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Danish contribution to openness and accountability on European capital markets

The international financial crisis and the turmoil in the financial markets have on several occasions been discussed in a European setting, resulting in a number of agreements. Denmark acknowledges the strong European focus and naturally supports the various agreements and initiatives.

The EU initiatives launched will not be touched upon in this paper. Denmark would, however, like to contribute concrete input for the current deliberations at European and international level with respect to addressing the issues exposed by the current financial crisis, including the underlying structural deficiencies and problems.

Overall, a strengthened joint European package of initiatives, based in particular on mutually binding EU rules, increased transparency, stricter authorisation procedures for financial businesses in the EU and strengthened capital adequacy requirements, should aim at ensuring adequate standards in the EU financial markets. Such initiatives must be designed so as to counter any tendencies towards national restriction of competition. The European crisis cannot be tackled by protectionism among the EU member states, but rather by mutually binding initiatives at European and, if possible, international level.

Adequate standards are an important prerequisite for restoring an efficient European financial market, which will allow the European countries to improve their economies again.

The current global financial crisis was very much triggered by the lack of adequate standards in the American subprime market. The crisis has affected the global economy as the market players (investment companies, structured products, credit rating agencies, etc.) are inter-related.

The equity markets have generally suffered major losses, and the central banks have been forced to inject funds into the markets to off-set liquidity shortages. The full extent of the crisis is as yet unknown.

The turmoil experienced by the international economies may very well face a new major, serious financial challenge when financial businesses and private equity funds are to refinance their debt in portfolio businesses to a significant degree. Should the crisis take such a turn, the problems facing the global real economy might be aggravated.

The rules of the financial markets indisputably need to be reviewed, not only at EU level but also globally, to ensure that they are up-to-date and adequate in relation to the various types of players, including private equity funds. The first important step would be efficient regulation at EU level, similar to the EU rules already governing other types of financial institutions and businesses.

It is essential to Denmark that existing and future EU-based regulatory and supervisory measures comprise all systemic, key financial players and entities. The alternative investment industry is no longer a "niche industry". It represents important players in the financial markets as do off-balance sheet entities (such as special investment vehicles) and hedge funds.

Private equity funds should, however, also be addressed as part of future efforts: They have a close interaction with banks in relation to loans, and with insurance companies and pension funds in relation to capital contributions with a view to subsequent investments in the form of acquisitions.

The great interest in players such as private equity funds is driven by their acquisitions of a growing number of major businesses at international level. As a result, the macro-economic effect of such acquisitions has grown, ultimately triggering increased interest in the activities of players such as private equity funds. One of the reasons for this is that the funds maintain considerable lack of openness with respect to their activities. In addition, the debts in acquired businesses often grow after they have been acquired by private equity funds, raising the question of whether the financial strength of acquired businesses is impaired as a consequence of the acquisitions.

As the financial markets are becoming more and more globally integrated and complex, the European legislative tools must be modernised, and Europe must develop supervisory and regulatory responses that are as up-to-date and finely tuned as are the financial markets. It would be inadequate and wrong to act as if Europe's present legislative structures, which are designed for the past, were not to be as modern and innovative as the players they are to regulate.

The EU is already well on its way with reforms of financial regulation and is in the process of implementing a number of action plans to support financial stability. This gives EU considerable momentum in terms of global follow-up action.

The Danish input addresses four specific overall challenges:

I. Increased openness

II. Strengthened capital requirements, prudent borrowing and taxation

III. Prevention of conflicts of interest

IV. Global regulation

I. Increased openness

The current financial crisis is to some extent attributable to a lack of transparency in the financial sector. It has been difficult to supervise and control the actions taken by players such as private equity funds, and it has been difficult for external parties to assess the financial condition of financial businesses.

This lack of openness must be addressed. The crisis has revealed vulnerability in the activities of private equity funds etc. and a strong interdependence with other key players such as investment banks, securitisation businesses and credit rating agencies.

New and improved legislation on players such as private equity funds cannot be separated from the need for improved regulation of other financial players. Such interdependence necessitates a coherent and consistent approach to legislation, based on equal conditions and “neutral” legislation governing all major players.

All investors, consumers and the financial markets will benefit from appropriate and modernised legislation. This would promote financial stability, the achievement of the Lisbon goals, long-term competitiveness and viability of businesses in the global economy, employment and social cohesion. The efficiency of financial markets is dependent on the transparency and faith in the markets.

Increased openness in connection with acquisitions of large companies (listed and unlisted companies)

1. In relation to listed companies, the EU is urged to widen the scope of the EU rules governing offer documents to the effect that they comply with the level of detail required by the Danish rules of the Danish Executive Order no. 947 of 23 September 2008. For example, offer documents must contain information on the strategic plans for the acquired company, whether the acquired company is still to be a listed company and whether any major dividend payments are scheduled immediately after the acquisition. The latter element ensures greater openness towards shareholders, as the offer document must be published.

2. In relation to unlisted companies, the EU is further urged to expand the scope of application of the EU rules on the requirement for preparing offer documents to comprise acquisitions of unlisted companies, but restricted to large, unlisted companies. The definition of unlisted companies that should be governed by the regulation could be based on the financial reporting directives, to the effect that an offer document should be prepared in connection with acquisitions of large companies. In that way, acquisitions of large, unlisted companies, as defined in the Danish Financial Statements Act, would be comprised.

The offer document should be published and be accessible to all stakeholders.

Management of and increased openness in relation to incentive pay etc.

3. The EU is urged to prepare proposals to prevent bonus and share option plans from triggering short-term, excessive risk-taking. This objective could be achieved by introducing requirements that prevent extreme bonus and share option plans and by increasing the restriction periods for such plans.

4. The EU is urged to introduce an EU-level prohibition against bidders making agreements on share options, bonuses and other incentive-based benefits with a target company's management in connection with takeover bids.

Such prohibition would ensure that management loyalty towards shareholders would not be questioned in connection with takeover bids.

More specifically, this would mean a prohibition against agreements on bonuses and similar benefits for the board and executive management of the target company applicable from the time when actual negotiations on a takeover bid, including the recommendation of a takeover bid, commence and until such time as the negotiations are discontinued or the takeover bid is completed. The prohibition does not cover initial investigative actions.

5. The EU is urged to introduce an EU-level duty for the bidder to disclose, before an acquisition, information about any contemplated distribution of funds (payment of dividends etc.) from the company subsequent to the completion of an acquisition.

This would ensure increased openness towards shareholders.

This would specifically imply that an offeror who has not disclosed information on payments of funds from the target company after the completion of an acquisition would be barred from distributing funds from the target company to the offeror or its related parties for a period of 12 months.

The offeror would also be barred from distributing funds in excess of the amount disclosed.

6. The EU is urged to introduce an EU-level requirement for shareholders of listed companies to approve in general meeting the general guidelines for the company's overall incentive pay to the board and executive management prior to any specific agreements being made.

This would ensure that the owners are also involved in the company's policies on incentive schemes for its management.

7. The EU is urged to ensure openness on the investment strategies of pension funds and insurance companies in relation to pension savers.

8. Following an acquisition, private equity funds and acquirers of businesses must in future inform the members of superannuation funds of funds used by them to acquire the company's treasury shares.

9. In relation to openness and transparency, limited partnerships should be placed on an equal footing with other corporate structures regulated at EU level. Such EU regulation should stipulate the same requirements in respect of openness and transparency for limited partnerships as those imposed by the EU on companies organised as public limited liability companies.

Openness on the capital adequacy and risk of banks

10. The EU is urged to require more transparency in the EU in respect of the capital adequacy and risk profile of banks, including publication of the results of the individual bank's own solvency requirement assessment.

Improved protection of employees in connection with acquisitions by private equity funds

11. The EU is urged to ensure that all employees enjoy the same protection and rights as in transfers of undertakings in terms of information and consultation when the control of a company or activity is transferred as a result of a private equity transaction or corporate acquisition.

Registration and authorisation of private equity and hedge funds

12. The EU is urged to draft harmonised EU regulation of private equity and hedge funds to serve as the basis of authorisation of marketing of shares in all EU member states. A single national supervisory authority would grant the authorisation to the private equity and hedge funds, and once a private equity or hedge fund has obtained authorisation in one member state, it would be permitted to operate in all EU member states. Authorised private equity and hedge funds should be registered in the joint register, see item 14. Such authorisation scheme for private equity and hedge funds must be based on the principle of openness. Key information to be disclosed could include:

- overall investment strategy and information on changes in strategy, debt financing/debt exposure and general fees;
- name and domicile;
- previous performance;
- risk management system and methods of measuring portfolio value;
- the share of the fund's assets contributed by the fund manager and its employees.

13. The EU is urged to establish a registration scheme for management and administration companies affiliated with private equity and hedge funds. Such registration scheme should be designed in the same way as for private equity and hedge funds (see item 12 above). The scheme should aim at minimising the risk of financial activities being relocated outside the EU. Accordingly, the EU is urged to seek to ensure that such registration scheme receives international support. Key information to be disclosed could include:

- names and domiciles of private equity and hedge funds to which they are affiliated;
- identity of fund manager;
- financial statements;
- remuneration of members of the board and executive management.

14. The EU is urged to establish a registration and authorisation database covering all of the EU and including information about private equity and hedge funds and management and administration companies as described above.

The supervisory authorities of all member states should have unrestricted access to this database. Relevant categories of the database should be publicly available.

15. Denmark supports the work to increase convergence between the national supervisory authorities. In this connection, the EU is urged to prioritise the efforts to ensure independent national supervisory authorities with uniform goals, resources and powers. Denmark also supports closer collaboration in the form of the establishment of supervisory panels to oversee cross-border financial groups. Moreover, Denmark supports the work towards a stronger and more ambitious collaboration in the three European supervisory committees (CEBS, CESR and CEIOPS) on the determination of the framework for the supervisory efforts.

II. Strengthened capital requirements, prudent borrowing and taxation

In connection with acquisitions by private equity funds, the debts in the acquired businesses often increase. It is imperative that the capital adequacy of the acquired businesses is not allowed to deteriorate to an extent that interferes with the financial stability.

Prudent capital resources and upper limits on debt financing for private equity funds

16. The EU is urged to review the capital adequacy rules to clarify whether they are adequate. In this context, Denmark welcomes the Commission's proposal for a new capital directive for financial businesses contemplating that in connection with securitisation lenders should to a larger extent bear the risks in order that they have a financial interest in encouraging prudent investments. But accountability may also need to be enhanced in other areas.

17. The EU is urged to require that the board of a business regularly considers – and is thereby made accountable for – whether the business' capital resources are adequate relative to its operations from time to time. This also implies a requirement for adequate distribution of dividends which takes into account all relevant matters relating to the group.

The assessment of whether a business' capital resources are adequate should always be based on a specific and overall evaluation of the challenges, including financial risks, facing the business and its subsidiary undertaking. The adequacy of capital resources must never be based on a mechanical or rigid calculation, for example a solvency ratio.

The proposal should reduce the possibility for irresponsible borrowing by ensuring that the level of debts in the target company is viable at all times, for example in connection with acquisitions by private equity funds, based on macroeconomic considerations as well as customer and employee considerations.

18. The Commission should urge the member states to introduce tax consequences in case of excessive borrowing, for example in connection with acquisitions by private equity funds.

Such tax consequences may include elimination or reduction of the tax deduction for interest payments on the relevant debt in accordance with the best practice of the member states.

Capital impairment

19. The EU is urged to propose rules for the harmonisation of requirements on board members and other members of the registered management of the target company to provide information on the background for payments from the target company to their related parties.

Related parties are persons or corporate entities in which one has significant influence on the decisions of the other. This is for example the case in transactions between a parent company and a subsidiary undertaking. Related party transactions may be made on terms and conditions and based on considerations that are not purely business-related. This is, for example, the reason why the financial reporting requirements for listed companies specifically provide for disclosure of related party transactions.

20. The EU is urged to introduce rules that require management to disclose information about the correlation between the payments under item 19 and dividend payments etc. and the long-term financing of the company's operations. Management should thus be able to justify that such payments do not impair the company's performance and that they are compatible with maintaining a prudent level of capital resources, cf. items 16 and 17 above. Such information is deemed to be material for the employees and other stakeholders of the acquired company.

Expansion of the prohibition against self-financing

The prohibition against self-financing implies that a business is not permitted to participate in financing its own or its parent company's acquisition, neither by directly making funds available for the financing nor by providing collateral security. There is also a prohibition against self-financing under EU law, but this prohibition does not apply to financing of the parent company's acquisition, it only applies to the acquisition of own company shares.

21. The EU is urged to work towards the explicit inclusion in the EU self-financing prohibition of parent company acquisition financing. The EU is also urged to adopt a principle-based approach to the prohibition. Such approach would ensure that transactions which, on the face of it, are not comprised by the prohibition may be comprised when applying an overall, principle-based interpretation of the prohibition and the considerations underlying the prohibition. This would counteract attempts by creative advisers to circumvent the provision.

Upper limits on debt financing for hedge funds

22. The EU is urged to prepare a set of rules aimed at limiting the debts of hedge funds and ensuring that the debts of hedge funds are at all times adequate in relation to the risks assumed by the fund. In this connection, possibilities for defining upper limits for the debt financing of hedge funds should be considered. This will contribute to maintaining the stability of the EU financial system.

EU registration of structured products

23. The EU is urged to establish a public register of structured products in the EU and to promote the establishment of an international clearing scheme.

Taxation

Taxation is only included to a very limited extent in the joint European discussions. Several factors indicate that there is a need to tighten practice in this area. As was recently pointed out by the French Presidency, the issues surrounding tax havens are also a matter of European concern.

24. The EU is urged to take effective steps to combat the remaining European tax havens.

25. The Commission is urged to investigate the possibilities of increased openness about the tax matters of private equity funds etc. and the tax consequences of investments made by private equity funds.

26. The EU is therefore urged to implement analyses to investigate whether the current national tax regulation of the EU member states takes into account aggressive tax planning and ensures the necessary robustness and competitiveness.

For example, initiatives should be investigated that can quickly and safely ensure information about:

- How the private equity fund is organised from a formal, legal perspective, where it has its corporate law and tax law domicile and how it is taxed in the relevant domicile country (corporation tax or participant tax).
- In connection with acquisitions by private equity funds, incentive programmes are often established for executive employees and they are often tax-advantaged. Such programmes should be disclosed, including information on taxation of programme participants.

27. The EU is urged to prepare new common tax guidelines to ensure uniform guidelines on openness across different legal corporate structures.

28. The EU member states are urged to work towards efficient taxation of income in private equity/hedge funds and their management companies in order that such income is taxed in the EU or another onshore tax country as far as possible.

III. Prevention of conflicts of interest

The financial crisis has exposed a number of unfortunate conflicts of interest. One example is the interaction between hedge funds and the banks they use (prime brokers). Another example is the relationship between private equity funds and the management of the target company. Moreover, it is important to establish a clear and unambiguous separation between the advisory and broker businesses operating in the market and the companies they work for.

29. Denmark supports a pan-European set of rules on credit rating agencies aiming to ensure actual independence and quality in credit rating services. Requirements should be made for authorisation/accreditation of credit rating agencies.

30. The EU is urged, among other things, to draft proposals for rules that prevent the conflicts of interest inherent in the current business models and arising from the interaction between players in the financial markets of today. This could be done on the basis of, for example, the Danish rules on the management and structure of financial businesses with a view to ensuring an efficient separation between the services offered by financial businesses (such as brokerage) and all their other units (including services relating to asset management, own-account trading etc.).

31. The EU is urged to initiate an investigation of the market concentration in the following financial services sectors: Hedge funds, private equity funds, investment banks (focusing on brokerage) and credit rating agencies.

IV. Global regulation

It is important to have free movement of capital on a global scale. When drafting the new rules, great care should therefore be taken to ensure that solutions are not only found at an EU level but also at a global level.

32. Denmark supports a continuation of the EU accounting strategy which is based on the accounting standards issued by the IASB (International Accounting Standards Board) and not least the part of the strategy aimed at making these accounting standards globally applicable. Denmark also supports the IASB's efforts to draw up guidelines for the measurement of illiquid financial instruments.

The international accounting standards comprise all types of businesses, not just financial businesses. It is crucial, not least for financial businesses, that the accounting rules provide a true and fair view but at the same time avoid procyclicality.

33. The EU is urged to take the initiative to a global coordination of the regulation and management efforts. The global efforts should be aimed at:

- achieving global standards to be implemented in all countries;
- introducing a global early warning system that can identify potential financial instability and thereby ensure timely action; and
- establishing cross-border "stability groups" to ensure cooperation and action in crisis situations.

34. Achieving the above aims requires an expansion of the institutional regulatory framework. For example, improvements should be made to the following effect:

- In the light of the legitimacy and global membership of the organisation, the IMF should play a key role in building a better and more efficient international financial structure;
- The IMF's monitoring efforts should be intensified and the IMF's reports should each year clarify whether the political monitoring targets have been met and whether these targets are adequate in relation to the specific financial situation.
- The IMF should work closer with the Financial Stability Forum (FSF) to optimise the opportunities for implementing an early warning system in case of potential global crises. The IMF and the FSF should each year submit a joint report to the group of ministers focusing on macrofinancial risk areas and recommended political initiatives.

Openness in relation to state-owned funds

35. In continuation of the IMF's initiatives, the EU is urged to take further steps to create greater openness about state-owned funds.