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# **Regulating Private Equity**

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## Regulating Private Equity

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### Abstract

We believe current regulatory approaches to private equity are misguided. Reasons for this include a poor public image and widespread misunderstanding. The best way for private equity to deal with these issues is by improving its transparency. We describe one such approach in this paper. We also believe that contracts between private equity firms and their investors have become too complex. This is not unique to private equity, but the result is sub-optimal for society. In our view, regulators can and should help market participants achieve a more healthy equilibrium and greater market efficiency. We make some proposals along these lines: they involve simplification and improved information flow, rather than prescribing behavior. Finally, we argue that adopting these proposals must be mandatory and must cover at least the US and Europe. Experience shows that softer approaches fail.

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## 1. Private equity and the politicians

Private equity has never been a crowd pleaser. Over the years, politicians, unions and journalists have called buyout bosses locusts, tax avoiders and asset strippers. Some people imply that private equity on its own is, or could be, responsible for a global financial crisis.<sup>1</sup>

Controversy is not new to private equity, which dates back in its current form to the mid-1970s. Its first big cycle in the 1980s, which took place in the US, ended with a bang. Kohlberg Kravis Roberts (KKR) bought giant conglomerate RJR Nabisco for \$30 billion, of which \$29 billion was debt, and Jensen's seminal article (1989) extolling the virtues of private equity appeared a few months later. By that time the first private equity party was over. But a book and a movie about the RJR Nabisco deal made the general public aware of private equity for the first time. Its catchy title, "Barbarians at the Gate", set the tone for much of the coverage to come.

Private equity's second major peak (2004-07) involved bigger numbers and more countries. This brought more attention from politicians, especially in Europe.<sup>2</sup> Paul Nyrup Rasmussen, former prime minister of Denmark, is one of private equity's most outspoken critics: "The big private equity funds have proven to be a menace to healthy companies, to workers' rights, [...]. These 'leveraged buy-outs' leave the company saddled with debt and interest payments, its workers are laid off, and its assets are sold. A once profitable and healthy company is milked for short-term profits, benefiting neither workers nor the real economy." In 2004, German politician Franz Muntefering picked up the colorful tradition of "Barbarians". He made a name for himself by calling private equity firms "irresponsible locust swarms, who measure success in quarterly intervals, suck off substance and let companies die once they have eaten them away."

Perhaps as a result of the increased political attention and its poor image, private equity has seen a number of regulatory initiatives. Three of them stand out, with more in the pipeline.

First is Europe's Alternative Investment Fund Managers (AIFM) directive.<sup>3</sup> Although AIFM was aimed mainly at hedge fund managers, private equity was included so that politicians could show voters they had "ticked that box". AIFM's final version dropped several of the most inappropriate suggestions about private equity.<sup>4</sup> But it still requires a private equity fund manager to employ an external depository, i.e. an independent guardian of the assets held. In private equity, though, an external depository is unnecessary. This requirement is clearly designed to prevent Madoff-style Ponzi schemes - thus confirming that AIFM is really about hedge funds. Where private equity is concerned, we fear AIFM's 210 pages will create additional cost without bringing any real benefit.

A second initiative is the Volcker Rule in the US, designed to prevent banks investing in private equity and acting as fund managers. A third is Solvency II, a European directive covering insurance companies which sets a high capital requirement for investing in private equity. Combined, these two initiatives may reduce the capital invested in private equity by about a third.

Voters and taxpayers have every reason to be angry about the financial crisis. Demanding regulations that would prevent such a crisis from happening again is a rational response. The danger comes when neither politicians nor the public understand what it is that they are trying to regulate. They may produce legislation that not only misses the point but also has damaging consequences. We also believe regulation should be about more than just preventing systemic crisis; it should also promote market efficiency. Regulation should act as a catalyst to help market participants achieve a healthy equilibrium. We discuss ways that regulators could do this for private equity in section 4, after sections 2 and 3 have provided a dispassionate view of what private equity does.

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<sup>1</sup> The term "private equity" covers both buyouts, which are politically controversial; and growth equity and venture capital, which most politicians welcome. For our purposes in this paper, "private equity" means buyouts; that is, using other people's money to buy existing businesses with higher than average debt levels and then sell them on. This may not be the only activity that any one "private equity firm" engages in.

<sup>2</sup> Formal investigations into private equity have been held by the US, the European Union, the UK, Australia etc.

<sup>3</sup> After being formally introduced on 29 April 2009, AIFM underwent 18 months of negotiations. On 19 October 2010 an Ecofin press release announced that agreement had been reached and we understand AIFM is expected to go into effect in early 2011. Member states must then implement it by 2013.

<sup>4</sup> For example: hard limits on leverage at any one portfolio company; minimum holding period for any one portfolio company; publication of a portfolio company's corporate strategy; geographical limitations that would prevent EU-based investors from investing in non-EU funds, and non-EU funds from investing in EU-based portfolio companies.

## 2. Private equity positives

One of the private equity community's most important claims is that it runs companies better than public (i.e. quoted) companies and there is ample evidence supporting this claim. Start at the crudest anecdotal level. "Barbarians at the Gate" described how KKR, a private equity firm, bought a large quoted consumer goods company called RJR Nabisco in 1989. The chairman/CEO of RJR Nabisco had been running the company more in his own interests than those of the shareholders who nominally owned it. Among the most flagrant examples was a fleet of ten corporate aircraft, unofficially known as the "RJR Air Force". KKR quickly eliminated the corporate air force, thereby increasing the value of the company.

Moving beyond anecdotes to the academic literature, research indicates that private equity generates significant improvements in financial performance and total factor productivity. Cumming, Siegel and Wright (2007) and Kaplan and Stromberg (2009) provide useful surveys. In addition, recent work shows that employment appears to fall at first under private equity ownership, but a significant increase generally follows (Amess, Girma and Wright, 2008, and Davis et al., 2008).

When it comes to asset-stripping, the popular charge is that private equity managers buy companies in order to break them up. In fact, "buy and build" or growth strategies are much more common. These involve making add-on acquisitions and injecting new equity into companies. Also, the average private equity holding period is more than four years (Lopez-de-Silanes et al., 2010, Stromberg, 2007), so their horizon does not appear particularly short.<sup>5</sup>

Another charge is that private equity might strip companies bare by starving them of investment for short term profits. One way of measuring this is through patenting activity, as a proxy for innovation by companies. A recent study (Lerner, Sorensen and Stromberg, 2010) finds no decrease in patenting activity after a company is bought by a private equity firm. Better, innovation quality increases, as reflected in the number of times these patents are cited.

Opponents also suggest that private equity creates systemic risk through its use of debt. Private equity managers use high debt for about two thirds of the companies they buy. These companies' capital structures tend to be around 75% debt - 25% equity, i.e. close to the reverse of quoted companies (Axelson, Jenkinson, Stromberg and Weisbach, 2010). All other things being equal, high debt levels create high risk. To quote Reinhart and Rogoff (2009): "If there is one common theme to the vast range of crises we consider in this book, it is that excessive debt accumulation, whether it be by the government, banks, corporations, or consumers, often poses greater systemic risks than it seems during a boom" (page xxv).

But private equity has not yet caused a financial crisis. No private equity firm has needed a public bailout – unlike hedge funds (LTCM), insurance companies (AIG) and banks (all of them?!). Nor does any private equity firm seem likely to need one.

Because private equity firms raise most of their debt at the level of their portfolio companies, it is may be more meaningful, however, to analyze the financial risk of portfolio companies. About 10% of private equity held companies go bankrupt (Stromberg, 2009, Lopez-de-Silanes et al, 2010). This does not seem a huge number. In addition, Wilson, Wright and Atlanlar (2009) show that, all other things being equal (including leverage), a company controlled by private equity is less likely to enter bankruptcy. This makes intuitive sense because private equity firms specialize in managing leveraged capital structures. So if a company is going to have a 90% leverage ratio, it will probably be less risky in the hands of a private equity manager than it will in the hands of the hereditary head of a privately-held family firm or even a public company.<sup>6</sup>

Finally, Bernstein, Lerner, Sorensen and Stromberg (2010) conclude that it is hard to find support for claims that industries with private equity backing are more exposed to macroeconomic

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<sup>5</sup> However, Lopez-de-Silanes et al. (2010) show that shorter-term investments ("quick flips") generate the highest returns. Companies held more than four years generate low returns.

<sup>6</sup> Note that the AIFM directive at one point proposed, ironically, to limit leverage only for private equity owned companies. Meanwhile, people who have inherited a family firm are able to operate with a 99% leveraged capital structure. It seems strange to believe that people who specialize in managing highly levered companies would pose a systemic risk and the family heir would not.

shocks or have higher volatility. This is consistent with results in Franzoni, Nowak and Phalippou (2010) showing that cash flows generated by private equity firms (i.e. the stream of investments and divestments) are closely related to both public equity returns and macroeconomic shocks, but private equity involvement does not seem to amplify movements. In other words, if stock market returns are low and/or economic growth is low or negative, private equity returns will be lower - but not disproportionately so.

Private equity may be a victim of its high media profile. One well-known portfolio company going bankrupt makes a bigger splash than any number of anonymous real estate developers. When the end of the 1980s saw a US banking crisis and the implosion of the Savings and Loan industry, many headlines talked about leveraged buyouts, junk bonds and Michael Milken. In practice, it was real estate lending that caused most of the problems. The 2007-2009 crisis feels similar.<sup>7</sup>

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<sup>7</sup> An anecdote from the UK illustrates this point. In late 2008 Lloyds TSB bought HBOS. HBOS had been one of the most aggressive UK lenders to risky sectors including real estate and private equity. As of December 2009 the combined group, now known as Lloyds Banking Group (LBG), had taken £17.2 billion of impairment provisions against its combined £211 billion portfolio of corporate loans. Three quarters of these provisions related all or partly to real estate. Less than 10% of the total related to LBG's loans to private equity.

### 3. Remaining questions

Even after emotion has been removed from the debate, the news about private equity is not all positive. Here we review three areas of possible concern.

#### 3.1. What are the risks of leverage?

Despite the observations made in the previous section, debt may remain an issue. Much of the debt used by private equity's portfolio companies migrated off bank balance sheets and into structured vehicles such as Collateralized Loan Obligations (CLOs). CLOs were one example of the kind of "structured credit" business that at least contributed to the financial crisis.

Private equity managers' own behavior raises questions. They claim that leverage is a small component of their returns but they always invest more when debt is cheap. This suggests they may be using leverage to game their returns. Fierce competition for additional leverage when debt is cheap may drive acquisition prices too high (see Axelsson, Jenkinson, Stromberg and Weisbach, 2010). This attitude may lead to value destruction and higher costs for society because leverage levels rise beyond what is optimal.

Companies owned by private equity are not the only ones to use high levels of debt, and private equity managers probably handle it better since that is their specialty. But the key question still left to answer is: what would have happened to those portfolio companies if private equity had not increased their debt in the first place? It is crucial for society to understand fully what higher leverage implies. In the Netherlands, the largest chain of day care centers is owned by a private equity firm. What would happen if it defaulted? Suddenly, thousands of people would be unable to get to work unless the government stepped in to ensure that children could keep on attending day care. The social cost would be significant.

#### 3.2. The investor issue

Every quarter, private equity manager associations trumpet the findings of independent information providers showing that private equity has outperformed public equities. But a series of academic studies (see Phalippou, 2010, for a survey) have reached the opposite conclusion. As a result, investors' continuing willingness to invest in private equity is often seen as a "puzzle" (Acharya, Hahn and Kehoe 2009, Phalippou and Gottschalg, 2009, Lerner, Schoar and Wong, 2007).

Some argue that this does not matter at the level of society. It is just an allocation issue between economic actors. If private equity activity increases the size of the overall economic pie, should we care about who gets to eat the extra slice?<sup>8</sup> In our view, if the people who are actually paying (meaning fund principals, not agents) do not understand what is happening, then the answer is "Yes".<sup>9</sup>

#### 3.3. Externalities when "running companies better"

Private equity has always stressed that it adds value through its focus on maximizing profits - as opposed to gaming earnings announcements, or tolerating perks for top executives. That may explain the evidence showing private equity usually improves companies' profits.

But maximizing profits may create externalities for other constituencies in society. For example, Chevalier (1995) and Matsa (2011) find that private equity ownership leads to higher prices and less choice, respectively, for consumers. In addition, suppliers may suffer the effects of optimized working capital management. Employees' stress level may increase; their pay may decrease or

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<sup>8</sup> Some point out that investor naivety of this kind lies behind many great inventions. From the US rail network, through the Channel Tunnel, to the internet, investors lost their shirts but created a valuable good for society. In those cases, though, the investors lost their own money. Another difference is that private equity firms mainly buy and sell existing assets.

<sup>9</sup> Note that Calpers, for example, has been sued to provide information – first about returns, then about fees. Calpers provided information, but only in a way that makes it effectively useless. For example, it does not reveal whether Calpers' private equity investments have outperformed public equities; how close NAVs are to market values; or how much is paid in fees per dollar invested.

become more uncertain.<sup>10</sup> Private equity ownership represents an extreme case of profit maximization in general. The associated externalities need to be better understood.

#### **4. Regulating information, not behavior**

One aim of regulation is stability (i.e. preventing systemic crises). Another, equally important in our view, is to make markets as efficient as possible. The best way to do this is not to prescribe particular forms of behavior (e.g. preventing insurance companies from investing), but to help market participants find a healthy equilibrium by themselves. We are optimistic (naïve?) enough to believe that if all the parties involved in private equity (including trustees and qualified outside observers) fully understand how it works, and have all the information they need to assess it, a better outcome will be achieved.

Currently the complexity and lack of transparency make private equity poorly understood. How many pension fund trustees understand fully a private equity limited partnership agreement: the fees they pay (both explicitly and implicitly); the incentives they give; the risk they take; or the fact that the seductive IRR is not a rate of return?

Oliver Gottschalg via his consulting company (Peracs) once sent a survey to private equity managers, asking them in which quartile they belonged and how they justified their claim. He found that fully 77% of private equity managers reported themselves as “top-quartile”. Most of them achieved this simply by playing with both the benchmark they selected and the basic notion of “vintage year” (i.e. the starting year of a fund’s life). A concept as basic as “vintage year” is thus defined so loosely in private equity that it contributes to get this nonsensical outcome. This sort of absurdity is just one example of the current unhealthy situation and it is all too easy to imagine the power of more sophisticated kinds of window-dressing.<sup>11</sup>

It is sometimes argued that private equity is a competitive market involving sophisticated players who should be able to find a healthy equilibrium on their own. Anecdotal and empirical evidence makes us question whether this is actually the case. Gabaix and Laibson (2005) also provide an important theoretical explanation of why expected competitive pressures might fail. They show how complexity can be used in a way that benefits both suppliers and those consumers who understand the details. All market participants who understand the details naturally welcome the status quo, while those who do not understand fail to realize they need changes.

Some large investors in private equity may believe (correctly, in our view) that complexity and opacity give them an advantage over smaller investors. So even if complexity increases cost, larger investors may be content with the status quo. But we do not believe this is desirable.

We make suggestions about three areas: partnership agreements; disclosure; and regulatory approval. We stress that our arguments could apply to other sectors such as real estate and infrastructure investing. Private equity is a useful example because it is economically sizeable and involves a relatively small number of participants, making regulation somewhat easier to implement.

#### **Partnership agreements.**

Private equity partnership agreements need to be simplified, standardized and, potentially, improved. Currently, we believe they are unnecessarily complex.

The market needs standard definitions for key items (e.g. carry interest, vintage year, and leverage). The absence of any standardization makes it difficult (and therefore expensive) to compare one agreement with another and one track record with another. For example, currently, limited partnership agreements calculate key items like carried interest and management fees in many different ways. Market participants could decide that there are just (say) five standard types of contract. Then a fund raising prospectus would just have to say it is using (say) Contract 4, with a 30% carried interest, 2% management fee and a given standard set of covenants.

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<sup>10</sup> In addition, Warga and Welsh (1993) show that previous bondholders lose money in an LBO. Governments may see reduced tax income (although Jensen, Kaplan and Stiglin, 1989, are skeptical about that for the 1980s wave in the US).

<sup>11</sup> These include, for example: playing with Net Asset Values; playing with dates at which investments and dividends are recorded; showing selective track records, etc.

We also believe that there is some room for improvement in partnership agreements. The fact that private equity managers charge “hidden” fees is already an issue.<sup>12</sup> The fact that they are not contracted in advance, i.e. they are left to the discretion of the private equity manager, makes them really problematic, especially since they are meaningful in size. During the recent boom, large private equity managers derived about half of their net fee income (excluding carried interest) from such items.<sup>13</sup>

Private equity managers say they have to be reasonable with these fees because they cannot afford to upset their investors. But suppose a manager for some reason stops raising money. It would be foolish to rely on a sense of ethics. Contracts are supposed to solve this kind of problem, not create them. In addition, these fees are hidden, and we believe most investors have little idea of their size. At the same time, performance results can be window dressed. So investors on average may be paying higher fees than they realize, for performance that is lower than they realize. That is not a healthy situation.

Standardizing and simplifying may have some initial cost but should save a lot of time and money for everyone (both investors and managers).<sup>14</sup> It is hard to see what benefit comes from using twenty different ways to calculate a management fee and this sort of complexity feels like obfuscation. There will be no significant loss of flexibility if, as we suggest, investors and managers participate in the process. Only the most economically meaningful fees/covenants will survive as standard options.

The intention here is not for anyone, least of all regulators, to dictate specific terms and rules. Instead, the idea is to make important items easier to understand and compare. Valuable work on some of these areas has already begun: see for example ILPA’s “Private Equity Principles” and IOSCO’s May 2008 report “Private Equity”.

The regulator’s role in our view is not to impose specific types of behavior, but to create an environment in which participants are able to coordinate effectively. Initiatives such as ILPA’s often fail because they are perceived as simply a way for investors to reduce fees. The regulator should not be interested in lowering fees *per se*, but in making sure everyone understands what is happening. If private equity firms start charging carried interest of 50% rather than 20%, we believe neither we nor the regulator should object - as long as everyone involved knows clearly what is happening.

### **Information disclosure.**

Private equity firms should disclose relevant data on a standardized basis to an independent agency. The agency would make it available to independent parties (e.g. policymakers, academics) who wish to study it – as well as to private equity firms and private equity investors. Each constituency needs reliable data.

The current situation is, quite simply, a mess. Private equity firms provide a lot of information (strictly in private) to their investors. But the information has limited value if it is non-standardized, fragmented and non-comprehensive. Take an investor who receives a 20-page report every quarter for each of the 500 portfolio companies it is invested in. Who can process 10,000 pages each quarter? The fact that the data is not in the same format makes it even more costly and less precise. Meanwhile it is hard for the same investor to get any information on companies she did not invest in; for a fund manager to get information on the companies held by other funds; and for academics and policymakers to gather a large and representative sample.

Imagine instead a standard template for information. Market participants agree in advance how to record cash flows, deal characteristics, leverage, number of employees, add-on acquisitions, acquisition multiple, how to flag and treat distributions in kind, how to record portfolio company fees

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<sup>12</sup> These are often called “portfolio company fees”. Private equity managers charge portfolio companies, i.e. indirectly their investors, additional fees for doing things like arranging acquisitions, refinancing debt, monitoring the company etc. – see Phalippou (2009) for a discussion. See also Metrick and Yasuda (2010): “It is not clear exactly what these transaction fees are paying for, since GPs should already be receiving their fixed costs from management fees....It is difficult to find reliable information about the frequency and size of these fees...As with transaction fees, we think of monitoring fees as just another way for buyout funds to earn a revenue stream.”

<sup>13</sup> See filings by Apollo, Blackstone and KKR with the Securities and Exchange Commission.

<sup>14</sup> Note also that another benefit of standardizing contracts might be to reduce the potential cost of legal actions involving managers and investors.

etc. If the information went into a standard template, everyone would be able to merge in the data of all private equity managers in two clicks and be ready to do analysis.

The first objection to this proposal might be cost. But private equity firms already provide much if not all of this basic information to their investors – simply in different formats. Standardizing it would reduce costs to the community as a whole, not increase it!

In addition, most private equity held companies routinely prepare quarterly and even monthly financial statements for their lenders. Every US buyout with a public security outstanding (e.g. a high yield bond) has been making these filings for decades. Even in Europe, consider a small packaging company called Clondalkin with revenues of €800 million and EBITDA of €80 million ([www.clondalkin-group.com](http://www.clondalkin-group.com)). Private equity firm Candover bought Clondalkin in 1999. A second private equity firm called Warburg Pincus bought it in a secondary buyout in 2004. Even though Clondalkin is a small business its quarterly and annual results are freely available on its website.

A second objection might be competitive disadvantage.<sup>15</sup> But no one is asking private equity managers to reveal the formula of Coca Cola. It is hard for us to see how reporting the items mentioned above creates competitive disadvantage. US buyouts which file public quarterly reports with the SEC have managed to survive. So have Clondalkin and many others.

Third, private equity firms might object by pointing to local legal requirements. If local regulations do not make reporting mandatory, then why should they report?<sup>16</sup> The answer is that - unlike the typical private business for which these rules were designed - private equity firms are managing funds on behalf of millions of pension scheme members.

It is hard to see reasonable grounds for objecting to this kind of disclosure. Indeed, the private equity community in the UK has already taken some voluntary steps in the directions indicated above.<sup>17</sup> But although the British Private Equity and Venture Capital Association (BVCA) should be applauded, some fundamental flaws remain.<sup>18</sup> Data that is controlled by one side of the market (in this case, private equity firms) and provided only on a voluntary basis will never be fully trusted. It also makes no sense to do this exercise on a country-by-country basis: the private equity market is global. We could have the newly-created Office of Financial Research (OFR) in the US joining with a similar EU and Asian agency which could be created.

### **Regulatory approval.**

Regulators should introduce the equivalent of a kitemark for private equity managers.<sup>19</sup> The kitemark would imply no judgement about the manager's competence, fees or track record. It would simply indicate whether the manager complied with agreed standards in terms of its contracts and data disclosure. Managers who do not meet kitemark standards would not receive regulatory approval. Pension funds, banks and insurance companies could be prevented from investing in non approved funds. We realize this may seem draconian, but well-meaning regulation that lacks teeth tends to fail. Abrahamson and Jenkinson (2009) is an alarming cautionary tale about a different area of institutional investment: public equities. It shows how some fund managers and investors have tried to evade well-meaning regulations that were designed to improve transparency.

We believe this approach is the most effective way to improve transparency and market efficiency. Regulators need to be involved because market participants have proved unable to reach a healthy equilibrium on their own. The arguments in Gabaix and Laibson (2005) show that an unhealthy situation can remain in place for a long time.

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<sup>15</sup> Note that our proposal involves strictly *historic* information. In November 2009 a BVCA document claimed that AIFM would require portfolio companies to publish their *prospective* corporate strategies. We believe this really would be inappropriate – precisely because, unlike our proposal, it actually would involve substantial, and unfair, competitive disadvantage.

<sup>16</sup> Rules covering reporting by bond issuers in Europe are ambiguous, and some issuers take advantage. This is a separate but related issue that is long overdue for addressing by regulators.

<sup>17</sup> BVCA "Annual Report on the Performance of Portfolio Companies, 2008" page 15: "Ernst & Young contacted the Private Equity Firms on 1 August 2008 and requested a **standard data template** [emphasis added] to be completed for each Portfolio Company. Individual company data is held confidentially in an electronic data room that will facilitate future years' submissions."

<sup>18</sup> Further discussion in Morris, 2010

<sup>19</sup> Kitemarks were first introduced in the UK in the early twentieth century to encourage standardisation. At the time, manufacturers of tram rails were using 75 different gauges. Introducing the first kitemark helped to reduce the number of gauges in use from 75 to 5 and saved the industry collectively an estimated £1 million in contemporary values.

Private equity is not the only market that would benefit from standardization of the kind we describe. The high yield bond market is just one other that suffers in a similar way from excessively complicated contracts. Investor associations have long argued in vain for some kind of standardization. It seems unlikely to happen unless regulators get involved as catalyst.

But we stress that regulation's job is to allow information to flow, not to dictate anyone's behavior. Private equity participants and associations are currently spending valuable time and resources fighting regulations that dictate their behavior. By contrast, our proposals would produce nothing to fight against: just standardization and improved information flow.

We assume that independent analysts (e.g. academics) will use the data to produce the hard evidence about private equity that is currently lacking. As independents, their evidence will be more credible than what comes from sources in the private equity community.

Finally, an appropriate regulator needs to be identified. It needs to be close enough to private equity to adapt requirements as necessary, but not so close that it risks being captured. Current regulatory bodies seem good candidates.

## **5. Conclusion**

We believe regulators should aim to be catalysts. Their role should be to allow and encourage market participants to coordinate and thus create a healthy equilibrium. In our view, private equity currently fails this test. Regrettably, we think AIFM and other initiatives do not address the real issues in private equity and boil down to useless paper work.

Regulators should focus on simplifying contracts and improving information flow in order to make the market for private equity more efficient. We think this can be done quite cost-effectively. Note also that our two propositions, i.e. simplification and information flow, are independent: one can be adopted without the other.

If data becomes available in the way we describe, academics and others will do the analysis for free. The increased transparency will produce the kind of creative destruction that private equity relishes. If private equity is as good an investment as it claims, it can only benefit from improved credibility, more favorable public opinion and more capital to manage. Taken together, we believe our proposals would help to create a healthy equilibrium in the private equity market.

We recognize there are complications. But the appropriate benchmark is where we are now. Any improvement from here would represent a win. And even if these proposals fail to become reality, simply discussing them may help people focus on the right issues about private equity.

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