Private equity can help itself – and the public

By Jeffrey Garten
Published: March 14 2007 19:31 | Last updated: March 14 2007 19:31

Private equity firms have been accused of asset stripping in Europe and anti-competitive activity in the US, with additional charges of improper tax treatment of partners' incomes now arising in Washington. That is why several big American private equity firms, such as Blackstone, Texas Pacific, KKR and Carlyle, created their own trade association in Washington last December – the Private Equity Council. For similar reasons, earlier this month, the British Private Equity and Venture Capital Association launched a task force to write a code of conduct for the kind of information private equity firms should publicly disclose.

These moves are not enough. In view of their size, the range of the companies they own, the wealth they have created for their partners, the secrecy that surrounds them and the spectre of bigger and more politically sensitive deals ahead, private equity firms' plans to lobby Congress or to make available a modest bit of information will not mollify critics and regulators. Here, then, are the additional measures they might consider.

The first priority should be to allay fears that the enormous financial leverage that private equity firms employ does not risk widespread danger to the global financial system. The worry is that the massive pools of cheap money sloshing around the globe could begin to dry up, causing one or more private equity firms to experience debt problems, perhaps producing a knock-on effect with banks and hedge funds.

In order to deal with this potential problem, big firms could voluntarily give detailed information on their capital structures, borrowings and debt service strategies to central banks on a confidential basis. This way, no one would be left doubting that the authorities have the right information to uphold their responsibility for financial stability. The big private equity firms should also create an independent and fully endowed foundation to collect other types of data that could clear up many alleged misconceptions about what they do.

This includes information that addresses whether, in the interest of cost-cutting, private equity firms are squeezing employment for strictly short-term gains, neglecting environmental obligations, gutting important research and development efforts, or hollowing out once-vibrant communities. It also involves information on how private equity investments perform once they go public. The data should be audited by one of the four big accounting firms. The independent foundation plus the third-party attestation will be essential to prove the credibility of information. Such credibility will never come from industry-owned trade associations.

Third, one reason why private equity firms have attracted so much attention is the enormous wealth that their partners have accumulated. These men and women could create charitable organisations, perhaps in the names of their firm, with the scale and scope that parallels that of the private equity groups themselves.

Some of the funds might assist workers to be retrained, or invest in communities that have suffered as a result of industrial restructuring. It took Andrew Carnegie and John Rockefeller a long time to become major philanthropists. Bill Gates did it in much shorter time and to almost immediate positive effect to himself and his company. The new tycoons might take note.

None of these measures will prevent increased public scrutiny, nor bouts of negative media coverage. They will not help much if a gigantic deal explodes, exposing shaky underlying financial structures and causing government investigations.

What is certain, however, is that without a more fulsome strategy that goes beyond what private equity firms seem to be contemplating, these companies will be hanging from an even more precarious limb.

That is not good. The world needs a robust private equity sector alongside, and in tension with, the public markets. Private equity investors create billions of dollars of value. They challenge complacent management and boards of directors to think like owners. They will be a leading edge of the massive corporate restructuring that will take place as emerging market companies become actually world players. In helping themselves the private equity firms are serving the broader public interest.

The writer is the Juan Trippe professor of international trade and finance at the Yale School of Management

Copyright The Financial Times Limited 2007