Protection of private equity fund investors in the EU

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Abstract

On June 8, 2011 the Alternative Investment Fund Managers Directive (AIFMD) was adopted. As a result, the regulatory approach to the private equity regulation was significantly changed – from no regulation to its overregulation. I analyze to which extent private equity fund investor protection should be provided at the legislative level. I consider private equity fund investors not as a homogenous group but as several different ones where each of them has own interests. I also examine what is the most cost-effective regulatory approach to private equity regulation, taking into account interests of private equity fund investors and capital market efficiency. I argue that the AIFMD provides an overprotection of private equity fund investors to the harm of capital market efficiency. I consider co-regulation as the best regulatory approach to private equity regulation.

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Protection of private equity fund investors in the EU

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Introduction

For several years that proceeded the financial crisis of 2008 a lot of institutional investors suffered much from hedge fund fraud scandals. In the wake of the financial crisis institutional investors again suffered significant losses, including from alternative investments. As a result, there arose the question, whether alternative investments, are safe enough for them.

Motivating by the necessity of investor protection and additionally systemic risk prevention, in the aftermath of the financial crisis the EU policymaker changed the regulatory approach to private equity (further – PE) regulation – from absence of regulation to strict regulation of private equity fund managers’ (further – PEFM) activity. Now PE regulation is formulated in the EU’s Alternative Investment Fund Managers Directive (further – AIFMD) of 2011 [1], and is partly covered by Basel III and Solvency II Directive, which have an impact on banks and insurance companies investment allocations to private equity.

Providing a strong protection to private equity fund (further – PEF) investors, the AIFMD imposes significant compliance costs on PE industry and in some extent restricts flexibility of PEF structures. That is why these recent legislative reforms have been a subject of a heated discussion among academics, PE industry and policymakers. The core issues are whether the price of new PE regulation is reasonable for a safe and competitive investment environment; also whether interests of different actors are proportionally reflected in the AIFMD.

This article is in part determined by the fact that prior works have shown the present debt crisis has more to do with housing finance than with private equity and PE regulation shouldn’t be directed towards prevention of systemic risk (Thomsen (2009))². In this relation the necessity of PE regulation from the point of view of PEF investor protection is of great importance. Professors Franks, Mayer and da Silva pointed out that investor overprotection can have negative consequences for both market and inves-

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2 Steen Thomsen, Should Private Equity Be Regulated? 10, EBOR, 97, 106 (2009).
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tors3. There is a range of regulatory alternatives to PE regulation (contractual regulation, self-regulation, and coregulation) (McCa-

Previous studies have already covered the issues of PEF investor protection on the U.S. market5. But I assume that the structure of PEF investors on the U.S. stock market is different from the EU one. That is why PEF investor protection in a European setting should be a subject of a separate research. There are also some studies, which deal with the issues of hedge fund investor protection6. Indeed, the AIFMD provides the same regulation for all alternative investment funds and, at first look, it may seem that regulatory proposals for hedge fund investor protection will be the same for private equity funds. However, in the academic literature incorrectness of such approach has been proved7. Private equity and hedge funds have different investment strategies; they pose different risks to their investors8. That is why their regulation, and corresponding protection of their investors, should be different.

This article extends the existing research regarding PEF investor protection in two ways. Firstly, I investigate to which extent PEF investor protection should be provided at the legislative level. Herewith, I consider PEF investors not as one homogenous group but as several different ones, where each of them has its own interests. Secondly, I examine what is the most cost-effective regulatory approach to PE regulation, taking into account interests of PEF investors and capital market efficiency.

The structure of the article is as follows: Part I provides an overview of the main groups of PEF investors under the EU legislation: professional, direct and indirect retail ones. Part II gives a

7 Eilis Ferran, After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU, 12 (3) EBOR, 379, 398 (2011).
8 Ferran, supra note 7, at 381, McCallery & Vermeulen, supra note 4, at 208.
brief overview of the legislation that seeks to protect investors of PEFs. It shows the main approach and tools of PE investor protection. In the third section I provide an in-depth study of other common justifications for increasing PEF investor protection. I have questioned whether there is proof that PEF investors couldn’t protect themselves; even if there is, whether it is justified the strengthening of PE regulation and whether the proposed remedies would resolve the problem. In the last section I analyze how protection of PEF investors is aligned with other purposes of securities regulation, in particular, capital market efficiency. It also presents an analysis of the different approaches to PE regulation. The section ends with defining the optimal approach to PE regulation.

Part I. Private equity fund investors in the EU

Sophisticated investors historically had access to private equity investments. In the U.S., where PEFs originally emerged, issuers could avoid expensive public disclosure registration regime of the Securities Act of 1933 if they raised capital from sophisticated investors⁹. The legislator supported the existence of such exclusion as it was considered that ‘sophisticated investors could fend themselves’ (SEC v. Ralston Purina Co.)¹⁰. In particular, the Court reasoned that if offerees have access to the same type of information that would be available in a registration statement, they do not need the protection guaranteed under the federal securities laws¹¹.

In 1982 the sophisticated investor doctrine had been proscribed at the legislative level in the Regulation D, which defined accredited investors as institutional investors with assets in excess of $5 million, banks, savings and loan associations, brokers/dealers, insurance companies and other investment companies; wealthy individ-

⁹ Securities Act of 1933 Section 4(2).
¹¹ Martin, supra note 5, at 66.
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...uals who have had incomes of at least $200,000 in each of the two most recent years or a joint income with a spouse in excess of $300,000, or who have a net worth exceeding $1 million (Rule 506 exemption) 12.

Later a similar regulation was envisaged at the EU level. If PE firms marketed their funds only to sophisticated - professional investors, they had been out of the scope of MiFID II regulation. According to the Annex II to Directive 2004/39/EC professional investors include financial institutions; large undertakings (meeting two of the following size requirements: balance sheet total: net turnover: own funds: EUR 20 mln, EUR 40 mln, EUR 20 mln); governments and its agencies, international organizations; and high-net-worth individuals (if an average frequency of carried transactions 10 per quarter over the previous four quarters; the size of its financial instrument portfolio exceeds EUR 500 000; or the client has had a professional experience in the financial sector for at least one year). As we can see, the threshold for sophisticated investors in the EU is much higher than in the USA.

With the adoption of the AIFMD, it was clearly proscribed that units or shares of PEFs must be marketed to professional investors (art. 31 (6); art. 32 (9); art. 35 (17); art. 39 (11); art. 40 (17); art. 42 (1)).

In comparison with institutional investors, retail ones can’t protect themselves effectively because of lack of the experience and knowledge to negotiate adequately favorable terms for themselves as limited partners, or difficulties to engage in due diligence and include provisions aimed a contractual liability of an issuer for the ignorance of the mandatory disclosure provisions of the securities laws 13. That is why AIFs may be marketed to retail investors as an exception but not a general rule if a member-state of the EU permits this (article 43 of the AIFMD). Retail investors can directly invest in PEFs, e.g. in France, Ireland, Italy, and Luxembourg, but in Germany and Netherlands their investments significantly restricted, while in the UK and Sweden - prohibited 14. In the U.S.

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12 Rule 506 of Regulation D; Rule 501 under Regulation D contains the definition of “an accredited investor.”
PEFs can be marketed to retail investors but in this case PEFs are subject to strict disclosure requirements of the Securities Act of 1933.

The special attention deserves participation of retail investors in PE, listed on stock exchanges, otherwise called listed private equity. For the last decade it could be noticed their significant growth. On June 30, 2013 there were 18 well-known listed private equity funds with a combined global investment portfolio of £6.2 billion\textsuperscript{15}. There are several options on how a retail investor can participate in listed private equity: purchase a share (unit) in a listed PEF (which makes direct private equity investments or it is a fund of fund which invests in other PEFs) and to gain exposure to a portfolio of private equity investments; purchase of shares in the PE management company which provides shareholders an opportunity to gain exposure to the management fees and carried interest earned by the investment professionals and managers of the PE management company\textsuperscript{16}.

Another way of retail access to a PEF is purchase of derivatives as a result of securitization of PEF interests. However, this scheme is not widespread in the EU\textsuperscript{17}.

As the main investors of PEFs in both the US and EU are pension funds, investors of which are retail investors, academics and policymakers suggest considering them as indirect retail investors of PEFs\textsuperscript{18}. Currently, the share of pension funds in the EU PEFs is 37.2\%, in the US - 43\%\textsuperscript{19}.

The group of pension fund investors is quite vulnerable (retirement savers as a rule don’t have a sufficient level of sophistica-

\textsuperscript{18} See, Chapter 3.2 of this article.
Part II. An Overview of the private equity fund investor protection under the AIFMD

After the financial crisis the whole financial system had been restructured, including a shadow banking system. One of the ways of its reforming was the adoption of the AIFMD. The main aims of securities regulation were to restore trust in the EU financial markets by means of providing strong investor protection and preventing a new possible financial turmoil through a systemic risk control. Strengthening of investor protection is considered likely to

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boost consumer confidence and increase allocations in alternative investments thus stimulating economic growth.

The AIFMD is designed to improve the reliability of markets by direct regulation of AIFMs and by applying protection tools of professional investors.

First of all, under the AIFMD all PEFMs need authorization (art. 6-8). However, this Directive provides a lighter regulation regime for AIFMs with limited assets under management (art. 3).

The AIFMD is aimed at investor protection from suffering of undue investment losses, which are mainly caused by fraud and market failure. Alternative investments are considered to involve complex and illiquid investments. Besides, the lack of transparency of these investment vehicles increases the potential of fraud24.

The AIFMD considers disclosure of information to be the main legal tool of PEF investor protection. It is considered that having all necessary information about the activity of PEFs, investors can make reasonable investment decisions and protect themselves against corporate abuses and mismanagement. Besides, there is no need for the government to engage in more substantive securities regulation-merit review25.

The AIFMD includes extensive disclosure requirements as to persons conducting the business of the AIFs; the identities of the AIFM’s shareholders or members; the organizational structure of the AIFM (art. 7); remuneration policy (art. 13); conflict of interest (art. 14); valuation of AIFs’ assets (art. 19); delegation of AIFM’s functions (art. 20); investment strategies including the types of underlying funds if an AIF is a fund of funds, and the AIFM’s policy regarding the use of leverage, the risk profiles and other characteristics of AIFs; whether the master AIF is established or if the AIF is a “feeder AIF”; the rules of incorporation of each AIF the AIFM intends to manage; a description of the AIF’s liquidity risk management (art. 23); appointment of the depositary for each AIF the AIFM intends to manage (art. 21) and some others. As we can see,

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the AIFMD is motivated, mainly, by the assumption that more disclosed information is better than less\textsuperscript{26}.

A number of AIFMD’s rules are also designed to ensure adequate capital reserves (art. 9) and to induce investors to take risks, e.g. restrictions on taking leverage (art. 22-25). At the same time, as the IOSCO Technical Committee stresses, many measures that reduce systemic risk also provide investor protection\textsuperscript{27}.

The U.S. Dodd-Frank Act provides a range of similar requirements to PEFMs activity\textsuperscript{28}. However, the EU AIFMD goes significantly further in harshness of its regulation than the US Dodd-Frank Act. Unlike the latter, the AIFMD contains rules of capital requirements, independent valuation providers and depositaries and the possibility for regulators to impose specific limits on private equity fund leverage\textsuperscript{29}.

Assessing the AIFM regulation, it is necessary to note that the EU policymaker, like the US one, revised the conception of sophisticated investors, who until recently had been considered as such, who have enough financial savvy to protect themselves and don’t need legislative protection.

The AIFMD provided strong protection for professional investors, which is evidenced though a variety of protection mechanisms. In their nature, the abovementioned protection tools of professional investors are very close to those, provided by the UCITS Directive\textsuperscript{30} to the retail investors. It shows that the distinction between the regulation of professional investors in the AIFMD and retail ones in the UCITS Directive is blurred and regulation of professional investors is getting retail-oriented.

\textsuperscript{26} Troy Paredas, supra note 25, at 418.
\textsuperscript{27} IOSCO Technical Committee, Objectives and Principles of Securities Regulation (May 2003), at p. 5.
\textsuperscript{28} Impact of the Dodd-Frank Act on Private Equity Funds, Hedge Funds and Their Investment Advisers, Private Equity Newsletter (September 16, 2010), http://www.davispolk.com
\textsuperscript{29} See also, Nathan Greene, John Adams, US Regulation of Investment Advisers and Private Investment Funds – a Concise Overview, pp. 355-378 in Research Handbook on Hedge Funds, Private Equity and Alternative Investments, edit. by Phoebus Athanassiou (2012).
Such strengthening of the AIF regulation is a natural and consecutive result of the conditions, in which the AIFMD was adopted, namely a reaction to the financial crisis of 2008. Politicians always considered more regulation is better than less but in the conditions of the financial crisis of such a big scale as was the crisis of 2008, the regulation became particularly harsh.

It was passed mostly in a hurry and without a thorough analysis of the impact of these reforms on financial market industry\(^{31}\). The AIFMD was planned to be a hedge fund directive\(^{32}\), however, its final version regulated along with them all other AIFs.

As a result, there is a great need in conducting a thorough analysis of how justified strong PE regulation is from the point of view of both the market and investors. Why doesn’t a contract remain an effective investor protection tool anymore? To what degree is regulation aligned with the interests of other participants?

Part III. The rationale for private equity fund investor protection

Assessing the rationale for PEF investor protection, it is important to find out how it applies to every group of investors (sophisticated investors, direct retail investors and indirect retail ones (general market participants). I question whether PEF investors need strong legislative protection, provided by the AIFMD.

3.1. Protection of private equity fund sophisticated investors

Traditionally PEF investor protection is exercised by means of a PE contract\(^{33}\). It is considered to be the most cost-effective tool for solution of agency problems between investors and a PEF manager\(^{34}\).

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\(^{32}\) Ferran, supra note 7, at 396.

\(^{33}\) McCahery & Vermeulen, supra note 4, at 198.

However, the growth of alternative investment fund industry in 2000s (when it began to be considered too big to fail)\textsuperscript{35}, multibillion frauds in hedge funds (among which are the most remarkable LTCM and Madoff scandals)\textsuperscript{36} and significant losses of institutional investors from allocations to alternative investment funds in the wake of the financial crisis of 2008\textsuperscript{37}, caused a sharp discussion on whether professional investors are sophisticated enough to be exempted from regulation\textsuperscript{38}. As a result, the concept of sophisticated investor has been reexamined and PEFMs were subject to regulation both in the EU and US.

At the same time, compliance costs of the AIFMD are high for PEFs\textsuperscript{39}. That is why it is very important to analyze why contractual protection doesn’t remain an effective tool anymore and how justified strong legislative protection of PEF investors is.

Policymakers and scholars stress that professional investors quite often failed to perform proper due diligence of alternative investments\textsuperscript{40} and couldn’t protect themselves against fraud during the financial crisis. In particular, Foundation for European Progressive Studies argued, “just relying on the ability of institutional investors to understand what is going on has proven not to be enough in the recent crisis”\textsuperscript{41}. Thus, the ability of institutional investors to protect themselves by means of contract has been questioned.

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\textsuperscript{35} 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 in McCahery & Vermeulen, \textit{supra} note 4, at 201.


\textsuperscript{38} Martin, \textit{supra} note 5, at 54.


\textsuperscript{40} Ingrid Vancas, \textit{Due Diligence and Risk Assessment of an Alternative Investment Fund}, (Diplomica Verlag, 2010), at p. 76.

\textsuperscript{41} House of Lords Report, \textit{supra} note 31, at § 101.
In order to understand how justified these concerns are, it is important to find out what caused failures of due diligence and widespread frauds with alternative investments.

First of all, due diligence of PE investments is quite challenging because of difficulties with their valuation. PEFs are not traded on a public market; the duration of such investments is long (7 years or more). That is why prior to the sale of underlying investments it is difficult to provide their accurate valuation.

Secondly, limited amount of information, disclosed by PEFMs, is considered as one of the possible reasons of failures in due diligence. Limited partnership agreements usually don’t provide their investors with extensive rights to access to information. According to the IOSCO Technical Committee, PEFMs usually disclose all information, provided by such an agreement. However, the American court practice has cases when PEFMs didn’t disclose information to their fund investors.

Professor Harris points out that PEFMs tend to undermine even the most thoughtful incentive-based compensation arrangements. Indeed, there is an agency problem between PEFM and limited partners and PE contract tries to resolve it. So when a PE firm doesn’t disclose information about PEF activity to its investors, it means confirmation of the agency problem existence.

The key issue is whether PEF investors can protect themselves in case of breach of contractual terms by PEFM and enforce ful-

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filling a contract through a court procedure. As the U.S. court practice shows, in a range of cases the SEC sued against PEFMs for frauds, and in such a way indirectly protected the interests of PEF investors\(^\text{47}\). In my opinion, they had an opportunity to protect themselves in court but didn’t do this, trying to avoid possible court expenses. Huge court costs in the US are well known. Moreover, the increase in the number of cases, where the SEC sued against PEFM, took place after the financial crisis and it can be considered as a direct reaction to it.

The next issue, which deserves attention is why having information, institutional investors can’t take the right investment decision or conduct adequate monitoring of PE investments.

As in the last decade we could notice a huge growth of the PE industry, complication of PEFs structure and diversity of used investment strategies, it is not difficult to guess that information disclosed by PEFM became more complicated, massive and ambiguous for assessment even for professional investors.

A recent study of AltAsset showed that the key problem lay not in the limited amount of disclosed information, but in the lack of standardized and comparable data\(^\text{48}\) to make proper due diligence and monitoring of PE investments.

Another reason for legislative protection of PEF investors is the wish to protect them against fraud. At the same time most authors who referred to frauds as factors that cause the necessity to reconsider the notion of sophisticated investors. For example, Jill Fisch, refers to recent revelations of fraud, such as the Madoff investment scandal, and losses arising from investments in collateralized debt obligations, and argues that “even sophisticated institutional investors require greater regulatory protection”\(^\text{49}\). Professor Markham has a similar point of view stating that institutions do not always have the ability to protect themselves from speculative investment losses. Even institutional investors also asserted it in the context of deriva-

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\(^{47}\) I didn’t find the similar court cases in the EU, when the government agency sued against PEF in the interests of investors. As a rule, such cases are considered in the arbitrage courts and are closed for public.


itive regulation\textsuperscript{50}. Taub says “even when buyers know all the relevant information” it is nearly impossible to price even the simplest collateralized debt obligations and that it would take many days even for powerful computers to establish a price. As a result, even expert analysts got lost in the complexity and fell prey to decision-making biases\textsuperscript{51}.

However, the majority of studies mainly refer to scandals in the hedge fund industry and problems with derivatives. PEFs have a lot of similarities with hedge funds but unlike the last ones they are less likely to engage in speculative trading activities and market manipulations because they usually do not actively trade in public capital markets and they practically don’t use derivatives\textsuperscript{52}.

Private equity frauds concern mainly valuations of PE investments, the potential overvaluation of assets when funds are marketed. Some managers exaggerate the performance or quality of holdings by boosting their reported values during the fundraising period, then writing them down after that period closes\textsuperscript{53}. The main reason why PEF investors can’t identify these frauds is absence of unified standards of valuation of PE investments.

A range of PE self-regulatory organizations, both pan-European and national ones, directed their efforts at working out a solution of this problem. They elaborated standards of disclosure of information, valuation and reporting by PEFs in order to make such information less complicated and simpler for understanding\textsuperscript{54}.

\textsuperscript{50} Jerry W. Markham, Protecting the Institutional Investors - Jungle Predator or Shorn Lamb? 12 Yale J. on Reg. 345, 358-359 (1995).
\textsuperscript{51} Taub, supra note 10, at 189.
\textsuperscript{52} Martin, supra note 5, at 74.
However, as IOSCO remarks, another problem is that while private equity standards are widely used, they still have not been adopted consistently across the industry. So there arises the problem of providing of compliance of these standards by PEFMs.

Moreover, analyzing the problem of failure of sophisticated investor doctrine, academics mainly refer to the problems of the retailization of the U.S. private equity industry. The U.S. definition of accredited investors permits an average individual to invest in PEFs. Indeed, 200,000 USD is not a high amount of money in the U.S. and it is possible to agree with the SEC, which questioned the ability of this expanded class of accredited investors to understand the complexity and risks of privately offered pooled investment vehicles, including the lack of publicly available information about the investment, undisclosed conflicting interests, complex fee arrangements, and higher risk structure. However, the problem of retailization of the private equity industry is not relevant for the EU, which has a much higher investment threshold to be considered as a professional investor and less so high-paying jobs as in the U.S.

The argument, which can be used in favor of contractual protection of PEF investors, is unequal extent of protection of different categories of institutional investors. Studies of Lerner, Schoar and Wongsunwai (2007), Da Rin and Phalippou (2011) showed that institutional investors are characterized by heterogeneity. It can be argued that small institutional investors don’t have enough sophistication to invest in alternatives.

On the one part, the volume of the given information will differ depending on the size of investment and the type of investor, and their ability to demand favorable terms of contract. Unlike PEF large investors, smaller ones usually can’t afford to hire a large team of specialists-professionals, receive more favorable contractual terms and engage in a great number of monitoring activities. But

56 Smith, supra note 10, at 271.
58 Da Rin & Phalippou, supra note 57, at 1.
despite the fact that investors with larger investment allocations have more power to impose, e.g., restrictive covenants on PEFs, some covenants, imposed by large investors can be beneficial for smaller ones (e.g. restrictions placed on a fund operation, liability of PEFM etc.).

From the other hand, without minimal disclosure requirements, limited partnership agreement will not be concluded. At the same time, the law doesn’t provide an exhaustive volume of the information that should be disclosed to the investors. Thus, a PE contract is an effective tool for monitoring of PE investments irrespective of the type of investor. However, for smaller investors it can be too costly to provide the enforcement of a PE contract terms. That is why the law should provide mandatory disclosure of basic information as to PEFs. Herewith, PEFMs usually don’t mind disclosing basic information about PEFs. The main worries concern depositary and leverage costs of the AIFMD59.

Herewith, increasing of the volume of disclosed information does not always facilitate taking the informed investment decisions by investors. As the study of Paredas shows, overloading investors with information can have the opposite result. In case when the more information becomes available, people do not always focus on the most relevant information but might become distracted by less relevant information. Moreover, investors might use less information, as the information search and processing costs increase60. As a result, investors can take worse investment decisions in case when PEF discloses more information.

Increasing of disclosure of information can also impose additional costs on PEFMs, as a result, they will reduce promised returns to their investors. The core issue, whether PEF investors are ready to pay such price for increased protection of their interests. I think, the answer is no; that is why the law should provide disclosure of just basic information by PEFMs to their investors.

It is worth to note that replacing contractual protection by the legislative one will not take place. Legislative protection just supplements contractual one. As the majority of private equity invest-

60 Troy Paredas, supra note 26, at 441-442.
ments are multi-million transactions, legislative protection is not sufficient to provide an adequate level of investor protection. Only private equity contract can minimize agency costs in the most efficient way.

The important issue is whether protection of hedge funds of sophisticated investors should differ from PEF ones. As it has been mentioned above, unlike private equity, hedge funds are more involved in speculative activity and a great number of frauds, committed by them, have been documented. That is why, in my view, unlike PEFs, the legislator should provide stronger protection of hedge fund investors, which should be expressed both in the higher volume of disclosed information to hedge fund investors and increased oversight of hedge fund activity by the authorized agencies.

Thus, the financial crisis revealed the problems of PEF institutional investor protection. Failure in due diligence and frauds are explained not by non-disclosure of information but by its form, which became too complicated and burdensome. PE contract is still an effective tool of investor protection. The law will not replace a contract. However, for the enforcement of PE investments by small institutional investors the law should require the disclosure of basic information about PEFM activity.

3.2. Protection of private equity fund indirect retail investors

In the academic literature it is stressed that institutional investor allocations in PEFs also may affect participants in the financial markets who are not direct fund investors. Herewith, it is pointed that sophisticated institutional investors, whether it is a bank, pension fund, mutual fund, or other entity, often represent investments from many individual retail investors. Such institutions just hold legal title to these investments but all the risks are on the “ultimate investors”, who are ordinary people – workers, which on their own behalf would not be considered sophisticated. Therefore, when a sophisticated investor makes poor choices, this harms the

ultimate investors, the people whom the securities laws were designed to protect.\(^{62}\)

Moreover, pension funds investments to private equity are quite significant. According to the EVCA, pension funds have invested more than €50bn of private equity and venture capital for the past four years and their investments in private equity continue to grow (in 2012 investments in alternatives made up 19% of all pension fund assets globally, compared with 5% 15 years ago).\(^{63}\)

The remarkable growth of pension fund investments in private equity, however, was accompanied by a number of challenges. In the wake of the financial crisis of 2008 EU pension funds, as well as the US ones became significantly underfunded.

Despite that fact that direct failures of pension funds are rarely observed, and they don’t pose systemic risks (there were not chain failures), pension funds have suffered sharp losses from PE investments.\(^{64}\) Particular concern is the possibility of government bailouts at the expense of taxpayers’ money, as it was with banks in the wake of financial crisis. Taxpayers’ money should not be exposed to risks of the bailouts again. However, in case of pension funds’ failures or significant underfunding, the government has a moral, if not a statutory, duty to help where pensions are mandatory and annuitisation at retirement is obligatory.\(^{65}\) This caused policymaker’s concerns about the necessity of the both private equity, pension fund and banking regulation revision to provide a strong protection of retirement savers.

Assessing the necessity of justification of PE regulation, motivating by pension fund investor protection, it is also necessary to look what caused pension fund underfunding and what was the nature of pension fund losses in the wake of the financial crisis.

\(^{62}\) Taub, supra note 10, at 190.

\(^{63}\) Emma Boyde, Pension Funds Press forward on Alternative Route, Financial Times (July 8, 2013), at p.15.


\(^{65}\) Brian & Love, supra note 37, at 81.
It is also important to note that such losses were not higher than losses from other investments (e.g. in real estate funds)\(^\text{66}\). Moreover, they were mainly caused by the losses in the value of private equity investments. Before the financial crisis private equity funds have been highly leveraged. As such leverage is not a true risk itself, but it exacerbates liquidity problems in market downturns. In particular, dependence on leverage creates the risk that the fund will be unable to meet its obligations\(^\text{67}\). So pension fund investment losses in private equity have been caused not by the problems of private equity industry but banking system. The legislative response to the problem of pension fund losses followed on two levels: through enhancing of bank capital requirements in Basel III and PE regulation in the AIFMD. From this point of view, strong private equity regulation is excessive.

However, managers of underfunded pensions may have incentives to engage in more myopic investment strategies by taking more risky projects, which may generate higher short-term returns (and also higher possibilities of losses)\(^\text{68}\). This is a classic principal-agent problem, when retirement savers delegate decision-making authority to pension fund managers\(^\text{69}\) and the last ones breach their fiduciary duties. Development of guidance of sound due diligence and monitoring of private equity investments, especially for public pension funds’ ones, and enhancing supervision of such investments by pension fund regulator could be an adequate response.

Assessing the necessity of extent of PE regulation, private equity and pension funds are interconnected\(^\text{70}\) and overregulation of


\(^{69}\) Edwards, *supra* note 6, at 47.

private equity funds will have negative impact on pension fund industry. Only private equity investments can provide the necessary level returns to pension funds in order to fulfill their obligations before the growing number of pensioners. Especially state pension funds have a pressure to cover payouts to baby boomers born after the World War II who turned 65 years old and became eligible for pensions. The potential for alternative investments such as PEFs also helps to decrease funding volatility and diversify plan assets - while seeking to close the funding gap.

Thereby, it is necessary to note that there should be provided a reliable protection to pension fund investors, otherwise they will not invest in private pension funds but too extensive protection will limit returns of PEFs and respectively payouts to retirement savers and they will not invest in pension funds. In my view, the law should provide transparency of the private equity industry and require the minimum level of disclosure of information in the interests of retirement savers. In such way it will enhance trust of retirement savers and at the same time facilitates the development of pension fund and private equity industries.

3.3. Protection of private equity fund direct retail investors

As already mentioned, if AIFs marketed to retail investors, a member-state may impose stricter or additional requirements on the AIFM or the AIF than the requirements applicable to the AIFs marketed to professional investors, except when the EU AIFs established in another Member State and marketed on a cross-border basis than on AIFs marketed domestically (art. 43 of AIFMD).

As a general rule, for marketing PEFs to retail investors, they should get permission. Herewith, those jurisdictions that permit distribution PEFs to retail investors impose entry requirements for the retail investors – the minimum size of investment (it is much higher than in the UCITS) or the nominal value of the PEF securities. In Netherlands additional disclosure of information should be provided to supervisory authorities (Financial Market Supervision Act art. 4:37p; para 10.3.1.1 Financial Market Supervision Act Market Conduct Decree. In Luxembourg a comparable level of investor protection as to UCITS should be provided (art. 46 Law of
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Luxembourg of July 12, 2013 on Alternative Investment Fund Managers).

In the listed PEs investor protection is exercised by means of reporting to their investors, however, a full disclosure of information is often limited because of the commercial sensitivity of PEs71.

Retail investors, which bought derivatives as a result of securitization of PEF interests, are protected by means of derivative regulation72.

Considering an issue about the necessity of direct PEF retail investor protection by general legislation (the AIFMD), it is necessary to take into account if such regulation will reflect the interests of all investors proportionally according to their share in PEFs) and transaction costs of such regulation.

According to data of European Commission from 2007 direct retail investor participation in PE and venture capital funds was approximately 2% of the net sales73.

Now a debate concerning an increasing of retail investor access to them is under way. From the one hand, this policy will provide a greater consumer choice for retail investors and gives additional capital for PEFs, what can be beneficial for them74.

This is particularly acute in the view when PEFs have lack of capital as a result of the financial crisis and recent legislative reforms, which strengthened capital requirements in banks and insurance companies and thereby disincentivized their investment allocations to PE. If the policymaker will apply Solvency II standard to pension funds, who are the major investors to PE now, it is more likely that the share of retail investors in PE will grow even faster and, as Professor Lerner said that over the next five to ten years

74 Lee, supra note 13.
years they would be a very important source of capital for alternative asset managers.\textsuperscript{75}

From the other hand, encouraging of greater retail participation in PEFs can be costly. It is questionable whether retail investors have the level of sophistication to understand financial matters so well to make investments in a private equity. Increasing of retail investors in PEFs will inevitably entail a shift towards strengthening of the PE regulation (even more than now), providing retail investors with additional remedies. The costs of retail investor protection are too high. It is for this reason retail investors of PEFs have been excluded from the participation in PEFs what allowed the last ones to be unregulated for a long time.

Thus, until the number of retail investors in PEFs will reach a critical mass, their protection should be envisaged in special regulation but not in general one. Otherwise, it would be breached the principles of proportionality and economic efficiency of PE regulation.

Part IV. Protection of PEF investors and capital market efficiency. An optimal approach to private equity regulation

The analysis of justifications of investor protection showed that they don’t need such a strong investor protection as provided by the AIFMD. In fact, we can even notice overregulation of the European PE industry, which is motivated by an investor protection objective; wherein the main principles of efficient and effective market functioning are breached and undue costs are put on PE industry.

As the reports of all committees appointed by the European Commission emphasized, along with protection of investors, no less important goal is to ensure efficiency of the capital markets\textsuperscript{76}. The U.S. legislative acts (the Securities Act of 1933 (§ 2(b)), the Investment Company Act of 1940 (§ 2(c)) clearly define the goals


Protection of private equity fund investors in the EU

of securities regulation: to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Moreover, in 1980s in the U.S. the focus of securities regulation was shifted from investor protection to market efficiency and capital formation. A number of studies proved that effective and transparent market is the best investor remedy77.

Among the main cost of overregulation Professor Mayer names higher costs for firms and investors, altering the costs of entry and competition; loss of competitiveness of financial centers, leading to the migration of firms from over-regulated to better (or less) regulated markets78.

The increasing costs of regulation cause a major concern for private equity industry and its investors. The success of a high tech sector and private equity (venture capital) industry hinges crucially on the ability of the financial sector to provide the degree of flexibility and innovation required by the corporate sector79. The sophisticated investor doctrine and low cost of banking capital gave some kind of flexibility to PEFs and, as in the case with hedge funds, let them grow80. Loss of those advantages by the private equity funds is likely to limit their profitability of the funds and lower returns for investors. At present, investments in PEFs have been significantly reduced81. It can be explained by the consequences of the economic downturn as a result of the financial crisis of 2008, the increasing costs of compliance with the AIFMD; the impact of enhancing capital requirement of banks and insurance companies, posed by Basel III and Solvency II respectively, that make their investments in private equity less attractive.

78 Franks, Mayer & da Silva, supra note 3, at 376.
79 Franks, Mayer & da Silva, supra note 3, at 376.
Imposing of undue investment costs will reduce competition inside PE industry; it will be too costly for small PEFs to follow such a regulation\textsuperscript{82}.

Loss of competitiveness of financial centers, leading to a migration of firms from over-regulated markets to less regulated ones, causes particular concern. Coordination with the US regulatory regime in particular is essential in avoiding a situation in which the EU alternative investment fund industry loses competitiveness at a global level as a result of regulatory arbitrage\textsuperscript{83}. As it was mentioned above, the US private equity regulation is more liberal than the EU one.

This problem is known due to the Sarbanes-Oxley Act of 2002 (SOX) adoption, which jeopardized the competitiveness of the US equity market. SOX compliance costs were so high that a lot of companies deregistered and moved to stock exchanges in other countries\textsuperscript{84}.

That is why a legislator should be very careful when designing an effective system of PE regulation. PEFs are important elements of a financial system, where all of them are interconnected, and overregulation of PEFs can have a negative impact on the whole economy. Thus, it is necessary to design a balanced regulation which will take into account both: PEF investors’ and PE industry interests.

Thus, there arises the question: What is the optimal approach to PE regulation in the post-crisis environment? Academic literature presents several ones: contractual regulation, legislative regulation, self-regulation, co-regulation\textsuperscript{85}.

PE contract allows to PEF investors to enter a variety of covenants, which provide the maximum protection of their rights and reduce agency costs.


\textsuperscript{83} House of Lords Report, supra note 27, at 5.


\textsuperscript{85} McCahery & Vermeulen, supra note 4, at 198-200.
However, as it have been abovementioned the information, disclosed by PEFs, became more difficult for assessment even by institutional investors. As a result, the role of PE contract as the most efficient investor remedy decreases. In this relation, self-regulation can be considered to be an optimal strategy. This regulatory approach permits to protect investors and at the same time to preserve flexibility of PE structures, as it is generated by the industry professionals. Ranges of standards for PE industry have already been developed. But the major concern is how to provide compliance with these standards.

Considering the legislative PE regulation, it is important to note that mandatory legal rules are inflexible in their nature and may prevent firms from making well-considered decisions and timely changes in response to underway innovations in the economy86. Moreover, transaction costs of such a regulation are too high, what is confirmed by a range of researches of both private equity industry and independent academic ones87.

Currently, membership in private equity and venture capital self-regulatory organizations is voluntary. In fact, the law can provide the enforcement of compliance with standards, developed by self-regulatory organizations. Moreover, legislation performs an important function of small institutional and indirect PEF investor protection by providing minimum requirements to disclosure of information at the legislative level. Such approach, which combines different ways of regulation, is called co-regulation in the legal literature. Taking into account the above-mentioned, I agree with a view of legal scholars McCahery and Vermeulen, who consider co-regulation as the most optimal way of PE regulation88.

Conclusion

The conducted analysis of the legislative protection of different categories of PEF investors showed that nowadays we could observe their overprotection. In my view, the EU legislator should

86 McCahery & Vermeulen, supra note 4, at 199.
88 McCahery & Vermeulen, supra note 4, at 223-225.
reconsider its approach to PE regulation towards its liberalization. The most efficient regulatory approach to PE regulation is co-regulation, which includes contractual protection, self-regulation and includes some elements of legislative enforcement of standards, developed by self-regulatory organizations, and minimum disclosure requirements in the interests of small institutional and indirect PEF investors. Co-regulation allows supporting flexibility of PEF structures and provides efficient protection of investors.