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Private Equity Markets and Regulation: Policy Issues and Lessons from Dutch institutional investors*

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EXECUTIVE SUMMARY

The recent growth of private equity markets – and their visibility in the public eye – has been accompanied by rising public concerns about transparency, investor protection and governance. The pressure for regulation of private equity funds is increasing. The issues for policy makers are whether strengthened private equity regulation is warranted and, if so, in what ways.

Private equity has recently drawn public attention to itself in cases where it has initiated corporate restructuring (involving job losses) or opposed management strategy (e.g. Deutsche Börse). Such events have highlighted concerns about accountability. But in so far as private equity managers can foster important gains in efficiency, the real issue for policy makers should be how to enhance its development and role as a catalyst of economic growth.

This paper summarizes the results from a recent empirical study from a new dataset from 100 Dutch institutional investor' domestic and international asset private equity allocations. The data indicate that the comparative dearth of regulations of private equity funds impedes institutional investor participation in private equity funds, particularly in relation to the lack of transparency. The data further indicate that regulatory harmonization has increased Dutch institutional investor allocations to domestic and international private equity funds, particularly via the harmonization from the International Financial Reporting Standards (regulation of reporting standards and transparency), the Financieel Toetsingkader (regulation of portfolio management standards such as of matching assets and liabilities), and Basel II (regulation of risk management and disclosure standards).

This paper also discusses related empirical evidence on the effect of regulation on the development of private equity markets. Most notably, the most recent empirical evidence from Europe indicates low capital gains taxation stimulates the supply of entrepreneurial capital, while entrepreneur-friendly bankruptcy laws stimulates the demand for entrepreneurial capital.

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POLICY ISSUES

The recent growth of private equity markets – and their visibility in the public eye – has been accompanied by rising public concerns about transparency, investor protection and governance.[1] *The pressure for regulation of private equity funds is increasing. The issues for policy makers are whether strengthened private equity regulation is warranted and, if so, in what ways.*

INTRODUCTION AND SUMMARY

Private equity funds are partnerships between the providers of funds, usually institutional investors or wealthy individuals and the managers, or investors, of the funds. These partnerships can be structured as either Partnerships, Limited Companies or the more common Limited Partnership. Pursuant to such structures, the funds are governed by the same contract law and tax and reporting requirements that apply to all Partnerships, Limited Corporations and Limited Partnerships within any given jurisdiction. Since they do not issue securities or debt on public markets and do not seek deposits from the public or the interbank market their activities do not generally raise the same concerns that arise from organizations that do. The integrity of the private equity market is not deemed to be a factor with regard to the stability of the financial system. As a result they are generally free of any oversight by financial market regulators or supervisors. Issues of governance of the funds and investor protection remain but as players within the private equity market are thought to be major institutional and individual investors, they are accordingly deemed to be sophisticated enough to structure partnership contracts to provide themselves with adequate informed assurances and protection.

These funds are widely believed to not only generate above average returns for their investors, but more importantly facilitate innovation. In doing so, they contribute to improved allocation of capital and governance of enterprises. Provided the social consequences of their activities are managed responsibly, development of the market should be encouraged. The immediate issue is however, whether measures currently in place are able to facilitate private equity led growth and innovation.

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[1] See, e.g., "Capital ideas" in The Monitor Blue Skies Capital Ideas 4/09/2005 at http://www.epolitix.com/EN/Publications/Blue+Skies+Monitor/ <accessed 1 August 2005> (arguing that money flow into private equity is hampered by regulations in the UK, and facilitated by a dearth of regulations in continental Europe). It has also been argued that new UK disclosure laws are making private equity groups uncomfortable by Henry Tricks "Throwing Open a Secretive World" (Financial Times, page 20, 17 January 2005), and by John Mackie "Private Equity: An open-and-shut case for transparency complaints about the secretiveness of the private equity industry are at odds with its regulatory procedures" (Financial Times, page 10, 18 April 2005), and by Martin Dickson "UK: Time for faceless face of capitalism to grow up" (Financial Times, page 18, 24 August 2005). See also Andrew Hill "Blurred Distinctions in the Fund Industry" (Financial Times, p.6, 12 September 2005) arguing that over-strict regulations hampers the expansion of investments in other alternative asset classes.

A number of considerations suggest that they are not. For example, a survey of institutional investors in the Netherlands reported in Cumming and Johan (2005a) [Cumming, Douglas J. and Johan, Sofia A., "Regulatory Harmonization and the Development of Private Equity Markets" (September 2005) http://ssrn.com/abstract=842964] points to illiquidity, lack of performance transparency, risk of default, lack of know-how, governance (monitoring and managing) costs compared to other assets, legal and contractual issues, management time and resource consumption, long-term commitment, and reporting and corporate governance as factors that potentially hinder development of a private equity market. Much, although not all, of this can be addressed by strengthening regulatory arrangements.

On the other hand, common wisdom suggests that private equity managers benefit from a lack of regulation in terms of flexibility in their asset allocation decisions, independent contractual arrangements with investors and from a degree of secrecy or confidentiality around their investment strategies and holdings. And for a variety of reasons, the industry itself is resistant. To the extent that such "lack of regulation" contributes to higher returns or to the availability of well-managed funds, strengthening regulation could be counterproductive.[2]

The survey data from institutional investors in Cumming and Johan (2005a), however, support the view that more disclosure would bring in more money into private equity. This gives rise to an important question: if private equity funds realized these results, then would they not want to voluntarily disclose? Several reasons suggest that they may not want to voluntarily disclose in the absence of regulation mandating disclosure. First, certain private equity funds may not be aware that increased disclosure will increase capital commitments from institutional investors. This is particularly true in reference to private equity funds that do not have a relationship with institutional investors that have never invested in private equity, yet who would otherwise contribute capital to the asset class if it were not for the comparative dearth of mandated disclosure.

Second, disclosure imposes additional administrative costs of reporting, and such costs may exceed the benefits of additional deal flow. As a related matter, disclosure potentially discourages deal flow from entrepreneurial firms seeking capital, as entrepreneurial firms may not want public reporting of their financing terms from their private equity investors. The

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[2] Consider, for example, regulation over reporting standards in private equity. Perhaps one of the most significant issues pertaining to venture capital (VC), a subset of private equity, since the Internet bubble crash has involved the 'transparency lawsuits' in which public pension funds such as CalPERS, the largest pension fund in the US, were forced to disclose the performance results of VC funds to the public. VC funds have been vigorously opposed to disclosure of their IRRs, particularly in the aftermath of the collapse of the Internet bubble. Such disclosure has had drastic implications for the VC industry in the US. For example, some VC funds have restricted participation from limited partners that may end up disclosing their performance results, and likewise, some pension funds have been forced to rethink their investment strategy into VC funds. The European Venture Capital Association and the British Venture Capital Association, among others, have taken active steps to try to impose regularities in reporting standards for private equity funds.

benefits of disclosure in terms of raising additional capital from their private equity funds may be outweighed by the costs in terms of the quantity and quality of deal flow. In reference to the first point, private equity investors are unlikely to be able to quantify the benefits versus costs of increased disclosure as there has not been a prior history of mandating greater disclosure and the effect that has had on the market. Cumming and Johan's (2005a) study is the first attempt to empirically assess the benefits of increased disclosure in terms of facilitating greater capital commitments from institutional investors to private equity funds (although the costs of increased disclosure have not been empirically quantified).

Third, disclosure may disproportionately benefit nascent private equity fund managers relative to more established private equity fund managers. It is well established that there is persistence in the performance of venture capital and private equity fund returns (past performance is the best predictor of future performance). Established funds with a successful track record do not have problems raising additional capital for follow-on funds; in fact, established funds typically have long wait lists among institutional investors that would like to invest. Hence, greater disclosure disproportionately benefits newly established private equity funds relative to established funds. Existing well established private equity funds have an entrenched interest to avoid disclosure as a way to enforce a barrier to entry against new private equity fund managers.

Fourth, greater private equity fund disclosure is a benefit to not merely the institutional investors, but rather, it is a benefit to the beneficiaries of the institutional investors. For example, consider the main type of institutional investor for private equity funds: pension funds. Pension plan beneficiaries are not sophisticated investors, and they have a legal right to have access to the investment decisions made on their behalf, at least as per the CALPers' decision at common law. Information on the performance of a pension plan is relevant for retirement and savings decisions, among other things. Private equity funds do not take this into account in their decision as to whether they would like to disclose. Institutional investors, by contrast, do take this interest of their beneficiaries into account. For instance, with the most recent case brought against the Ohio Bureau of Workers Compensation on an issue similar to that raised by CALPERS,[3] it is becoming clear that even larger and sophisticated institutional investors such as pensions and insurance funds are interested in incorporating more disclosure based transparency in the discharge of their fiduciary as trustees of their customers' pensions and insurance premiums.

[3] Pursuant to rigorous debate on this issue, 43 of Ohio Bureau of Workers Compensation's private equity fund managers have filed a complaint for a declaratory judgment regarding the release of a report on the value of its private fund investments that managers have argued should be kept private and confidential due to the sensitive nature of the information. It is also noteworthy that the private equity fund managers. See http://hosting.mansellgroup.net/enablemail/ThomsonNewLetter/HostedWires/NewsLetters/Jan19-06.htm <accessed 19 January 2006>.

Government regulation of private equity fund disclosure has the potential to correct the above mentioned market failure in the private level of disclosure. While a full accounting of the costs and benefits has yet to be undertaken, the new evidence in Cumming and Johan (2005a) suggests that there are significant social benefits that warrant further consideration of government intervention mandating greater disclosure.

The remainder of this brief provides an overview of current arrangements that govern private equity funds, identifies the main areas where enhanced regulation or oversight could be considered and analyses the case for making changes. The overall conclusions in Cumming and Johan (2005a) are that where standardization in private equity reporting, i.e. by fund managers to investors, can be enhanced it may play a role in bringing transparency to the market in a way that benefits the entire industry insofar as it mitigates investors' search, screening, monitoring and transaction costs, and more importantly increases the level of investment by institutional investors. Indeed, analysis in the Cumming and Johan study cited above suggests that if regulation were to lower investors' rank of their view of the importance about disclosure problems, transactions and monitoring costs by a factor of 20% (a lowering by 1 on a scale of 1-5), then institutional investors on average would increase their investment in private equity by approximately 1% of their total assets (to 2.44% from a current average of 1.44%, or by around 70 percent).[4] Given the size of the Dutch market, this could amount to an increase of around €0.5 Billion. This would be significant for the financial industry as a whole. On the other hand, in the areas of limits on portfolio allocation, public disclosure and tax treatment the case is less clear. But since these conclusions rest on a quite limited empirical base, further study of attitudes on more countries is needed before confidence can be attached to these results.

THE CURRENT REGULATORY FRAMEWORK

Private equity funds act as financial intermediaries between institutional investors (such as banks, endowments, pension funds, life insurance companies) and wealthy private individuals, and entrepreneurs and entrepreneurial firms seeking private financing. Depending on the nature, stage focus and industry focus of the funds, the funds committed by the institutional investors and wealthy private individuals may be invested in companies that range from private start-up companies in the software industry to retail companies needing turnaround financing. Private equity funds can invest in the entrepreneur who needs start up financing for his new biotech related technology, or to a group of entrepreneurs who are planning a management buy-out of a silicon chip plant. The range of investments able to be

[4] Endogeneity was not at issue in their analysis given the structure of the data collected.

carried out by private equity funds will usually be restricted as per the contracts entered into between the fund investors themselves. Generally, private equity funds are often, but not necessarily, set-up as Limited Partnerships with the use of very long-term contracts that typically last for 10 to 13 years. In Limited Partnership funds, the institutional and wealthy private investors (hereafter collectively referred to as "institutional investors") are the limited partners not involved in the day-to-day operation of the fund; the fund managers are the general partner. [5] Institutional investors impose contractual restrictions or covenants on the fund manager in order to mitigate the "agency problems" associated with the investment of their capital, i.e. to ensure that the fund manager, as their agent, acts solely in their interests. As the contracts governing the management of the fund are privately negotiated between the institutional investors and fund managers, they are specifically designed to manage the incentives and control the potential for opportunistic behaviour not only among the fund managers, but even among the limited partners themselves. There are five main categories of such covenants, as discussed in Gompers and Lerner (1996, 1999) and Cumming and Johan (2005b):

Category 1: Authority of Fund Manager Regarding Investment Decisions

The restrictions on investment decisions limit the agency problems associated with the investment of the institutional investor's capital (Gompers and Lerner, 1996). This is important, since the institutional investors cannot (as limited partners they are legally prohibited from interfering, otherwise they lose their limited liability status) interfere with the day-to-day operations of the fund. These restrictions include, first, restrictions on the size of investment in any one portfolio company because otherwise a fund manager might lower his or her costs associated with diversifying the institutional investors' capital across a number of different entrepreneurial firms.[6] Second, there are restrictions on the ability of a fund manager to borrow money such as in the form of bank debt and reinvest that borrowed money alongside the institutional investors' capital. That type of behaviour would increase the leverage of the fund and increase the risks faced by the institutional investors. Third, there are restrictions on co-investment by another fund managed by the fund manager, as well as restrictions on co-investment by the fund investors. Those restrictions limit the conflicts of interest in the allocation of opportunities to different institutional investors of the fund, as well as limit the incentive by a fund manager to bail out the poor performing investments of a companion fund operated by the same manager. Fourth, there are restrictions on the re-

[5] The limited partners in Limited Partnerships have limited liability, just as shareholders do in Limited Companies. General Partners, because of their active involvement in the management of the partnership and of the funds, do not have limited liability.

[6] Note, however, in some cases funds are set up in a way that enables such restrictions to be waived upon approval of all the investors.

investment of capital gains obtained from investments brought to fruition. Some fund managers might otherwise pursue a strategy of “fame not fortune” in terms of trying to get as many IPO successes as possible, at the expense of a risk of losing the profits of one investment into a new unproven venture. Fifth, there are restrictions on the overall ability and independence of the fund manager to make investment decisions. Finally, there are other less common covenants on other types of investment and divestment decisions (such as limits in terms of timing of investment with drawdowns, and timing of exits).[7]

Category 2: Restrictions on Fund Manager’s Investment Powers

The covenants in the class of restrictions on investment powers also limit the agency problems in the separation of ownership (i.e., by the institutional investors) and control (i.e., by the fund managers) in the investment process. The first restriction in this class involves co-investment of the Fund Managers themselves. This is similar to co-investment by the fund’s institutional investors and co-investment of prior funds (as described above in Category 1), but instead involves the personal funds of the Fund Managers. This restriction limits the incentive problems associated with the allocation of attention by the fund managers to different entrepreneurial firms in the fund portfolio. If the fund manager were able to co-invest personal funds, there would be distorted incentives for the fund manager to spend most of their time allocating effort to the firms in which the manager is personally invested, instead of trying to maximize the value of the overall portfolio (as would be expected by intuitional investors). Second, there are covenants pertaining to the sale of fund interests by the fund managers, since the institutional investor’s financial interest will be compromised by the addition of new institutional investors, and more significantly the loss of commitment of the fund manager who is usually also the general partner or most active fund shareholder. Third, key person provisions and limits of the additions of investment principals regarding the fund managers, since the contract is made with specific fund managers and the institutional investors do want the management of their capital to be in the hands of specific people with whom they have contracted. Finally, there could be other types of restrictions on other actions of fund managers.

Category 3: Covenants Relating to the Types of Investment

Covenants pertaining to the types of investment ensure that the institutional investors’ capital is invested in a way that is consistent with their desired risk/return profile. Restrictions include investments in other venture funds, follow on investments in portfolio companies of

[7] Waiver of these covenants may also be subject to approval of the Fund’s Board of Advisors, which usually comprises institutional fund investors.

other funds of the fund manager,[8] public securities, leveraged buyouts, foreign securities, and bridge financing. Without such restrictions, the fund manager could pursue investment strategies that better suit the interests of the fund managers regardless of the interests of the institutional investors.

Category 4: Fund Operation

Covenants on fund operation are designed to oversee the administrative aspects of a fund, and include the sale of fund interests by fund investors[9], restrictions against the fund manager on raising a new fund,[10] public disclosure of fund matters to investors, and provisions to allow fund investors to vote to remove the fund manager without cause (no fault divorce clauses). The covenant restricting the sale of fund interest by fund investors (in this category 4) is differentiated from the covenant restricting the sale of interest by fund manager (as specified in category 2) because the specific fund manager action of selling pertains to things fund managers cannot do, whereas this category 4 pertains to administrative aspects of all investors. Recall that the fund manager is also the general partner or most active shareholder of a fund, unlike all other fund investors; hence, the different categorizations for seemingly related actions.

Category 5: Limitation of Liability of the Fund Manager

While categories 1-4 considered covenants constraining the activities of fund managers, this last category of covenants pertains to favourable awards of limited liability for the fund managers. Fund manager liability can be limited in the event of disappointing returns from investments made, limited if the fund manager fails to investment committed capital within the agreed time, and/or limited if the fund manager is found to be mismanaging the fund.

POLICY CONSIDERATIONS

There are three broad areas where the public policy framework governing the private equity market can be considered: regulation of institutional investor's portfolio allocation; reporting and disclosure requirements of the private equity fund; and tax. We consider these in turn [and then touch on some separate but related issues].

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[8] This is similar to the co-investment restriction in category 1, but where the category 1 restriction is against another fund managed by the fund manager investing in the fund, this restriction in category 3 is against the fund itself investing in another fund's (usually an earlier fund) portfolio company, also managed by the fund manager.
[9] In category 2, we identified a similar covenant on sale of fund interests by fund managers.
[10] This restriction on fundraising is typically either for a set period of time or hurdle rate.

Regulation of institutional investor's portfolio

Before looking into the regulation of the funds, we must first look at the regulations that affect the flow of institutional funds into the private equity arena. Institutional investors (for the purpose of this section, not including wealthy private individuals) are subject to stringent regulatory oversight in view of the nature of the products they offer and their customer demographics. Customers of pension funds, insurance companies and banks are more vulnerable than regular retail investors in financial institutions as they entrust a significant fraction of their income and accumulated wealth to these institutions, in the hope that such institutions not only protect their wealth, but also enlarge it. Regulations are therefore in place to address not only the funding of these institutions, but also the investments of such funds to ensure that the institutions do not take advantage of the customers and provide the proper products that are not only appropriate for each type of customer, but also structured properly to meet their expectations. We know that institutional investors' capital allocation decisions are made across a range of available investments, including but not limited to, equities, bonds, cash/currencies, index funds, derivatives, and various forms of alternative investments (including hedge funds, commodities, private equity, and property/real estate). In Cumming and Johan (2005a), they looked at the proposed new regulation affecting the current, and especially the future, asset allocation of institutions. The institutions sampled in that study deemed the new regulation as the most important regulatory development in private equity market. In addition, they found that the new regulation that compels institutions to rethink their investment strategy, and especially one that encourages diversification into alternative investments such private equity funds, is in fact a significant factor in the reported potential increase in private equity investments by the same institutions. It is interesting to note that unsophisticated pension fund holders, insurance policy holders and bank depositors will increasingly fund an area of finance that was deemed to be mainly comprised of sophisticated institutional investors and wealthy private individuals. With such increase in levels of "public" funding directed towards the less regulated private equity market, it will be increasingly important that there also be public policies in place to protect such funds.

An area of increasing attention in private equity is the issue of socially responsible investment. In a recent study that is the first to address the topic, Cumming and Johan (2005c) focus on institutional investor private equity allocations and provide comparisons to public equity, and show similarities in the determinants of socially responsible investment for different asset classes. The data show that socially responsible investment is more common among institutional investors with a greater international investment focus in Europe and the United States relative to domestic Dutch investment and investment in Asia. Socially responsible investment is also more common among institutions that place greater importance on the new International Financial Reporting Standards (IFRS). The data further indicate socially responsible investment is more common when the decision to implement such an investment plan is centralized, or placed more in the hands of a single CIO (the head of capital investments), as opposed to a broader investment team. Socially responsible investment is also more common among larger institutional investors and those institutions expecting relatively greater returns from such investments, and less common among fund-of-fund investments.

Reporting and Disclosure by private equity funds

The most basic reporting issue is whether private equity funds should be subject to *registration requirements*. It is common international practice that investment vehicles have at a minimum a registration requirement, and at a maximum an annual licensing and compliance requirement, with a regulatory body such as the Securities Commission, the Central Bank or the Ministry of Finance (sometimes, all three). This requirement should be extended to private equity funds. Such registration or licensing enables regulators to obtain additional financial and operational information, in addition to that required to be submitted by funds to the relevant incorporating bodies (such as the annual audited accounts). Registration or licensing however would also indirectly certify the ability of the fund managers to value investments and manage institutional investor capital, as proven by the license or registration, and would be beneficial to fund manager incumbents.[11] As this form of certification signals a minimum quality standard to institutional investors and increases the confidence level of institutional investors, which would in turn increase the flow of funds from institutional investors to private equity funds, increased regulatory oversight can be achieved by requiring fund managers to include information which will allow investors to not only determine the "quality" of the manager, but also enable disgruntled investors with access to some form of independent recourse in the event of mismanagement of funds.

Details such as the work experience of all the effective managers of the fund should be provided to enable the investors to make more informed investment decisions, and details of accountants and legal firms used in the manager's dealings should be included to enable the investors to gauge the level of expertise available to the fund. In most countries, the regulators are inclined to exercise strict oversight during the initial process of registration or applying for a license. The burden of compliance should be placed on the manager, as it seems to benefit more from the exercise, and strict, even criminal penalties should be put in place in the event

[11] This issue has come up in terms of regulatory changes with US hedge funds in recent years, for example. See http://www.sec.gov/news/extra/hedgestudyfacts.htm; ass also http://www.sec.gov/news/studies/hedgefunds0903.pdf

managers fail to inform the regulators of any occurrence that may affect its ability to manage the funds entrusted to it. These additional requirements would also discourage / exclude lower quality fund managers from the market place, which would again increase institutional investor confidence.

An obvious concern is cost. While the data in Cumming and Johan (2005a), cited above, do not specifically address this issue, we know that the direct costs of registration of private equity funds, and their managers, would not be very significant, particularly relative to the potential benefits. By analogy, the costs of registration of US hedge funds have been estimated to be "minimal" in testimony Chairman William H. Donaldson of the US Securities and Exchange Commission.[12]

A second issue concerns disclosure of *performance results*. At present, private equity funds are inclined to exaggerate returns or valuations of unexited investments (see Cumming and Walz, 2004). More stringent accounting rules would reduce significantly the incentives (and possibilities) to exaggerate valuations of unexited investments and even the calculation of IRRs. This, in turn, would make the valuations more transparent and informative, thereby benefiting the industry as a whole. In a sense, it would avoid a "negative equilibrium" with over reporting. Furthermore, the survey data [and econometric analysis reported by Cumming and Johan (2005a), see Box 1], are consistent with the view that institutional investor confidence in private equity funds would be higher (and therefore more capital would flow from institutional investors to private equity funds) if disclosure standards required annual statements for overall fund portfolio valuations to be made public. We know that the recent "public disclosure" debate centers on the extent to which such financial information should be made "public". We believe however that such additional, more informative, disclosure of performance results should not be an issue of contention among private equity fund managers and their institutional investors as the "public" dissemination of such information will be limited to the extent that the "public" has a legal right to the information. The "public" who invest in a certain insurance company should have access to the details of that insurance company's investments. The "public" who are required to place their pension fund with a certain company should have access to the financial details of that company. The "public" however will not have a right to access the financial report provided by a private equity fund to its wealthy private limited partner. This is also the case for a limited partner which is also an institution utilizing only private funds. Thus to say that the financial information will be made totally public will be an overstatement. This does not mean that specific investment details would be made public, as that level of detail would likely be detrimental to the private equity fund as well as its investee companies. (Private companies would otherwise seek their

[12] http://www.sec.gov/news/testimony/ts071504whd.htm

own listing on a stock exchange if they were to face that level of disclosure.) But annual aggregate portfolio valuations of a private equity fund do not disclose any individual investment details, and yet such aggregated valuations would enable institutional investors to make more informed decisions about whether to invest in private equity. In turn, as mentioned earlier, institutional investors should also be required to disclose the "valuation" of their private equity investments in their annual accounts, to allow their own "public" investors to make informed decisions about their investments in that institution.

Third, private equity funds should be required to disclose the *details of the auditors* used in their valuations (these auditors are usually the same used to audit the fund itself, but may differ in certain circumstances). Auditors themselves would have to be certified with the securities regulatory body and follow the standards set for uniform valuation standards in private equity (such as those provided by the Private Equity Industry Guidelines Group,[13] or by the European Venture Capital Association[14]).

Fourth, *private equity fund information disclosure quality (and as such the quality of reporting by their respective auditors) should themselves be assessed by regulators* over time in a way that compares the differences between unexited expected valuations in prior years to be reported and actual valuations of realized investments in subsequent years. A perceived pattern of massive differences in such valuations should result in investigations, and possibly a revocation of the license to operate as private equity fund or de-registration (and likewise as an auditor for private equity funds) in the event it is found that such discrepancies are a result of serious misconduct and mismanagement of funds or gross negligence. Regulators should disclose and inform the market of such disciplinary action in the event of problems. Regulators should also inform the market that they are undertaking such "back-testing" to increase confidence in the marketplace.

Fifth, the private equity funds should have to disclose their *management fees and their carried interest fees* to both their investors and also to the relevant registration or licensing body, as this information directly affects the institutional investors' beneficiaries and returns. This will allow current and potential investors in an institution to make informed decisions as institutional investors should have to disclose this information to such persons. Also, any other non-participating institutions will have access to such data from the regulators to also allow them to make informed investment decisions when making comparisons against funds competing for their investment. These details in no way compromise the private information of the investee companies of the private equity funds, but do directly relate to the returns of the institutional investors' beneficiaries.

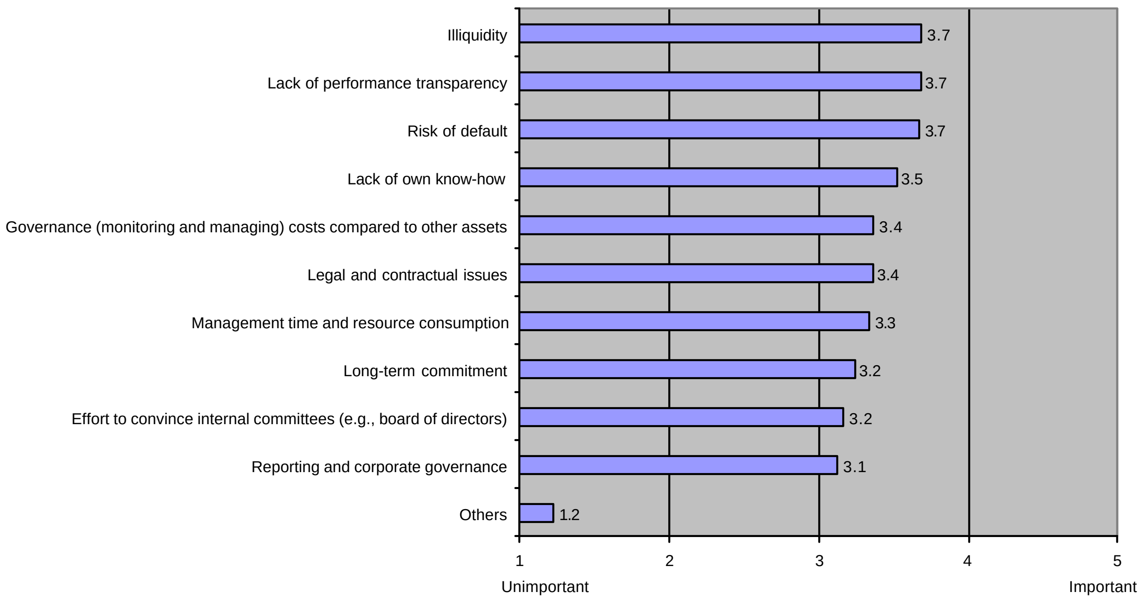
[13] http://www.ventureeconomics.com/vcj/protected/1110466091014.html
[14] http://www.evca.com/images/attachments/tmpl_13_art_63_att_820.pdf

Box1: Dutch Institutional Investors' Attitudes to Private Equity Fund Regulation

To examine attitudes of market participants to these issues, Cumming and Johan (2005a) carried out a survey of Dutch institutional investors in 2005. The survey data comprise information from 100 Dutch institutions (pension funds, insurance companies and banks), 29 of which are currently investing in private equity and 35 of which plan on investing in private equity over the period 2006-2010. The data comprise extremely specific details on the institutions' portfolio management practices, as well as their perceptions of the importance of various economic, legal and institutional factors that influence their portfolio allocation decisions. Institutional investors' positions regarding their objectives in their strategic asset allocation were sought. More significantly, views regarding the perceived risks and hurdles faced by such investors were sought to determine main concerns in adding private equity as a type of asset.

The figure below shows the main risks and hurdles perceived by those institutions that intend to invest in private equity in 2006 – 2010. On average, the most important risk faced by institutional investors is the illiquidity of the investment and lack of performance transparency (both ranked an average of 3.7 on a 1 – 5 scale where 5 is the highest). Private equity investments can take many years to bring to fruition (typically at least 2 years) in an exit event. Other important risks associated with private equity investment include risk of default, lack of know-how, and governance costs. As a related matter, there are legal and contractual issues with establishing private equity funds, and writing these contracts is viewed as a major hurdle to private equity investment (ranked an average of 3.4 on a scale of 1 – 5).

Perceived Risks and Hurdles Associated with Private Equity Investment Among Dutch Institutions that will Invest in Private Equity 2006 - 2010



Multivariate econometric analyses of the data in Cumming and Johan (2005a) suggest that the comparative dearth of regulations in private equity is in fact a hindrance to institutional investor private equity investment. In particular, they suggest that if regulation were to lower investors' ranks of the importance about disclosure problems, transaction and monitoring costs by a factor of 20% (a lowering by 1 on a scale of 1-5), then the probability that an institutional investor will invest in private equity would increase by approximately 17% and institutional investors on average would increase their investment in private equity by approximately 1% of their total assets (to 2.44 percent from 1.44 percent, or by around 70 percent). Based on the size and number of Dutch institutional investors in 2005, we may therefore expect Dutch institutional investors' allocations to private equity funds (both domestically and internationally) to be approximately €0.5 billion higher if such investors provided a 20% lower ranking about the importance of the comparative dearth of regulation in the private equity market.

Taxation and Other Legal Standards

In respect of capital gains taxation and other regulatory standards that affect private equity and venture capital markets, available empirical work[15] is consistent with the view that the benefits of encouraging entrepreneurship and innovation outweigh the forgone tax revenues, etc; however, these costs and benefits are themselves very difficult to precisely quantify.

The most recent European evidence is provided by Armour and Cumming (2005). Based on aggregate industry venture capital and private equity data spanning the period 1990 – 2003 from Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, The Netherlands, Portugal, Spain, Sweden and the UK (as well as Canada and the US), Armour and Cumming show that the legal environment is of paramount importance in measuring the supply of and demand for venture capital. Favorable tax and legal environments facilitate the establishment of venture capital and private equity funds and increase the supply of capital. Similarly, liberal bankruptcy laws stimulate entrepreneurialism and increase the demand for venture capital. These results have significant policy implications. The prevailing wisdom has been that deep and liquid stock markets are the most important determinant of venture capital investment (Black and Gilson, 1998). It was therefore thought that policymakers wishing to foster venture capital markets could only do so indirectly, by implementing legal measures that are conducive to the development of liquid stock markets, such as disclosure laws, minority shareholder protection, and antidirector rights (La Porta *et al.*, 1997, 1998; Black, 2001). An alternative route would be for governments to supply capital themselves, through publicly-funded schemes that would seek to stimulate the growth of private equity markets, with the success of such schemes being highly contingent on the appropriate design of incentives (Gilson, 2003). The results of Armour and Cumming (2005) cast doubt on both aspects of this wisdom. Armour and Cumming's results imply that a range of legal factors may affect venture capital investment directly, and that a liberal personal bankruptcy law increases demand for venture capital finance. Consistent with theoretical work by Keuschnigg (2003) and Keuschnigg and Nielsen (2003a, 2004), Armour and Cumming's results also imply that legislators may successfully stimulate venture capital markets by reducing direct taxation, particularly capital gains taxation.

[15] For U.S. evidence, see, e.g., Poterba (1989a,b); Gompers and Lerner (1999, 2001). For international evidence, see Jeng and Wells (2000). For European evidence, see Armour and Cumming (2005).

Related issues

The ability of private equity to attract funding is not only affected by the regulatory framework applying to the funds themselves but also by the framework applying to investors in private equity and to the businesses in which they invest. For example, countries with more entrepreneur-friendly bankruptcy laws and lower start-up costs thereby encouraging entrepreneurship, risk-taking and innovation tend to have significantly larger venture capital markets relative to the GDP of that country (Armour and Cumming, 2005).

The survey of Dutch institutional investors described in Box 1 touched on their attitudes in this regard. While the results, reported in Box 2, are not directly germane to the issue of how to regulate private equity they are nonetheless of interest. Indeed, it is noteworthy that some of the regulations having wide applicability rank as more important for attitudes toward investment in private equity than the dearth of regulation of the industry itself.

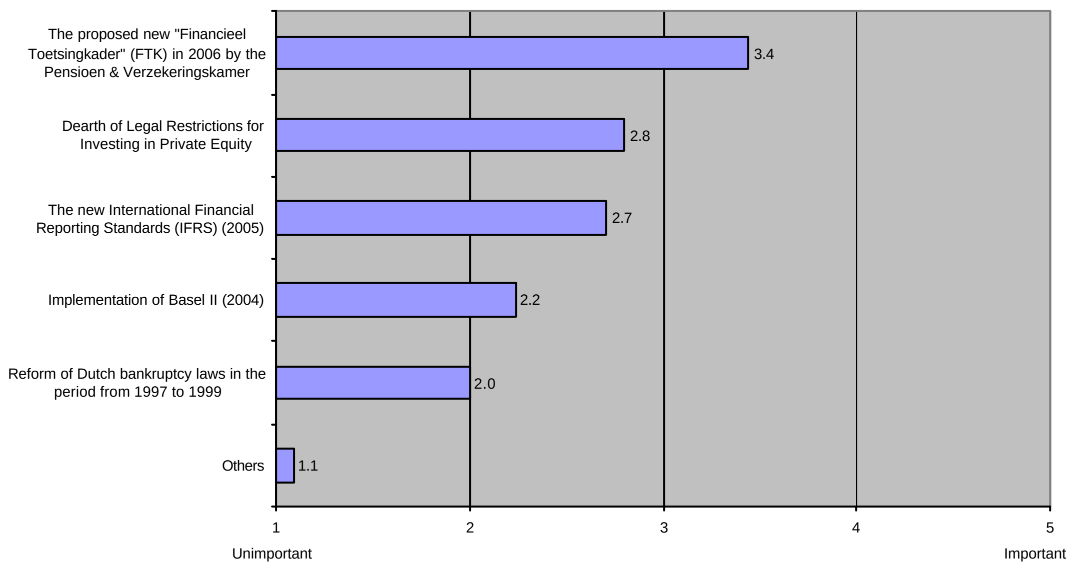
Overall the analysis provides support for the view that changes that tend to harmonize the regulatory environment facilitate investment in private equity, as well as international investment in private equity. In particular, the data support the propositions that harmonization of standards from the International Financial Reporting Standards (regulation of reporting standards and transparency), the Financieel Toetsingkader (Dutch regulation of portfolio management standards such as of matching assets and liabilities), and Basel II (international regulation of risk management and disclosure standards), all facilitated clarity and certainty for institutions that desired to invest in private equity. These regulatory changes are expected to give rise to changes in (1) an institutional investor's asset allocation decisions in private equity, (2) the geographic region in which the institutional investor invests, and (3) to changes in the mode of investment (direct private company, direct fund, and fund-of-fund investments). While an examination on this basis of the question as to whether there could exist better regulatory harmonization measures that would better facilitate private equity investment is not possible, this evidence is nevertheless consistent with the view that the IFRS, FTK and Basel II are steps in the right direction.

BOX 2: Dutch Institutional Investors' Attitudes to Wider Regulatory Changes

The Cumming and Johan (2005a) survey of Dutch Institutional Investors reported in Box 1 also examined the impact on their attitudes to private equity of regulatory changes that are (i) not targeted at private equity funds; but (ii) affect either themselves or the enterprises in which private equity funds might invest. In particular they examine three primary regulatory changes: the new International Financial Reporting Standards ("IFRS") in 2005, the proposed new Financieel Toetsingkader ("FTK") for 2006, and the new Basel II regulations in 2004. The IFRS pertains to accounting practices and reporting standards, providing clarity for private equity reporting practices among institutional investors and across countries. The FTK is a Dutch law that is designed to bring international / European Union standards to The Netherlands. The FTK primarily relates to asset allocation practices for pension funds such that an institution appropriately matches assets and liabilities (thereby increasing the scope for investment in private equity relative to Dutch investors' practices prior to 2005). Basel II relates to the credit risk management practices of banks, and indirectly relates to insurance companies and pension funds in respect of institutions adopting best practices and standards for risk management and capital adequacy.

The importance institutional investors attached to these changes are shown in the figure, together for with the relative importance attached to the dearth of regulations applying to private equity and to changes in Dutch bankruptcy legislation. Multivariate econometric analysis of the survey results suggests that the IFRS, FTK, and Basel II regulations all facilitate investment in private equity, including cross-border investments. The data indicate that an increase in the ranking of the importance of these regulatory harmonization measures (on a scale of 1 to 5 where 1 is the lowest measure and 5 is the highest measure) increases the probability that the institutional investor will invest in private equity by approximately 16%, and increases the amount invested by up to 1% of the institution's total assets. As well, we find evidence that an increase in the ranking of these regulatory changes on a scale of 1-5 by 1 point increases the amount invested in private equity in The Netherlands by up to 0.7% of an institution's total assets, and increases the amount invested in private equity in Europe, but outside The Netherlands, by 0.8% of an institution's total assets. An increase in the ranking of the importance of these harmonization efforts by 1 point also reduces the amount invested by way of direct fund investments by up to 0.8% of an institution's total assets, and increases the amount invested by way of fund-of-fund investments by up to 0.6% of an institution's total assets. The econometric evidence indicates there are some differences in the importance of these regulatory changes depending on the type of financial institution (pension fund, insurance company or bank), but these differences are not pronounced due to the fact these regulations are at least indirectly related to all of the institutions' portfolio management decisions in our dataset.

Rank of Important Aspects of the Legal and Regulatory Environment for Private Equity Investment Strategy Among Dutch Institutions that will Invest in Private Equity 2006 - 2010



One argument that might give rise to concern is the worry that more regulation on private equity fund disclosure lowers returns to private equity investing. By analogy, one might similarly argue that greater transparency in corporate governance lowers stock market returns, which we know to be untrue.[16] Similarly, Cumming and Walz (2004) show that, based on more than 5000 private equity investments in 39 countries, better legal and accounting standards enhances private equity returns around the world. We nevertheless believe that there is scope for further research on topic.

CONCLUSIONS

With regard to reporting and disclosure, the survey of Dutch institutional investors reported in Cumming and Johan (2005a) suggest that greater confidence in reporting standards and more transparency in the private equity marketplace would encourage increased capital contributions to private equity funds. Policymakers would be prudent at this stage to signal to institutional investors that they will take more active steps to design and implement such regulations in order to *benefit* the private equity market generally by increasing institutional investor confidence, enabling lines to be drawn as to the extent of such sensitive disclosure. As institutional investors such as pension funds and insurance companies seek to fulfill their fiduciary duties with increased transparency and as the private equity managers seek to protect the proprietary and sensitive financial and operational information of the companies they invest in, guidance is required from policymakers before more suits are initiated such as that brought by CALPERS and against the Ohio Bureau of Workers Compensation, and more importantly before such negative publicity proves detrimental to the industry as a whole. Incumbent private equity funds would benefit not by disclosing any confidential details to the public but, rather, by disclosing only those factors that increase the level of institutional investor confidence.[17] Indeed, excessive regulation and disclosure of private equity fund investments that are to the detriment of private equity funds and their entrepreneurial firm investees would likewise be to the detriment of the institutional investors as well.

But more comprehensive registration or licensing requirements to show minimum standards to become a private equity fund manager, as well as standards imposed on professionals involved in the management of the private equity fund, including but not limited to the managers themselves, the fund auditors, and the lawyers, could help institutional

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[16] See, e.g., seminal studies by La Porta et al. (1997, 1998) and the follow-up work of many related papers on topic.

[17] Of course, there would be transaction costs associated with following new regulations, which might be against the interests of PE funds.

investor confidence. In addition, the effective oversight of institutional investors themselves cannot be overlooked by regulators. While it is argued that less rigorous regulation is needed for private equity firms as institutional private equity investors are sophisticated investors, investors in these institutions in turn include relatively unsophisticated retail investors to the extent that they are contributors to pension funds and insurance companies. As more effective regulation increases investor confidence, and more institutional funds flow into private equity, retail investors should have access to more information regarding their investments and more importantly, some form of recourse in the event the funds are mismanaged.

Finally, further research should investigate more closely the role of different regulations across Europe in terms of regulatory changes and their affect on private equity markets. Empirical studies with additional data from institutional investors and private equity funds are warranted to better understand the affect of increased disclosure on the behavior of private equity fund managers and institutional investors.

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