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David Bailey
Capital Markets Sector Manager
Financial Services Authority
25 The North Colonnade
Canary Wharf
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By email: Dp06_06@fsa.gov.uk

Dear Mr Bailey,

Transport and General Workers' Union response to the FSA's discussion paper *Private Equity: a Discussion of Risk and Regulatory Engagement*

The Transport and General Workers' Union (T&G) is the UK's largest general union, representing 800,000 members across a broad section of the British economy, including the food and drink industry, retail, transport, docks, manufacturing, chemicals, and service sector.

The T&G would like to congratulate you and your officers on your private equity discussion paper. Its detailed and carefully-argued description of the institutional mechanisms of the private equity industry provides an invaluable resource for the current debate.

We also understand that the FSA is tasked with ensuring financial stability, and with the integrity and efficient functioning of financial markets, and this perhaps explains what we see as the narrow focus of the report[1].

While we understand the FSA's natural focus on financial stability, we would strongly urge you to widen the scope of the discussion. At present, there is a striking contrast in your discussion paper between a thoughtful and closely argued account, and an unthinking advocacy of the economic merits of private equity investment. So you express concern that the UK retain its current competitive advantage in this area, and take comfort from the fact that the UK is currently seen as, within Europe, the most favourable location for private equity. You assert that private equity 'creates jobs' and 'boosts economic efficiency'. We know of no soundly based research which supports these contentions, especially the former.

We believe that financial regulation cannot be detached from the economic impact of the activities being regulated. It must be based on a sound understanding of the consequences of the activities it seeks to protect. Financial regulation usually seeks to create a level playing field. But it is our contention that that this must be accompanied by a level playing field in all other areas - in disclosure, transparency and accountability; in employee rights; in stakeholder protection. In some of these areas, at present, the field on which private equity plays slopes rather precipitously in the opposite

[1] You state ' The risks inherent in the private equity market are not confined to the private equity fund managers/advisers. Rather, they affect all types of participant in varying proportions including, in particular, fund managers/advisers, leveraged finance providers, transaction advisers and investors in the relevant equity, debt and related derivatives products.' So no mention of other stakeholders, in particular workers, and social welfare more broadly.

direction. As a matter of urgency, research is needed into the modus operandi, and the consequences, of private equity investment.

Private equity funds may be present at the birth or creation of new firms, providing start-up or *venture capital*, or they may acquire or *buyout* the capital of existing firms. Since private equity almost invariably increases leverage, buyout is usually *leveraged buyout*. Many private equity houses had their genesis in the venture capital industry, but venture capital now forms a relatively small part of the private equity industry in terms of value. A clear distinction needs to be maintained between these two types of activity otherwise there is a danger that the perceived virtues of venture capital will confuse the discussion of buyouts. For example, the FSA says 'the private equity industry is praised for creating jobs - 19% of the private sector workforce is employed by companies that have received private equity backing.' (quoting BVCA Economic impact of private equity, 2005). Buying companies that have employees in them in no way creates jobs. We believe that when accurate figures are presented then they will show that far from creating jobs, far more jobs are lost than created once a firm is taken over by private equity leveraged buyouts. Moreover, continuing to grow employment in companies where employment was already growing strongly prior to takeover should not really be credited to private equity.

Private equity advocates like to confuse venture capital and buyout capital and your discussion paper seems to use these interchangeably in the same way. We have few doubts about the economic value of the venture capital industry. We also acknowledge there may be cases where buyout capital has transformed failing and poorly managed enterprises. However these represent a minority.

We have worrying cases of the buyout of firms that were not bust, and that did not need fixing. In these cases the buyout simply expropriates value - value is captured from the taxpayer, from selling shareholders, from other stakeholders, and most importantly from our perspective from employees whose claims are frequently the most vulnerable in these transactions. In our experience, the typical private equity modus operandi involves buying a change of allegiance by senior management, by sharing the spoils with them. This can lead to a consequent sense of despair and betrayal of trust throughout the organisation.

The FSA discussion paper highlights the dangers of the very high levels of financial gearing associated with private equity investment. The T&G naturally shares these concerns. By raising the financial risk of the firm and thus the risk of default, gearing shifts risk, often dramatically, to other stakeholders, in particular our members. Private equity engages with workers on a “heads we win, tails you lose” basis. If a highly leveraged buyout goes well, private equity principals and senior managers receive huge returns. Even in cases which turn out most positively, the most workers can expect is that a few extra jobs are created. Certainly there is no sharing of the rewards with workers whose livelihoods have been put in jeopardy by the high leverage.

However the true nature of the risk to workers occurs when a leveraged buy out does not go exactly to plan. With no significant equity capital to be drawn on and debt holders having to be paid, management in the acquired business are under great pressure from the private equity firm to rectify the situation and thus protect the private equity investment and returns - even if the original business plan was flawed. The easiest action for management to take is to extract concessions from the workforce either by making workers redundant or by reducing their pay and conditions of employment - all with knock effects on families and communities. The T&G believes that the unbalanced risk/return situation – where labour takes undue risk in order that capital can make undue returns – inherent in highly leveraged takeovers needs to be rectified by regulation. Its continuance is simply not in the public interest.

However, a number of other aspects of private equity investment are also urgently in need of review. We are deeply concerned over, and are keen to participate in a debate upon: the creation of a level playing field in taxation; in disclosure, accountability and transparency; in employee rights; in stakeholder protection. For example, when a business is acquired by buying shares, private equity successfully evades all the information and consultation and employment protection requirements under the Acquired Rights Directive.

As one instance, take the issue of accountability. As an agent of economic change, leveraged buyouts are best compared to traditional corporate takeovers by public companies, which they appear to be increasingly replacing. Whereas a great deal of research has been done into the economic

effects of different types of takeover, far less research exists on the consequences of buyouts. As a result, society understands the economics of takeovers and this informs the debate that typically accompanies takeovers, and establishes their acceptability. Buyouts are getting no such scrutiny.

Secondly, there has been a slow but continuous improvement in the GAAP accounting of takeovers. Acquirers must disclose their beliefs and expectations about the value created by a takeover when they publish a prospectus. In the first financial statement thereafter, they provide an account of the structure of the transaction, and in subsequent financial statements the consequences of the takeover can, to some extent, be seen. Private equity investment is currently able to entirely avoid this scrutiny. The T&G is very concerned that the private equity movement threatens to destroy a generation of hard-won progress in accountability.

Alongside the formal disclosure requirements on public companies is an informal framework of social pressures and expectations that imposes transparency upon public firms. A motive for some private equity investment may be to avoid the public scrutiny of public equity markets so as to do things that would be too shameful or embarrassing to do in public.

We believe that this state of affairs is entirely unacceptable. When private equity firms assume the same economic role as publicly-quoted firms it is reasonable to expect that they should be subject to similar levels of disclosure and regulation, inter alia in employment legislation, in the requirement to consult and negotiate, and in GAAP and company law disclosure requirements.

Yours sincerely,

TONY WOODLEY
GENERAL SECRETARY