

Private equity regulation: a comparative analysis

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Abstract This article examines the existing contractual arrangements and industry standards in private equity. It shows that investors are, in principle, capable of structuring their particular investments according to their own preferences, there are a range of governance problems and risks that could be potentially hazardous for some classes of investors. We examine the circumstances where existing industry codes and legal tools can be used to address the problems that arise in relation to private equity and buyout activity.

Keywords Private equity · Regulation

1 Introduction

The alternative asset sector successfully avoided the scrutiny of regulators and lawmakers which arguably contributed to its success in attracting investors. Yet, with concerns arising from the increased risk due to overleveraged transactions and the potential costs to investors from insider trading and price fixing arising from ‘club deals’ by mega funds capturing the largest amount of net capital flows, the trend has moved in the direction of increasing regulation of private equity funds and their managers. In this context, there is a division of opinion regarding whether

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private equity funds and their investments should be subject to regulation designed to protect workers and to discourage asset-stripping tendencies. Proponents of special regulation point to the negative image of private equity arising from decisions to cut jobs at companies—such as the AA, the UK motor repair services group, and Gröhe, the German bathroom fittings maker. They characterize private equity funds as ‘locusts’ interested only in their own enrichment at the expense of other interests within the firm. Conversely, the extant evidence seems to decry regulatory interference by suggesting a positive correlation between private equity investments and firm performance. Economic studies show that private equity investment routinely surpasses the Standard & Poor’s (S&P) index, enhances new product and market development, and increases the levels of employment and R&D expenditure.

However, the global turbulence in the credit markets, triggered by the turmoil in the subprime mortgage market in the United States in 2007, has arguably ended the private equity bonanza as well as the laissez-faire era in the alternative asset sector. In fact, the credit squeeze has already slowed down the level of private equity activity and, more importantly for this paper, resulted in increased scrutiny from regulators, policymakers and the judiciary. We can see, moreover, that a wide range of regulatory options, from industry self-regulation to governmental intervention, are being considered in order to lower the level of risk and to redress the balance between investors and private equity firms. Despite the absence of collapses in the buyout market, regulators were, even before the downturn, considering a number of governmental measures designed to reduce the incidence of buyouts, including caps on leverage limits or limits on the levels of interest payments that are tax deductible. There may, however, be other motivations that can better explain the demand for regulatory intervention other than to protect investors from manipulation and to promote certain regulatory responsibilities. That said, what strategy is ultimately implemented could be the result of a pent up demand, for example, of enhanced regulation that is very difficult to differentiate from what is required to ensure that investors and other stakeholders have an acceptable level of security in dealing with private equity funds and their advisers.

In the main, private equity funds are regulated by contract. These funds, which are predominantly formed as limited partnerships, limited liability partnerships or limited liability companies, are able consequently to take advantage of various exemptions and exclusions explicitly provided within the regulatory framework. These business forms are, for example, treated as transparent entities for tax purposes allowing funds to avoid taxation at fund level and to ‘pass-through’ tax liabilities to the fund investors. More importantly, the contractual flexibility of the limited partnership, limited liability partnership and limited liability company allows the managers and investors to enter into covenants and schemes that align their incentives and reduce agency costs. To give an example, the investors are usually permitted to vote on important issues, such as amendments of the contractual provisions, dissolution issues, removal of managers, and sometimes even the valuation of the portfolio. At the same time, the ‘private placement’ business arrangement is oriented and structured for large and sophisticated investors, making it possible to be exempted from the securities regulation

framework. In the United States, for instance, these funds rely on the exemptions from treatment under the Securities Act of 1933, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.¹

Still there are important issues that confront the world of private equity. The private equity industry must face the dilemma of identifying well-suited techniques to increase transparency and reduce the level of risk without substantially damaging the flexibility and the benefits of the business models that have prospered on limited interventions within contractual relations. In a period when private equity flourished, the mere contractual basis for the funds is usually adequate to address the agency problems among the players in this sector. However, when the economy gets weaker and the performance of buyouts is jeopardized because of over-aggressive capital structures, lawmakers are more likely to intervene without analyzing the contractual structure of the funds. In this respect, much attention has been directed recently to the reliability of private equity funds in justifying their contribution in the strategic performance delivered. In addition to these concerns, a related set of criticisms that has arisen relate to market abuse, conflicts of interest and market opacity that are likely to pose questions whether the current regulatory regime is best suited to address these concerns.

Naturally, the level of regulatory risk will increase substantially should a high profile buy-out fail, for example, leaving selling shareholders and employees in distress. Hence, as the risk becomes more critical for companies and their employees, we would, then, expect more direct government intervention at the expense of the system of private ordering employed by the funds and their investors. Financial considerations, however, invariably prevent lawmakers from simply introducing new legislation that could alter the balance of benefits and gains for the sector. Besides, mandating legal rules that are inflexible in nature may have perverse and uncertain consequences on the industry and some firms preventing them from making well-considered decisions and timely changes in response to innovations underway in the economy. To see this, we should recall that although private equity funds have become an essential part of the global financial system, there is only partial and insufficient information about their governance, impact and strategies.

In assessing whether a regulatory response is required, it is important to be clear about which mode is appropriate, and whether the existing regulatory framework is adequate to address the concerns associated with private equity fund investment. There are a number of considerations that are relevant. First, is the current structure sufficient to support private equity led innovation and development. Second, to what extent are the problems connected with private equity funds familiar, and are the current set of measures appropriate for dealing with the increased risk generated by

¹ The Securities Act regulates the issuance and offering of securities to the public. If funds decide to offer their services and products to the public, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 apply. The former governs the operation of the fund itself. The Investment Advisers Act governs the firms that manage the actual funds. Even if there is currently no requirement that private equity advisers register under the Act, numerous advisers have, in light of an SEC action against unregistered adviser, opted to create and maintain oversight and independent review in line with SEC expectations of fund behavior.

private equity funds and buyouts. To the extent that a problem does not raise any new problems for existing regulation, it can be presumed that no fundamental changes or new measures are required. Third, if the consequence of private equity fund activity raises a new risk or outpaces the current system of regulation, a question as to which type of response is required arises. In this context, there is a choice between self regulation and other regulatory strategies.

As we will see, traditional solutions, such as self-regulation, industry co-regulation and/or even the resort to regulation, could play an important role in protecting the stakeholders of the funds as well as the portfolio companies. Self-regulatory strategies are not new to financial regulation. The potential benefits are well-established, as evidenced by high levels of firm compliance and significant reductions in risk and other factors. Moreover, these strategies, if pragmatic and well-designed, are attractive because they are less burdensome, easily updated and permit firms to achieve regulatory goals with maximum discretion. Self-regulatory strategies are likely to be more effective than direct regulation because they are generated by persons directly involved in the industry. In this context of implementing such measures, we can expect private equity firms will have high powered incentives to adopt the standards and controls in a timely and efficient manner. Moreover, to the extent that large institutional investors are effective monitors, they can act as a counterweight by exerting pressure on funds that either under-comply or fail to implement the measures in a timely fashion. The self-regulation approach works best where the company has wide discretion and authority over the implementation of the negotiated industry standard.

It may be tempting to conclude that self-regulation is always the optimal strategy. Concerns about the negative impact of special regulation on the financial industry abound. Self-regulation can involve complex conflicts of interests, which may have a detrimental effect on the confidence that investors have in the industry standards. Moreover, the non-compliance with and enforcement of these regulations is yet another concern. To be sure, the effectiveness of self-regulation is connected closely to the incentives of the firms that are providing the measures and the quality of their efforts to monitor compliance. We are not indifferent to the possibility of ineffective or misdirected policies, but rather assume that the private equity industry has a stake in establishing a good reputation for compliance with industry standards. Second, when private equity funds' interests diverge from investors' interests, existing regulation and market responses should be sufficient for dealing with these problems. At the same time, it might be that current regulation is not sufficient to deal with all the risks of private equity funds or illegal conduct, and consequently a response may be needed.

In this paper, we evaluate whether the existing contractual arrangements and industry standards are sufficient for dealing with the problems generated by private equity and buyout funds. We consider the rapid growth of private equity and the stresses that have arisen as a result. The range of governance problems and risks are discussed in terms of whether regulatory intervention is warranted. We discuss the effectiveness of different regulatory models and examine the existing regulatory structure in Canada, Germany, the Netherlands, and the United Kingdom. The

survey of the diverse regulatory environments reveals which type of measures have been considered by regulators, and the reforms that have been implemented.

The paper is divided into five parts. Part 2 sets out background facts and figures that are relevant to understand the role of regulation and how it influences the players in this industry. We will make no attempt to provide an in-depth analysis of the economic impact of private equity, but will focus on the structure, investment objectives and investment strategies of private equity funds. These facts and figures offer important insights and observations about the trends and challenges in this alternative asset sector. Part 3 describes the terms and conditions of fund formation and operation, management fees and expenses, profit sharing and distributions, and corporate governance. The contractual features show that parties are in principle capable of structuring their particular ownership and investment instruments according to their own preferences without being bound to regulatory requisites. In this Part, we also focus on hedge funds. Typically, these funds use similar business forms, but, in contrast to private equity funds (which primarily invest in unregistered securities), they are structured by a team of skilled professional advisers, experts in company analysis and portfolio management, offering investors a wide range of investment styles. Hedge fund managers employ multiple strategies as well as traditional techniques and use an array of trading instruments such as debt, equity, options, futures and foreign currencies. Since hedge funds are characterized by the pursuit of absolute returns and the use of leverage to enhance their return on investment, the hedge fund industry also encounters increased scrutiny from regulators and lawmakers. The question then is if, and under what conditions, special regulations should come to the fore. Now that both the buyout branch of the private equity industry and hedge funds face sharp criticism from lawmakers, labour unions and shareholders in publicly held companies, the industry—convinced of the value-increasing effect of their investments and the benefits for employment, innovation, and research and development—increasingly responds by introducing self-regulatory measures to improve the transparency and accountability of private equity funds and hedge funds across the board. Part 4 will explain the function of soft law principles, guidelines and recommendations, specifically tailored to the activities of private equity funds. We will assess if self-regulation will come to be seen as a pragmatic and workable approach despite its purported disadvantages, such as the lack of public confidence or the possible inertia on the side of the self-regulatory body. Part 4 also addresses the role of regulators and lawmakers in a number of major jurisdictions, outlining the existing industry codes and legal tools that can be used to address the problems that arise in relation to private equity and buyout fund activity. Part 5 concludes.

2 The growth of private equity

The private equity industry has seen tremendous growth over the last decade, going from less than \$10 billion raised worldwide in 1991 to over \$180 billion in 2000.²

² See Kaplan and Schoar (2005).

Table 1 Top private equity funds

All funds	
Firm	Funds raised in the past 10 years (billion)
Goldman Sachs	\$66.4
Blackstone	\$58.4
Carlyle	\$52.5
Credit Suisse	\$32.4
TPG	\$32.0
KKR	\$31.7
Warburg Pincus	\$31.7
Apax	\$30.9
Bain	\$30.8
Permira	\$29.0
Buyout funds	
Firm	Funds raised in the past 10 years (billion)
Goldman Sachs	\$36.5
Blackstone	\$33.7
KKR	\$31.7
TPG	\$29.7
Carlyle	\$29.2
Permira	\$29.2
Bain	\$26.1
CVC	\$25.1
Silver Lake	\$21.8
Providence	\$20.2

Source: Private equity intelligence

Today, almost a decade later, private equity shows no signs of slowing down. In fact, private equity raised a record \$406 billion in 2006. Table 1 shows a summary of the leading private equity funds and buyout firms in terms of total value of funds raised over the last decade.

2.1 The performance of private equity

This section looks at the performance of private equity firms, particularly the returns of buyout funds. In the case of buyouts, the private equity firms that sponsor and structure the deal will arrange significant debt financing in order to take over a company. Typically, debt financing for buyout is raised from the syndicated debt market in Europe and the US.³ Private equity firms look for target firms in which there is fundamental inequality between market capitalization and firm value. The buyout firm has high powered incentives to increase the value in the target. Value enhancements that are agency driven extract performance improvements through installing new management, active monitoring and fundamental changes in the

³ See McCahery and Schwienbacher (2010).

firm's business plan. It is noteworthy that the high debt obligations may induce firm's to undertake fundamental governance reforms that can lead to performance improvements. Correspondingly, the high debt levels imply that the tax deductibility of interest are increased. Notice that performance improvements are also the result of financially driven arbitrage opportunities that arise as a consequence of differences in the company valuations.

Whatever the source of gain, the value of the equity investment will increase as a result of high leverage. Questions arise about whether the recent buyout boom was agency or financially-driven. To be sure, even though both elements have contributed, few observers would place primary emphasis on the agency side. As noted, readily available credit at low rates is probably a better explanation. Consider that risk premium on junk bonds over Treasuries reached a historic low of 2.63%, compared to the 20 year average of 5.42%. Recall that while buyouts returned to 1990s levels, the leverage in the capital structures was less than it had been in the earlier period. The average ratio of cash flow to interest cost was 3.4 in deals closing in 2004, 2.6 in 2006 and 1.7 in 2007. At the same time, many of the loans were also 'covenant lite', omitting debt covenants and ratio tests. In terms of the measuring the use of covenant lite debt, the volume reached \$48 billion in the first quarter of 2007, compared with \$24 billion in 2006.

Shifting now to the returns earned by private equity, we discuss the performance of funds as measured by investors. Even though private equity funds disclose information to investors about returns, it is often difficult to obtain accurate information because funds are under no legal obligation to disclose. Most financial economists rely on data bases collected from voluntary reports of private equity funds, which include information on returns. In terms of measuring fund manager performance, there are two leading measures used, namely the internal rate of return (IRR) and total value paid in (TVPIP), which supplies an estimate of the size of profits to investors relative to their initial investment in the fund.⁴ A recent study, by Kaplan and Schoar, on US private equity returns analyzed the returns of 169 buyout funds that were close to fully liquidated in the period of 1980–2001.⁵ They break the results into time periods to show that the IRRs were better for funds raised in the early 1980s and poorer for funds raised in the early 1990s. Moreover, they find that the average returns earned by investors in funds started by 1995 are about the equivalent of the amount that would have been earned on the S&P. A related study by Phalippou and Gottschlag, which revised and extended Kaplan and Schoar's data, indicates that the net returns by private equity funds lagged public equity markets by as much as 3.3% per year.⁶

2.2 The supply and demand side of private equity

Private equity can be defined as the investment of equity in non-listed companies. On the supply-side of private equity, we find the private equity fund, which is a

³ See McCahery and Schwienbacher (2010).

⁴ See Jenkinson (2007).

⁵ See *supra* note 2.

⁶ See Phalippou and Gottschlag (2009).

vehicle formed to pool the capital of different investors, such as pension funds, insurance companies, university endowments, and other wealthy individuals. They pool their money with others so that the fund can help to spread the risk of the investment. Professional fund managers invest the capital across a wide range of different holdings. The value of the investments can go up and down depending on the returns of the different investments. Investments of pooled investment vehicles are characterized by high expected returns and high risks. There are a number of reasons to invest in pooled investment vehicles which include: (1) to spread the risks and (2) investors have access to markets where the money has the potential for capital growth.

On the demand side, the pooled capital can be made available at several stages in a company's life. Private equity can take the form of venture capital. Venture capital funds have become the main funding source for high-growth businesses in the start-up and the expansion phase. Buy-out funds form another subset of private equity. These funds can decide to buy a business from a vendor (an institutional buy-out). If the target company's assets are used as collateral to raise additional debt to finance the acquisition, this is called a leveraged buy-out. It is also possible that private equity funds assist the existing (management buy-out) or new managers (management buy-in) in taking over a non-listed firm. Finally, private equity funds may decide to buy and acquire the shares of a publicly traded company. This is a so-called public-to-private buy-out. Thus there are two types of private equity funds: venture capital funds and buy-out funds.

Venture capital funds come in three variations in the United States: small business investment companies (SBICs),⁷ traditional venture capital funds, and corporate venture capital funds. In the United States, private equity is often associated with financing and developing companies that are unable to attract sufficient debt financing to support and finance their high-growth and often high-tech businesses. Not yet revealed and unproven technologies, the lack of liquid assets and the importance of human capital make bank finance unsuitable for these companies. Since future revenue streams are highly indefinable, access to debt financing through for instance asset backed securitization transactions remains a major obstacle for these firms. In the venture capital segment, fund managers make investments in businesses in which they play an important role in monitoring and participating in the day-to-day activities of management. In the first quarter of 2007, venture capitalists invested \$7.1 billion in 778 deals in the United States only, which is highest amount invested since the boom period of 2001–2002.⁸ Recent success stories include YouTube, Web 2.0, and Google. The post-boom resurgence has seen a noticeable shift in the venture capital industry, with data revealing the increasing role of corporate venture capital.⁹ The surge in corporate venture capital is attributable to a new level of risk-taking by large companies that are looking to

⁷ Under the Small Business Administration Act of 1958, the Small Business Administration (SBA) is authorized to license SBICs to make equity and loan investments in smaller entrepreneurial firms in the United States.

⁸ See US National Venture Capital Association (2007).

⁹ See US National Venture Capital Association (2006).

profit from investment in new technology and other innovations. With larger companies, such as Cisco, Intel, IBM, Kodak, Microsoft, and Siemens, expanding the scope of their operations to invest in start-ups, entrepreneurs tend to exploit the opportunity to obtain not only financial, but also technical and managerial assistance.

There may be several reasons why alliances between a start-up and a multinational may bear fruit for the venture. First, the start-up may very well offer strategic value of synergy to the multinational's core businesses. Second, even though a high rate of return is usually not the investor's main objective (thereby giving more stability to the venture), having a well-performing high-growth company in the portfolio may prove to be very lucrative. Third, it is generally accepted that these alliances often increase the credibility and reputation of the start-up firm. But there are also a number of disadvantages associated with the involvement of corporate venture capital funds. In particular the complexity of the transaction and the time-consuming decision-making procedures within large firms make traditional venture capital funds a more accessible source of private equity capital financing for high-tech start-ups. Alliances with corporate investors require the negotiation and drafting of a multitude of ancillary agreements relating to the promoting, selling, licensing and developing of technology and knowledge. More importantly, corporate investors are more inclined to carefully reconsider the investment and pull the plug in the event of a major downturn.

That is not to say that starting a business with capital from traditional venture capital pools is an easy task to accomplish. Venture capitalists tend to monitor and protect their investments through active participation, namely by due diligence, establishing a relationship with the start-up businesses' managers and by sitting on their board of directors. As soon as venture capitalists are hooked and involved, entrepreneurs and other key employees should be ready to abdicate control over their company. To be sure, venture capitalists will not typically depose an entrepreneur by acquiring a majority of the corporation's common shares. This is usually counterproductive, as discrepancies between them and the entrepreneur, implying an increase in agency costs. Allocating a substantial equity stake in the firm to the entrepreneur and other employees, which is akin to the stock option compensation system, fortifies the incentive to conduct the business diligently and discourages shirking and opportunism. Instead of seeking a majority of the corporation's equity, venture capitalists usually obtain control by utilizing complicated contractual mechanisms in their relationship with the entrepreneurial team and other investors. These contractual mechanisms protect the venture capitalists extensively from adverse selection and moral hazard problems. For instance, the use of staged financing and convertible preferred stock form an optimal combination which gives motivated entrepreneurs an incentive to take significant risks in order to increase firm performance while securing downside protection for venture capitalists.

The success of a venture capital market is mainly due to a private ordering regime in which contractual mechanisms are preferably employed to mitigate agency costs and to support the efficient structuring of staged financing and the sustained level of new entrepreneurs with high capacity to achieve their commercial

aims.¹⁰ Governmental interference and oversight appears to be counterproductive. Recent research seems to suggest that government initiatives could crowd out the supply of venture capital. Suppose, for instance, that a tax incentive to encourage individual investors to pour money into special venture capital funds turns out, in fact, to reduce the supply of other, relatively more informed venture capital investments by institutional investors.¹¹

By way of comparison, we look to buy-out funds which invest mainly in mature companies. The legal structure that makes the buyout market so effective also begins with the private equity fund by which providers of capital convey money to the fund managers who are running the business and actively making the investments in portfolio companies. Like venture capital funds, the relationship is governed merely by contractual provisions which allow the fund managers enough time and space to take firms private and restructure them. Note, however, that are significant differences in the organizational structure of venture capital and buyout funds. For example, buyout funds typically invest in mature companies with fairly predictable cash flows, which causes investors to give less leeway to the managers and to demand a minimum rate of return before profits are shared with the managers.

Until recently, buy-outs accounted for less than 10% of total number of investments. The statistical evidence shows the buy-out business continues to boom (The Economist, February 10, 2007), increasing in recent years to 20% in 2005 (EVCA data 2000–2005). For Europe, the total amount of private equity deals in Europe was €178bn, 41% higher than in 2005.¹² Remarkably the European market is dominated by US-based buyout firms. Overall, more than half of the funds raised in the private equity sector are invested in MBO/MBIs.

A clear pattern emerges from the many empirical studies that describe the LBO booms. It is worth noting that the 1980s LBOs boom was largely a US phenomenon. However, with the current LBO wave, the centre of gravity has shifted from the US to Europe and the UK. This should come as no surprise since the European economy has performed much better than in the 1980s. What are the causes for the current expansive round of LBOs? The now-standard explanation for the highly favourable circumstances to complete deals is the easy credit terms and low interest rates which have prevailed until recently. A second explanation looks to the pressures on fund managers which prompted them to increased the allocation levels for this particular class of assets. A third explanation points to the self-interested behaviour of the managements of public companies which have responded to shareholder pressure to obtain higher prices from private equity bidders. Another key feature of the boom has been the increase in corporate governance pressures. As a result, the cost of D&O insurance has increased substantially in the wake of Sarbanes-Oxley, which made executives personally liable for the accounting practices of their companies. In addition, we have also seen more shareholder scrutiny of executive pay. Given this, talented managers usually receive more generous compensation packages when

¹⁰ See Gilson (2003).

¹¹ See Cumming and MacIntosh (2006).

¹² See Financial News (James Mawson), Private equity levels double in Europe, 29 January 2007.

switching to a firm controlled by a private equity company. Finally, many laws, regulations and other measures are probably also responsible for the infrastructure to complete deals. One obvious message is that a favourable infrastructure is crucial for the acceleration of the private equity process.

At the same time, the case for leverage may have negative implications. It is also noteworthy that the buyout market, which peaked in the middle of 2007, collapsed rapidly in the last half of 2007 with the contraction in the credit market. During the most recent boom period, the leverage in private equity buyouts averaged about two-thirds. In Europe, buyout funds relied almost exclusively on banks and the syndicated loan market to fund their investments. The economic impact of private equity on the loan market has been significant given the amount of equity raised for highly leveraged buyouts over the past decade.¹³

However, with the credit crunch making it harder to place buyout debt, the average size of buyouts this year has fallen to \$120 million (Thomson Financial 2008). In the current environment, there are few incentives for private equity funds to make investments and draw down their clients' capital. This suggests that much of the new capital raised by private equity funds remains un-invested. Thus, to the extent that the current collapse parallels the 1989 decline in the buyout market, there will be a challenge for agency theory. While agency theorists identified faults in regulation for the earlier collapse, there is no easily identifiable regulation that can be held to account for this most recent decline in the market. As the recent wave has shown, buyouts take place only when the capital structure of target firms can be leveraged up with debt. So, even if fund managers have incentives to improve the performance of target firms through agency-driven improvements, it is unlikely that the potential for performance improvements alone could suffice for triggering a buyout wave.¹⁴

3 Dealing with agency problems: contractual arrangements

In this section, we begin by reviewing the similarities between private equity and hedge funds. We then discuss the extent to which the two fund types differ. At first glance, one noticeable incidence of convergence is the extent to which hedge funds

¹³ See *supra* note 4.

¹⁴ Equally, we would expect fund managers to look to alternative sources of capital, such as sovereign wealth funds which have an estimated combined resources of \$2,000 billion to \$3,000 billion, to step into the place of banks in funding leveraged buyouts. While it is easy to see why buyout firms are moving towards sovereign wealth funds, we have to acknowledge that a majority of these funds are unlikely to supply debt for buyouts for private equity firms. Reasons for the hesitance of large sovereign wealth funds to be a new source of capital for these deals may include the acknowledgement that they do not currently have the institutional capacity to manage more risky investments. Also, many mutual and sovereign wealth funds may be unwilling to lend in the circumstances where the sweetened terms are not sufficiently high to meet the investment objectives of the fund managers. We conjecture that sovereign wealth funds do not have the investment objectives, time or specialized skills with which to efficiently monitor and add value to investments in private equity and buyout funds. It is possible that private equity will continue to innovate and find new sources of funding, but it is more likely that the new sources will not be sufficient to support the level of debt required by these firms. Until confidence returns in the credit markets, the level of debt involved in private equity and buyouts will be considerably smaller than before.

and private equity managers pursuing similar assets and investment strategies to secure superior market returns. When hedge fund advisers are dissatisfied with traditional strategies and unable to obtain their desired rates of return, they have moved quickly to adopt those strategies usually employed by private equity funds, such as corporate restructuring and buyouts, to achieve better value on their investments. This is partly due to the overcrowding of the hedge fund market place. This has led to clashes with traditional private equity funds. A noteworthy example is the bidding war between one of the largest private equity firms, Kohlberg Kravis Roberts & Co, and Cerberus Capital Management for the acquisition of Toys 'R' Us.

Thus, the recent emergence of hedge funds competing with private equity firms for target companies to take private is another example of how these two forms are converging. There are a number of factors that account for this trend. First, the increased number of funds and new capital flowing into private-equity and hedge-funds make it harder for advisers to produce premium returns. Second, debt continues to be relatively abundant worldwide and at relatively attractive rates. Third, hedge funds and buyout funds are increasingly seeking the same cost savings and synergies that strategic buyers have always employed to justify their higher multiples. Effectively, these trends have blurred the differences between the two fund types.

The increased convergence has led hedge funds to incorporate private equity type features in their fund structures, reducing investor flexibility through side pockets (investments in illiquid stakes, which are accounted for in terms of administrative fees and incentive fees separately from the fund), gates (caps on the amount of annual withdrawals from the fund by investor to manage liquidity risk) and lock-ups (restrictions preventing investors from withdrawing from the fund within a specified period). Of course, one can cast doubt on whether these strategies can generate solutions for all the problems associated with hedge funds providing their investors with diverse investment opportunities. As long as management and performance fees are based on striking a net asset value of the fund, hedge fund investors are willing to pay the fees. However, investors are more likely to challenge performance payments to an adviser that has invested in illiquid securities that may not have an easily ascertainable market value. Private equity funds have addressed this concern through distributions based solely on realized events or the use of clawback provisions that mandate funds to return performance fees if the fund subsequently goes into a loss position. These strategies to manage valuation risk have been resisted so far by the hedge fund industry.

Despite these similarities, private equity and hedge funds differ in a number of important respects. For instance, private equity can be distinguished from hedge funds in terms of their investment strategies, lock-up periods, and the liquidity of their portfolios (see Table 2).

Moreover, private equity fund managers have incentives to take large illiquid positions in the non-listed securities of private companies. Investments made by private equity funds take place during the first 3–5 years of the fund, which is followed by a holding period which averages between 5 and 7 years in which few new investments are made. Unlike private equity, the shorter lock-in period of hedge funds and their more flexible structure explains the dominance of highly

Table 2 Hedge funds vs. private equity funds

	Traditional hedge fund	Traditional private equity
Investment strategies	Investment in liquid securities that can be marked-to-market easily Pursue alpha generating strategies (risk arbitrage)	Investment in illiquid equity stakes, for example stakes in private companies Add value for the fund through screening
Fund structure	Typically LP	Typically LP
Management vehicle	LLC or corporation	LLC or corporation
Other fund terms	Upfront investment (100% at subscription date) No lock-up periods; investors can access or exit the fund periodically Perpetual Management fees are typically 1% of NAV of the fund and paid quarterly Incentive fee: 20%, paid periodically, no clawbacks	Commitment upfront plus drawings over time Investors typically do not have withdrawal rights and are locked-up for multiple years Term Management fee is typically 2% of committed capital and paid quarterly Incentive fee: 20%, paid upon realization of profits, subject to clawbacks

liquid, short-term investments which allow investors easier access to the withdrawal of their investment funds. In the next section, we examine the typical structures used by pooled investment vehicles, namely private equity and hedge funds. We focus on the three parties: (1) the general partner; (2) the investment adviser; and (3) the limited partners. We consider the extent to which hedge funds and private equity employ similar legal forms and contractual provisions between the GP and LPs. We note that despite some overlap in fund structure and organization, private equity and hedge funds typically employ different trading strategies, compensation and governance arrangements which are reflected in the main contract between the GP and the investors.

3.1 The relationship between investors and fund managers: the limited partnership structure

A fund of a private equity firm, hedge fund or venture capital firm is a pooled investment. The fund can be seen as a vehicle formed to pool the capital of different investors. Contributors to these funds are institutional investors, pension funds, university endowments and other wealthy individuals. They pool their money with other so that the fund can help to spread the risk of the investment. Professional fund managers invest the capital across a wide range of holdings. The value of the investments can go up and down depending on the returns of the different investments. Investments of pooled investment vehicle are characterised by high expected returns and high risks. There are a number of reasons to invest in pooled investment vehicles which include: (1) to spreading of risks; and (2) gaining access to markets with the potential for capital growth.

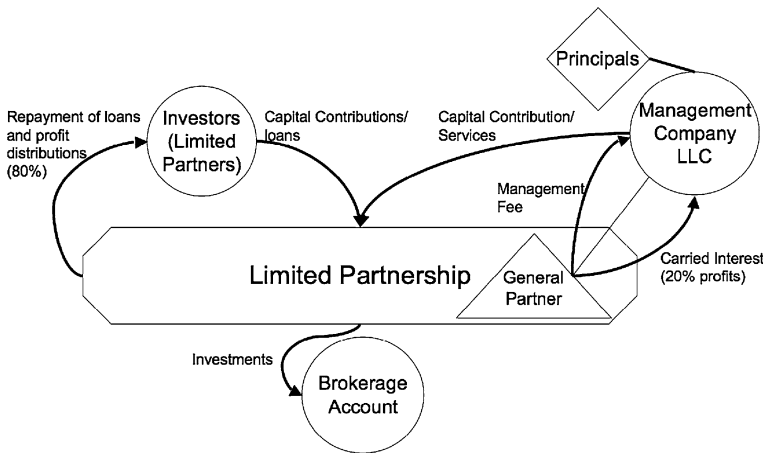


Fig. 1 Typical private equity fund structure

In the United States and elsewhere, the limited partnership form is the dominant legal vehicle used in hedge fund and private equity structuring. Both fund types are usually organized as a LP, with a GP and management company, both structured as separate legal entities, and the limited partners (see Fig. 1).

As we have seen, the popularity of this form is due to its contractual nature which allows the internal and external participants to reduce opportunism and agency costs. Indeed, the limited partnership structure permits fund managers to achieve extensive control over the operation of their funds subject to few intrusive legal obligations. Other features, such as tax benefits, the flexibility surrounding its structure and terms, and its fixed life, contribute to its continuing viability as the business form of choice for collective investment vehicles. The LP has other important advantages as well. First, it is familiar to most investors and intermediaries, which contributes to its enduring popularity. Second, there is a risk that LLCs, operating outside the US, could be treated as a non-transparent foreign entity and taxed as a corporate body. As a consequence, some sponsors are reluctant to switch to the LLC.¹⁵ Typically the sponsor will invest between 1% and 3% of the fund's total commitments. In order to obtain fees, the sponsor will create two entities: an LP and a management company, which is organized either as an LLC or corporation. Moreover, the management company is either a separate entity from the GP or affiliated with one of the GPs, or is a subsidiary of a bank or insurance company and, accordingly, will exercise effective control over the GP and fund manager. With a management company, the day to day management is separated from the fund which may assist in resolving some tax issues while limiting doing business and other concerns.

The relationship between the limited partners and the general partners mainly relies on explicit contractual measures. Table 2 below shows the most common

¹⁵ Nevertheless, some sponsors are now beginning to structure their funds as a Delaware LLC since it has the same organizational flexibility and tax efficiency as the LP.

Table 3 Limited partnership agreement: negotiating the terms

General partners	Limited partners
Carry calculations	Carry calculations
Management fees	Claw-back provisions
Claw-back provisions	General partner conflict issues, including limitations of opportunities
General partner capital commitment	Key-man provisions
Limitations of liability	Management fees
Indemnification by general and limited partners	General partner capital commitment
Investment strategy, limitations and guidelines	Side letters
Fundraising period, investment period and term	Investment strategy, limitations and guidelines
Permitted activities of general partners	Permitted activities of general partners
Limited partner approval rights	Portfolio company fee offsets

Source: Adapted from Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth

contractual measures that have been developed for dealing with the investment activities of GPs, and the relationship between GPs and LPs inside private equity funds.

A key contractual technique, for example, is the compensation arrangement between the fund manager and the investors. Compensation derives from the two main sources. First, fund managers typically receive 20% of the profits generated by each of the funds. The second source of compensation is the management fee. Historically, a significant majority of funds assess management fees as a constant percentage of committed capital. It is noteworthy that there has been a decrease in the management fees in recent years due to a number of economic factors. In particular, some funds are more likely to have a fixed fee of 2% of the funds assets which is paid annually for 5 years and then decreases by 25 basis points for the next 5 years period. Other fund managers will allow reductions of the fixed fee based on a change from committed capital in years 1–5 to net invested capital in year 6–10. Given these changes, a substantial proportion of buyout firms' median take off-the-top of committed capital has been reduced to 12% (Table 3).¹⁶

To be sure, investors attempt to maximize fund managers performance by insisting on hurdle rates that climb upwards to 15–20%, which means that profits can only be distributed after a certain threshold has been reached. Thus, from the perspective of private equity, the contractual flexibility of the limited partnership plays a central role in aligning the interests of management and investors. For instance, in order to protect the 80/20 deal, a clawback provision will be included in the agreement that provides that an overdistribution to a GP will be clawed back to the fund and then distributed to the LPs. What triggers a clawback provision?

In practice, clawbacks can be triggered when the preferred return or hurdle is not reached and the GP obtained carried interest or if the GP has received more carried interest than the agreed 20% of cumulative net profits. Here we can use an example

¹⁶ See Metrick and Yashida (2010).

Table 4 A clawback example

	GP	LP
Profits	$5 \times 0.20 \times 100 = \100	$5 \times 0.8 \times 100 = \400
Contributed capital		$5 \times 100 = \$500$
Initial investment		$6 \times 100 = \$600$
Investment return		$(5 \times 200 - (6 \times 100))/600 = 67\%$

to show how the clawback is intended to function. If we assume that a fund has six investments: A to F with each was purchased for \$100. Also assume that five of these investments were sold each year for \$200. As a result, the GP receives a carried interest of 20% and the LP receives 80% of the cumulative profits of the investments and of course the contributed capital. But, the 6th project defaults to \$0. Thus, the total net profits of the fund are \$400 – (500 – 100 loss) or 67% for the LPs. Yet, it was agreed that the GP would receive 20% of the net profits, or \$80. But the GP received \$100, which accordingly triggers the clawback provision.

It is noteworthy that there also number of approaches for structuring the clawback obligation, including the “pay it back now” approach or the segregated reserves approach. Under the first approach, the GP will immediately provide a clawback to the LPs. This method is remarkably straightforward and requires a potentially large cash contribution by a group of individual managers who may not have the financial ability to make the required contribution. In contrast, the reserve account approach places costly constraints on managers by requiring that the cash deposited in the reserve account is invested in a safe, cash-equivalent instrument in order to satisfy eventually the clawback obligation. At the same time, there is also a limited partner clawback which is intended to protect the GP against future claims, should the GP become the subject of a lawsuit. For the most part, the clause will include limitations on the timing and amount of any judgement.

Finally, as it happens, many LP contracts will include a preferred return provision. This is a minimum return rate which ranges from 5 to 10%. The idea of preferred return is that it affects the timing of the carried interest. Such a targeted return must be met before the fund manager can share in the fund profits. Preferred returns are normally required by LPs who make commitments to new funds or funds involved in buy outs. Most priority returns have a catch up provision, which permits a reallocation of the profits to the GP after the priority return has been distributed to the LPs (Table 4).¹⁷

Overall, the contractual mechanisms for determining GP’s compensation include both a profit sharing arrangement that balances investors’ concerns regarding pay-for-performance, and a distribution scheme to investors to limit overall fund risk-taking. Moreover, there are a variety of factors that affect fund manager compensation. First, fund managers are expected to have higher fixed fees and

¹⁷ Interestingly, while the literature has spent much time analyzing the optimal compensation structure for GPs, recent empirical work has found that legal and institutional factors explain the differences in fund manager payment terms, the timing of the distributions to investors, and the probability of clawbacks (Cumming and Johan 2006).

carried interest percentages in jurisdictions with high quality legal rules and enforcement environment. Second, fund focus and characteristics can result in quite different outcomes for fund managers. For example, funds focusing on venture capital investment are more likely to require professional staff and expertise which leads to lower yields and higher performance fees to align interests. Conversely, larger funds, such as buyout funds, are more likely to have lower fixed compensation because they require less staff than funds focusing on venture capital. Finally, the type of institutional investor and their risk appetite may influence the fixed and variable fee structure of fund managers.

3.2 The relationship between investors and fund managers: restrictive covenants

In the previous section, we examined how the flexibility of the limited partnership form allows the internal and external participants to enter into contractual arrangements that align the incentives of fund managers with those of outside investors. If well structured, the limited partnership agreement can effectively reduce agency costs. In this section we turn to consider how limited partners are usually permitted, despite restrictions on their managerial rights, to vote on important issues such as amendments of the partnership agreement, dissolution of the partnership agreement, extension of the fund's life, removal of a general partner, and the valuation of the portfolio. In addition, we examine how limited partners employ several contractual restrictions when structuring the partnership agreement depending on the asymmetry of information and the market for investment opportunities.

In recent years, a number of law and finance scholars have studied the role and frequency of covenants in the agreements between institutional investors and professional fund managers. An early study by Gompers and Lerner (2006) focuses on restrictive covenants imposed by institutional investors on fund managers in respect of the operation of the fund. They grouped the venture capital fund restrictive covenants into three categories: (1) restrictions on management of the fund; (2) restrictions on the activities of the GP; and (3) restrictions on the types of investment.¹⁸

In terms of the first category of covenants, the first restriction in this class involves limits on the size of investment in any one firm which discourages the GP from allocating a large portion of the fund to a single investment. This is similar to the restrictions on the type of behaviour that would increase the leverage of the fund and thereby amplify the risk for institutional investors. A restriction on co-investment is designed to limit the opportunism of fund managers so as to avoid one fund artificially improving the performance of another. A second category of covenants are designed to limit the investment activities of the GP. The restriction on co-investment by fund managers is designed to limit the agency problem which might arise from selective attention to certain portfolio firms at the expense of the

¹⁸ See Axelson et al. (2009). The frequency of standard covenants in limited partnership agreements, suggested by Gompers and Lerner's evidence, is related to funds having to seek third party investment for all investments above a specified fraction of the fund's level (20%) or for taking on leverage at the fund level.

performance of the entire fund. The covenant is designed to limit the sale of fund interest by fund managers to ensure that their commitment to the fund is not compromised. Further, the key person provisions and restrictions on additional partners is intended to ensure that management does not opportunistically hire new personnel to manage the fund in breach of their commitments made to the LPs. The third category of covenants is related to restrictions on types of investment that GPs can make. These covenants reduce or eliminate the potential for management to opportunistically alter the focus of the fund for their own profit at the expense of investors. Restrictions include limitations on investments in venture capital, public securities, LBOs, foreign securities and other asset classes.

In the context of determining the frequency of the covenants for such funds, Gompers and Lerner found that the number and type of covenants correspond to the uncertainty, information and asymmetry and agency costs in the portfolio companies. Table 5 shows the distribution of covenants for VC funds.

They demonstrated, moreover, that there is positive relationship between the use of restrictions and the propensity of the fund managers to behave opportunistically. As Table 5 shows, there are a number of distinct covenants that address problems relating to the management of the fund, conflict of interests, and restrictions on the type of investment the fund can make. Other factors affecting the use of restrictions are the fund's size, the compensation system of the managers, and their reputation.

Table 5 Distribution of covenants in venture capital funds

Description	% of Covenants
Covenants relating to the management of the fund	
Restrictions on the size of investment in any one firm	77.8
Restrictions on use of debt by partnership	95.6
Restrictions on coinvestment by organization's earlier or later funds	62.2
Restrictions on reinvestment of partnership's capital gains	35.6
Covenants relating to the activities of the general partners	
Restrictions on coinvestment by general partners	77.8
Restrictions on sale of partnership interests by general partners	51.1
Restrictions on fund-raising by general partners	84.4
Restrictions on other actions by general partners	13.3
Restrictions on addition of general partners	26.7
Covenants relating to the type of investment	
Restrictions on investments in other venture funds	62.2
Restrictions on investments in public securities	66.7
Restrictions on investments in leveraged buyouts	60.0
Restrictions on investments in foreign securities	44.4
Restrictions on investments in other asset classes	31.1
Total number of partnership agreements in sample	45
Average number of covenant classes	7.9
Average number of covenant classes (weighted by fund size)	8.4

Source: Gompers and Lerner (2006)

In contrast, hedge funds rely less on covenants due to the shorter lock-up periods and the funds liquidity. Finally, the public nature of the activities of hedge funds, particularly in the market for corporate control, tends to limit the principal-agent problems that might otherwise emerge.

It is noteworthy that the average frequency of use of covenants in non-US VC partnerships is unrelated to the supply and demand of venture capital. Schmidt and Wahrenburg (2003) show that established European funds are more severely restricted by the use of three sub-categories of covenants within VC-partnership agreements. An international comparison of contractual covenants among private investment funds across countries also indicates a significant difference in probability of use of covenants (Cumming and Johan 2006). Figure 2 shows the distribution of use of covenants of international VC-partnership agreements.

In this context, Cumming and Johan (2006) have offered a “quality of law” explanation for the frequency of use of investment covenants imposed by institutional investors pertaining to GPs’ activities relating to investment decisions, investment powers, types of investment, fund operations and limitations on liability. According to Cumming and Johan (2006) the presence of legal counsel that review covenants would increase the probability of covenants. They find evidence, moreover, that the quality of law and other institutional and legal practice factors is positively correlated with the number of covenants relating to fund operations. In their view, an improvement in the legal system, as measured by an increase in the Legality Index (a weighed average of the legal index variables introduced by La Porta et al. (1997, 1998) as defined by Berkowitz et al. (2002)) from 20 to 21 (normal improvement rate for developed country), correlate to a higher the use of an additional covenant relating to fund operation by about 1%, but an increase in the Legal Index from 10 to 11 (normal improvement rate for developing country) increases the probability of the presence of an extra fund operation covenant by about 2%.

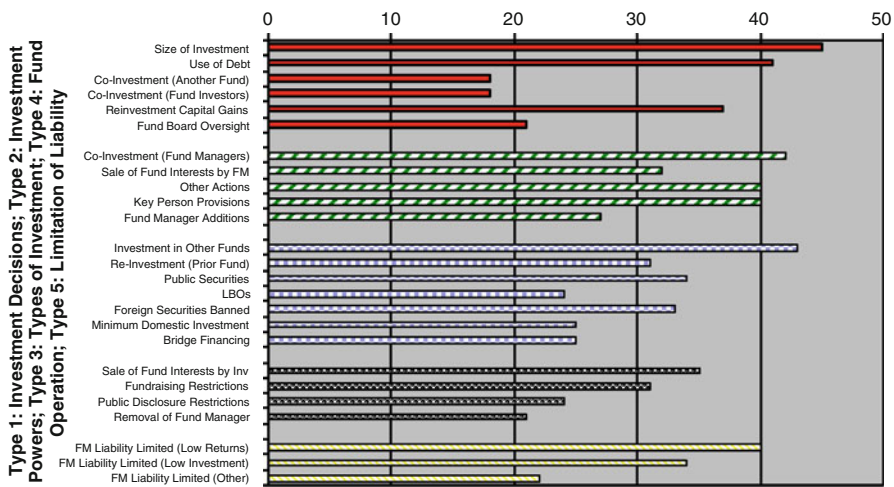


Fig. 2 Frequency of use of each covenant. Source: Cumming and Johan (2006)

The above studies emphasize how important it is to recognize the critical role of management influence in determining the management and structural characteristics of a fund, the agency problems and control issues that emerge in the investment process and the conflicts of interest that occur in times of market upheaval. LPs have high powered incentives which greatly improve their ability to focus on addressing these problems through negotiating and implementing covenants to protect LPs and ensure the GP's incentives serve investors' interests. Further improvements in the training of legal counsel that review covenants is likely to positively influence the frequency of some covenants. A more complete solution would require increases to the quality of legal systems generally in developing and civil law jurisdictions.

3.3 The relationship between the funds and their portfolio companies

In exchange for their investments, private equity funds usually demand control rights in addition to their shareholdings. In practice, it appears that private equity investors often avail themselves of the features of convertible preferred stock.¹⁹ Initially, finance scholars argued that convertible preferred stock was an optimal instrument to control the substantial agency problems related to the investment process.²⁰ Economic studies show that convertible preferred stock is predominantly used by venture capitalists to protect themselves against the downside risk of their investment by providing seniority or priority rights over the common equity.

Convertible preferred stock allows for significant *ex post* flexibility in the determination of control rights and the conditions upon which venture capitalists are allowed to exit their investment. Convertible preferred stock is considered optimal, on the one hand because it secures downside protection for venture capitalists, and on the other hand because it gives entrepreneurs incentives to take significant risks in order to obtain a higher final firm value in the event of success. In fact, convertible preferred stock limits opportunistic behaviour by allocating exit control to the venture capitalist. More recent models show that convertibles are an optimal form of finance when entrepreneurs and venture capitalists are required to introduce value into the firm sequentially. The use of convertible preferred stock is crucial for venture capitalists, since, having become active investors, they must obtain a secure means of exit from their investment.²¹ The precise scope of the features is

¹⁹ See Dent (1992: 1060–1061) ('[a] separate class of common stock could include these features. Yet, because they are not typical features of common stock, drafting would be somewhat difficult.')

²⁰ More recent research has looked at the contractual relationship between institutional investors and fund managers, suggesting that there is a positive correlation between the quality of a country's laws and the use of contractual provisions regulating private equity investment. The implication is that there are significant benefits to encouraging stronger legal conditions that could benefit fund manager compensation, fund returns and the development of venture capital markets (Lerner and Schoar 2005; Cumming and Walz 2009).

²¹ It is widely acknowledged that convertible preferred stock is the dominant form of security used by venture capitalists in the United States. This may be due to the standardization of purchase agreements. See Gilson and Schizer (2003). Commentators argue that there are a number of reasons for the significantly higher usage of convertibles in the US compared to Europe, Canada and elsewhere (Cumming and Johan 2008). First, it is assumed that US venture capitalists are more sophisticated and better established than the venture capitalists elsewhere, which accounts for the significantly lower use of

established by the terms of the stock purchase contract. Although we speak of a contract, the rights must traditionally be defined in the corporation's articles of incorporation for the purpose of certainty of information.

The following terms can usually be distinguished: preference on dividends and liquidation, voting rights, conversion rights and anti-dilution provisions, redemption of the preferred shares, pre-emptive rights, go-along rights and information rights. All of these rights must be defined in detail. It is also the case that, in addition to the contractual provisions provided to preferred shareholders, they are offered certain minimum protections through fiduciary obligations.²²

Venture capitalists can acquire preferred shares with a *cumulative dividend right*. This right means that if a preferred dividend is not paid in any year, it accumulates; the accumulated arrears must be paid in full before any dividends are paid on common stock. Preferred shares can also be non-cumulative, so that the portfolio firm has no further obligation for unpaid dividends. In between these two scenarios are partially cumulative preferred shares. Furthermore, venture capitalists sometimes use participating preferred shares. In such a case, in addition to the dividend preference, they may participate with the common stock in any dividends declared on that stock. In practice, since most innovative start-ups scarcely yield any profits during the period of the venture capital financing, the parties often agree that the corporation pays no dividends at all.

Preferred stock usually grants the venture capitalists a *liquidation preference*, which provides that on liquidation a designated amount—typically, the price at which the preferred shares were issued—should be paid to the preferred shareholder before any distributions are made with respect to common stock. In the worst-case scenario, this right gives the venture capitalists a senior claim to cash flow and distributions in liquidation, through which they can retrieve at least some of their investment. It shifts the risk from the venture capitalists to the entrepreneur.

Preferred shares are normally non-voting shares. However, venture capitalists often procure convertible preferred stock that confers a *right to vote*. The voting rights typically correspond to the number of shares they would have after conversion. They are entitled to vote as a separate voting group on amendments that are burdensome to them as a single class and are beneficial to other classes.²³ If the

Footnote 21 continued

these instruments by non-US venture capitalists. Second, the size of the European debt market and the preference on the part of venture capitalists in Europe for straight debt may account for a lower rate of use of convertible preferred stock. Third, Gilson and Schizer (2003) have argued that US venture capitalists are attracted to the tax advantages associated with convertible preferred stock, which allows them to make a lower valuation for the entrepreneur's common shares. Implicit in this argument is the view that the tax incentives connected to the reduced initial valuation of common stock for venture capitalists are the reason for the significantly higher use of convertible preferred stock in the US, rather than the agency cost-reducing qualities of the instrument identified by models created by finance scholars.

²² Note that under Delaware law preferred stockholders are protected by the core fiduciary duties of care, loyalty and good faith. Any special rights attached to preferred stock are interpreted like any other contractual rights. See e.g. *Benchmark Capital v Vague*, 2002 WL 1732423 at 6; *Sanders v Devine* 1997 WL 599539 at 5.

²³ The Model Business Corporation Act (1984) §10.04 lists nine types of proposed amendments that trigger the right of a class of shares to vote as a separate voting group on an amendment.

venture capitalists do not actually control the majority of the votes, this ‘class voting’ mechanism protects them against troublesome resolutions. In addition, the class of preferred shares is typically entitled to elect half or more of the members of the board of directors.²⁴ This implies that venture capitalists may participate directly in management by serving on the board themselves. In so doing, they have substantial control over the board. It also gives them the opportunity to replace the entrepreneur as Chief Executive Officer (CEO) if the business is in danger of failing.

Venture capitalists typically elect take *convertible* preferred stock. If the business is successful and an IPO is feasible, the venture capitalists may, at their option, convert their preferred shares into marketable common shares and sell them profitably as soon as the corporation goes public.²⁵ The articles of incorporation must contain the conversion ratio at which the conversion is to take place.²⁶ A favourable ratio to venture capitalists may mitigate window-dressing by the entrepreneur, since manipulating short-term signals may persuade the venture capitalists to exercise the conversion option and so dilute the ownership of the entrepreneurial team. The ratio may also depend on the performance of the business, i.e., ‘if the company does well, the conversion price might be higher’. A contingent conversion ratio will increase the short-term incentive to the entrepreneurial team, as a high price due to good (short-term) results may prevent the venture capitalists from converting. In such a case, ‘window dressing’ would decrease the chance of dilution of the common stock held by the entrepreneur and his key employees.

In addition, the articles of incorporation normally provide for *antidilution* provisions to take into account changes that have occurred in the number of outstanding common stocks since the preferred stock was issued. They ensure that the venture capitalists retain a relatively steady level of ownership.

Preferred stock is often made redeemable at the option of the venture capitalist (often called a ‘mandatory redemption’, a ‘put’ or a ‘buyout’). This right supplies an exit mechanism in the event that the business ‘is financially viable but too small to go public’. The redemption price is typically the original purchase price augmented by a reasonable rate of interest. In a few isolated instances, the entrepreneurial team has the power to redeem the preferred shares from the venture capitalists on behalf of the corporation.

The venture capitalists are usually entitled to purchase new shares proposed to be issued pro rata basis with their common-stock-equivalent holdings. Such a *pre-*

²⁴ See the Model Business Corporation Act (1984) §8.04 provides that directors may be elected by certain classes of shareholders. As for the removal of directors, §8.08(b) provides that if a director is elected by a voting group of shareholders, only the shareholders of that voting group may participate in the vote to remove him.

²⁵ Agreements usually confer on the venture capitalists the right to register their shares with the Securities and Exchange Commission (SEC) for public sale. ‘Piggyback’ rights entitle the investor to include his stock in the firm’s public offerings. ‘Demand rights’ go further by allowing an investor to compel the firm to register the investor’s stock with the SEC. See Dent (1992, pp. 1049–1050).

²⁶ The ratio determines how many shares of common stock a preferred shareholder receives upon the exercise of the conversion.

emptive right avoids the dilution of the proportional interest of the venture capitalists in the corporation.

In the event of the entrepreneur and the key employees receiving an offer to sell their stock, most preferred shareholder contracts provide that the venture capitalists can sell their shares after conversion at the same time and on the same terms. Such a *go-along right* protects the venture capitalists from the unwanted influence of a third party over the business. While they cannot prevent the third party from buying the shares, they can demand that the third party buy them out on the same terms as the entrepreneur and the key employees. This right prohibits the entrepreneurial team from selling their stock unless venture capitalists are offered the same terms.

Finally, the articles of incorporation often specify that the firm must maintain and provide specific records, including financial statements and budgets. They also provide that the venture capitalists can inspect the business's financial accounts at will. The right to information is essential, as (1) information is necessary for venture capitalists to use preference rights intelligently, (2) it restrains the entrepreneurial team from engaging in reckless conduct, and (3) in most states, corporation statutes by default restrict the right to inspect the books and records either to certain documents or to certain events.

What becomes even more pressing in an era in which hedge funds and private equity are playing an increasingly important role in corporate governance and corporate control. The rapid transformation of activism by hedge funds and private equity is heralded by some as the next corporate governance revolution. This activism is, as we have seen, characterized typically by mergers and corporate restructurings, increased leverage, dividend recapitalizations, and the replacement of management and board members. The result has been that if a firm is mismanaged, these funds use their capital in a focused and leveraged way so as to take over control and initiate different, more beneficial and effective business strategies. Yet even though they have the potential to impose tremendous discipline on boards and managers of firms, these funds are often opaque and complex. Moreover, hedge funds are being accused of neglecting long-term goals and pursuing short-term payoff. The risk involved in investing huge amounts of capital calls for corporate governance measures for investment funds. By focusing on regulation, we seek to contribute a better understanding of the advantages and limitations of investor-owned firms.

4 Regulation of private equity funds

Policymakers and the media have drawn attention to the confusion that private equity funds are currently causing in the world of finance and corporate governance. The recent wave of private equity-based buyouts of publicly listed companies has prompted questions and political controversy about whether private equity is always beneficial. For example, the purchase of VNU, a global information and media company, by a consortium of private equity firms triggered concerns that the advantages of taking the firm private, including cost reduction and increased operational efficiency, may not offset the costs involved when the delisting of

companies entails a significant reduction in liquidity of equity markets. Moreover, the sophisticated use of financial engineering techniques, in particular the funding of acquisitions with large amounts of debt, which are subsequently loaded on the acquired businesses, raises suspicion.

The ongoing debate over the costs and benefits of the rise of private equity raises the question as to whether more detailed regulation and supervision of funds is required. Given the contractual mechanism that prevail in the governance of both private equity and hedge funds, an initial hands-off approach might be warranted. What is more, private equity are evolving into more transparent investment vehicles. First, institutional investors, demanding better risk management, encouraged equity funds to adopt better valuation techniques and controls. Second, buy-out groups attempted to improve their reputation and image by joining respectable industry bodies, like the British Venture Capital Association, or initiating the establishment of such a group in their respective countries, such as the Private Equity Council in the United States. The purpose of these groups is to conduct research and, more importantly, provide information about the industry to policymakers, investors and other interested parties. Lastly, in search for more stable capital, private equity funds increasingly raise or are planning to raise money by listing funds on public markets. By floating shares or units of a fund, advisors voluntarily subject themselves to regulatory supervision. The contractual nature of private equity funds in combination with the trend towards self-regulation by industry groups suggests that the sophisticated players in the private equity industry are themselves capable of disciplining opportunistic behaviour by fund managers and advisors. This strategy, which ensures that possible rules and regulations are in line with both best practices and standards applied in the world of private equity, is examined in the next section.

4.1 Self-regulation

This section will explain the function of soft law principles and industry standards specifically tailored to private equity funds in assisting general partners and investors from overcoming bargaining problems and uncertainties connected with the operation of private equity funds. The following questions will be addressed. Is there a credible role for best practice guidelines in improving the contractual governance arrangements of private equity funds? Does each industry segment require the introduction of governance guidelines specific to the segment and its business model? Which institutions or group is best placed to develop the right set of principles? Do governmental committees or industry-based associations ensure the creation of optimal guidelines? Having seen that the procedures involved for the creation of best practice guidelines enhance integrity and awareness for the business practices and stakeholders, the question is whether what matters most is the substantive variation in guidelines across the industry sector or the standardization achieved by a general code.

Answers to most of these questions can be found in practice which already shows the emergence of distinctive guidelines for private equity firms. A soft law example is the launch of the European Venture Capital Association (EVCA) Corporate

Governance Guidelines for the Management of Privately Held Companies in 2005 (European Venture Capital Association 2005). Designed in consultation with industry experts, the EVCA guidelines provide a set of optional measures that focus on the staged investment decisions of venture capital and private equity funds and the contractual circumstances surrounding these investments. In this regard, provisions that enunciate the duties and responsibilities in relation to design and execution of corporate strategy are a core feature of the recommendations.

These corporate governance recommendations supplement other standards and guidelines in order to provide greater transparency to the venture capital industry. For instance, the development of a system of timely reporting is called for with respect to annual reports and financial statements on a company website within 6 months of year-end. Indeed, to the extent that investors need to be informed about the operation of the fund, the guidelines call for a financial review that refers to the risk management objectives and policies in light of the risks and uncertainties facing the company, and the impact of increased leverage and the other fund risks. Likewise, investors in such funds invariably expect timely disclosures and therefore the EVCA guidelines specify that management should issue an interim statement not more than 3 months after mid-year. In addition to these guidelines on financial disclosure and governance, there are specific reporting requirements for General Partners pertaining to fund management team composition, including senior members of the general partner team and supervisory committee, experience and responsibility for management of the fund, as well as fund factors such as stage and industry focus, holding periods and fund history. Also pertinent is the compensation and categorization of the limited partners, as well as the investors countries of origin and their institutional characteristics.

Industry based guidelines have also appeared at the national level. For example, a separate code for private equity funds was introduced by the Dutch Private Equity and Venture Capital Association in 2007. Experts immediately praised the Code for encouraging more transparency with respect of fund practices and its educative value to firms. While there had been some doubts about the willingness of firms to adopt these practices in their dealings with investors and third parties, the Code will become mandatory for all member of the Association at the end of the one year trial period. With the introduction of the Code, the Association aims to professionalize private equity firms by encouraging the adoption of standardized practices, such as fund managers providing clients with clarity regarding their plans and investment decisions, and to enhance accountability by taking into account the considerations of other interested parties when making investments in the Netherlands.

The governance principles work in tandem with other core features of the Code in order to provide better transparency for investors in private equity firms. This is important, since there are restrictions on the ability of investors to obtain superior information on fund operation and the management of their investments. The principles include, first, that the fund manager take into account the specific information needs of investors based on the specific contractual conditions between the parties. Second, pertaining to the management of the portfolio company, private equity firms—including other shareholders and fund management—must make

disclosures about their investment objectives, financial structure, investor participation period, and the responsibilities of the supervising party.

In the case of buyouts, the Code obliges the fund to disclose a plan within six months of the transaction. In addition, buyout funds are required to comply with traditional corporate governance measures regarding the internal organization of the company, which are designed to improve the relations between the parties, limit potential agency problems and enhance firm performance. Third, with respect to other shareholders of the portfolio company, a Code requires that shareholders must make disclosures about their decision-making powers, the frequency and content of disclosures, management of the portfolio company, confidentiality agreements and loan agreements. In terms of the monitoring and supervision of portfolio companies, private equity funds have an incentive to achieve high standards of management supervision in order to maximize performance and manage the activities of the fund in the interests of the parties involved. To this end, the Code recommends the fund's supervisory board may can serve to limit the conflicts of interests between the fund manager and fund investors by appointing qualified, knowledgeable members that can act independently. To be sure, the Code recognizes that the conflicts will be easier to manage when the supervisory board has full information regarding the investor and management agreements. Finally, fund managers should have incentives to engage with other stakeholders, such as creditors, about management and investor agreements.

It is noteworthy that a similar set of guidelines were produced in November 2007 by Sir David Walker's working group for the British Venture Capital Association (BVCA) on disclosure and transparency in the UK private equity industry. The guidelines, which are a voluntary set of rules to be implemented on a comply or explain basis, require greater disclosure by private equity firms and their portfolio companies. While the purposes of the guidelines are similar to the Dutch code, it is notable that there are differences in the both the scope and details of the guidelines. It is conjectured that the differences in the guidelines may indicate the growth of some transactional structures (e.g., growth capital transactions) in the UK which play a smaller role in the Netherlands. Focused primarily on buyout activities of private equity firms, the Walker Guidelines (Guidelines) covers firms that advise or management investment funds that own or control one or more UK portfolio companies. The Guidelines cover portfolio companies that generate more than 50% of their revenues in the UK, employ more than 1,000 employees, and that exceed 300 million pounds of market capitalization plus market premium, or 500 million pounds in enterprise value.

There are three main areas covered by these comply or explain measures. The Guidelines provide transparency requirements for private equity firms, which include the filing of an annual report and financial statements on a company website within four months of the end of year as against the current nine months. As is the case with the Dutch code, portfolio firms should also file a short interim statement not more than two months after mid-year. At the same time, general partners are required to publish an annual review, accessible on their website, which should serve as an effective channel to communicate their business orientation and the governance structure of their portfolio companies. Finally, there is an expectation

that the private equity firms will provide to the BVCA, on confidential basis, data for the previous year involving the amounts of capital raised, acquisitions and disposals by transaction value, fee payments made to advisers and for other services related to the establishment and management of their funds, and for exits. Overall, the Walker Group did not envisage the need for new regulatory or legislative provisions on disclosure in the UK. Consistent with this view, the Walker Group expects that the soft law framework, reinforced by the active monitoring and review role played by the BVCA (along with the likelihood that institutional investors will also strive to monitor the disclosure and governance activities of the portfolio companies in important respects) will provide sufficient incentives for private equity firms to comply with the guidelines.

It goes without saying that a specific set of guidelines induces private equity funds to pay increasing attention to the importance of professional governance structures. Besides enhancing the likelihood of the adoption of good governance practices, optional industry guidelines can serve another important goal. They can function as a self-regulatory mechanism in response to increased political pressures for greater disclosure and transparency of fund capital structures and management practices. Although voluntary by nature, guidelines could be used by the industry as a 'sword of Damocles' in the event of non-compliance. If non-compliers were expelled from the industry's association, the voluntary guidelines would arguably have a mandatory effect, as with the Dutch code. The advantage of this approach over legislative measures is the flexibility and adaptability of the regulations. The next section considers the circumstances where a combination of industry measures and government involvement in monitoring the activities of portfolio companies may prove beneficial to both investors and the industry.

4.2 Co-regulation

In view of the factors discussed above, the challenge is to locate the right mix of soft law and government measures that encourage funds to effectively disclose and inform their investors and the market about their performance, investment strategy, valuation of their investments, fees and debt levels. In order to find the right mix, it is important to consider co-regulation strategies that rely on industry standards that are ultimately reinforced by independent monitoring committees.

Co-regulation, which is a combination of governmental and non-governmental regulatory actions, has the advantages of the predictability and legal certainty of legislation along with the flexibility and acceptance of self-regulation. Several factors suggest that it is an effective means to coordinate public and private resources to manage regulatory risk. First, co-regulation has the possibility of resolving conflicts through cooperative engagement involving firms choosing from a variety of mechanisms to manage a specific problems. This model's success depends not only on the flexibility of the techniques employed by the parties, but also on the alignment of the regulatory benefits and the incentives of the parties engaged in the regulatory process. In theory, financial benefits themselves provide sufficient incentives, given the removal of regulatory barriers. Second, while co-regulation models concentrate on identifying the basis for cooperative relational

advantage, the process largely involves public and private parties in developing *ex ante* an appropriate set of standards that can be assessed on objective criteria to determine which provisions should be implemented.

As noted above, a number of recent factors have led to questions about whether governments should step up their monitoring and regulation of private equity funds. Regulators have suggested that economic studies show that the respective benefits and costs of private equity funds are inconclusive producing little support for new legislation in the area. In continental Europe, a virtual torrid of press reports on the negative sentiment resulting from buyouts has stimulated interest in self-regulatory and industry actors producing codes of conduct for both private equity funds and private equity backed companies.²⁷ However, co-regulation has worked well in the case of best practice codes of corporate governance. In this regard, periodic review of the company compliance is conducted by government-sponsored monitoring committees which publish the industry-wide compliance level yearly. There are implications for companies that under-comply or engage in avoidance strategies. In fact, there is economic evidence, from a number of jurisdictions, that shows a correlation between a company's compliance rate and their share price performance.

In the Autumn of 2007, the UK Treasury Select Committee recommended that the Walker Guidelines be implemented, and that there is room for extending the Guidelines to facilitate portfolio management standards (communication of governance approach to stakeholders and mode of investment of portfolio company), disclosure by general partners (disclosure of performance results and value creation methods), and transparency regarding the structure and level of debt.²⁸ More importantly, the Select Committee endorsed the view of requiring additional independent monitoring of the industry's code of conduct. Subsequently, the Walker Guidelines were implemented in fall of 2007.

This is likely to result in greater consistency in disclosure across funds that would not only benefit institutional investors, pension funds and insurance funds in meeting their fiduciary duties to their clients, but will inevitably facilitate funds in their capital raising efforts with investors. Second, we suspect that there are a number of practices by private equity firms will also be effectively curtailed by an independent monitoring committee. Consider conflicts of interests. By far and away, investors are concerned about the evidence pointing to large scale material conflicts of interests between private equity funds and their managers in relation to the allocation of their investments. While many of these allocation problems have been largely addressed by the industry standards, there is concern that abuses may arise in other contexts, such as between proprietary and advisory activities, or when a manager plays more than one role in a single transaction. It is worth stressing that the most effective way of identifying and communicating these conflicts is through the industry-wide compliance system that is reinforced by an independent monitor. Although it is inevitable that some fund managers will not be persuaded to comply

²⁷ An example is the launch of the European Venture Capital Association (EVCA) Corporate Governance Guidelines. Designed in consultation with industry experts, the EVCA guidelines provide a set of optional measures that address the contractual circumstances surrounding venture capital and private equity investments. See McCahery and Vermeulen (2008).

²⁸ Treasury Select Committee 10th Report Session 2006–2007, 24 July 2007.

fully with the industry guidelines, it can be expected that additional independent monitoring will be supplied by a mixture of institutional investor, trade union and pressure group associations.

Moreover, there is at least a suspicion that self regulation measures and industry co-regulation are likely to be more effective, given the complexity and range of activities pursued by private equity funds, than direct regulatory intervention. It is crucial to recall that the challenge here is to comprehend the amount of work required by government regulators to simply understand the impact of their intervention, the scale of their target and its ultimate effectiveness on firms. At the same time, concerns arise over the decision-making procedures for consultation with funds and their advisers and the standards of review for evaluating their compliance. For co-regulation to succeed, consideration must be given to increasing the level of incentives for parties to abide by the industry wide standards since a positive approach, as the evidence suggests, will be more beneficial in the long run.²⁹ To the extent incentives are insufficient to induce individual fund-level cooperation, we would expect that some level of harmonization might be needed, given the dispersion of PE funds internationally, to obtain these regulatory goals.³⁰

4.3 The regulatory response

In this section we consider the circumstances where direct government regulation could usefully supplement the industry mix of contractual and self-regulatory strategies. In assessing the need for a regulatory response, we have seen that there are various mechanisms and contractual arrangements available to regulate private equity participants and their transactions. As we have seen, industry-wide standards are intended to illustrate how the industry operates, incorporating schemes for the valuation of investments, the governance of the investment vehicles, the resolution of conflicts of interest, and the transparency of collective investment vehicles. This development is, however, limited across jurisdictions since private equity standards developed by industry bodies have only emerged in the leading countries where private equity funds have a significant presence. Presumptively, the payoff for ensuring the widest diffusion of the new industry wide standards is significant. To date, no empirical analyses have been performed using the EVCA guidelines to measure compliance across the many separate funds and time periods. Consequently, it may be too early to assess whether these measures have reasonably high chances for dealing with the problems that have been identified above.

²⁹ This argument has been reinforced recently by EC Commissioner Charles McCreavy in a speech to the British Venture Capital Association wherein he stated that ‘when we look at the numbers, we can quickly see that there is a distance to travel. The number of BVCA firms that have signed up to the Walker Guidelines is a case in point. According to certain reports only 32 out of a possible 200 members would be currently signatories. The limited reach of the Walker Guidelines is also apparent when we look at the number of portfolio companies covered by the guidelines. On 56, out of about 1,300 portfolio companies in the UK that are targeted by private equity investments, are reported to comply with the disclosure and transparency rules. See, Charlie McCreavy, European Commissioner for Internal Market, ‘Private Equity: Progress on Disclosure and Transparency (Walker Guidelines)’, EC/SPEECH/08/701.

³⁰ See Cumming and Johan (2007).

In the United States the increasing attention to private equity has led to questions as to whether funds and their advisers should be subject to registration and more rigorous information disclosure. More recently, lawmakers have focused on capital gains taxation, considering whether a change in the tax code on carried interest is consistent with the goals of fostering innovation and entrepreneurship. Arguably, while the debate in the United Kingdom has much in common with US concerns, such as the parliamentary investigations into taxation of carried interest, the UK response has managed to diverge slightly with its focus on the whether the regulator is capable through its different risk-based regulation to meet its statutory objectives. In this section we document the response by regulators to the rise of the private equity sector within Europe.³¹ To this end, we look at the UK's Financial Service Authority's (FSA) recent analysis of the risks posed by private equity buyouts.

With a clear focus on the risks identified, the FSA sought explicitly in a 2006 discussion paper to classify the risks in private equity.³² A most obvious concern is the risk identified above, namely excessive leverage. The data cited above refer to increasing multiples, transaction structures being extended and more and more 'covenant lite' loan deals. The concern is that with a serious contraction in the credit market, as we've seen recently, there could be a large number of corporate defaults that might significantly impact the debt and credit markets, respectively. The significance of this is that banks and other intermediaries might be exposed to excessively leveraged transactions that could have a detrimental effect on the balance sheet of a number of large banks.

A second and related concern involves the unclear ownership of economic risk. At present, private equity and hedge funds rely on increasingly complex financial transactions, such as credit derivatives, and other risk transfer practices that involve use of off balance sheet transactions that arguably could exacerbate existing structural weaknesses and lead to unclear ownership of economic risk. Furthermore, it is worth noting that the different (and sometimes competing) bankruptcy regimes could give rise to different claims creating costly barriers for lenders to negotiate settlements. The evidence suggests, according to the FSA, that excessive leverage and obscure ownership of economic risk do not bode well for the UK economy and are categorized as medium to high significant risks.

Third, private equity funds may, given the shroud of secrecy under which they operate, face charges related to alleged conflicts of interest between interested fund managers and fund investors. To the extent, for example, that fund managers are allowed to participate in transaction in which a private equity fund participates, there are concerns that managers will capture the greatest source of gains from themselves at the expense of other investors. To be sure, some fund managers may still be accused of a conflicts of interest to the extent that they act as a director of a company owned by the fund. Other potential conflict situations arise where the fund is a both a source of finance for a buyout of a target firm, which is also a fund client

³¹ Italian lawmakers introduced a new Corporate Law Reform (Legislative Decree 6/2003, applicable as of 1 January 2004) which set forth the basis of regulating leveraged buyout transactions. For the implications on buyouts in Italy, see Cumming and Zambelli (2007).

³² Financial Services Authority, Private Equity: A Discussion Paper on Risk and Regulatory Engagement (DP 06/6, November 2006).

Table 6 Risk assessment and private equity participants

Participants	High	Medium	Medium Low	Low
<i>Risk</i>				
PE firms	Market abuse & conflicts of interest	Excessive leverage		
Lenders	Market abuse			
Investors		Market access	Market opacity	Reduction in market efficiency
PE-owned firms		Excessive leverage		

Source: MacNeil (2008)

or as a result of supplying finance to competing bidders on a deal. Also, there may be other residual conflicts which funds have incentives to resolve in their favour. On the whole, therefore, the FSA indicated that the conflict of interests were of high risk.

Fourth, the other notable concern is the risk of market abuse that could occur in the context of a buyout transactions and proprietary trading. Much attention is given to the possibility that material inside information could be disclosed which could have a detrimental effect on investors. Market abuse is rated as a high risk by the FSA. Finally, there are other risks, such as market access constraints, market opacity and the reduction of overall capital market efficiency, that the FSA considers as low to medium risks. In assessing the risks, it is noteworthy that the market participants are differentially affected (see Table 6).

It is worth noting that the FSA's review of the regulatory risks supports the view that private equity funds are typically subject to relatively light regulatory oversight. A number of considerations support this view. First, private equity is classified as alternative investment in which the funds are governed by same company law, tax and governance requirements that apply to all partnerships and publicly listed companies involved in the bidding process or other buyout arrangements. Second, it is worth noting that since private equity funds are not typically involved in issuing debt or securities in public markets, they are largely free of regulatory oversight in most jurisdictions. Third, most fund managers contract with clients who are sophisticated institutional investors or individuals that structure their investment activity through partnerships and contractual arrangements which provide for adequate information and investor protections. As a result, private equity firms are largely outside the scope of existing regulatory regime in most jurisdictions. In the next section, we discuss the three broad areas in which the regulation of the private equity market can be considered.

4.4 Legal tools

In this section, we briefly describe four legal tools that are commonly used to deal with the problems involving participants and transactions in the private equity market. The four legal tools considered are (1) reporting and disclosure

requirements of private equity funds and general partners, (2) enhancing market access, (3) governance and investor protection measures, and (4) taxation.

4.4.1 Enhancing disclosure and fund reporting

Given the structure of private equity funds, disclosure of financial and operational information, including the valuation of their investments in their annual accounts, provides significant benefits to investors and can be an effective tool in limiting abusive actions by fund managers. Second, well-designed measures on disclosure of performance results may prove more effective than market (fund) competition in supplying the incentives to avoid exaggerating valuations of investment returns and unexited investments. Third, the imposition on the private equity firm to disclose their management fees and carried interest and the independent oversight body will allow investors to make a more informed investment decisions.

4.4.2 Enhancing market access

Empirical research on venture capital and private equity shows that the quality of the legal environment is an important determinant in raising the supply of investment funds.³³ Since exiting is crucial for buyout funds, the creation of a deep and vibrant securities market is considered crucial for the development of a deep and liquid market for initial public offerings. It again follows that a hospitable IPO market may require liberalizing the stock exchange listing rules on board independence and control, thereby allowing private equity funds to list investment vehicles. Moreover, given that some markets are characterized by a small number of dominant firms that limit or restrict access, largely to the detriment of retail investors, there are good reasons for regulators to address this problem by facilitating more competition.

4.4.3 Governance and investor protection

Looking at the circumstances the market suffers from harmful conduct has led regulators to simply place a ban on insider trading and market manipulation. Not only does the market suffer, but investors may encounter significant losses, which undermines the confidence in public markets. When it comes to dealing with market manipulation and related misconduct, the existing mix of securities regulations are the most effective tool to prevent specific forms of abusive harms and to undertake investigations. The benefit of this type of intervention is twofold. First, given the complexity of these transactions and the number of parties involved, the expenditure of resources to investigate these transactions tends to favor centralized oversight. Second, there is evidence that regulatory strategies that favor stiff sanctions will have a strong deterrence effect which offers support for more enforcement actions by securities regulators.³⁴

³³ See generally McCahery and Renneboog (2004).

³⁴ See Karpoff et al. (2008).

4.4.4 Taxation

Another type of regulatory intervention that affects the private equity market and fund managers is the taxation of capital gains on the sale of entity interest, withholding taxes, the deductibility of interest on debt, and the taxation of carried interest earned by general partners in private equity firms. It is important to note that a favourable taxation regime is an important determinant to the development of a favourable private equity environment. Moreover, the supply of efficient tax vehicles for such investments is considered a necessary mechanism in terms of the structuring and executing private equity transactions. Therefore, fiscal measure that are unattractive for both investors and fund managers, such as the proposed increase in tax on carried interest in the UK and US, will inevitably place serious stress on the vitality of a private equity market.

The discussion that follows highlights the efforts of lawmakers to enact private equity reforms that fall under the four categories discussed above.

4.5 Regulatory responses to hedge fund and private equity in Canada, European Union, Germany, the Netherlands and the United Kingdom

The rapid growth in the private equity market in recent years has prompted calls for the introduction of new regulatory measures to control for conflicts that are likely to arise between private equity funds and their investors as well as the problems related to buyouts. We review a few of the measures that have emerged in response to private equity and activist hedge fund engagements with target companies.

4.5.1 Canada

In Canada, the corporate law system, which operates at both the federal and provincial level, has long played a central role in regulating many central transactions, including amalgamations and the sale of all or substantially all assets of a company. The corporate statutes allocates power to shareholders to approve such transactions, rights to dissent and a fair value remedy. Canadian securities regulation operate also under a two-tier system and regulate such activities as: annual and continuous disclosure, insider trading, public offers, and tender offers. In the case of going private transactions, the Ontario Securities Commission regulation provides a system for a formal valuation that must be prepared for the shares held by minority shareholders, approval by minority shareholders (depending on the transaction), and the recommendation that a special committee of directors negotiate with the controlling shareholder or related parties and ensure that all shareholders receive fair disclosure and the right, where necessary, to approve the transaction. Tax reforms have been undertaken recently in Canada to stimulate investment in private equity and venture capital. In particular, Canada and the US signed in September 2007 a new protocol to the Canada-US Income tax treaty which provides for US resident member of an limited liability company to claim benefits under the Treaty. US LLCs, which are fiscally transparent for US federal income tax purposes are not recognized by the Canada Revenue Agency under the Treaty. Thus, the

effect of the protocol is to allow gains realized by certain LLCs on the sale of shares of a Canadian corporation and which will apply to dividends received by an LLC with US resident members and the reduced branch tax rate of 5% applies to repatriated earnings of a Canadian branch of an LLC with US resident members that are companies.

4.5.2 *Germany*

Recently, Germany introduced legislation to curb co-operation between shareholders on share votes, which would be deemed 'acting in concert.' More specifically, the German Federal Cabinet adopted a draft bill for the Act on Limitations of Risks Relating to Financial Investments or Risikobegrenzungs-gesetz (Risks Limitation Act), which was passed on 27 June 2008 by the Deutsche Bundestag and was approved by the Bundestag on 4 July 2008 and came into force on 19 August 2008. While the draft bill would clearly have deterred private equity and hedge fund activism, the legislation actually adopted is unlikely to dampen legitimate communication between large and small shareholders.

Under the new Act, concerted action will apply not only to cooperation on the voting right behaviour but also to the coordination of other shareholders' interests outside the shareholders' meeting. Second, the Act has also provided a basis for determining when acting in concert would be extended to coordinated conduct of shareholders. Examples would include cases where shareholders agreed to coordinate their voting behaviour or if they agreed to cooperate based on long term strategy to influence or alter the target firm's business goals. Naturally, agreements that are designed to affect the composition of the supervisory board and the appointment of its chairman would not fall within the ambit of the reform unless the replaced board members or chairman used their power to introduce a new business strategy for the firm. The legislation may serve to deter some potentially damaging actions by activist hedge funds and buyout funds and consequently insulate boards and directors so that they can focus on the long-term interests of the company. However, the reform is likely to have an effect not only on activist shareholders motivated by short-term incentives, but also on institutional investors that might be perceived to be cooperating with other investors when exercising their right to vote or when using their power to call an extraordinary meeting or when undertaking other actions to protect the interests of shareholders.

4.5.3 *Netherlands*

In the Netherlands, a number of reforms have been prompted by a recent wave of high profile buyouts of Dutch listed companies. Unsurprisingly, the Dutch Minister of Finance has proposed, based on a recommendation from the Monitoring Committee Corporate Governance, lowering the notification threshold for shareholdings in listed companies, under the Transparency Directive, from 5 to 3%. Furthermore, the Minister recommended a change in the disclosure rules mandating a higher threshold (from 1 to 3%) to gain the right to include agenda items at the shareholders' annual general meeting. Finally, the EU Takeover Directive has been

implemented which requires a shareholder that owns more than 30% in a listed company to make an unconditional offer for the outstanding shares of the target company.

4.5.4 *United Kingdom*

In the United Kingdom, the Treasury Select Committee Report recommended that the Walker Guidelines, as noted above, be implemented and proposed an independent monitoring committee to ensure industry's compliance with the code. Also, The Pre-Budget Report of the Chancellor addressed the issue of carried interest, declaring that, from 6 April 2008, capital gains tax will be charged at a rate of 18% and both taper relief and indexation will be withdrawn. The change will involve an 80% increase in the marginal tax rate applicable on investments held for less than 2 years. However, there has been little done with respect to carried interest being classified as income.

5 Conclusion

This paper analyzed the regulatory alternatives for the private equity and hedge fund industry. We examined the structure of fund formation and operation, and the system of fixed and performance fees that are designed to align investor and fund manager's interests. In particular, we argued that while contractual mechanism allow parties to structure their particular ownership and investment instruments according to their own preferences, legal and institutional differences may explain the differences in fees and fund performance across jurisdictions. We noted that the industry's contractual system of regulation is being usefully supplemented by self-regulatory measures designed to improve the transparency and accountability of private equity funds and hedge funds. We then examined the costs and benefits of industry based measures, arguing that the strength of the industry self-regulation outweighs its weaknesses.

Having explored the benefits of both contractual and self-regulatory techniques, we considered whether, under certain conditions, co-regulation is attractive measure to support industry body monitoring and compliance measures. As we made clear, a system of co-regulation can induce, if properly designed, effective compliance by providing an effective threat in those hard cases when self-regulation fails. We turned to review the regulatory measures currently in place designed to provide important checks limit market abuses by some fund managers and to facilitate growth and innovation. In this context, we showed that there is a well-developed framework of corporate and securities law that is appropriate for dealing with private equity transactions and parties to these transactions. In particular, we indicated that European policymakers have focused on implementing laws recently on the regulation of takeovers, disclosure and the prohibition of market abuse and insider trading that will improve the procedures for takeovers and buyouts while protecting the interests of investors and promoting confidence in the market. Finally, we examined some of the recent changes in fiscal measures in Canada and the

United Kingdom and the governance and investor protection measures that have been promulgated in the Netherlands and Germany in response to institutional investor activism.

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