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Mr Peter Hallahan
Secretary
Senate Economics Committee
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Sir

Submission to Senate Economics Committee
Inquiry into the Private Equity Investment and its effects on Capital Markets and the Australian Economy

Ernst & Young welcomes the opportunity to make a submission to the Senate Economics Committee in respect of its inquiry into the private equity investment and its effects on capital markets and the Australian economy.

Our submission refers to the inquiry's terms of reference items (a) and (b):

"(a) an assessment of domestic and international trends concerning private equity and its effects on capital markets;

(b) an assessment of whether private equity could become a matter of concern to the Australian economy if ownership, debt/equity and risk profiles of Australian business are significantly altered;"

but focuses on item (c):

"(c) an assessment of long-term government revenue effects, arising from consequences to income tax and capital gains tax, or from any other effects."

1. Executive Summary

Increased private equity activity is the result of the combination of a number of commercial factors that have helped to create greater business dynamism and have encouraged increased merger and acquisition activity in Australia generally. We discuss these commercial factors below.

Private equity is not a new development and private equity funds are still only a small part of Australian financial market activity.

We discuss the tax impact of private equity transactions and how, in our view, private equity does not adversely affect business profits and the Australian tax base. We also explain why concerns in other countries about the tax effects of financing of private equity transactions do not apply in the same way to Australia.

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In our view the analysis shows that there is no rationale to consider modification of the current income tax treatment for Australian or foreign private equity investment in Australia.

Our more detailed comments are set out below.

2. Private equity is undefined

We note that 'private equity' is a general and undefined term, as noted in the inquiry's terms of reference. The committee's report will be useful to highlight the issues, to reduce confusion which might incorrectly mix issues about takeovers and business acquisitions on the one hand with acquisitions by specialist shorter-term private equity funds (including venture capital funds and leveraged buy-out (LBO) groups) on the other. While the regulatory issues in the two sectors may differ, the economic effects are similar, in enhancing Australian business growth, modernisation and productivity gains which underpin secure long-term employment for Australians.

The UK Economic Secretary to the Treasury, Ed Balls, MP stated, in a speech to the London Business School on 8 March 2007[1]:

> "…our work on the investment chain has not suggested, … that -- from the point of view of the health of the British economy -- any particular form of ownership is inherently to be preferred over any other. On the contrary, whatever the form of ownership -- the real issue for the investors whose money is at stake, for the health of the company concerned, for the workers whose jobs depend on the company's success, and ultimately for the economy as a whole, is how effectively that ownership is exercised, in promoting the long-term creation of value, investment and employment.
>
> 60. Our aim should be to support economic dynamism and long-term investment and job creation. And the Government's objectives in the field of private equity should be no different from its objectives in relation to any other form of ownership: to promote an environment of long-term, sustainable business success, underpinned by a strong culture of clear disclosure to, and engagement with, underlying investors. This is the way to ensure that "good" long-term investment propositions prosper."

3. Some commercial factors leading to greater business dynamism, merger and acquisition activity in Australia – and increased private equity transactions

Business takeover activity has increased in Australia and globally, for several reasons.

First, businesses develop through not only organic growth but also through takeovers of other business targets. Acquisitions might be attractive for many reasons, including the target's specialist knowledge and intellectual property which can dovetail with the bidder's business or the target's business might represent a diversification for the bidder. As well, a merger of the bidder and target can create a larger, stronger business which can grow domestically and internationally to a larger scale, to be more significant in the Australian or global business environment. With greater international business activity, these factors have become more important for Australian businesses.

Second, Australia's business tax reforms of the last ten years have removed many of the tax inefficiencies which retarded Australian businesses' growth and development. Reforms such as the scrip takeover rollovers, demergers relief and particularly tax consolidation have improved the

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[1] Extracts from the speech are attached as Appendix 1

Australian tax system, which was previously uncompetitive and created many problems for Australian buyers of assets in acquiring and then restructuring businesses. In our experience, Australian companies are now able to be very competitive with foreign bidders and with private equity bidders in bidding for target businesses.

As a result, many older, slower-moving businesses have been acquired by more dynamic businesses. Australian businesses have been acquirers as well as targets, and have acquired businesses globally as well as in Australia.

In our view, this more efficient, more dynamic Australian business tax environment has been a significant driver of growth for Australian business and growth of Australian company tax revenues. Australia's development is not due merely to the mining boom. It is facilitated by more nimble, more dynamic Australian businesses which have a greater ability to acquire other businesses without tax impediments.

Third, the capital markets have developed globally, to serve the superannuation and pension funds sector and other major investors. The increased professionalism of the funds management industry has seen a willingness by superannuation and pension funds, and their funds managers, to diversify from investment exclusively in existing listed companies to a willingness to create increased returns by investing a portion of their funds in new or alternative investments such as:

- Infrastructure assets
- Hedge funds, and
- Private equity.

Australian and international superannuation and pension funds accept that a small, prudent, portion of their assets can be invested in such alternative or new assets to enhance their returns. The Reserve Bank, in its March 2007 Financial Stability Review[2], quotes APRA as follows:

> "Non-traditional assets, such as infrastructure, private equity and public-private partnerships, are acceptable in a diversified portfolio, provided the trustee has considered their expected return and diversification effect on the portfolio and can demonstrate appropriate expertise and process to manage such asset classes within a superannuation fund portfolio."

This increased depth and diversity of capital markets, with an increased risk tolerance within prudential boundaries, has increased the range and size of potential transactions which acquirers – both existing businesses and funds managers - can execute.

Fourth, the last decade has seen, globally, ready availability of lower cost finance. This lower cost finance comes from various sources including:

- countries in recession or coming out of recessions,
- countries whose central banks are seeking to maintain growth to avoid recessions,
- superannuation funds and pension funds investing directly as lenders, rather than through bank intermediaries, with this disintermediation resulting in lower cost of funds (a similar trend arose, for example, in home mortgage securitisation).

[2] http://www.rba.gov.au/PublicationsAndResearch/FinancialStabilityReview/Mar2007/Pdf/financial_stability_review_0307.pdf

This combination of factors has encouraged not only a step-up of Australian business activity, but also the greater development internationally and in Australia of specialist private equity investors.

Private equity investors focus on identifying businesses which might be under-priced by the capital markets relative to their potential, or not well-managed from a strategic, financing or operational viewpoint. The private equity investors seek to purchase such businesses, improve their financing structure, adjust their management and restructure their assets to be more attractive. The private equity investors will then aim to re-sell some, most or all the target's businesses to other participants in the capital markets – either as trade sales to existing businesses or by re-floating the businesses back to the capital markets.

Private equity investment is not a new development. This practice has been known for decades, although in recent times the volume of investment in such private equity arrangements as equity participants or debt providers has expanded.

The Reserve Bank of Australia report notes that private equity funds now account for about 1.5% of funds under management in Australia, with four fifths of the funds provided by institutional investors, and loans to private equity transactions by Australian banks represent less than 3 per cent of total loans in the Australian banking system. In other words, private equity is a small part of the Australian financial markets.

It is important to note that, like existing businesses, private equity investors look to the medium term. In fact, the president of the Australian Institute of Company Directors, Mr John Story, observed[3] that private equity was prepared to invest for a longer period than some equity investors on the stock markets:

> "They will approach an investment on the basis of a three to five year time span. That's a healthy basis. In recent years in Australia, there's been limited (ability) on the part of our markets to make that type of assessment.
>
> "They've been looking for a return in 12 months, or at the longest two years. If you can't demonstrate a return in that period, then the company is treated harshly in its share price. Private equity is gaining an advantage there because it is more realistic."

Other submissions to the inquiry have noted the strong Australian regulatory supervision of credit and capital markets and we note those comments.

4. Some tax issues relevant to private equity transactions

We summarise below some relevant tax issues relevant to a consideration of private equity investment.

In our view the outcomes suggest that there is no need to modify the current income tax treatment for Australian or foreign private equity investment in Australia.

4.1 Taxes payable by investors selling their investments to private equity

To the extent that the existing shareholders of target companies acquired by private equity are Australian residents, they pay tax on the disposal of their investments under either the capital gains

[3] Quoted in "Privateers thrive in over-regulation" by Rowan Callick, China correspondent, The Australian, 10 May 2007

tax rules or as part of ordinary assessable income for traders. Private equity transactions result in greatly enhanced sale prices for the existing (selling) shareholders.

Private equity transactions may therefore be revenue-positive for Australian tax revenues to the extent that capital gains tax and trading profits are generated on disposal of existing investments.

4.2 Reinvestment of proceeds and the tax base

Australian investors selling their investments in the target entities will typically reinvest the proceeds in investments in Australia. To the extent that the sale proceeds of their investments are reinvested in Australia, the income and subsequent disposal of replacement investments continue to be taxed in Australia. Even if some of the funds are invested overseas by Australian investors they will eventually be returned to Australia. We do not see any reason for concern about the revenue effect here.

Some of the investors in Australian companies which sell their investments to existing companies or private equity purchasers will be foreign investors ("foreign vendors"). The foreign vendors might themselves reinvest the proceeds in other Australian companies, this maintaining the stock of capital in Australia and Australia's tax revenue base. If the foreign vendors remove the sale proceeds from Australia, the acquirers of the business (whether long-term Australian companies or private equity houses) might use foreign capital to fund their acquisitions, so maintaining the stock of capital in Australia and Australia's tax revenue base.

4.3 Takeovers and the efficiency benefits on business profits and tax base

If private equity restructuring improves business profits before interest then it follows that future profits and income tax should increase. Additionally, improved profit in the business subject to private equity ownership will in due course enhance the likelihood of that business being re-offered to the public in a public float, which will then again see profits enhanced. Typically the ownership of a business by private equity investors should be seen as temporary and should not result in major impacts on the Australian tax base.

4.4 Why international tax concerns about financing of private equity transactions do not apply in the same way to Australia

There is debate in some countries about the impact of high levels of debt that may be used in private equity transactions including the resulting increased interest deductions. However there are several major distinctions between Australia's tax business system and that of other countries.

First, Australia taxes superannuation funds at 15% of their taxable income. Australia is almost unique in the world in taxing superannuation funds. As a result, Australia has a reduced opportunity for tax arbitrage through debt instruments being issued between taxable and nil-taxed entities.

Australian superannuation funds are prima facie taxed at 15% (integrity measures tax some 'special income' at 45% however) compared to the UK where retirement funds are not taxed.
As a result, structures might be adopted in other countries whereby retirement funds will be encouraged to lend funds to private equity transactions, generating tax deductions for the business and no tax revenue from the retirement fund. By contrast, the only Australian retirement funds which are tax-free on their income are pension funds.

Second, Australian superannuation funds are also entitled to tax offsets for franking credits attached to franked dividends and to refunds of any excess credits. This attraction to franked dividends encourages tax neutrality for Australian superannuation funds between franked dividend income from companies and interest income, and reduces the tendency for tax-motivated leverage in transactions. Private equity transactions might nonetheless have significant debt for purposes of finance flexibility, but there is not the strong tax incentive to use shareholder debt which exists in other countries.

Third, Australia also has comprehensive debt:equity borderline integrity rules, introduced with effect from 2001. These rules ensure that interest deductions are allowed only for genuine debt and not for equity-like interests. The rules apply to all domestic financing arrangements. These rules, contained in Division 974 of the income Tax Assessment Act 1997, were introduced in response to various privatisation and other transactions which involved heavy leverage and attempts to seek tax-deductible debt status for quasi-equity arrangements. Australia's debt:equity rules have restricted the scope for companies to use debt funds which are at-risk and are really repackaged equity investments and help to support the tax revenue flowing from Australian companies. Other countries do not have such rules, which requires them to consider development of similar tax policies.

Fourth, Australia has thin capitalisation laws that limit deductions for interest, broadly to a 3 to 1 debt to equity ratio. These rules apply in relation to Australian companies investing overseas, and foreign-owned Australian companies. These rules operate to limit over-leveraging of Australian companies involved in international business. These rules were reformed in 2001 and, as Treasurer Costello recently noted[4], are monitored by the ATO.

Australia should, in our view, be less sensitive to issues of debt leverage and interest deductibility than might be the case in the UK for example which does not have a formal 3:1 debt equity thin capitalisation ratio.

Australia does not have domestic thin capitalisation rules for debt issued by an Australian-owned entity with no assets outside Australia. Interest incurred by the borrower will be an allowable deduction subject to normal deductibility principles and interest earned by the lender will be included in their assessable income. However we emphasise that, unlike the position in other OECD and non-OECD countries, Australian superannuation funds are taxable on their investment income. And, unlike the other countries, if an Australian company were to pay dividends to an Australian superannuation fund, the fund would receive a credit for the underlying company tax paid.

These significant structural features of Australia's tax system, which have been introduced or adjusted in the last few years, have addressed the issues of tax arbitrage which became evident in the 1990s. These features reduce substantially the tax revenue risk in Australia flowing from tax arbitrage between companies one the one hand and tax-exempt retirement funds on the other, which is a greater feature of other countries' tax systems.

[4] "Costello puts private equity on tax alert", AFR, 10 April 2007, page 1

We recommend that the report of the committee should highlight, when considering the results of any tax review of private equity in other countries, or tax policy changes in other countries, the different tax environments in other countries relating to:

- Taxation of superannuation funds
- Debt:equity rules and
- Thin capitalisation rules.

4.5 Tax impact of the acquirers eventually re-selling the target companies

The income tax impact when private equity investors eventually re-list or sell their shares is also relevant.

If the participants are Australian resident taxpayers they will have Australian tax to pay on the disposal, either as a revenue gain or under the capital gains tax (CGT) rules.

If the vendors are non residents and the sale is not of a land-rich company there will be a CGT exemption under the foreign resident CGT rules introduced in 2006.

There has been some concern about whether this outcome provides undue benefit to foreign investors in Australian businesses. However we observe that:

- Foreign investors would potentially be free of Australian tax in any event under Australia's double tax treaties (DTAs), if the non-resident's investment is of an income nature. Under ordinary international DTAs, such as the standard DTA issued by the OECD, a foreign investor in a treaty country is not taxed on business profits if they have no permanent establishment in that country. See for example Article 7 of the Australia-UK DTA. Australia has DTAs with similar effect with most of our major trading partners.
- Thus, foreign private equity investors would potentially be free of Australian tax in any event under Australia's DTAs, if they characterise their private equity investment as a short-term trading asset.

  Correspondingly, Australian private equity participants in foreign transactions will enjoy similar opportunities under Australia's DTAs with those foreign jurisdictions. As well, other foreign jurisdictions have concessions for foreign investors selling shares in local companies.
- The CGT amendments which were introduced in 2006 flowed from a desire to align Australia's international CGT rules with those of other countries such as the US or UK which do not tax non-residents on investments other than investments in land-rich companies (such as applies in the US). The intention of this measure was to reduce disincentives to foreign investors to establish and grow their Australian subsidiaries, otherwise foreign owners of Australian subsidiaries would be dissuaded from investing because they would not be able to restructure or sell those subsidiaries without an Australian tax impost on the disposal. This measure therefore better aligned Australia's tax rules with those of other countries.

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In our view, there is no basis for Australia to change its tax policy settings in relation to Australian-sourced or foreign-sourced private equity. Further, if any changes in the tax settings were ever

contemplated, these would need to be supported by compelling and unambiguous policy rationales emerging from an overall policy review of all of the issues including the deductibility (and assessability) of interest as well as the taxation of capital gains, because changes introduced in isolation create a risk of bad or inconsistent policy outcomes.

If you wish to discuss any aspect of this submission please contact in the first instance Alf Capito on 02 8295 6473 or Tony Stolarek on 03 8650 7654.

Yours faithfully

Alf Capito
Partner

Appendix 1

Extracts from a speech by Economic Secretary to the Treasury, Ed Balls, MP to the London Business School London, 8 March 2007[5]

"Introduction

"6. … today I want to look back on some of those reforms -- through the lens of long-termism -- a lens which, as I will argue, is also the right way to view recent debates in relation to different models of ownership of British companies. A platform of long-term stability …

18. For decades the UK's productivity performance has lagged behind that of many industrialised economies. And while the macroeconomic instability of the past had contributed to these productivity gaps, the problem of short-termism in the British economy ran deeper -- and goes to the heart of how a modern and dynamic economy works.

19. The fact is that most productivity improvement does not come from weak firms becoming strong. It comes from innovative and profitable firms expanding, new firms entering and the weak going out of business. It is this process of competition in which lies the very essence of a dynamic economy. And in such dynamism lies not only the strength and resilience to adapt to survive, but the flexibility to respond to new markets and new opportunities -- driving the economy into a cycle of increasing productivity.

20. So a dynamic and successful economy depends on two key characteristics. First, competition so that firms experience pressure to adapt and change. And second, companies succeeding through making the right long-term investments in the areas which are critical to competitive advantage -- with government playing a vital role in promoting competition, supporting companies to make long-term investment decisions and equipping employees with the skills and opportunities they need to prosper and move from job to job…

23. Since 1997, our wider approach to industrial and economic policy has been to understand and tackle barriers to long-term investment and dynamism. Our approach has been shaped around what we have called the five "drivers" of productivity growth: competition; enterprise; innovation; skills; and investment…

30. It is the fifth driver, investment, that I want particularly to focus on today -- and where the issue of long-termism arises most acutely.

31. A decade of stability has undoubtedly helped improve the environment for UK businesses to invest -- and since 1997 we have seen the fastest growth in business investment in any nine-year period since data began in the 1960s. We have also reformed the tax system to support long-term investment, matching CGT reform with the R&D tax credit. And we are responding to business concerns about regulations with all regulators now introducing a risk-based approach as set out by Philip Hampton's report and annual simplification plans to outline what government departments are doing to reduce burdens and remove old laws.

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[5] Available on http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/press_27_07.cfm

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The Investment Chain

32. But the environment which determines the climate for investment is not simply a function of macroeconomics, tax, or regulation, vital though these all are. Investment decisions are also determined by a chain of relationships -- we call this the "investment chain" -- linking the owners of capital, through savings products or pensions, to institutional investors, to fund managers to the boards of companies, themselves accountable to shareholders. ..

36. Since 1997, we have set out systematically to review each link in the investment chain, and have conducted a number of major reviews -- by Paul Myners, Ron Sandler, Sir Derek Higgs and Sir Derek Morris -- to look different aspects of the workings of the chain. These have identified a number of important issues.

37. First, a lack of effective pressure on companies and institutional investors from consumers of financial saving and investment products to pursue their long-term best interests. This arises partly from a lack of financial skills on the part of savers, partly from a lack of transparency in certain products; but also from historic weaknesses in the role and expertise of those whose role it is to protect customers' interests -- especially pension fund trustees.

38. Second, the sheer complexity of the chain and real questions over whether those acting at each stage of the chain have the right incentives and expertise to ensure that the long-term interests of savers and pension fund beneficiaries are effectively represented.

39. Third, concerns around the governance of public companies, including the need to strengthen the oversight of non-executive directors and their accountability to shareholders.

40. Fourth, Myners pointed to the tension inherent in money being invested for the very long term -- in pension or life funds -- but typically managed by fund managers judged on the basis of quarterly performance league-tables and the risk of unnecessary short-termism as a result.

41. A great deal of change in some areas of the investment chain has been achieved -- partly as a result of market developments and conditions, partly as a result of regulation and self-regulation following these reviews:…

The debate about private equity

46. What our work on the investment chain has not suggested, however, is that -- from the point of view of the health of the British economy -- any particular form of ownership is inherently to be preferred over any other. On the contrary, whatever the form of ownership -- the real issue for the investors whose money is at stake, for the health of the company concerned, for the workers whose jobs depend on the company's success, and ultimately for the economy as a whole, is how effectively that ownership is exercised, in promoting the long-term creation of value, investment and employment.

47. Which takes me to the debates of recent weeks about the role of private equity in the British economy. It is in this context of effective ownership to meet these long-term goals that we should view private equity.

48. You will know that, starting from some high profile specific cases, wider fears have been raised that private equity firms can be particularly short-termist -- and therefore impact negatively on jobs and investment in the companies in which they take an interest.

49. For some, the fear is that private equity is simply based on financial engineering -- rearranging a company's balance sheet and potentially taking on excessive debt without transforming the underlying commercial reality of the business. For others, the fear is that private equity relies on "hollowing businesses out", dressing companies up for sale, making short-term earnings look good at the expense of long-term investment in capital, skills or R&D.

50. But, as I have argued, we know too that private equity can be a positive form of governance and help to reinvigorate a company and strengthen its long-term prospects. This is achieved mainly through changing management incentives, improving productivity and making more efficient long-term investment decisions.

51. Let me start by with a few words of caution:

First it is important to keep this in perspective -- private equity remains a relatively small, although growing, part of our economy;
Second, this is not a subject about which it is easy to generalise. Transactions vary very widely in their nature and impact -- and the picture is also constantly changing;
And third, although this is proving a rich area for more academic study, the evidence base remains weak and the results that emerge are inevitably to some extent conflicting and mixed.

52. Nevertheless, some facts are reasonably clear.

53. First, while private equity does play a relatively small role in our economy, it is significant and growing. Private equity investment in UK firms amounted to approximately £7 billion in 2005, an increase of almost £4 billion on the rate in 1997. And it is this growth that has heightened interest in the sector.

54. Second, there is a reasonable consensus that private equity investment has -- on average -- a positive impact on productivity. For example one study of over 35,000 UK manufacturing firms found a substantial increase -- of over 90% -- in productivity for those firms which received private equity investment.

55. Third, private equity can also have an impact on employment -- though this may be more complex than it first appears. A study by Nottingham University shows that whilst employment typically fell in the first year following a leveraged buy-out, it rose strongly thereafter with employment levels 26 per cent higher after five years.

56. Fourth, evidence suggests that private equity firms do, in fact, tend to hold onto companies for the length of time it takes to add the value they can to the business before selling on. And on average this is around three years -- 20 per cent longer than the average length of time institutional investors hold shares, suggesting that private equity, without the short-term pressure of quarterly reporting, may, in fact, be able to take a longer-term view.

57. Fifth, of course, as with all investments, there are 'bad' ones as well as 'good' ones. Particular private equity transactions can and do occur that add no value, or conceivably even destroy it. But the fear that this is the norm is very difficult to square with the aggregate evidence about the sector's impact. The conclusion I draw from the evidence, taken overall, is that private equity can play an important role in our economy, and especially in exposing companies to dynamic competitive challenge.

58. So what should be the attitude of government?

59. Private equity, like any other form of ownership, has good and bad aspects -- and it has features of both long-termism and short-termism. But the evidence does not suggest that Government has any intrinsic reason either to "favour" private equity or to do the opposite.

60. Our aim should be to support economic dynamism and long-term investment and job creation. And the Government's objectives in the field of private equity should be no different from its objectives in relation to any other form of ownership: to promote an environment of long-term, sustainable business success, underpinned by a strong culture of clear disclosure to, and engagement with, underlying investors. This is the way to ensure that "good" long-term investment propositions prosper.

61. One potential advantage of private equity is that the long and complex chain of ownership and communication does not exist, giving the owners of capital much clearer direction of the businesses which they are financing. The shorter chain, the clearer targets and accountabilities, and the stronger incentives which can be put in place, all have the potential to provide higher levels of efficiency. These advantages will in some cases outweigh the benefits of public market ownership, such as access to large amounts of long-term risk capital and the ability to attract top management talent, although investors need to be vigilant, too, about any potential for misalignment of incentives within the private equity model. Moreover, it is harder for private equity to do this if it fails to provide the information needed to judge its contribution to a modern economy, or if there is any obscurity in its information flows to its investors.

62. A number of important issues relating to private equity have been highlighted in recent weeks and I would like to comment on each of them in turn. They relate particularly to regulation, disclosure, and tax.

63. First, regulation.

64. With the private equity market becoming an increasingly important component of UK and international capital markets it is right to consider whether there is currently an appropriate level of regulatory engagement with the sector.

65. The FSA regulates the private equity market activity through, for example, the authorisation of firms conducting regulated activities such as investment management. It manages potential systemic risks via the potential channels of contagion through effective supervision of the institutions which lend to private equity, including specifically monitoring exposures to leveraged buy- outs. The FSA issued a discussion paper in November, identifying potential risks the sector may pose such as excessive leverage or unclear ownership of economic risk. As the report stresses, these are risks that also arise in other types of markets with other types of institutions and the FSA concludes that its approach to the risks is both risk-based and proportionate. Whilst confident that the current arrangements are robust, the FSA has also identified a number of potential options to improve further the efficiency and effectiveness of their regulatory approach, on which they are seeking comments through their consultation exercise.

66. Also, in the field of pensions regulation, private equity firms share the same responsibilities as other companies who have made pension commitments to their staff. We created The Pensions Regulator in April 2005 to ensure that, in common with companies with other forms of ownership, private equity firms act responsibly to properly fund work-based pension schemes over time, including following any company restructuring. We also set up the Pension Protection Fund in April 2005 to protect pension scheme members' benefits should the sponsoring employer become insolvent when the scheme is in deficit. All defined benefit pension schemes which could qualify for help must pay a levy to ensure their scheme members are protected should the worst happen.

67. Second, disclosure.

68. Large private equity-owned companies are not required to provide operating and performance data of the same quality and depth as listed companies. And what they are required to publish can be published much later.

69. This difference is logical …

73. So we welcome the announcement last week that Sir David Walker will chair an independent working party to develop a voluntary comply-or-explain code to improve the private equity industry's transparency and level of disclosures for large companies in these areas. This initiative has received wide support across the industry, demonstrating a commitment to make this happen, and also a desire to meet the legitimate concerns of interested parties…

75. And third, tax.

76. The Government has actively promoted a number of tax measures which have been particularly relevant to investment in early-stage firms. These include the Enterprise Investment Scheme, R&D tax credits payable for small businesses and capital gains tax taper relief. But the question has been raised in recent weeks as to whether our tax system gives an unfair advantage to private equity over other forms of ownership -- in particular as a result of the tax-deductibility of interest.

77. There is, of course, nothing specific to private equity in the tax-deductibility of interest. Any kind of company can claim it, and most quoted companies do. It is also the international norm -- that interest is in general treated as a business expense and deductible from taxable profits for companies in any form of ownership. We have no plans to review this principle.

78. However, concerns have been raised with the Treasury that something further may in some cases be occurring -- in particular, that 'shareholder debt' is replacing the equity element in highly leveraged private equity funding arrangements. This shareholder debt is a form of risk-bearing equity that is treated as debt for tax purposes, giving these arrangements a tax advantage that is inconsistent with the principle that interest is a business expense. Tax legislation already distinguishes between debt and equity and contains detailed provisions to ensure that equity is not disguised as debt to obtain a tax deduction. Rules have changed from time to time over many years to adapt to the development of new financial instruments and forms of debt, most recently changes in 2005 to enable the transfer pricing rules to be applied more readily to the issue of shareholder debt.

79. Today, I can announce that the Government will review the current rules that apply to the use of shareholder debt where it replaces the equity element in highly leveraged deals in the light of market developments, to ensure that existing rules are working as intended and report back by the Pre-Budget Report. This is consistent with the Government's focus on ensuring that commercial decisions are taken on a level playing field, take a long-term view and maximise opportunities for employment and investment.

Conclusion

80. So, I end where I started -- the Government's central economic objective of high and stable levels of growth and employment and the importance of encouraging the long-term investment and engagement to get there…. "