How should we regulate private equity and hedge funds?

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SAMENVATTING This paper discusses the activities of hedge funds and private equity funds. We consider the rationale used by proponents for introducing new regulation for hedge funds and private equity. There is a division of opinion regarding whether this alternative asset sector should be subject to new regulation. The competing views are assessed critically. We conclude that more economic evidence is required before new legislation can be introduced. We also focus on the effects of the partial convergence of hedge funds and private equity funds. Clearly the differences in the contractual structure of hedge funds and private equity vehicles indicate that parties are capable of structuring their particular ownership and investment of their instruments without having to satisfy burdensome regulatory requisites. Moreover, even though both private equity and hedge funds are typically organized as limited partnerships, there remain a number of contractual provisions that differentiate the two main alternative investment fund strategies. In this regard, we examine the terms and conditions of fund formation and operation, management fees and expenses, profit sharing and distributions, and corporate governance of the respective fund structures. On balance, our analysis shows that the contractual basis for each fund type is usually adequate to address the agency problems that abound in this sector.

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1 Introduction

This article helps to fill the gap in the hedge fund and private equity debate by focusing on the contractual basis of collective investment vehicles, the influence on funds' investment strategies and the rationale for why private equity and hedge funds have chosen to play the role of activist investors in companies in which they invest. Policymakers are urged to review the economic effect of private equity and hedge funds on investors' returns before imposing new regulation on the sector.

In recent years, hedge funds and private equity groups have come to represent a significant part of the current trading activity in the financial and mergers and acquisition markets in both Europe and the United States. The sheer size and amount of funds for investment are considerable and growing. For example, hedge funds, having first emerged in the 1950s as single fund investments, now number more than 9,000 funds globally holding more than 431 trillion dollar in assets.[1] Typically, these funds are structured by a team of skilled professional advisers, experts in company analysis and portfolio management, offering investors a wide range of investment styles. 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. In recent years, hedge fund advisers have engaged in high-risk investment strategies, including restructurings, credit derivatives, and currency trading, in order to obtain superior returns for their funds. Even though hedge funds take a variety of forms, they are characterized by a number of common features such as the pursuit of absolute returns and the use of leverage to enhance their return on investment.

In contrast, private equity fund advisers invest primarily in unregistered securities, holding long-term positions in private companies. They employ, also, a

wide range of investment strategies with varying levels of liquidity. Not only do private equity funds advance capital to new and developing companies, but provide investment capital for management buyouts, corporate restructurings and leveraged buyouts. During the 1990s, the venture capital industry grew in the United States with a record amount of capital raised in 2000. With the post-boom decline in the venture capital industry, beginning in 2002, buyout funds emerged as the leading investment style with their level of investment funds increasing rapidly worldwide. In 2006, buyout funds peaked with 'mega funds' capturing the largest amount of net new capital flow. The emergence of the buyout fund as the dominant investment style in this sub-sector, is attributed mainly to favourable credit market conditions, robust debt supply and low interest rates, changes in investor preferences, a proliferation of publicly listed private equity vehicles, and the increased demand by institutional investors for alternative assets (Thomson, 2007).

While hedge funds and private equity are both seen as alternative investments, private equity funds can be distinguished from hedge funds in terms of their investment strategies, lock-up periods, and the liquidity of their portfolios. Moreover, given their indefinite life span, fund managers have incentives to take large illiquid positions in the non-listed securities of private companies, such as Kohlberg Kravis Roberts (KKR) and Silver Lake of the US and Dutch buyout house Alpinvest which purchased a controlling stake of Philips' semiconductor unit, NXP, for €8.2bn in cash.[2] Investments made by private equity funds take place during the first three to five years of the fund, which is followed by a holding period which averages between five to seven 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 liquid, short-term investments, which allows investors easier access to the withdrawal of their investment. Despite these differences, it is becoming more apparent that private equity and hedge funds are converging in a number of ways. One noticeable incidence of convergence is the growth of hedge funds and private equity managers pursuing similar assets and investment strategies to secure superior market returns. For example, when hedge fund advisers are dissatisfied with traditional strategies and unable to obtain their expected rates of return, they have quickly adopted those techniques usually employed by private equity funds, such as corporate restructuring and buyouts, to achieve better value on their investments. Partly due to the overcrowding of the hedge fund marketplace, hedge funds started to capitalize on opportunities presented in the lucrative private equity market thereby clashing with first generation private equity funds. An example of this convergence is the bidding war between one of the largest private equity firms, KKR, and Cerberus Capital Management for the acquisition of Toys 'R Us.[3]

The recent emergence of hedge funds competing with private equity firms to take listed companies private is further evidence of convergence in the alternative asset sector. For instance, Cerberus Capital Management successfully acquired MeadWestvaco's paper business in 2005 for $2.3bn.[4] 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 makes it harder for advisers to produce premium returns. At the same time, debt continues to be relatively abundant worldwide and at relatively attractive rates. Furthermore, hedge funds and buyout funds are increasingly seeking the same cost savings and synergies that strategic buyers have always achieved to justify their higher multiples. Convergence is further facilitated by legal strategies that constrain investors.

At the same time, private equity funds and hedge funds play an increasingly important role in corporate governance and corporate control (McCahery and Vermeulen, forthcoming). Hedge fund activism is characterized by mergers and corporate restructurings, increased leverage, dividend recapitalizations, and the replacement of management and board members. To a lesser extent, activist investors suggest changes to corporate strategies, which can act as a powerful incentive for managers to act in the interest of shareholders. While fund managers have the potential to impose immense discipline on boards and managers of firms, activist funds are shrouded in nebulous mystery, obscurity and complexity. Moreover, private equity funds and, in particular, hedge funds are being accused of neglecting long-term goals and pursuing short-term payoff. The risk involved in investing huge amounts of capital has led to calls for corporate governance measures for these investment funds.

This paper is divided into four parts. In Part 2, we discuss the activities of hedge funds and private equity funds. Although hedge funds and private equity converge (not only because they operate and compete in the same equity market, but also because large buy-out funds have established or purchased hedge funds and vice versa), their function and activities differ in a number of important respects. These

differences are relevant to understanding the contractual structure of hedge funds and private equity vehicles. To be sure, both private equity funds and hedge funds are typically organized as limited partnerships.[5] However, the contractual provisions set in place for each type of fund differ in a number of significant ways. In Part 3, we describe the terms and conditions of fund formation and operation, management fees and expenses, profit sharing and distributions, and corporate governance. The contractual features that distinguish private equity from hedge funds show that parties are capable of structuring their particular ownership and investment instruments according to their own preferences without being bound to regulatory requisites. The fact that hedge funds are currently entering the private equity space thereby quickly responding to new market conditions suggests that fund managers have ample incentives to adopt effective information duties, stringent distribution procedures and investor protections. Part 4 concludes.

2 Do we need special regulation for private equity funds and hedge funds?

Policymakers and the media have drawn attention to the confusion that private equity funds and, particularly, hedge funds, are currently causing in the world of finance and corporate governance. As private equity and hedge funds are now entering the corporate governance scene with a fury, adding a new dimension to the struggle between shareholders and managers, questions arise increasingly about their proper role in relation to management and other shareholders and creditors. The recent wave of private equity based buyouts of publicly listed companies has also prompted questions about whether private equity can perhaps be detrimental to the market or to the targeted company. 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. Table 1 summarizes an overall assessment of the costs and benefits of private equity investment.

Hedge funds, like private equity funds, provide markets and investors with substantial benefits. Since these funds tend to be engaged in extensive market research before taking significant trading positions, they enhance liquidity and contribute to market efficiency. Yet, regulators are concerned about the lack of understanding and regulatory mechanisms to protect possible downsides of hedge funds' investments. Hedge funds are reluctant to disclose any information about their investors and investing strategies. The fact that they pursue aggressive short selling techniques in order to make profit on overvalued stock just adds to the negative reputation of these funds. When they sell short, they sell borrowed shares under the expectation that they will be able to buy the shares back in the market at a lower price. Obviously, this phenomenon gives hedge funds an incentive to actively drive down the stock price by voting the borrowed shares in value-reducing ways. This so-called 'empty voting' strategy of decoupling voting rights from economic ownership has recently added a new dimension in the corporate governance discussions (Hu and Black,

Table 1 Assessment of private equity

Benefits	Costs
Private equity funds help large publicly held companies restructure their businesses, thereby forming a symbiotic relationship	Delisting reduces liquidity in financial markets
Private equity deals often allow multinationals to retain a minority stake in the spun-off divisions, thereby creating the opportunity to share in any improvements in performance	The high debt levels loaded on acquired firms as a result of leveraged buy-outs may have implications in an economic downturn
Private equity offers publicly held firms an opportunity to circumvent the over-regulatory approach to listed companies	Flipping companies—within a year of taking them private—can lead to post- IPO underperformance
	Private equity deals entail rather small takeover premiums for target shareholders

2006). Naturally, given the inherent difficulties with detection, there is some confusion about the extent of the actual use and the effect of empty voting strategies on firms.[6] Nevertheless, we have already seen policymakers respond, in the UK (in the context of takeovers) and Hong Kong (generally), by adopting new disclosure measures to reduce the adverse effects of empty voting.

Questions arise also increasingly about the hedge funds' role in relation to management and other shareholders and creditors (Klein and Zur, 2007). Unlike earlier periods, the new activist investors are more directly engaged in investment fund management. These funds not only endeavour to deliver high returns by diligent research and insightful analysis, but also by actively reshaping a portfolio firm's business policy and strategy (Bratton, 2007). Many argue that the investment style of these funds fits into the current corporate governance movement of shareholder activism. Proponents of this view urge regulators to adopt a 'hands-off' approach, pointing to the overall increase in share price and performance of firms associated with hedge funds. Others are of the opinion that it would be overly costly if activist shareholders were too much involved in the daily management of the firm, in particular, if they hold more votes than economic ownership. They point to the fact that funds' activism is mainly directed toward short-term payoffs, and argue that the transfer of effective control to a team of specialists (i.e., the board of management) will add to efficiency and long-term wealth creation. Complaints by managers and shareholder groups arguably encourage policymakers to consider increasing regulation and supervision over collective investment pools and their actions.

A new empirical literature, however, is emerging in the US that shows hedge funds being long-term investors in some industries, often, like their peers in private equity, waiting very long periods to cash-in on their investment (Brav et al., 2007; Bratton, 2007). What is more, private equity and hedge funds are evolving into more transparent investment vehicles. Firstly, institutional investors, demanding better risk management, encouraged equity funds to adopt better valuation techniques and controls. Secondly, buy-out groups attempt 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 and recently also hedge 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 and hedge funds in combination with the trend towards self-regulation by industry groups suggests that the sophisticated players in the private equity are themselves capable of disciplining opportunistic behaviour by fund managers and advisors. In order to enhance capital market efficiency and transparency, policymakers and governmental supervisors should work closely together with private industry bodies. Such an approach ensures that possible rules and regulations are in line with both best practices and standards applied in the world of private equity and hedge funds.

This mixed picture suggests that questions remain about whether more detailed regulation of funds is required. Given the contractual mechanisms that prevail in the governance of private equity and hedge funds, an initial hands-off approach might be warranted. Accordingly, the next section turns to examine the contractual nature of private equity and hedge funds.

3 The contractual structure of private equity and hedge funds

It is well-documented that there is an agency problem in the portfolio company between the active funds and other shareholders and managers (Metrick, 2007, chapter 2; Smith and Smith, 2004, chapter 12). A second agency relationship exists in the hedge fund and private equity market. Fund managers act as agents for external investors, who choose to invest in publicly held or closely held firms through an intermediary rather than directly. This agency problem is likely to be particularly difficult and intractable. There is inevitably a high degree of information asymmetry between the fund managers, who play an active role in the portfolio companies, and the passive investors, who are not able to monitor the prospects of each individual investment closely. The legal practice, however, has developed governance and incentive techniques effective in limiting opportunism and controlling the level of risk.

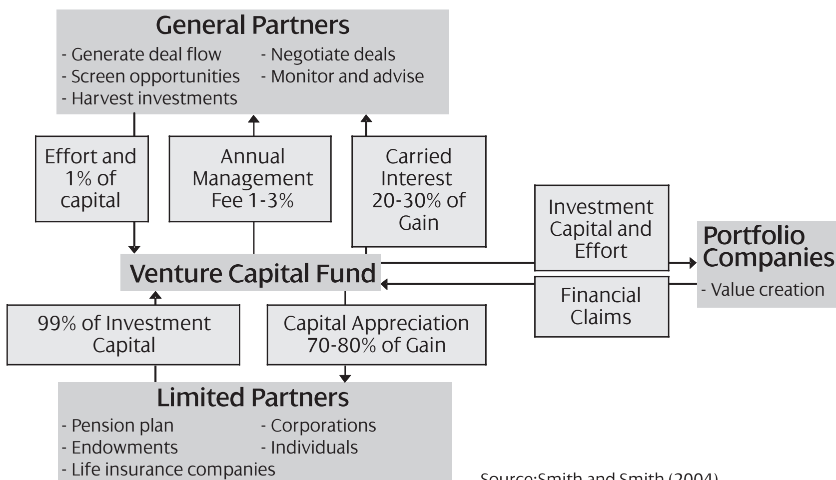
The attention to the governance structure of investment funds is important now that the private equity and hedge fund market is under severe scrutiny by national policymakers and regulators trying to protect domestic portfolio companies from the potential

negative effects of this new form of shareholder activism. It is argued that governance issues associated with these active funds are best understood by first investigating the internal governance structure of the funds. Indeed, an analysis of the organizational and contractual features shows that business parties themselves engage in designing good governance structures so as to take advantage of investment opportunities that would otherwise never have been available. It stems from this analysis that the individual players are better capable than regulators to deal effectively with possible negative effects related to activist funds.

One of the central features of the governance environment of investment funds is the limited partnership structure. In the US and elsewhere, the limited partnership form has become one of the dominant legal structures used in the private equity industry. Its popularity 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. While private equity and hedge funds rely on similar features of the partnership form, they diverge in some important respects due to demands made by investors. For example, the partnership's duration for private equity is usually ten to twelve years, after which the profits are distributed either in cash or in shares of portfolio companies. Hedge funds, however, have shorter lock-up periods (one to three years), confirming the emphasis on short-term investments.

The flexibility of the limited partnership form allows the internal and external participants to enter into covenants and schemes that align the incentives of fund managers with those of outside investors and reduce agency costs. For instance, 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.[7] In addition, limited partners employ several contractual restrictions when structuring the partnership agreement depending on the asymmetry of information and market for investment opportunities. For example, a positive relationship exists between the use of restrictions and the propensity of the fund managers to behave opportunistically. In such cases, the limited partner will insert more restrictions in the partnership agreement. In fact, 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. For the most part, the number and type of covenants correspond to the uncertainty, information asymmetry and agency costs in the portfolio company. Other factors affecting the use of restrictions are the fund's size, the compensation system of the managers, and their reputation. In contrast, hedge funds rely less on covenants due to

Figure 1 Governance structure of private equity investment



Source:Smith and Smith (2004)

the shorter lock-up periods and the fund's 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.

The relationship between the limited partners and the general partners is governed not only by self-regulatory means (i.e. covenants), but relies also on explicit contractual measures (McCahery and Vermeulen, 2004). A key contractual technique is the compensation arrangement between the fund manager and the investors. Compensation is usually comprised of two main sources for managing investments in each limited partnership. First, fund managers are typically entitled to receive 20% of the profits generated by each of the funds (see figure 1). A second source of compensation is the management fees the fund managers charge to each venture. Investors ensure 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. That said, the contractual flexibility of the limited partnership plays a central role in aligning the interests of fund managers and investors in limited partnerships. The compensation rate is fairly uniform across the industry (Fleischer, 2006, p. 7). However, older and more established funds may receive a lower fixed fee. Apparently, the reason for the lower compensation is a matter of incentives, that is, newer private equity firms have powerful incentives needed to develop a reputation for quality, which gradually over time leads to increased market share. While we may think that the compensation structure works in the main to reduce agency costs, its effectiveness can be questioned. It can be argued that the agency costs result from the details of the general partner's option-like carried interest. Indeed, it is here, in particular, that questions arise about whether the compensation system is effective in reducing the opportunism which grows out of giving the general partner the discretion to choose when, and under what conditions, to realize investments. In this context, a limited partner clawback provision, which typically is triggered in connection when earlier carried interest is paid to the general partner and later proceeds are insufficient to reach certain contractually defined thresholds, is perhaps the best mechanism to limit the distorted incentives of general partners (Metrick, 2007). Moreover, similar problems may also emerge from the allocation of control to private equity managers in respect of mandatory distributions.

4 Conclusion

We have reviewed the activities of private equity and hedge funds. Our discussion of the questions concerning private equity and hedge fund activities does not provide a clear-cut answer to the question of whether policymakers should intervene with new measures to limit the effects of activist funds. Naturally, a well-informed analysis requires empirical research showing the trade-offs between the benefits and costs of private equity and hedge fund effects in the governance of publicly-traded companies. On the one hand, many observers point to the obvious benefits associated with enhanced disclosure of their portfolio, valuations, investment criteria, and investor returns. Yet, on the other hand, the contractual nature of the governance of private equity and hedge funds suggests that better external monitoring and higher reliance on contractual mechanisms in their dealings with investors and the public corporations in which they invest may lead to better governance.

Arguably, ad hoc regulation of private equity and hedge funds could lead to higher costs and few corresponding benefits for investors and firms thereby limiting the beneficial effect of contracting. Nevertheless, concerns arising in many European countries about private equity and hedge fund activism have prompted initiatives relating to investor protection and financial market stability. Calls by top regulators and policymakers for tougher investor protection measures to limit the alleged abuses by some funds include: mandatory shareholder disclosure of borrowed voting rights in a target company, lowering of disclosure requirements on concentrated ownership from 5% to 3% (or even 3% to 1%), disclosure of voting patterns of funds and their corporate intentions, and supervision of the relations between portfolio companies and fund investors. Even though a few of these techniques may prove effective deterrents for some high-risk strategies pursued by certain collective investment pools, they are unlikely – in the long run – to form the basis of a coherent and effective regulatory regime that provides funds with sufficient incentives while protecting the interests of most sophisticated investors who typically prefer their own contractual mechanism over a regulatory straightjacket offered by policymakers. After all, the analysis of the governance of hedge funds and private equity and their effect on public corporations should be further examined before engaging lawmakers to enact inappropriate or ill-advised measures. ■

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Notes

1 *Hedge funds begin to show up on regulators' radar,* Washington Post, February 9, 2007.

2 'Philips sells bulk of chip division', Financial times, August 3, 2006 (by Ian Bickerton).

3 'A private dose of tough love: KKR the investment method', Financial times May 15, 2007 (by Francesco Guerrera and James Politi).

4 'Cerberus to buy MeadWestvaco Paper Arm', Financial Times, January 19, 2005 (by James Politi).

5 Since emergence of new company law forms, which combine the "best" provisions of both the partnership and corporate law statutes, equity funds also employ the Limited Liability Company in the United States and the Limited Liability Partnership in the United Kingdom. See McCahery, J.A. and Vermeulen, E.P.M. (2006).

6 Compare Hu, H.T.C. and Black B. (2006), Spectre of empty voting is 'far from reality', Financial times, April 2, 2007.

7 Limited partners have very limited statutory rights to participate in management; if they exceed these limited rights, they run the risk of being personally liable for partnership liabilities and obligations (Sahlman, 1990).