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Should Private Equity Be Regulated?*

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Abstract

Private equity has become a multi-trillion dollar business in recent years, but its rapid growth has been accompanied by public controversy and calls for regulation. I review the policy debate, from voluntary best practice codes of UK private equity firms to proposals for supervision and control by continental European socialists, and analyse the economic case for regulation. I find little evidence of market failure and strong arguments for private ordering by investors, banks and labour unions, who appear to have both the ability and the incentives to safeguard against managerial conflicts of interest, excessive debt and other maladies. In contrast, it is doubtful whether politicians have sufficient information to fine-tune activity in this area, and more or less unpredictable policy changes may cause significant harm to business confidence. Altogether, the case for regulation is weak. However, if political pressures to 'do something' are overwhelming, as they currently appear to be, greater disclosure and transparency may be the least costly alternative.

Key words: private equity, regulation, market failure, public choice.

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* This paper draws on a previous working paper entitled 'A Review of Private Equity' by the author and Frederik Vinten.

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1. INTRODUCTION

Private equity has grown into a multi-trillion business in recent years. Companies valued at some US$ 3.6 trillion (5.5% of global GDP) are currently owned by private equity funds, 3/4 of which were acquired after 2001 (Stromberg, 2007). At the same time, private equity has become a topic for political discussion across the world. Concerns have been raised over market abuse by target company managers, excessive leverage and financial instability, lack of transparency and conflicts of interest between fund managers and investors (Ferran 2007, Yeoh 2007). Proposals to regulate range from attempts to ensure tax neutrality and transparency, to more direct intervention in capital structure, competition policy and corporate governance (Walker 2007, PES 2008).

In this paper, I analyse the rationale for political intervention in private equity. I concentrate on this question and refer to previous work to explain industry trends and characteristics (e.g., OECD, 2007a and 2007b, Cheffins and Armour 2007, Vinten and Thomsen 2008, Lerner et al. 2008).

I start by defining private equity in section 2. Ambiguity concerning the nature of the business turns out to be a major obstacle to efficient regulation. Section 3 reviews some important initiatives to regulate private equity, ranging from the mild, almost non-existing self-regulation proposed by Walker (2007) to the comprehensive proposal by the Party of European Socialists (PES). In section 4, I analyse the economic rationale for regulation, which I find too weak. Section 5 concludes. While *laissez-faire* is probably the first-best policy choice, I argue that disclosure and tax neutrality may be a more realistic second-best option.

2. WHAT IS PRIVATE EQUITY?

An important source of confusion and controversy appears to be the lack of a generally accepted definition of private equity. This is not just a purely academic question, but an important – and perhaps crucial – obstacle to regulation, since private equity activities can conceivably be carried out in many different legal forms. For example, private equity activities may be carried out by companies instead of partnerships. Attempts to regulate one form of private equity might then be contravened by the appearance of new functional forms. Alternatively, regulation may have to be very comprehensive and costly for it to be effective.

In this paper, I define private equity/buyout firms as investment funds which:

- buy, own and sell controlling positions (typically close to 100%) in mature companies;
- finance a substantial part (e.g. 2/3) of their investments by debt;
- employ fund managers paid by performance (e.g., 20% of financial returns in excess of 8% a year);

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- have a finite life span and are dissolved after a finite number of years (e.g., 5).

Although private equity funds and hedge funds are often lumped together, it is very important to distinguish between the two categories (even the OECD mixes them up, see OECD 2007). Hedge funds are short-term investors, which seek to profit from short-term speculative investments, much of which is not even directed at company stock. Hedge funds may be activist investors that try to influence corporate governance, but they typically do not acquire controlling ownership stakes. In contrast, private equity funds nearly always acquire control (i.e., 50% of the votes and typically more).

Moreover, it is important to distinguish between private equity funds and venture capital funds (for example, Kaplan and Schoar (2005) lump the two together, which is common practice in the US). Venture capital funds invest in the early stages of the company life cycle, most often in high-tech firms. Private equity funds invest in mature firms.

Finally, private equity funds are often treated as a single entity in public discussion, but there are substantial differences among them. For instance, the investment focus may differ by portfolio firm size, industry focus, domestic or international focus, seller type (industrial, family), track record and experience. In addition, some private equity firms (3i, Capman or Blackstone and, soon perhaps, KKR) are publicly listed, while others are not.

It is tempting to inquire why the confusion of definitions persists despite numerous attempts at clarification. One reason may be that it is endogenously generated in public discussion because different interest groups have different vested interests in labelling. For example, proponents of private equity may want to include venture capital in an overall definition because venture capital has a better public reputation for contribution to innovation. In contrast, critics may want to include hedge funds in the definition of private equity because of their bad press as short-term speculators. The formal, legal differences between different funds may be relatively small, while the nature of their business is in fact very different. There may also be some overlap in their work; for example, many private equity funds became involved in the dot.com firms at the end of the 1990s (Cheffins and Armour 2007). Thus, it may be difficult to curtail private equity and hedge funds without unintentionally also reducing venture capital activities.

3. INTERNATIONAL POLICY DISCUSSIONS

Currently, private equity is severely criticised by politicians both in the US and in Europe for burdening companies with excessive debt, evading taxes, asset stripping and overcompensation of CEOs and fund managers. Politicians and

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organisations across the world are calling for regulation. In this section I give an overview of the policy discussion.

I focus on two specific approaches. First, I review the UK Walker Report (Walker 2007), which is limited in scope to disclosure issues, sets very modest standards and is implemented as soft law based on comply-and-explain. I then review the proposal to the European Parliament by the PES (Party of European Socialists), which brings together the Socialist, Social Democratic and Labour Parties of the European Union (EU) comprising 33 full member parties from the 27 EU Member States and Norway. This proposal is far more radical with specific provisions on capital structure and much higher disclosure requirements. Finally, I briefly review the tax policy discussion.

3.1 The Walker Report

The UK Walker Report (2007) is a voluntary initiative by the British Venture Capital Association (BVCA) focusing on disclosure and transparency in UK private equity. Tax policy is not discussed, but the report concludes that there is a major transparency and accountability gap to be filled. The report therefore proposes voluntary guidelines on a comply-or-explain basis. The recommendations are directed at both portfolio companies, fund managers and the BVCA.

The guidelines apply to funds approved by the British Financial Standards Authority and concern only large portfolio firms with a value of more than £300 million (£500 million for private acquisitions), more than 50% of revenue generated in the UK and more than 1,000 employees in the UK. It is interesting that only companies with more than half their revenue generated in the UK are to be included, since this would imply that other countries would have to propose codes of their own to ensure similar information access. Regulation advocates will probably not hesitate to see this as a demonstration of the need for pan-European regulation.

Walker et al. recommend that such portfolio companies should publish an annual report and a summary mid-year update which include:

- Fund information, i.e., 'the identity of the private equity fund or funds that own the company, the senior managers or advisers who have oversight of the fund or funds, and detail on the composition of its board.'
- Enhanced reporting (as in public companies), i.e., 'a business review of main trends and factors likely to affect the future development, performance and position of the company's business and to include information on the company's employees, environmental matters and social and community issues' and 'a financial review to cover risk management objectives and policies.'

Each fund should disclose:

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- Fund information, i.e. 'a description of its own structure and investment approach and of the UK companies in its portfolio, an indication of the leadership of the firm in the UK and confirmation that arrangements are in place to deal with conflicts of interest.'
- A commitment to conform to the guidelines on a comply-or-explain basis;
- Investor information, i.e., 'a categorisation of its limited partners by geography and by type.'

Finally, the industry association should provide aggregated information on fundraising, investor profiles, existing portfolios, debt structures, changes in employment and investments by portfolio companies, performance measures for portfolio companies and funds as well as fee structures.

Altogether, these recommendations are very modest in scope and will almost certainly fail to satisfy public critics.

3.2 The PES proposal

The PES published a report on private equity funds and hedge funds in spring 2007 (PES 2007) which raises objections against the private equity industry for lack of openness, short-termism, tax evasion and excessive fees. The recommendations of the report consist of legislation initiatives and guidelines aimed at greater transparency, enhanced corporate governance, job safety and a fairer tax policy. Specifically, they suggest that there should be a stronger focus on disclosure at the fund level – more information on the investment strategy, disclosure of the risk management practices, details of asset ownership and the management incentive structure. The report also suggests more direct supervision of LBOs through appropriate agencies via guidelines and direct controls. Withdrawal of liquid assets from the target company should be limited so that value extraction is prevented. The EU should restrict owners' freedom to decide on management pay. Other suggestions include introducing minimum capital standards, maximum levels of debt, fair advisory fees and adequate funding of pension schemes. Deductions for interest expenditure in holding, target and subsidiary companies after the buyout should be limited. Fees to fund managers should be taxed as income, not as capital gains.

The final proposal – put forward by Poul Nyrup Rasmussen, President of the PES, to the European Commission on 18 April 2008 – is motivated by three main concerns:

- Transparency: '(…) enhanced appropriate levels of transparency towards the public, investors and supervisory authorities (…) are crucial to ensure (…) well-functioning and stable financial markets as well as for promoting competition between market actors and products.'

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- Debt problems: '(…) excessive debt required by (…) hedge funds and private equity threatens financial stability, prejudices the realisation of the long-term investment, growth and jobs agenda and is, moreover, unfairly favoured in national tax regimes.'
- Conflicts of interest: 'conflicts of interest either arising from the business model of private equity or hedge funds or from the relationships between those vehicles and other actors in financial markets.'

It is proposed that these concerns should be remedied by a set of policy changes:

- Mandatory capital requirements: '(…) an appropriate capital requirement (…) at the level of the entity that controls the investment of the fund or funds concerned (i.e., management firm), covering all funds regardless of their place of registration.'
- Mandatory valuation standards: '(…) precise rules on the valuation of illiquid financial instruments in order better to protect investors and the stability of financial markets.'
- Disclosure: 'Registration and authorisation of management companies (…) In order to promote a well-functioning single European financial market, the Commission should ensure that management firms disclose (…) the name and domicile of funds they control, the identity of managers, corporate earnings and bonuses, remuneration of directors, senior executives and other staff with investment responsibilities, and relationships with prime brokers.' Funds should disclose: 'general investment strategy and immediate information on any changes thereto, leverage/debt exposure, overall fees (…) breakdown of fees (including any stock options awarded to employees), source and amount of funds raised, past performance, risk-management system and portfolio valuation methods, information on the administrator of the fund, and share of the fund contributed by the management company and its staff.'
- Limits on leverage: 'The Commission should (…) introduce rules to specify the appropriate level of debt at any given time in relation to the target company (…) introduce taxation consequences for private equity funds in cases of excessive debt; such taxation consequences could include eliminating or reducing the tax deductibility of interest payments on the debt concerned (…).'
- Disclosure to limit conflicts of interest: 'The Commission should formulate rules by which to deal with the conflicts of interest between the private equity partners and the management of the target company (and any others who stand to gain from the deal). Those rules should include a requirement of public disclosure of any fees or other incentives received by directors (i.e. management board and supervisory board members) or employees of the target company.'

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3.3 Taxation

One question is whether carried interest (fees to fund managers) should be taxed harder. Carry is currently taxed (lightly) as capital gain, but some argue that carry accounts for a substantial fraction of fund manager compensation and should therefore be taxed harder, e.g., as income (i.e., a 'Schwarzman tax'). In the US, several congress hearings have been held on this question. In early September 2007, the US Senate-House Committee on Ways and Means held hearings on this issue.[1] During these hearings, it was proposed that taxes on carried interest should be raised from 15% to as much as 35%. Another suggestion has been to differentiate between investor-type partners and manager-type partners, where the investor-type partners should be entitled to capital gains treatment. There have also been tax policy proposals regarding the treatment of carried interest in the UK. One problem here is that private equity firms may decide to incorporate funds in countries which tax partner income lightly (i.e., as capital gains tax).

A second question concerns tax deductibility of interest payments. This is (in reality) a key part of the financial engineering in LBO deals due to the heavy use of leverage. With respect to tax deductibility legislation, Denmark – as the first country – passed a law which limits tax deductions following an acquisition, and other countries have since passed similar laws. For example, Germany recently enacted a new 30%-limit rule on interest deductions: net interest expenses may only be deducted if they do not exceed 30% of EBITDA. A similar 'interest stripping rule' has been adopted in Italy (EVCA 2007). Belgium has gone the other way and has introduced a notional deduction for equity capital, which makes it less attractive to substitute debt for equity (Loyens 2007). The important issue here (to be discussed in section 4) is whether interest rate expenditure reduces the overall tax base or merely transfers taxation to interest-income earners.

A third question is whether there should be restrictions on the possibility to transfer funds to holding companies in countries where taxes are low. In this connection the proposal is to limit existing tax agreements with certain countries from which it is possible to transfer funds to tax havens such as the Cayman Islands, Jersey, etc., but so far no legislation has been passed.

3.4 Overview

Altogether, the policy initiatives range from very mild – based on voluntary disclosure (Walker) – to more radical measures as proposed by the European Socialists. However, it is noteworthy that not even the most extreme critics appear

[1] Hearing on Fair and Equitable Tax Policy for America's Working Families, House Committee on Ways and Means, 6 September 2007.

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to favour prohibition. In contrast, they seem to aim for a more transparent and orderly structure of the industry.

4. THE RATIONALE FOR INTERVENTION

Theoretically, effective policy intervention – i.e., policy intervention that will benefit society as a whole – requires a rather stringent set of conditions to be fulfilled (Mitchell and Simmons 1994, Sheffrin 1993, Stiglitz 1989, Tullock, Seldon and Brady 2000, Zerbe 1999), which I summarise in the following four points:

(1) Significant market failure;
(2) Failure of private remedies;
(3) Informed and well-intentioned policy makers;
(4) Low or moderate costs of intervention.

If the market works well, there is no reason for policy makers to intervene, so market failure is a necessary condition for welfare-enhancing government intervention. The market must fail in such a way that it produces negative returns to some stakeholders, which are significant relative to the value created by others and which can in principle be corrected by regulation that makes decision makers internalise these costs. Since rational actors will not engage in activities that reduce their welfare, this typically implies significant externalities for third parties which are not incorporated in market prices because of high transaction costs. If private actors can address market failures using their own means, there is again no reason to intervene politically. A third criterion for effective policy intervention is that policy makers – bureaucrats and politicians – have the right information and motivation to correct market failures. Finally, for government policy to increase welfare for society as a whole, the costs of policy intervention must not exceed the benefits.

In the following, I examine to what extent these conditions are fulfilled in the case of private equity. Obviously, these four conditions do not supply a descriptive theory of how regulation actually comes about. Interest group politics, ideologies, bounded rationality of politicians and other factors may well be more important in practical politics than economic efficiency. But these conditions provide a starting point for analysing whether specific proposals are likely to create value for society as a whole.

Market failure? In a market economy, the standard assumption is that market participants can protect their own interests. Nobody forces incumbent shareholders to sell to private equity funds. Nobody forces institutional investors to invest in them or banks to lend money to them. From this perspective, issues like

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management compensation, partner fees or the purchase and sales prices of firms are inappropriate topics for regulation because they involve transactions with counterparts who are able to look after their own interests. Thus, the European Commission 'has acknowledged that there are no compelling investor protection reasons for national regulators to interfere in financial transactions involving professional investors who understood the risks associated with an investment' (Ferran 2007). EU internal market Commissioner McCreevy (2008) states: 'I am not in favour of heavy handed regulation to deal with these issues. Because I do not see an obvious market failure at EU level.' Even when shareholders have decided to dilute their control of firms to the extent that they only exercise vague control, this reflects a choice, i.e., a trade-off between the costs and benefits of exercising control: the investors will have a right to be passive if they choose not to incur the costs of being active (but they cannot have their cake and eat it too).[2] They are free to suggest policies concerning compensation, takeover defences or other practices at shareholder meetings, and many of them do so. Note also that protection of minority shareholders is a major part of existing securities and company law and that the issue here is whether to add an extra layer of mandatory protection (Ferran, 2007).

Information problems constitute a classical source of market failure, and a standard liberal response is therefore to ensure transparency in the belief that better informed participants are more likely to act rationally in their own interest and thus to maximise overall social welfare. The same logic can be said to underlie the calls for increasing transparency which are common to private equity regulation initiatives. More generally, however, there are both costs and benefits to greater transparency (Hermalin and Weisbach 2007). In the case of private equity, the market participants often voluntarily choose to renounce the information benefits of publicly listed firms. This points to costs of (or lack of benefits from) transparency. For example, the potential short-termism involved in continuous public scrutiny may be a barrier to efficient decision making. As owners in complete control, the funds do not find it difficult to obtain the information that they require from their companies and so have less need of public transparency. And banks generally get the information that they need by asking for it (or they

[2] The principal-agent problem – that management may not act in the interest of shareholders – occurs as a more or less inevitable result of delegation of responsibility to managers. For example, it has been argued that a firm's management might serve its own interests (high bonuses, etc.) instead of the interests of the incumbent shareholders when negotiating with private equity buyers. But since the principal-agent is the result of a voluntary agreement between managers and shareholders, who carry all costs between them, it does not constitute a market failure. Existing owners have the right and the motivation to ensure that managers act loyally. Moreover, existing law requires them to do so. Finally, the problem is by no means limited to private equity acquisitions.

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may refuse to lend). Thus, while arguing against greater transparency is probably a lost cause, it is not clear that more disclosure will enhance social welfare.

The systemic risk of high leverage is another potential source of market failure because financial distress in a company increases the risk of financial distress in other companies (e.g., Allan and Gale 2000, Kyle and Wei 2001). However, it is generally accepted, even in the Socialist proposal, that the present debt crisis has more to do with housing finance than with private equity. In the case of private equity, excess lending is primarily a question of bank regulation since banks provide most of the loans. Because of lax monetary policy, abundant global savings and changes in bank and accounting regulation (Basel II, fair value accounting), banks probably lent too much money up to the subprime crisis in 2007. This increased the supply of credit to private equity firms and reduced their cost of capital, but it would be wrong to say that private equity caused excessive lending. Because of their ability to call on additional funds from investors, it is not clear that private equity-owned companies are more susceptible to financial distress than other companies, but if they were, higher bank reserve requirements or similar regulation would probably be the most adequate policy instrument.

Moreover, intervention in the capital structure of firms makes little sense without regard to their underlying business (e.g., Bradley, Jarrell and Kim 1984), for instance earnings volatility, cash flow and collateral value of fixed assets. A leverage ratio which is highly risky to one firm may be sustainable and prudent in another. But it seems unrealistic for legislation to take these trade-offs into account. A direct cost of policy intervention would therefore be to tie up capital in suboptimal applications, which would increase the costs of capital and reduce the competitiveness of European firms.

Labour as a third party. The more serious advocates of regulation generally do not make the obvious claim that opportunistic private equity funds achieve their results at the expense of the employees, for example by downsizing and outsourcing to third world countries. The reason is probably that it is far from obvious that private equity funds destroy jobs, although the claim that the industry creates many jobs because it acquires many companies is clearly absurd. The most authoritative study by Davis et al. (2008) indicates lower employment growth in portfolio firm employment in the first three years after takeover, but slightly higher growth after that, and more new jobs created overall. More fundamentally, the increasing European competitiveness sought by, e.g., the Lisbon Treaty is difficult to envision without some restructuring. Nor is it clear that lower unemployment is a natural policy goal in full-employment economies.

Tax and interest rate deductibility. It is clear that increased leverage reduces company income tax because of deducted interest. What is much less clear is

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whether this involves a decrease in the tax base (see Nielsen, Bennedsen and Thomsen 2008). For example, interest expenditure may be paid to banks and taxed as profits there, it may be passed on to their depositors (and taxed there), become part of the interest margin (and taxed as salary income) or become purchases (and income) from other suppliers. Even in the event that the interest is paid to foreign banks, this income stream will (with an unchanged balance of payment position) be cancelled out by a similar transaction in the opposite direction.

Does private equity create value? There is no evidence that private equity generates net costs to society. Although industry associations like the Private Equity Council routinely claim that 'private equity firms have delivered superior returns', private equity funds and their portfolio firms appear not to outperform other investments when adjusting for financial leverage and other risk factors (Thomsen and Vinten 2008). However, neither do they appear to underperform, and there is some evidence that well-performing funds persistently generate attractive returns to their investors. As alternative investment vehicles, they presumably also provide some diversification of risk. The fact that institutional investors invest an increasing share of their funds in private equity funds is an indication that it creates value for them. The real or imagined social costs attributed to other stakeholders must be weighted against these benefits.

Private remedies. There are many private remedies which can insure stakeholders against potential expropriation by private equity funds. For example, voluntary best practice codes may in principle substitute for hard law. The recommendations by Walker et al. could be an example if they had more meaningful content.

More importantly, stakeholders can protect their own interests directly by bilateral bargaining. As regards labour, these include employment contracts, legal protection of employees, union bargaining and other mechanisms. It is well known, however, that overprotection of employees may lead to underemployment because firms become more reluctant to hire new employees (Solow 1968, Sargent 1978, Ljungqvist and Sargent 2008). As regards creditors, banks and other creditors can demand and enforce covenants on loan contracts, and suppliers can negotiate long-term contracts or enter into strategic alliances with buyers. Shareholders can adopt takeover defences which prevent undesired takeovers, and many European firms have such defences. Thus, it is not clear that stakeholders are insufficiently protected against expropriation by private equity funds. Nor is it obvious that maintaining the status quo is a recipe for future success: in many – perhaps most – cases, dramatic changes in supply chains, work force, ownership and capital structure are required for companies and nations to thrive in global competition.

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Political efficiency. The assumption that politicians are well informed and have good intentions is normally tenuous at best, but in the case of private equity it appears to be particularly doubtful. While policy should in principle be free of special interest groups to work credibly for the common good, policy makers have been unable to come up with satisfactory documentation for their suggested policies. It is worrisome in this regard that much public debate has been strongly partisan, for example pro-labour (PES) or pro-private equity (BVCA).

Regulation costs. For government policy to increase welfare for society as a whole, the costs of policy intervention must not exceed the benefits. Marginal changes in tax rules, voting procedures or disclosure requirements may appear to be relatively innocent, but they can easily damage the trust which capital markets – including banks, institutional investors, advisers and private equity – place in national financial systems. With open capital markets, this is fatal. Money will flow to jurisdictions that enforce freedom of contract and property rights with stable rules. Amateurish governments which stumble into regulation will no doubt do damage to their country.

Altogether, the policy analysis supports the view of Commissioner McCreevy (2008). The proponents of regulation have not produced a convincing case for market failure, there is substantial scope for private remedies, the policy debate is populist rather than pragmatic, and untimely intervention may undermine rather than improve business confidence. However, the same argument implies that there is no rationale for subsidising private equity. For example, lenient taxation of carry fees may be a hidden subsidy. Loopholes in the taxation of cross-national business transaction may provide another hidden subsidy.

5. Conclusion

Since private equity is relatively new, it has yet to find its proper niche in society. In the long run, this will happen more or less automatically if markets are left to their own devices (Cheffins and Armour 2007). For example, it is possible that restructuring will emerge as the main competitive strength of private equity funds. If so, they have a crucial role to play in the Schumpeterian creative destruction which generates economic growth. But not all companies need downsizing and restructuring. It is also possible that private equity funds will come to be seen as intermediaries, which orchestrate ownership changes – i.e., reallocate companies to 'best owners'. In that case, the focus could be on succession in family firms. Or they may have a role to play as growth accelerators, which would also make them more suitable for some firms than others. In principle, they may even become extinct as we enter a period of low growth and high interest rates. It is difficult to foresee their future precisely. Under these circumstances, trial and error by the

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markets will no doubt be better than politicians in defining the future of private equity. I do not see convincing evidence of market failures which cannot be remedied by private means. The costs of policy changes are high, and policy makers have insufficient information and inadequate incentives to regulate efficiently. Efficient regulation requires more convincing arguments, better information and less partisan views. Politicians who have a reform agenda should be obligated to show that their policies will pass the four criteria mentioned above.

However, in current circumstances the pressure for regulation may be so strong that some kind of intervention is inevitable. Under these circumstances, the best feasible (least costly) alternative may to advocate standard liberal solutions like transparency and tax neutrality. The private equity business itself has already taken some steps in this direction (cf., the Walker Report and similar work in other countries). Arguably, transparency also constitutes the core of the PES proposal, which makes very direct and specific recommendations with regard to disclosure but is much less precise with regard to rules on leverage and capital requirements.

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