverage effect explains a company's return on equity in terms of its return on capital employed and cost of debt. The leverage effect is the difference between return on equity and return on capital employed. Leverage effect explains how it is possible for a company to deliver a return on equity exceeding the rate of return on all the capital invested in the business, i.e. its return on capital employed. When a company raises debt and invests the funds it has borrowed in its industrial and commercial activities, it generates operating profit that normally exceeds the interest expense due on its borrowings. The company generates a surplus consisting of the difference between the return on capital employed and the cost of debt related to the borrowing. This surplus is attributable to shareholders and is added to shareholders' equity. The leverage effect of debt thus increases the return on equity. If the return on capital employed falls below the cost of debt, then the leverage effect of debt shifts into reverse and reduces the return on equity, which in turn falls below return on capital employed.*

Limited partners: *Limited partners or investors are the private suppliers of capital for private equity or venture capital funds. Most limited partners are pension funds, banks, insurance companies, and funds of funds.*

Liquidity: *The ability to convert an asset to cash quickly. It is safer to invest in liquid assets than illiquid ones because it is easier for you to get your money out of the investment. Examples of* *assets that are easily converted into cash include blue chip and money market securities. Also known as "marketability".*

Management fee: *Compensation received by a private equity fund manager company. This annual management charge is equal to a certain percentage of the investors' commitments to the fund.*

MiFID: *The Markets in Financial Instruments Directive - MiFID. With the Directives a single market and regulatory regime for investment services across the 25 member states of the European Union was introduced. The key objectives behind the Directive are threefold: 1) to complete the EU single market for investment services and 2) to respond to changes/innovations in the securities markets and 3) to protect investors.*

Mutual fund: *A security that gives small investors access to a well-diversified portfolio of equities, bonds and other securities. Each shareholder participates in the gain or loss of the fund. Shares are issued and can be redeemed as needed.*

Merger: *The combining of two or more companies, generally by offering the stockholders of one company securities in the acquiring company in exchange for the surrender of their stock.*

Offshore: *Located or based outside of one's national boundaries. The term offshore is used to describe foreign banks, corporations, investments, and deposits. A company may move offshore for the purpose of tax avoidance or relaxed regulations.*

Prime brokerage: *A special group of services that many brokerages give to special clients. The services provided under prime brokering are securities lending, leveraged trade executions, and cash management, among other things. Prime brokerage services are provided by most of the large brokers, such as Goldman Sachs, Paine Webber, and Morgan Stanley Dean Witter.*

Private equity fund: *A private equity investment fund is a vehicle for enabling pool investment by a number of investors in equity and equity-related securities of companies. They are generally private companies whose shares are not quoted on a stock exchange. The fund can take either the form of a company or of an unincorporated arrangement such as a Limited partnership.*

Recapitalisation: *Restructuring a company's debt and equity mixture often with the aim of making a company's capital structure more stable.*

Shareholder value: *Refer to the concept that the primary goal for a company is to enrich its shareholders (owners) by paying dividends and/or causing the stock price to increase.*

SEC: *Securities & Exchange Commission - SEC. A federal agency that regulates the US financial markets. The SEC also oversees the securities industry and promotes full disclosure in order to protect the investing public against malpractice in the securities markets.*

Short Selling: *The selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short. Selling short is the opposite of going long. That is, short sellers make money if the stock goes down in price.*

Stock option: *An individual's right to purchase a share at a fixed price. Stock options are a widely used form of employee incentive and compensation. The employee is given an option to purchase shares at a certain price (at or below the market price at the time the option is granted) for a specified period of years.*

Stress test: *A simulation technique used on asset and liability portfolios to determine their reactions to different financial situations. Stress-testing is a useful method of determining how a portfolio will fare during a period of financial crisis. The Monte Carlo simulation is one of the most widely used methods of stress testing.*

Systemic risks: *Risk common to a particular sector or country. Often refers to a risk resulting from a particular "system" that is in place, such as the regulator framework for monitoring of financial institutions.*

Tax transparency: *A fund structure or a vehicle is transparent when the fund itself is not subject to taxation and the investment in an underlying company is treated as if it would be a direct investment for the initial investor (the limited partner) who is taxed only when the investment structure distributes its gains and revenues*.

Tracking return:

UCIT: *Undertakings for the Collective Investment of Transferable Securities - UCITS. A public limited company that coordinates the distribution and management of unit trusts amongst countries within the European Union.*

Venture Capital: *Financing for new businesses. In other words, money provided by investors to startup firms and small businesses with perceived, long-term growth potential. This is a very important source of funding for startups that do not have access to capital markets and typically entails high risk for the investor but has the potential for above-average returns.*

VaR model: *Value at Risk model - VaR model. Procedure for estimating the probability of portfolio losses exceeding some specified proportion based on a statistical analysis of historical market price trends, correlations, and volatilities.*