

THE (NON)SENSE OF PRIVATE EQUITY REGULATION?

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Abstract: *The 2007-2009 global financial turmoil has taught risk managers lessons that will be crucial for developing more stable financial markets in the future. Private equity funds are sometimes believed to have played a major role during this global financial turmoil. In the light of serious economic problems, questions arose whether the regulation of these funds were sufficient or whether the effects of the global crisis would have been mitigated if regulation and supervision had been stricter. In this paper we argue that the private equity regulatory proposals included in the Directive on Alternative Investment Fund Managers in the European Union and the Dodd-Frank Act in the USA will be inefficient, i.e. the costs of such regulations will outweigh its benefits and will not offer future market protection.*

Keywords: *Private Equity, Regulation, MAC Questions, Global Crisis, Financial Markets.*

JEL Classification: *G01, G23, K23, L51.*

1 Introduction

Private equity funds are often believed to have played a significant role during this global financial turmoil. For instance, [10] argues that private equity contributed to the extent of the crisis and increased the pace of its spread over the world. Subsequently, in the light of serious economic problems, questions arose whether regulations of these funds were sufficient or whether the effects of the global crisis could have been smoothed, if regulation and supervision had been stricter. As a result, many ideas of reforming the regulatory framework of the overall financial system including private equity have arisen.

In this paper we analyze private equity business in the light of the global crisis. Moreover, we focus on positives and negatives of two key regulation initiatives in this respect – The Directive on Alternative Investment Fund Managers (the “AIFM Directive”) in the European Union and the Dodd-Frank Act in the USA. The paper is structured as follows. After short introduction, we discuss basic terms related to private equity. The third part provides an overview of the worldwide private equity market. In the fourth section, we provide an empirical analysis of current private equity regulation. Finally, in the fifth section we conclude the paper.

2 Basic Terms

Private equity might be defined as “*a broad term that refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market. This also includes public companies that are delisted as part of the transaction*” ([15], p.2). The term private equity encompasses several industries –

buyouts (investments in more mature companies), venture capital (investment in companies that have undeveloped or developing products), expansion capital (financing for growth and expansion of a company which makes a profit), etc. Although there are important distinctions between these terms, they tend to be generally referred to as private equity [7].

Buyout is a slightly more often used form of private equity investment. As can be seen in Figure 1, buyouts accounted for 66% of total funds raised in 2008, while in 2009 they accounted for 57%. The smaller category – venture capital – is further divided into four subcategories:

- (1) *seed stage* represents financing of research and development of an initial concept,
- (2) *start-up stage* focuses on facilitating product development and marketing,
- (3) *expansion stage* finances growth of a company which is already making a profit,
- (4) *replacement capital* represents an acquisition of existing shares in a company from another private equity investor or from other shareholders.

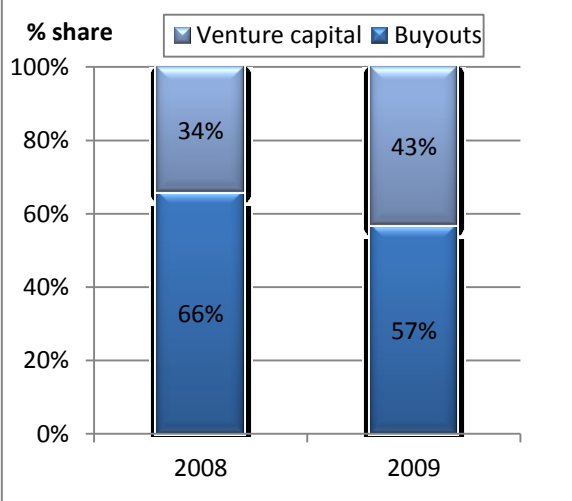


Figure 1: Private equity funds raised by expected form of investment

Source: <http://www.thecityuk.com/media/179004/private%20equity%202010.pdf>

Private equity firms create private equity funds – large pools of private money used for investing in companies. Like hedge funds, private equity funds belong to the group of contractual savings institutions. [7] defines them as unregistered private collective investment vehicles pooling money from investors to invest in equity securities. Private equity funds are legally set up usually as limited partnerships, with the private equity firm as a general partner (analogy to hedge fund managers) and the investors as limited partners. The objective of a private equity fund is to invest in the equity of different, mostly unlisted, companies and to generate profits stemming from holding stocks of a particular company in a portfolio which is then distributed among investors of the fund. Private equity management of a portfolio company works to improve the company’s performance, so that its stock price rises. The private equity fund then earns profit by exiting the company, either by an IPO of its stock or by a direct sale.

According to [7], a typical private equity fund has a lifetime of ten years, with the first five years of investment period, i.e. the period when managers of the private equity firm are allowed to invest in new companies and demand the committed capital from investors, and the second five years for carrying on of the existing investments or exiting of the existing portfolio companies. Actually, private equity funds bear many similarities with hedge funds (a special type of a mutual fund for wealthy individuals) such as:

- **accredited investors**

The private equity funds investors are either institutional or they are the high net worth individuals. To qualify for an investment in the fund, they must be accredited at first, i.e. they must be willing to invest certain minimum amount of money. Minimum requirements for investments vary considerably across funds. Like hedge funds, private equity funds do not attract investors publicly by advertising but rather directly or through a broker.

- **managerial and performance fees**

Managers in a private equity firm who run a fund typically charge a management fee and a performance fee. The former one, being the only source of fixed income, has traditionally been computed as a fixed annual rate from the committed capital, e.g. 2% a year over the life of the fund, say 10 years, hence accounting for 20% of the committed capital altogether, leaving 80% of the committed capital free for investments. Recently, however, a trend of a decreasing management fee has prevailed. In such a case, managers charge certain fee over the investment period, which is then decreased by a certain amount of basis points a year after the investment period has ended [7]. The performance fee is a source of variable income and it is computed as a percentage of the profits of the fund.

- **lack of regulation**

Similarly to hedge funds, private equity funds usually operate exempt from the obligation of registration with the regulatory authorities, hence without any or with only a light touch of regulatory requirements.

- **leverage**

In case of buyouts, private equity funds use leverage as well as private funds for investing in selected companies. Actually, there is a category of the private equity business which is called leveraged buyouts which uses heavy leverage for acquiring portfolio companies, so that the committed capital is diversified among many investments. Usually, the assets of an acquired company serve as collateral to the loan. Moreover, also the portfolio companies of a private equity fund use leverage, although much lower than the large financial institutions [9].

There are however significant differences that distinguish private equity funds from hedge funds. Let us review them briefly:

- **invested capital vs. committed capital**

Unlike in case of hedge funds or mutual funds, the level of assets under management of private equity funds is not well-defined, since private equity firms

receive only commitments from investors to provide funds when needed for investments of the private equity fund [7]. The total amount of such commitments is referred to as the committed capital. Hence private equity funds do not maintain a pool of uninvested capital but they rather perform a capital call to investors when the private equity firm – the general partner – decides to invest in a selected company.

- **infrequent redemptions vs. virtually no redemptions**

Investment in the fund is of a long-term nature with very few possibilities, if any, to withdraw money from the fund before the end of the ex-ante contracted investment term. However, over the life of a fund there can be a cash distribution among investors in case the fund sells its investment in a portfolio company, or the fund can distribute company shares instead.

- **variety of investment strategies vs. long-term investment in a portfolio company**

While the main objective of a hedge fund is to create short-term profit and for this purpose it uses many different strategies combining short and long positions, private equity funds invest long-term, working to improve the company’s performance, cut costs, sell assets and motivate the management of the company [7].

3 The Global Private Equity Market

Over recent years, the interest in the private equity market has grown rapidly because of the fact that private equity investments have experienced constantly higher returns than other more conventional forms of investment. The growth of private equity market over recent years has taken place largely thanks to private equity funds which act as intermediaries in the market. On one side there are investors, on the other issuers of securities. According to [[12]1], almost four-fifths of private equity investments flow through intermediaries, the rest being invested directly in the issuers. Most of the overall private equity capital comes from institutional investors. The structure of a private equity market looks as illustrated in Fig. 2.

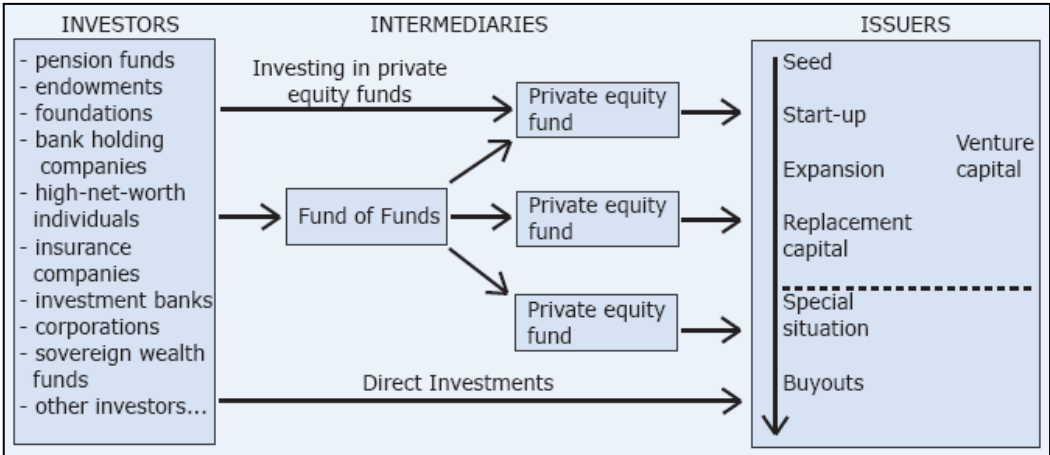


Fig. 2: Private equity market

Source: (<http://www.thecityuk.com/media/179004/private%20equity%202010.pdf>)

Tab. 1 demonstrates the number of persons directly employed in the private equity industry in the UK as well as in the whole EU are presented in the year of 2008. Moreover, the table proves that tax inflow generated from private equity industry is also significant.

Tab. 1: Contribution of the private equity industry to the economy – amount of tax revenues generated and people directly employed in 2008

	Tax (€ million)	People employed
United Kingdom	2,433	8,147
European Union	4,989	27,272

Source: OpenEurope (2009)

At the end of 2009, assets under management of private equity firms worldwide totalled over \$2.5 trillion, a value only slightly higher than in 2008. Thereof funds available for investment accounted for approx. \$1 trillion or 40%. Fig. 3 depicts that the growth of assets under management over recent years has been mostly due to the growth of the unrealised portfolio value because of lower investment activity associated with falls in equity markets [14].

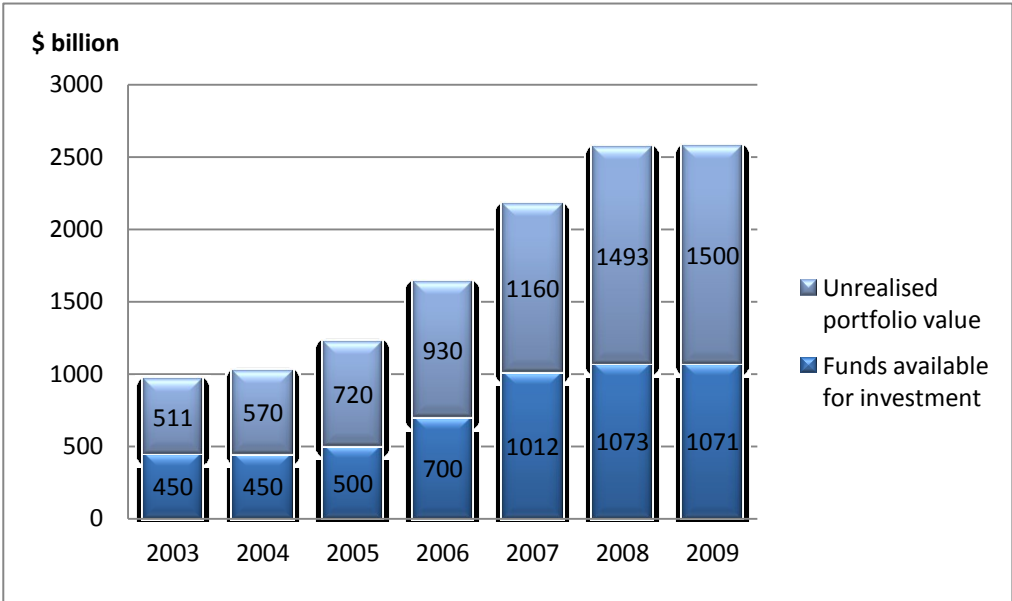


Fig. 3: Private equity assets under management worldwide

Source: (<http://www.thecityuk.com/media/179004/private%20equity%202010.pdf>)

Key Players

At the end of 2009, the world’s largest private equity firm was Goldman Sachs Principal Investment Area with amount of capital raised equal to \$54.6 billion and thus comparable to the amount of assets under management of the largest hedge fund. It was followed by The Carlyle Group with \$47.8 billion and Kohlberg Kravis Roberts

with \$47 billion. Similarly as in case of the hedge fund industry, New York and London are the key locations for private equity firms. Of the ten major private equity firms listed in Table 2, five are based in New York (Firms 1, 3, 5, 7 and 9) and two in London (Firms 6 and 10).

Tab. 2: Largest private equity firms by amount of capital raised for direct private equity investment in 5 years up to end-2009

Private Equity Firm	\$ billion
1. Goldman Sachs Principal Inv. Area	54.6
2. The Carlyle Group	47.8
3. Kohlberg Kravis Roberts	47.0
4. TPG	45.1
5. Apollo Global Management	34.7
6. Bain Capital	34.2
7. CVC Capital Partners	31.1
8. The Blackstone Group	29.2
9. Bain Capital	23.0
10. Warburg Pincus	21.7

Source: (<http://www.thecityuk.com/media/179004/private%20equity%202010.pdf>)

Key Transactions

The three biggest transactions in the private equity market during 2009 and the first half of 2010 were the \$3.9 billion acquisition of Talecris Biotherapeutics by Grifols SA, the \$3.1 billion acquisition of Bridas Corp. by CNOOC Ltd. and the \$3.0 billion acquisition of Interactive Data Corp. by Interactive Data SPV. Tab. 3 displays a more comprehensive list of private equity deals.

Tab. 3: Largest private equity transactions during 2009 and the first half of 2010

Transaction	Private Equity Firm (Acquirer)	\$ billion
1. Talecris Biotherapeutics	Grifols SA	3.9
2. Bridas Corp.	CNOOC Ltd.	3.1
3. Interactive Data Corp.	Interactive Data SPV	3.0
4. Healthscope Ltd.	Healthscope Ltd. SPV	2.1
5. Michael Foods Inc.	GS Capital Partners	1.7
6. Styron Corp	Bain Capital Partners	1.6
7. Pets At Home Ltd	KKR & Co	1.5
8. DynCorp International	Cerberus Capital	1.4

Source: www.reuters.com

Although they were the largest over recent 20 months, these transactions were still relatively small. It becomes obvious immediately when compared to the list of largest transactions generally (Tab. 4). The differences from the pre-crisis amounts are striking. The sum of the eight largest private equity investments of 2009 and the first half of 2010 is only slightly higher than the single seventh largest private equity transaction generally. According to [11], the sharp decline has taken place due to

buyout managers shifting funds to distressed debt, bankruptcy financing, private investments in public equity, emerging markets and financial institutions.

Tab. 4: Largest private equity transactions until 2010

Transaction	Private Equity Firm (Acquirer)	\$ billion
1. Equity Office Properties Trust (2007)	Blackstone	38.9
2. Hospital Corp. of America (2006)	Bain, KKR, Merrill Lynch	32.7
3. RJR Nabisco (1989)	KKR	31.1
4. Harrah's Entertainment (2006)	Apollo, Texas Pacific	27.4
5. Clear Channel Communications (2006)	Bain, Thomas H. Lee	25.7
6. Kinder Morgan (2006)	Carlyle, Riverstone, Goldman Sachs	21.6
7. Freescale Semiconductor (2006)	Blackstone, Carlyle, Permira, Texas Pacific	17.6
8. Albertson's (2006)	Cerberus	17.4

Source: <http://finance.fortune.cnn.com>

Interestingly, Tab. 4 shows that the year of 2006 was really good for the private equity industry, as six of the eight largest private equity transactions of all times took place in this year. The years 2006-2008 were by far the most successful over recent decade as for both funds raised as well as funds invested. On the other hand, the year 2009 experienced a steep decline in both values as the markets were hit by global crisis (for more details on risk management during the global turmoil see, for example, [1]). These facts prove a high correlation of private equity deals with economic cycles.

4 Private Equity Regulation

Before discussing advantages and drawbacks of private equity regulation we will present so called “MAC” questions in regulation theory as developed by [12]. There are three fundamental questions for regulators when intending regulation of any industry and entity:

1. **Materiality** – Are activities of a newly regulated entity material and significant? Does this future regulated entity play a significant role on the relevant market?
2. **Accountability** - Is the entity accountable, can the regulator easily described and defined it?
3. **Credibility** – How successful were similar regulations? Does any applicable best-practice regulation exist?

Effective regulation (i.e. its benefits outweigh its costs) requires positive answers to all three questions. However, private equity regulation fulfils neither of these answers. Firstly, private equity business is insignificant in a global scale - [14] estimates that private equity amounted to less than 2% of total assets under management of world financial institutions as of the end of 2009. Secondly, the term private equity encompasses many forms of business, what makes the scope of the regulation difficult to capture. Finally, regulation of financial markets does not seem to be efficient when

considering both Basel capital accords (Basel II and Basel III) in the field of banking industry.

Similarly to hedge funds, private equity funds have traditionally been exempt from financial regulation imposed on traditional investment vehicles. What distinguishes them from hedge funds, however, is that there seems to be a wider agreement on the fact that private equity funds do not represent a significant threat to the financial system. Private equity managers deal almost exclusively with sophisticated investors who are able to assess and understand all the risk stemming from the investment. This fact is very much reflected in the type and level of regulation of private equity funds.[[14]3]

There are further arguments refusing the idea about private equity funds being systemically risky which are mostly of the following nature: [9]

- private equity relies on long-term capital and invests mostly in illiquid assets, hence the funds are not subject to runs, as was the case of many other investment vehicles
- they do not have to sell assets in times of diminishing prices in order to fund investors' redemptions, since there are usually no redemption periods
- low, if any, leverage in comparison to other (alternative) investment vehicles
- portfolio companies are not deeply inter-connected with other players in the financial markets, hence they are not likely to trigger a series of losses leading to systemic risk
- private equity funds' portfolios are diversified across multiple industries, hence they are not exposed to any single sector performance risk.

The opinion of private equity funds not being systemically risky is supported also by the [4] stating that “*private equity funds, due to their investment strategies and a different use of leverage than hedge funds, did not contribute to the increased macro-prudential risk*”. Further, neither the De Larosière Report nor the Turner Review deal with private equity funds at all, on the contrary to hedge funds. This suggests a wide agreement among experts on private equity funds being not of a systemic importance.

Indeed, considering the EU, until recently there was no harmonised regulatory framework for private equity at the EU level. Instead, the industry was regulated on a national basis in most EU member states. Notwithstanding, according to EVCA, the private equity industry was indirectly affected by other EU legislature, such as the Markets in Financial Instruments Directive, UCITS, the Pension Funds Directive, and the Capital Requirements Directive in a way of placing regulatory requirements on the institutional investors investing in private equity funds [3],[5].

Nevertheless, the main documents representing the post-crisis regulatory response of both EU and the U.S. actually do deal with private equity, mostly because the alternative investment sector of the financial market, which along private equity covers also hedge funds, etc., is usually looked at en block by the regulatory authorities. So, the AIFM Directive reshapes regulatory framework of the European AIFs, including private equity funds. And it is widely criticized for this “one-size-fits-all” approach,

since, besides not distinguishing between various types of AIFs, it does not even distinguish between systemically important funds and those with no systemic potential [8]. Hence, private equity funds are subject to the same requirements as hedge funds although they are much less controversial from the systemic point of view. Further, although the industry welcomes the fact that some kind of legal certainty has been achieved, it is concerned that some provisions of the Directive might cause an unintended harm to small businesses in the form of adversely affecting financing of SMEs [[14]]. Aside from that, outcomes of the discussion of the AIFM Directive provisions are included in Tab. 5.

The adoption of the Dodd-Frank Act in the U.S. will have broad consequences for private equity funds. According to the Act, all private equity funds with more than \$150 million of assets are subject to registration as well as periodic inspections by the SEC. If the SEC finds the fund too risky, it can place it under the Fed supervision [2]. Venture capital funds are exempted from the obligations imposed by the Act which generally is a welcomed fact, since companies benefiting from the activity of venture capital funds will not be adversely affected. The Volcker Rule, which is incorporated in the Act, limits banks in their investments in private equity funds. Generally, the Act places heavy focus on banking institutions while imposing only moderate provisions upon alternative investment vehicles. Hence it creates a competitive advantage for institutions such as private equity funds in a way that they are likely to benefit from banks being forbidden to engage in certain activities, e.g. proprietary trading.

Tab. 5: Summary of the proposed or adopted modifications of the private equity regulatory framework

Author/Measure	Year	Description	Advantages	Drawbacks
European Commission <i>De Larosière Report</i>	2009	De Larosière Report does not deal with private equity funds except for a minor note in Paragraph 92 stating that banks should not be prohibited from owning a private equity fund, but rather they should be monitored closely.	N/A	N/A
Financial Services Authority <i>Turner Review</i>	2009	It does not mention private equity funds at all.	N/A	N/A
European Commission <i>AIFM Directive</i>	2010	The Directive imposes registration, disclosure and transparency requirements on AIFs including private equity funds and sets conditions for the EU authorization of their managers.	Thanks to requirements imposed by the Directive, transparency of the industry will be increased. Further, the Single Market will be enhanced by allowing the authorized fund manager to market his fund throughout the	Due to its third-country policy, non-EU funds' access to the EU market will be difficult which will result in a decline in the investor choice and in the overall competitiveness of the EU. Further, the Directive's "one-size-

			EU.	fits-all” approach will have adverse affects on the private equity industry.
U.S. Government <i>Dodd-Frank Act w/ the Volcker Rule</i>	2010	Similarly as for hedge funds, the Act imposes obligation to register on private equity funds with more than \$150 million in assets and prescribes obligatory SEC inspections (venture capital funds remain exempted). The Volcker Rule prohibits banks from proprietary trading and limits their private equity activity.	More transparency is brought to the industry by registering large private equity funds, while no excessive burden is imposed on the industry. Limits placed on the private equity activity of banks create competitive advantage for private equity funds.	Despite private equity funds being far less debatable than hedge funds with respect to systemic risk, the SEC treats them equally and is empowered to extend its regulatory authority over them upon its own discretion.

Source: Authors

5 Conclusion

The 2007-2009 global financial upheaval has taught risk management lessons that will be crucial for future financial markets development. Regulation of financial markets should help diminish the negative impact of future potential crises by adding higher credibility, accountability, transparency and risk diversification of the world financial markets [[1]]. Private equity funds are often believed to have played a significant role during this global financial turmoil. In the light of serious economic problems, questions arose whether regulations of these funds were sufficient or whether the effects of the global crisis could have been smoothed, if regulation and supervision had been stricter. As a result, many ideas of reforming the regulatory framework of the overall financial system including private equity have arisen. In this paper we argue private equity regulatory proposals included in the Directive on Alternative Investment Fund Managers in the European Union and the Dodd-Frank at Act in the USA will be inefficient. This conclusion corresponds to the findings of [13], who demonstrated ineffective regulation of private equity through MAC questions in regulation theory.

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