

Securities law hurts the private capital markets.

How Private Is Private Equity?

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The financial reform plan of Obama Treasury Secretary Timothy Geithner includes measures to rein in private equity and other forms of private capital formation that have been, up until now, largely exempt from the federal securities laws. Geithner and the Obama administration would require registration and reporting from these otherwise private entities, bringing them under the discretion of the Securities and Exchange Commission (or whatever regulator might take its place).

A commonplace justification for this sort of registration and reporting program is that disclosure does not place a great burden on companies — all they need to do is not lie. But this begs several questions: What does it mean to say that private equity is “private”? What are the advantages of being private in this sense? And if there are benefits to being private, why is it that not everyone does it?

In answering those questions, I will make two related points in this essay: First, disclosure is not a costless activity and the benefit of being private is that private firms can limit their disclosures and avoid those costs. Because of the uncertainty regarding the future and the inherent subjectivity of reporting (even of ostensibly historical information), imperfectly enforced disclosure rules can have the effect of placing a great deal of risk on firms and managers — risk that is better borne by a firm’s diversified security holders. The securities laws essentially impose mandatory contract terms that would unwind the optimal risk-sharing arrangements that firms, their shareholders, and their managers would prefer. Maintaining exemption from the securities laws is then a form of regulatory arbitrage: by structuring one’s capital formation in a certain way, much of the regulatory apparatus applicable to public companies may be bypassed. The benefits of such a strategy are especially appealing where, as in the realm of private equity, managers and entrepreneurs tend to have large personal invest-

ments in the firm and are particularly vulnerable to the securities laws’ imposition of risk. Bringing private firms under the regulatory radar would largely eliminate these benefits of regulatory arbitrage without offering much in the way of offsetting value, as there is very little reason to think that private equity investors are unable to bargain for joint welfare-maximizing contractual provisions.

Second, this regulatory arbitrage process is neither painless nor free. Opting out of the federal securities regime requires considerable distortions of behavior. The relationship between the private equity fund and its investors, the limited partners, is severely constrained. To opt out of securities law liability, funds must be structured to provide limited partners with little or no disclosure, few or no control rights, and artificially reduced liquidity of limited partnership interests. While such a complement of contractual provisions avoids much of the securities laws’ reach, it imposes the cost of greatly reducing the accountability of the general partner and exacerbating agency costs in the management of the private equity firm. One manifestation of these agency costs is the dramatic performance-based compensation (the customary 20 percent “carried interest” that general partners receive) required to align incentives between general and limited partners. While there is a tendency to view the general partner’s 20 percent cut as a market wage for extraordinary talent, it is more properly attributable to the massive agency costs that the typical private equity structure creates. It is also a measure of the extent to which the public capital markets have been degraded with regulatory over-reaching: while the costs of being private are large, the costs of being public are greater still.

Put another way, the negative impact of the U.S. securities laws are not limited to the public company sphere. In the world of private equity, the constraints of compliance with securities law exemptions create a situation in which limited partner investors must give up much or all of their ability to monitor their investments and to hold fund managers accountable by controlling or exiting the fund. Thus, the

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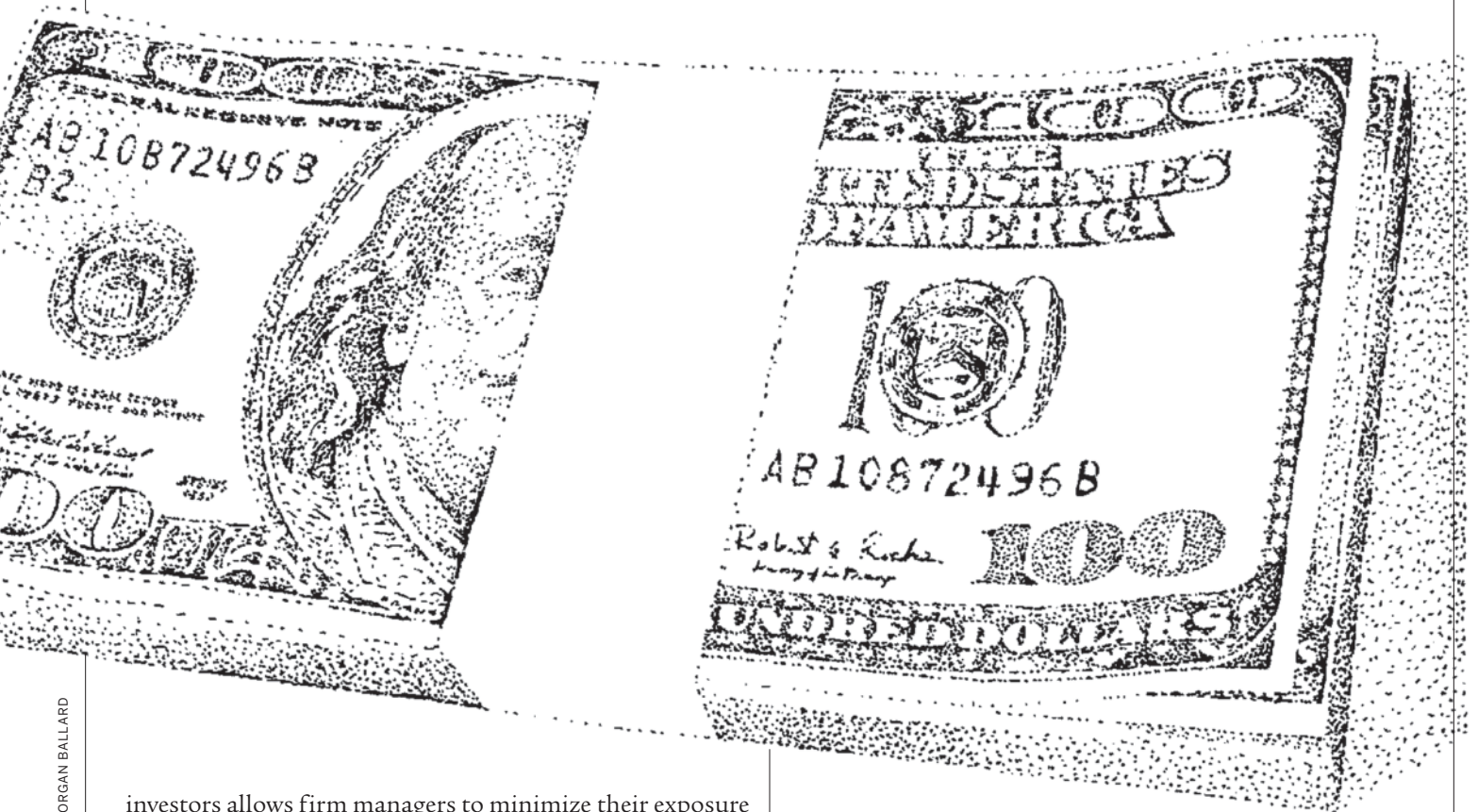
best recourse of limited partners has been to find a reputable general partner with a past history of success, award that general partner a huge slice of performance-based compensation, and then sit passively for 10 to 15 years and hope. This is not a first-best arrangement; without the distortions imposed by the securities laws, limited partners would monitor with an appropriate level of contractually imposed disclosure and retain some ability to exit or seize control of the fund when managers fail to perform their duties adequately. With such an ability to monitor and to act on their information, managers would require less inefficient performance-based compensation and still have incentives to compel performance at or above current levels. Unfortunately, the securities laws crowd out such a solution.

THE VALUE OF BEING PRIVATE

Much of the benefit of equity financing lies in the efficient allocation of risk. Offloading equity interests to outside

can sell to risk-neutral shareholders, the entrepreneur has greater ex ante incentives to undertake effort in pursuit of value-adding innovations. Second, after the sale, the manager is no longer subject to such an extreme degree of idiosyncratic risk and will be willing to take on higher-value projects even if they come with a higher degree of risk.

There is, however, a drawback to this strategy. Agency costs or moral hazard can become a problem as soon as the entrepreneur sells to investors who cannot monitor the firm's activities or the entrepreneur's behavior. If it is difficult for the investor to tell whether the manager is managing the firm in the investor's interests, then there is the possibility that the manager will manage in a way that maximizes her own self interest. That can include under-exertion of effort, attempts to hide managerial quality, or, relatedly, the overuse of leverage and risky instruments (a particular concern in the private equity sphere is that managers can generate high returns through leverage in a rising market). Performance-based com-



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investors allows firm managers to minimize their exposure to the firm's idiosyncratic risk beyond that which is required for incentive purposes. Outside investors can hold diversified portfolios, rendering them risk-neutral, which means that it costs them nothing to bear the firm's idiosyncratic risk. This arrangement, where outside investors carry the bulk of the firm's idiosyncratic risk, is optimal in a static sense because the firm is effectively worth more: the entrepreneur or manager can sell the firm to risk-neutral investors whose value for the firm's shares is higher than that of the entrepreneurs and managers. It is also dynamically welfare maximizing in two ways: First, since the manager knows that she will receive a greater payoff from her innovation if she

can compensate for a lack of monitoring, though only to an extent. A great enough equity share will give the manager incentives to manage better, though such a solution is both expensive and incomplete because of the manager's risk aversion. Thus, reliance solely on performance-based compensation is unlikely to be as efficient as a mixture of performance-based compensation and some form of shareholder monitoring and control.

One of the advantages of a securities law that requires disclosure and prohibits fraud is that it lessens the extent to which investors need to rely on performance-based compen-

sation. It does so by augmenting investors' ability to monitor. Suppose, for instance, that the antifraud rules function perfectly: fraud is always detected and punished when it is committed, and never otherwise. Such a rule would allow investors to police the entrepreneur/manager costlessly and to fire or otherwise punish a manager who manages badly, does not exert optimal effort, or who takes advantage of her position to the investors' detriment. Such a disclosure rule (assuming it did not cost anything to enforce) would in fact enable a first-best outcome: the manager could receive a simple cash salary (the best thing for her, given risk aversion), while the investors would enjoy the benefits of a firm managed free and clear of agency costs.

However, this is not to say that investors are better off with any disclosure rule. A bad disclosure rule — such as a rule that makes mistakes about when managers have lied and punishes them when they have not — not only fails to compel optimal effort on its own, but it can also frustrate the operation of the performance-based compensation that would otherwise achieve the second-best outcome. To take as a concrete example an extreme case, suppose that every time the firm loses money, the entrepreneur is forced, under the antifraud rule, to pay back to the investor the amount of the investment. (Some would argue that this is not all that far off from how private securities class actions operate.) This means that the entrepreneur bears all of the risk of the firm's performance — that is, the antifraud rule has completely unwound the optimal risk-sharing and performance-based compensation package that would have made the entrepreneur and investor each better off. In such a case, the risk-averse entrepreneur may well choose not to invest his effort in the first place, leading to the socially worst possible outcome.

This general problem of agency costs and potentially overbearing disclosure rules applies to private equity limited partnerships. The general partner's expertise and diligent effort is essential to the success of the private equity partnership: successful private equity firms must be able to bring underperforming portfolio companies up to their full potential and must have a trained eye for value, risk, and opportunities for growth. Yet these general partners (or, more specifically, the fund managers who control the general partner and the fund) are risk averse and, without the ability to offload some of this risk, there will be ventures, though profitable, into which the general partner will not be willing to invest her time, effort, and personal funds. Here, a properly fashioned disclosure rule could be useful: if the rule enhances the ability of limited partners to monitor the general partner, both general and limited partners may be made better off because there is no need to rely on costly and inefficient performance-based compensation.

However, it is quite possible for a bad disclosure regime to make things worse. Suppose that the general partner is subject to a disclosure rule that forces him to pay back limited partners for their losses when the general partner's disclosure turns out, *ex post*, to be inaccurate. In such a case, if there is no way to avoid the disclosure rule, the general partner would

either require a massive risk premium in order to undertake risky projects or would tend to avoid risk instead of managing the firm to maximize its value. From an *ex ante* perspective, the entrepreneur may be unwilling to take on or put much effort into risky projects (since the effect of the disclosure rule is that they can never offload the risk) and limited partners may be unwilling to invest.

Finally, suppose that such a bad disclosure rule exists, but that it is possible to avoid its application. In this case, such avoidance or exemption has significant value if it allows the general and limited partners to allocate risk in an optimal fashion. If this value is great enough, private equity firms might seek exemption even if it has significant costs. Unfortunately, such exemption from the U.S. system does have significant costs: as described below, escaping the reach of securities disclosure liability requires limited partners to relinquish much of their ability to monitor and constrain the general partner.

FINDING EXEMPTION AND STAYING PRIVATE

The federal securities laws impact virtually any financing activity. The scope of what may be a "security" for purposes of the securities laws is so broad as to encompass almost any process of capital formation. For purposes of raising funds, the securities regulations do two things: they create disclosure obligations and they create rights of action and penalties for violations of those obligations.

The federal securities laws of interest are the Securities Act of 1933 ("Securities Act"), the Securities Exchange Act of 1934 ("Exchange Act"), the Investment Company Act of 1940 ("Investment Company Act"), and the Investment Advisers Act of 1940 ("Investment Advisers Act"). Much of the securities law regime can be circumvented fairly painlessly; however, some provisions do present substantial challenges, the most problematic being Rule 10b-5 of the Exchange Act.

The Securities Act makes it illegal to offer or sell securities unless the securities are registered with the SEC or if an exemption from regulation applies. Disclosure obligations under the Securities Act can be enormous (typical public offering prospectuses can run into the hundreds of pages), and the disclosure made is subject to strict liability for material misstatements and omissions. Registered offerings are therefore prohibitively expensive for many enterprises, and those enterprises must then use one of the Securities Act's several exemptions in order to raise capital.

For private equity, fitting under an exemption from the Securities Act is fairly easy: the partnership issues limited partnership interests in a private placement of securities under Regulation D and § 4(2) of the Securities Act. The private placement exemption provides significant relief from the disclosure obligations that would otherwise control in a public offering; if the firm restricts offers and sales to "accredited investors" (essentially wealthy individuals and institutions), no disclosures are necessary.

The Exchange Act creates ongoing, periodic reporting requirements for companies that have filed a registration statement under the Securities Act or companies that exceed

a threshold number of shareholders of record. Exchange Act disclosure requirements are comparable to Securities Act registration disclosure, although the legal standards for misstatements are less severe (a fraud standard, as opposed to strict liability). Since private equity funds do not conduct a public offering of securities in the first place, they can generally avoid Exchange Act periodic reporting obligations by limiting the number of holders of record. This is accomplished either by limiting the number of fund investors or by having beneficial investment interests held through a limited number of intermediaries (typically brokers), where the intermediaries serve as the holders of record.

The Investment Companies Act requires non-exempt firms to provide information about their investment positions and financial condition. In addition, registered investment companies are subject to substantive investment restric-

that are made will be subject to Rule 10b-5's antifraud liability standard.

Even though Rule 10b-5 cannot be directly disclaimed, there is still some ability to minimize its application. The rule makes "unlawful ... any untrue statement or [omission of] a material fact necessary in order to make the statements made ... not misleading ... in connection with the purchase or sale of any security." As this has been unpacked by the relevant case law, a private equity firm can avoid application of much of Rule 10b-5 by avoiding any of: (1) a materially untrue statement or omission, (2) a purchase or sale of a security, or (3) the requisite degree of reliance and causation that links elements (1) and (2).

How do these three points translate into action? First, the firm should limit disclosure as much as possible. One important way to reduce disclosure is to avoid mandatory dis-

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tions, such as limited ability to take on debt or to take short positions. To obtain exemption from the Investment Company Act, a fund must either keep the number of beneficial owners below 100 or else each investor must meet an accreditation requirement, which essentially entails having a high net worth.

The Investment Advisers Act requires registration with the SEC, prohibits deceptive acts and practices among registered investment advisers, and gives the SEC substantial leeway to compel information disclosure and investigate the fund's books. An exemption from the Investment Advisers Act applies where the adviser has fewer than 15 clients (with "clients" meaning funds advised, rather than investors).

So far, obtaining an exemption is typically not very difficult for a private equity firm. All the firm must do is restrict offerings to accredited investors, avoid a public solicitation, and keep the number of holders or funds below the requisite threshold (which may be purely formal).

What is not so easy to get around, however, is the application of the securities fraud rules, particularly Rule 10b-5. Rule 10b-5 and § 10(b) of the Exchange Act make actionable material misstatements or omissions in the sale or purchase of securities without regard to whether those securities are publicly traded or have been registered under the Securities Act or Exchange Act. Section 29(a) of the Exchange Act prohibits disclaiming of fraud protections, and this greatly limits the ability of parties to contract around securities fraud liability. While some leeway exists to negotiate what the parties will consider a disclosure, any disclosures

closure obligations: the less one is required to say, the less one will get in trouble for misstating things. This means qualifying for exemptions from the requirements of Securities Act registration, Exchange Act reporting, the Investment Advisers Act, and the Investment Company Act. Practically speaking, the issue must be sold as a private placement under § 4(2) of the Securities Act (most likely, under Rule 506 of Regulation D, which requires no disclosure to accredited investors), and the number of record holders must be kept below a certain prescribed threshold. In addition to reducing mandatory disclosures, the fund will want to restrict voluntary disclosures, making clear in any contract with fund investors that the fund is required to disclose little, if any, information. It is as Calvin Coolidge once remarked, "I have found out in the course of a long public life that the things I did not say never hurt me."

Second, to the extent that the firm cannot avoid making some disclosure to its investors, the fund avoids liability by limiting the opportunity of fund investors to be "purchasers or sellers" within the meaning of Rule 10b-5. Under the purchaser/seller requirement of *Blue Chip Stamps v. Manor Drug Stores*, a Rule 10b-5 plaintiff cannot simply allege that she would have transacted in the security had she not received fraudulent information; instead, she must (with limited exceptions) have actually transacted. Limiting liquidity also limits liability. There are multiple ways in which a fund can limit the ability to buy or sell its interests. Most simply, this could be (and often is) achieved through a contractual restriction upon the ability to resell. More indirectly, making very little information available about the fund and its invest-

ments will tend to cause illiquidity, since outside investors would require a significant discount to purchase when they are unable to verify the firm's prospects.

Third, a firm can limit the investors' control rights. Suppose that a court concludes that investors were misled, but they could have done nothing to avoid the resulting harm even if they had been correctly informed. Without some way of acting upon the information, the information (or lack thereof) cannot have caused a gain or loss. So, for instance, if there is no discretion, say, to draw one's money out of the fund, it would be difficult to make out a claim that losses could have been avoided through accurate disclosure. Thus, restricting rights also restricts the ability of investors to sue for fraud; if

than does equity, and the debt that buyout funds incur is typically placed at the portfolio company level, which also limits the fund-specific disclosure that must be made.

What disclosures do limited partners contract for? At first blush, it would seem that general partners make significant disclosures to their limited partners. Most private equity limited partnership agreements call for some sort of periodic report to be made to investors, and that report is almost always required to be prepared in accordance with Generally Accepted Accounting Principles (GAAP).

But there are significant limitations on the general partner's disclosure commitments. General partners often retain the right to reduce or eliminate disclosure with regard to par-

The three ingredients are little or no disclosure to investors, little or no investor control, and reduced avenues of investor exit.

there is nothing the investor can do to act upon disclosure, it cannot be the case that the disclosure (or lack thereof) harmed the investor.

In sum, then, to avoid as much of the securities antifraud regime as possible, the three ingredients are little or no disclosure to investors, little or no investor control, and reduced avenues of investor exit.

WHAT DO PRIVATE EQUITY FUNDS DO?

It is somewhat difficult to determine what exactly private equity funds do, since they are exempt from public reporting requirements. Further, reports made to limited partners, as well as the limited partnership agreements themselves, are usually confidential. Because of this, the academic literature on private equity has relied on information that funds volunteer about themselves (which may be subject to bias), as well as informal and off-the-record discussions with private equity partners.

With these limitations in mind, what we know about private equity suggests that private equity firms generally follow the prescription above for avoiding securities law liability. General partners typically make little disclosure to limited partner investors, and the limited partners cannot do much with the information that they do get, since both their liquidity and control rights tend to be minimal.

PRIVATE EQUITY DISCLOSURE For the most part, private equity partnerships are able to, and do, obtain exemption from the mandatory disclosure provisions of the securities laws. Offerings are qualified under the private placement exemption to accredited investors, to whom no disclosure need be made. One exception to this rule, however, is that buyout funds often do retain some form of publicly traded debt. However, debt presents less of a disclosure liability risk

ticular matters, such as through explicitly granting the general partner the discretion to keep information related to investments confidential. Further, while the limited partnership agreement does usually require reports on an annual and quarterly basis, specific line items (such as individual portfolio company performance) are not required. So, while the general partner has a contractual obligation to make some disclosure — and to make it in accordance with GAAP — the scope of what must be disclosed is left very much to the general partner's discretion.

In practice, it appears that general partners often go beyond their literal contractual obligations in making disclosure to investors. Limited partners will often receive information regarding investments and portfolio companies, such as the rate at which a portfolio investment is "burning" cash, expectations of future profitability, and valuations of individual portfolio firms. One issue with such discretionary disclosure, however, is that it may be more forthcoming in good times than in bad, or when risks appear to be lower. Another problem, more concentrated in the venture capital side of private equity, is that valuations themselves have traditionally not been meaningful, since inchoate firms could be carried at book value rather than having to be marked to market (though this may change under new accounting rules). Buy-out funds will generally have more valuation information available, since a buy-out target may be a public reporting company at the time of the buy-out and may retain publicly traded debt securities. However, the problem remains that there is typically little disclosure commitment regarding how firms are performing under the general partner's management.

USING THE INFORMATION Even supposing that a limited partner were to receive plenty of information from the general

partner, and that information turned out to be negative, given current private equity contracting practices there would be relatively very little that the limited partner could do about it. Private equity limited partnership agreements typically grant limited partners some rights to take over the fund or to exit their investments — but those rights do not always exist and, even if they do, may not be practicable. Ultimately, limited partners may have little choice but to ride out the duration of their investment in the fund and hope for the best.

One of the features of the limited partnership entity that is so attractive to private equity is that limited partners can play a vanishingly small role in the governance and operation of the firm. Despite the limited partner's strict obligation to provide capital to the partnership, the limited partner enjoys very little control over what the capital is used for.

To the extent that limited partners have protections under the limited partner contract, these usually take the form of covenants on the part of the general partner. Perhaps the most common and most significant are the restrictions placed on the use of proceeds, such as prohibiting concentrations of investment in particular industries or geographical regions. These sorts of forward-looking covenants provide only the roughest sort of control over the prudent management of the firm, and so long as the general partner stays within the covenant boundaries, the covenant affords limited partners little ability to influence the firm's management.

Apart from that, it is only in extreme circumstances that the typical private equity limited partnership agreement gives investors the right to discontinue capital contributions or take control of the fund to liquidate and distribute its assets. These rights are usually contingent upon some major event, such as the departure of key managing individuals or enumerated bad actions (such as committing a crime) of the general partner. As one might expect, in practice such rights appear to be very rarely executed.

Because the limited partners' investments are staged over a period of between two and five years, the ability to default on capital commitments may provide some minor degree of control over the early life of the fund. But such a default can carry a very substantial penalty, such as forfeiture of already-contributed amounts or accrued profits, or an action to compel contribution.

The limited partner's exit from her investment is significantly constrained. The usual term of a private equity fund is between 10 and 15 years. During that time, limited partners cannot withdraw their investments. Discretion to make distributions resides with the general partner. In some cases, limited partners may consider exiting their investments by selling their interest. However, many agreements provide that the general partner must approve such a sale, which the general partner may be reluctant to do.

Even where the limited partner is permitted to sell, it is not easy to do so. First, given the dearth of disclosure in most private equity funds, there would be little information with which a potential buyer could price the fund. Disclosure by

the general partner could give rise to antifraud liability, and hence may not be readily forthcoming. In such a situation, sales would occur only at a steep discount, and only if the buyer could somehow undertake its own due diligence on the fund and manager. Second, according to practitioners, selling one's limited partnership interest is looked upon unfavorably in the private equity world: sellers would be viewed as troublemakers and are unlikely to be invited to participate in future private equity activity.

A BREEDING GROUND FOR AGENCY COSTS

In sum, the rights that limited partners forgo in order to preserve exemptions from federal securities laws create a situation in which there is little accountability of managers. Disclosure is largely at the discretion of the general partner. And even if they receive disclosure, there is not much that limited partners can do with that information: they can neither control the fund nor, in most cases, achieve any sort of practicable exit.

Of course, the benefit of setting up the private equity limited partnership in this way is that it helps to minimize the impact of the federal securities law in unwinding the optimal allocation of risk between manager/entrepreneur and investor. Disclosure is dangerous: any statements of value can lead to ex post second guessing by investors and the courts. The less said, the better. Control and liquidity are dangerous, too: the ability to control or exit the fund in the event of poor performance can meet the causation and reliance elements of a securities fraud claim. Rendering the limited partner unable to act on the information she receives severs the causal relationship between fraud and damages, and minimizes the general partner's potential liability.

But being "private" in the sense of securities law exemption has significant costs. By curtailing disclosure, control, and liquidity, the only mechanism keeping general partners' interests in line with those of the limited partners is the massive performance-based compensation typical of the industry. This is an inefficient form of compensation and an incomplete substitute for investor monitoring. And it is important to recognize that, far from being an example of laissez-faire contracting, the performance-based compensation endemic to the private equity industry may indeed be an artifact of overly burdensome securities regulation.

As a final word, it is often said that reputation provides a check on general partner behavior, and this is undoubtedly true to an extent. However, reputation functions best in the long term, when there is certainty that the players today are also going to be the players tomorrow and the next day. Even in rising markets, there is always the specter of rolling the dice, making a quick buck, and getting out of the industry. Reputational constraints may only work well in a good market, when it is unlikely that funds may go bust and exit the stage. To quote Warren Buffett, "you only find out who is swimming naked when the tide goes out." When, inevitably, the tide goes out (as it may already have done), limited partner investors may well have been better off had they possessed some modicum of control over the fund and its investments. **R**