



THE ROLE OF PRIVATE POOLS OF CAPITAL IN CORPORATE GOVERNANCE:

SUMMARY AND MAIN FINDINGS

**ABOUT THE ROLE OF
PRIVATE EQUITY FIRMS AND "ACTIVIST" HEDGE FUNDS**

The OECD Steering Group on Corporate Governance, May 2007

Background and Main Conclusions

In November 2006, the OECD Steering Group on Corporate Governance initiated a study of the role of privately organised pools of capital (sometimes referred to as “alternative investment vehicles”) in corporate governance. The Steering Group’s inquiry is focused on those private equity firms and hedge funds that pursue investment strategies that explicitly aim at increasing the value of their pooled capital through active engagement with individual, publicly held companies. While the terminology may not be perfect, these investors are referred to as private equity firms and “activist” hedge funds. As a consequence, the inquiry is limited to a relatively small subset of privately organised pools of capital and does not cover other policy aspects, such as financial stability or the participation of retail investors in private pools of capital. The Steering Group recognises that financial stability and investor protection are also important since sound financial markets are important for promoting good corporate governance practices. Nevertheless, at this stage of the debate, the Steering Group considers it more appropriate to focus on its area of specific expertise and experience in the area of corporate governance, leaving the broader issues to be considered by other specialised fora.

While private equity firms and “activist” hedge funds have been operating for some time in both the UK and the US, they are comparatively new in many other jurisdictions where they have been subject to increased attention, partly due to differences in corporate governance frameworks and company structures. With a rapid increase in the size of transactions and investments, there has been a growing public interest also in the US and the UK. The Steering Group agreed that the distinct corporate governance aspects that emerge in these discussions required special attention based on the OECD Principles of Corporate Governance (OECD Principles).

This Report summarises the main conclusions from the Steering Group’s meeting on 16-17 April, including the findings of a factual review that were taken into consideration. A full version of this background report will be released later.

In developing their conclusions, the Steering Group drew on principle I.A of the OECD Principles: *The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets.* This meant that the Steering Group considered not only the direct actions of the investor categories being considered (in relation to the OECD Principles), but also the available empirical and analytical work about the impact on economic efficiency and the adequacy of the corporate governance framework in which these investors operate.

On the basis of available evidence, the Steering Group concluded that “activist” hedge funds and private equity firms could help strengthen corporate governance practices by increasing the number of investors that have the incentive to make active and informed use of their shareholder rights. This may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition plans. Such active and informed ownership is expected to stimulate the search for the best possible use of corporate assets and thereby contribute to better risk and resource allocation in the economy as a whole. Promoting efficient outcomes for actions taken by active and informed ownership is therefore likely to remain an important policy objective for the years to come. To this end, the Steering Group discussed the potential implications for some areas of the OECD Principles, notably: the efficiency of the market for corporate control (including takeover regulation), transparency requirements, the reliability of voting systems and the monitoring/management of conflicts of interest through the exercise of fiduciary duties by management and boards.

It was agreed that, from a corporate governance perspective, there was no need to promote a special set of principles for private equity firms and “activist” hedge funds. The opportunities and challenges that follow from their ownership strategies should instead be analysed within the general framework of the OECD Principles. The analysis will also take into account existing voluntary standards established and promoted by the industry.

It is hard to define the differences between activist hedge funds and private equity and between these investors and other investors

The Steering Group’s attention is focused on those self-described private equity firms and hedge funds that pursue investment strategies that explicitly aim at influencing corporate behaviour and organisation of publicly held companies. This Report refers to these investors (or investment strategies) as private equity firms and “activist hedge funds” respectively. The Group recognised that legal definitions of these two types of investors are not forthcoming and that other categories of investors pursue similar investment strategies and use similar financial techniques to support investment strategies such as hedging, leverage and share borrowing. Moreover, not all private equity firms and far from all hedge funds pursue such strategies. This difficulty of definition is an additional reason to focus on the effects of the increasing role of private equity and activist hedge funds on the robustness and effectiveness of the overall corporate governance framework rather than developing corporate governance regulations addressing specifically the behaviour of these investors.

The business model of private equity firms and “activist” hedge funds can be summarised as seeking to increase the market value of their pooled capital through active engagement with individual public companies. This engagement may include demands for changes in management, the composition of the board, dividend policies, company strategy, company capital structure and acquisition/disposal plans, which are normally regarded as corporate governance issues. The investor may also take a public company private for a period of restructuring before either returning it to public ownership or by selling it to another company. This “public-to-private” strategy is typically associated with private equity firms (it has been adopted by a few activist hedge funds, too) and is the form of private equity transaction covered by this Report. In line with this focus, the Report does not cover, for example, private-to-private deals by private equity firms.

“Activist” hedge funds are only a small part of the capital market.

Although there is little to prevent a migration of hedge funds to the activist strategy, the number of activist hedge funds in the global economy is probably only about 100-120 with funds under management of around USD 50 billion (excluding leverage). If all funds pursuing “event-driven strategies” were to be included, the sum would rise to about USD 200 billion and perhaps to some USD 1-1.5 trillion if high leverage is taken into account. By way of comparison, the global mutual funds industry alone has USD 18 trillion under management.

Record levels for public-to-private transactions in 2006 involved larger companies and more employees, but conventional mergers and acquisitions remain more significant

The value of public-to-private buyouts surged to a record USD 120 billion in the USA in 2006 from around USD 85 billion in 2005, about 1.5% of GDP. Outside of the US, the figures are very sensitive to a few large transactions. In the UK, public-to-private transactions amounted to GBP 7.2 billion in 2005 falling to GBP 5.8 billion in 2006 (around 1.75% of GDP) with just 24 transactions and none involving a FTSE 100 company. In Continental Europe, transactions amounted to EUR 25.7 billion in 2006 from 16 transactions but almost 85% came from two large transactions in Denmark and in the Netherlands. In

most OECD countries, the level of public-to-private transactions remains well under 1% of GDP. The transactions also need to be viewed against the background of a mergers and acquisitions boom: in 2006, public-to-private buyouts accounted for only 20% of total mergers and acquisitions, albeit up from around 10% in 2001.

The average share of debt in financial structures varies markedly across deal sizes with larger deals having the higher shares of senior and mezzanine debt. Among the very largest deals, the average combined share of financing structures accounted for by debt has increased from 55% in 2000 to 67.3% in 2006.

Public-to-private transactions sometimes involve very large publicly held enterprises and the size is tending to increase. This also means that the work forces are correspondingly significant. In 2003, 450 000 employees were involved in new European deals. In 2005, the figure reached 850 000, although biased by one large transaction in Denmark. The larger deals often involve a number of funds. There are some indications pointing to coordination problems with “clubs” of private equity funds, suggesting that they are also starting to experience coordination problems similar to public company shareholders.

Any addition to the pool of informed and active investors is positive for corporate governance

The Steering Group concluded that in the presence of perfect capital markets there would be little scope for a special category of “active” investors, like private equity firms and “activist” hedge funds. However, when markets are not perfect but characterised by information asymmetries and costs of collective action, managements might pursue their own goals and interests rather than those in the best interest of the company and its shareholders. In these circumstances, there is an important role for “active” investors with incentives to invest in both acquiring and using information. Capital markets around the world are, however, increasingly dominated by institutional investors that often adopt passive investment strategies. These strategies include index-tracking rather than stock picking. There is also a collective action problem made worse by the side-effects of prudential regulation that limits the share of equity held in a company by some institutional investors. As the OECD Principles note, limiting the proportion of equity held in a company reduces the private returns from monitoring the corporate governance arrangements of a company and in exercising shareholder rights. In such a situation, activist hedge funds that are not constrained in their shareholding levels and that have strong incentives to exercise their shareholder rights could improve the overall efficiency of capital markets and underpin good corporate governance.

The OECD Principles call for an efficient and transparent market in corporate control which will counter-balance any tendency for management and boards to weaken their accountability to the company and to its shareholders. The Group recognised that active ownership functions as an incentive for improving corporate governance practices. In this context, private equity transactions and “aggressive” demands vis-a-vis the management, or indeed the threat of such actions (where they do not undermine market integrity), could make a contribution to improving corporate governance and also to improving economic performance.

The case of short termism

It is sometimes suggested that activist strategies weaken corporations by directing resources away from long-term, value-creating strategies, which are the ultimate objective of good corporate governance. This point of view is associated with other propositions including a belief that the economic and corporate governance frameworks together foster short termism rather than patient, long-term investment by “real owners” that leads to improved economic performance. The period of engagement by activist investors of some 2-6 years is often taken as proof of the “short run” proposition.

The claim is closely related to a long running debate about the degree of market myopia and about whether and under what circumstances markets are likely to be strongly efficient (“perfect foresight”). Empirical work suggests that while markets are not necessarily perfect, longer term factors are valued even in markets characterised by short-run behaviour: equity valuations tend to reflect corporate investment activity and price/earnings ratios imply long term considerations of often around 15 years. Research and development (R&D) investments and related innovation strategies are also incorporated quite rapidly into market valuations. Even if investors as a whole might be myopic, the literature indicates that a small pool of active investors looking at long-run prospects are key to market performance even if the same investors will only invest in the company for a limited period. Hence, at least in cases where these market participants consider long-term prospects, reference to the investment horizon of an investor class does not say much about the efficiency of the market and long-run economic performance.

Available empirical research suggests that it is the lack of a credible long-term strategy that makes a company a target for active investors in the first place, especially when it has large cash reserves and is unable to communicate a credible investment strategy. It is not surprising that corporate strategies that have been developed to make companies less attractive to private equity firms and “activist hedge funds” typically highlight the need for the company to: (a) have an informed board; (b) communicate a viable long-term strategy to market participants; (c) review the capital structure; (d) establish a clear dividend policy, etc. That is to say, even in response to investors with a limited time horizon, companies are encouraged to make sure they meet standards that are commonly associated with good corporate governance.

How well does the corporate governance framework accommodate new ownership practices?

The OECD Steering Group agreed that there is scope to analyse the specific issues that relate to the behaviour of private equity firms and “activist hedge funds” within the framework of the OECD Principles. In line with the OECD Principles, this analysis should be made with a view to overall economic performance, market integrity, incentive structures for market participants and the promotion of transparent and efficient markets. Areas where deviations, shortcomings and/or stresses in the corporate governance system may appear include: (a) the integrity of voting systems; (b) the efficiency of the market for corporate control; (c) transparency; (d) market integrity; and (e) controlling potential conflicts of interest among managers, board members and shareholders. Going forward, it should be noted that some of these issues are addressed by voluntary standards developed and promoted by the industry. It will also be useful to obtain a better empirical understanding of practices beyond the US and the UK, which are the two dominant markets for private equity firms and “activist” hedge funds, in order to also analyse the role of these new forms of activism in systems characterised by different models of ownership structures and control mechanisms. It would be interesting, in particular, to investigate if there is room for a positive role for active investors to play in the corporate governance of companies with a high level of ownership concentration and in more bank-oriented financial systems.

“Activist hedge funds” seek to influence corporate behaviour without acquiring control ...

“Activist hedge funds” use a range of strategies, usually founded upon ownership of relatively small but nevertheless significant voting stakes in companies and the threatened use of voting rights, often combined with public campaigns for change. They sometimes use derivatives (or other financial techniques such as share lending) to boost their voting power at a relatively low cost and often solicit support successfully for their reform programmes from other private pools of capital and more traditional institutional investors. From this position, they make corporate governance demands on boards and management from a position of strength. Their demands often target the company’s operational strategies and use of capital. They may also seek changes in corporate governance structures and policies where it appears that shareholders’ ability to exercise key ownership functions (such as to elect and remove board

members) has been restricted. Their success rate seems to be impressive with several studies indicating rates of 60-75% in preventing mergers or supporting takeovers, changing CEOs and board composition, and in altering the capital structure of a company through share buybacks, etc. There is no evidence that such firms have been damaged for short term gain by an activist investor.

which puts the voting systems to a test ...

Hedge fund activism has led to more closely fought corporate votes, *e.g.* in board elections and contests for control in some jurisdictions. In a few jurisdictions, these battles have raised questions about the integrity and efficiency of the existing mechanisms to identify, process and execute voting rights. This problem seems to have been accentuated when “activist hedge funds” make use of share lending close to a proxy contest or shareholder meeting in order to increase their influence. While there is nothing inherently problematic about share lending, it has put the voting system to a test and appears to have resulted in cases of over-voting in a few jurisdictions. This will of course make the outcome of close contests difficult to judge and challenges the principle of equitable treatment of shareholders. Another issue concerns activism in cases where the shareholder turnout at annual or extraordinary general meetings is low. The first, best solution in this case is to remove the barriers to shareholder participation.

A practice that has received a great deal of attention by academics is so-called “empty voting” but in practice it does not appear to be widespread. This happens, for example, when the economic interest in a share (*i.e.* the risk held in a company) is hedged or in effect sold so that the voting right is all that remains. Empty voting is not the exclusive domain of hedge funds. Management might use this technique to transfer the economic risk of ownership while retaining voting power to facilitate entrenchment. A majority shareholder might use the technique to maintain control while minimising its exposure to the company. A few hedge funds using this strategy have attracted attention when it puts them in a potential conflict of interest relative to other shareholders. This could happen, for example, if a hedge fund that has an interest in both the acquiring company and the target company fully hedges its exposure in the acquiring company and publicly comes out in favour of the acquisition even though the purchase price overvalues the target company. Similar conflicts of interest between shareholders have arisen in the past, so the issue is not a new one in company law, but managing this situation can become more problematic with the increasing importance of new active investors and with continuing financial innovation.

While the problems connected with these practices can be very relevant, it seems necessary to carefully consider the effects of any possible policy actions on the development of capital markets and on the effectiveness of corporate governance discipline. An adequate balance among different needs could be reached mainly through increasing transparency rather than prohibiting or hampering these new practices. In any case, costs and benefits of any “selective” rule should be carefully evaluated, once market failures have been clearly identified.

...and may call for improvements in related regulatory provisions for disclosure.

In the course of building up their ownership stakes, “activist hedge funds” are subject to laws of general application requiring timely disclosure, consistent with the OECD Principles. These take the form of disclosure once certain ownership thresholds have been reached (*e.g.* 2%, 5% or 10%). In some jurisdictions, detailed disclosure must also be made regarding the blockholder’s intentions and its arrangements with the company or other shareholders. While originally introduced to control takeovers by stealth, such requirements have served to improve transparency and discipline in the market for corporate influence. Questions have arisen in some jurisdictions, however, about whether existing requirements: (a) fully and consistently encompass the kinds of economic and voting interests that can be created through

derivatives transactions; and (b) are set at the optimal threshold for these new market conditions where it is possible for investors to exert significant influence without having or seeking control.

In executing their value creation strategy, “activist hedge funds” typically rely on the support from other investors with whom they might consult and often use public declarations rather than private negotiations with management. Communication and coordination between investors is advocated by the OECD Principles subject to safeguards regarding market abuse. The opportunity for market abuse and especially insider trading and abusive self-dealing appears to be a significant concern at times and in some jurisdictions and would not be compatible with the OECD Principles that advocate equitable treatment of shareholders. An appropriate regulatory framework and effective oversight in this area are particularly important, given the powerful incentive structures for hedge fund managers.

Private equity is a major force in public-to-private transactions...

Private equity firms apply a wide range of different and complementary strategies including financing public and private companies and the provision of venture capital. As mentioned above, this Report is concerned with transactions where publicly held companies are taken private, so-called public-to-private transactions. The objective of such transactions is typically to restructure the company, improve the use of corporate assets, increase its value and sell it again at a higher price. The pooled capital that is used in this process is typically locked-in for a period of ten years and levered by taking on debt, often at a ratio of about 3:1 depending on the type of transaction.

... which requires an efficient and transparent market for corporate control.

The process of taking a public company private involves some key corporate governance issues covered by the OECD Principles. The review of current practices undertaken by the Steering Group points to several potential concerns that deserve special attention. These are primarily related to the requirement that the “markets for corporate control should be allowed to function in an efficient and transparent manner”. A related issue concerns the fiduciary duties of board members and management, since they are often a party to the takeover and therefore conflicted. One study of fifty large public-to-private transactions in the US showed that 34% of the boards of target companies did not form an independent committee to evaluate, negotiate and approve the proposed transaction. Questions about whether boards have fulfilled their duties to the shareholders in general and to the company have also arisen with a number of transactions in other jurisdictions.

Compensation structures might also be an issue and might raise specific problems with regard to the integrity of management and board behaviour as defined by the OECD Principles. For example, it appears that in some cases options for managements and board members might vest in the case of a successful takeover, leaving the suspicion that they might be disposed to accept a takeover (*i.e.* “throw in the towel”) even if the transaction does not maximise value for shareholders and the company. Pension funds and other institutional investors might also be disposed to lock in a cash gain. In combination with the recent tendency to form private equity clubs to bid for large firms, there is often a perception that despite high acquisition premiums of 30-40 %, some companies are being sold too cheaply.

Other concerns can arise, from an opposite point of view, where the fluidity of the market for corporate control is hampered by regulations or practices which over-protect and lead to the entrenchment of management. While public-to private transactions are often uncontested by the board and management, the OECD Principles recognise that an efficient market for corporate control requires that anti-take-over devices should not be used to shield management and the board from accountability. It cannot be excluded

that the presence of such anti-take-over provisions may limit the number of companies that may otherwise be the target of “activist investment strategies”.

Only some companies attract private equity investors...

Empirical work suggests that the typical target for a public-to-private transaction is likely to be undervalued, with high cash balances and a relatively low level of debt. Since the transactions are rarely “hostile”, there will also be a potential for close relations with management and the board, many of whom have significant equity positions and will be favourable to the transaction. In the UK, companies that are subject to public-to-private transactions have a significantly higher default probability prior to being bought-out than other companies. This is not the case in the US where the probability of a public-to-private transaction is actually lower when there is potential financial fragility.

Tax arrangements can drive transactions but is far from the sole factor

The Steering Group was also interested in the role of taxation in public-to-private transactions. On average, pre-transaction shareholders in the target company of a public-to-private transaction receive a premium of approximately 40%. In trying to determine how tax influences the premium, studies for the US and for the UK come to different conclusions, although it should be noted that the research covers different time periods. Older research in the US suggests that the tax effect might account for between 20-70% of the premium depending on the structure of the transaction. In the UK, the fact that higher premiums are paid for firms with lower leverage provides weak support for the tax benefits hypothesis. The unused debt capacity is likely to create a large additional tax shield. However, the tax system is important in other ways than just through corporate taxation of the target company.

Taxation of private equity partners and of limited liability partnerships differs from one country to another and can encourage or discourage investment activity through private pools of capital. The treatment of capital gains is also important, especially for the general partners (*i.e.* carried interest). In some countries there appears to be a contradiction between taxation incentives to encourage venture capital on the one hand, and the desire to discourage private equity involving public-to-private transactions on the other hand.

Exits by private equity are a critical part of the process

A key step in the private equity model is the exit phase when the private equity fund sells the company either through a new listing, sale to another company (trade sales) or through sales to another private equity firm (secondary sales). An initial public offering (IPO) is usually the most profitable and desirable route for a fund but trade sales have been the most common form of exit except in recession periods, accounting for a third of all exits in some jurisdictions. It is important to note that in an IPO, the private equity fund often maintains a sizeable equity position for some time thereafter, and presumably remains an active monitor.

Partial sale of the portfolio company provides a means for realising part of the initial investment without losing control and might indicate an evolution of the private equity model. The number of partial sales following buyouts is generally between 70 and 100 per year in the UK and around half this level across Continental Europe. The total value of partial sales peaked at around Euro 9 billion in 2005, with Euro 2.2 billion worth of disposals in Continental Europe.

The performance of companies re-listed after a public-to private transaction is good and in many cases superior to other companies

It is sometimes argued that firms exiting private equity are weakened by high debt. While there are some high profile examples of quick collapses (*e.g.* Refco), this image is not supported by the data. The review of empirical work conducted for the Group pointed to one important study of 496 private equity-led IPOs in the US during the period 1980-2002 that found that these companies, and especially the larger ones, significantly outperformed the market and other IPOs. The exception to this result concerns “quick flips”, such as when a company is returned to the market within one year. Such “quick flips” receive a great deal of press attention but are not common.

...but some methods have raised concerns

Some concerns have been raised about the sharp rise in refinancing and leveraged recapitalisations in recent years. Leveraged recapitalisation usually involves returning to the debt market in order to release capital from the enterprise to investors (*e.g.* by a special dividend). At this stage it is difficult to see whether this is a temporary phenomenon or a sign of a change in the business model.

Company performance appears to improve under private equity...

The review of research about company performance commissioned by the Steering Group noted that empirical evidence is at present mainly confined to the UK where there is a reasonable sample of exited transactions. This allows for the measurement of the increase in the value of the enterprise as distinct from the return to equity which is biased upwards by leverage and dividend distributions. One study of exited buyouts in the UK found an average return of 22% net of market index returns on the enterprise value of the firm, indicating that real gains are achieved. The most common form of value creation by private equity investment is through add-on acquisitions (53%) and replacements within the top management team (43%). In around a fifth of the cases, value-creating activities involved expansion of the product line, growth in sales, a new marketing approach, strategic reorientation, organisational restructuring, geographical expansion, cost cutting and adjustments in work force/consolidation and outsourcing.

.... but the risk adjusted returns to investors do not suggest unlimited potential for private equity so that it might be seen as a complement to public markets

An important question is whether the private equity model is sustainable and represents an alternative to public markets. While it appears to be highly profitable for private equity partnerships (one has to also bear in mind the significant losses from failed investments), does it offer returns to investors net of fees that would encourage them to maintain their investment? The evidence considered by the Steering Group is mixed. A recent study of 199 US buyout fund investments finds a positive and statistically significant alpha (*i.e.* excess returns to the market return) in comparison with equally risky levered investments in the S&P 500. Other studies are more agnostic, indicating average returns net of fees to be roughly equal to holding the S&P 500 but there is a wide and persistent difference between private equity funds. This might indicate that the room for such funds is limited so that it is a far from universal model.

The empirical work reviewed for the Steering Group indicates that private equity is a risky business with a number of transactions involving companies already in difficulties yielding low returns, offset by some highly profitable investments. As an illustration, one study showed a mean rate of return to equity of 70.5% but a median of -17.8%.

The aggregate effect on employment is not inherently negative and should be further assessed...

The Steering Group noted that employment effects were often a public concern when discussing ownership by private equity firms and intervention by “activist” hedge funds. However, it is not possible at this time to draw any substantiated conclusions about their aggregate effect on the overall level of employment, which is the relevant aspect from a public policy perspective. The aggregate employment effect will depend on how long companies have been held by private equity funds and the age composition of the portfolio of public-to-private companies. It will also depend on the state of the business cycle, labour market flexibility and adjustment policies. It would not be economically meaningful to record the employment of a public-to-private company sold to another company (*i.e.* trade sale) as an employment loss associated with private equity. When viewed over the whole life of the public-to-private investment, it does not appear that active ownership strategies have an inherently negative impact for employment by a company. Considering this topic’s importance, the Steering Group will nevertheless continue to follow empirical and analytical work related to the link between active ownership strategies and the aggregate impact on employment.

...together with stakeholder issues more generally.

In line with Chapter IV of the OECD Principles, the Steering Group recognised that various stakeholders often have a strong interest in the outcome of a public-to-private transaction. In some jurisdictions, these rights might be less defined and enforceable than in others. One aspect that has been observed in a number of cases concerns creditors in the target company suffering a market loss when their debt is downgraded due to a leveraged buyout. Such an event can also happen in a conventional merger or acquisition when the purchaser is highly leveraged. A solution adopted by some creditors is to insist on change of control covenants in their loan agreements, but these may not be enforceable in some jurisdictions.

The Steering Group also noted that in some jurisdictions, employee rights established by mutual agreements might also be an issue in a public-to-private transaction. The acquired rights include agreed health and pension provisions as well as performance-enhancing mechanisms. The issues are often complex, especially in those cases where a company is in financial difficulty and is being acquired by private equity to be restructured. The question facing employees might be either to renegotiate the pension or health agreement or force the company into bankruptcy in the hope that claims will be protected. Much evidently depends on the specifics of the jurisdiction including the insolvency regime. In some jurisdictions, performance-enhancing mechanisms are enshrined in labour or corporate law and therefore, like other rights established by law, do not change even in the event of a change in ownership.