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Private Equity in the United States and Europe

Market and Regulatory Developments

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Introduction

The private equity (PE) industry gained mainstream attention during the U.S. takeover battles of the 1980s epitomized by the iconic leveraged buyout (LBO) of RJR Nabisco (Burrough and Helyar 2010). The controversial tactics used by private equity firms during the takeover boom such as hostile takeovers and the aggressive use of leverage created a negative image of the industry. The public started to view PE firms as corporate raiders seeking to make quick profits by stripping companies of their assets. Nonetheless, academics recognized the benefits of the LBO model in improved corporate governance and operating performance of target firms leading Jensen (1989) to predict that LBOs would eventually eclipse publicly held corporations. Regulatory changes, the mild recession of the early 1990s, and a decline in the availability of credit stopped the first buyout wave (Cheffins and Armour 2008).

Buyout activity resumed in the late 1990s with LBOs spreading rapidly in Europe (Wright, Renneboog, Simons, and Scholes 2006; Kaplan and Strömberg 2009). The bursting of the dot-com bubble in 2000–2001 severely affected private equity activity, but the market quickly recovered and entered its most robust period in history. Between 2004 and 2007, the value and number of LBOs increased exponentially with PE firms completing 7 out of the 10 largest LBOs in history (Gaughan 2011). Some credit the second LBO wave to record levels of capital raised by PE firms, the abundant liquidity in the financial system, and the growing recognition among public company chief executive officers (CEOs) of the benefits of going private (Kaplan 2007).

The crash of the U.S. housing market in 2007 and the resulting financial crisis of 2007–2008, which saw freezing credit markets and widespread failures of financial

intermediaries, caused the collapse of the PE market. Cain, Davidoff, and Macias (2012) estimate that during 2007 and 2008 the total transaction value of takeover terminations by PE bidders in the United States reached $168 billion. The sovereign debt crisis and the turmoil created in financial markets in the United States and Europe during the period 2010–2011 further constrained the ability of PE bidders to finance takeovers. However, the unprecedented actions of central banks aimed at lowering interest rates resulted in rising stock prices and buoyant debt markets boosting the revival of PE markets in the United States and Europe. PE sponsors took advantage of robust credit markets in 2013 to complete new deals, refinance existing ones, and cash out their investments by dividend recapitalizations while record high stock prices made the initial public offering (IPO) exit route attractive (Dezember 2013). Deal activity remained robust in 2014. 2014 was also a record year for exits via sales with corporate acquirers utilizing their cash balances to acquire PE portfolio companies (Canada 2014).

The financial crisis of 2007–2008 and the deep flaws revealed in the regulatory design of the financial system prompted a forceful regulatory response by European Union (EU) and U.S. regulators. Privately organized pools of capital previously outside the regulatory reach were one of the first targets of regulatory action. The result was the adoption in 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in the United States and the Alternative Investment Fund Managers Directive (AIFM Directive) in the European Union that went into effect in 2011. The Dodd-Frank Act brings PE firms under the regulatory radar for the first time, mandating their registration with the Securities and Exchange Commission (SEC), and disclosure of various types of information. Further, on the determination of the Financial Stability Oversight Council (FSOC), systemically important private equity managers and/or funds may be brought under the Federal Reserve's supervision. Overall, the Dodd-Frank Act adopts a measured approach toward the risks posed by the PE industry having as a primary focus the protection against systemic risk. According to Caruana (2010), *systemic risk* is the "risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy." In contrast, some forcefully criticize the AIFM Directive, which regulates both hedge fund and PE fund managers, for its burdensome and restrictive terms. The AIFM Directive contains complex provisions aimed at protecting investors in PE funds and tackling the systemic risks the industry poses to the financial system.

The purpose of this chapter is to offer an analysis of market and regulatory developments in the PE industry after the financial crisis of 2007–2008. The chapter is divided in four sections. The first section provides an introduction to PE and the LBO model and introduces the sources of value creation in buyouts. The next section discusses market developments in the PE market in the United States and European Union in the post-financial crisis era. Section three contains an analysis of major regulatory developments focusing on the Dodd-Frank Act and the AIFM Directive. Section four concludes by offering an assessment of market and regulatory developments in the PE industry during the post-financial crisis era.

Leveraged Buyouts and Private Equity: An Overview

PE covers various forms of financing catering to different investors and development stages of companies. Major types of PE include venture capital, development capital, mezzanine capital, distressed investments, and LBOs (Metrick 2006). Venture capital funds extend staged financing to early stage firms using complex financial contracts responding to the problems of uncertainty, information asymmetry, and potential opportunism of entrepreneurs (Gilson 2003). Development capital provides growth equity financing to already established and profitable companies seeking to expand their operations (Temple 1999). Mezzanine capital involves the provision of subordinated debt or preferred equity to support expansions, acquisitions, and recapitalizations of companies, and LBOs (Silbernagel and Vaitkunas 2012). Distressed debt investors invest in securities of companies undergoing extraordinary situations such as bankruptcy, reorganization, liquidation, or debt restructuring (Jain 2011).

LBOs are the most well-known PE investments. LBOs acquire an existing and mature company by a PE firm funded by using equity and high levels of debt (Kaplan and Strömberg 2009). The debt component of the price offered to buy the target company ranges from 60 to 90 percent with the rest of the price funded by PE investors' funds. If the target company is a public company, which is subsequently transformed into a private one, the LBO is defined as a *public-to-private transaction*. Buyouts of companies initiated by the incumbent management in partnership with a PE firm are termed *management buyouts* (MBOs). In case of *management buy-ins*, an outside management team with the support of a PE investor leads the acquisition. PE firms lead institutional buyouts without involving the incumbent management. However, the PE buyers will retain incumbent management in the post-buyout company compensating it with an equity stake. PE firms usually seek to avoid buyouts without the consent and cooperation of target management to avoid bidding wars (Cheffins and Armour 2008).

The PE firms orchestrating LBOs raise the capital necessary to execute transactions by establishing individual PE funds (Fenn, Liang, and Prowse 1995). The funds are structured as limited partnerships with PE firms serving as general partners (GPs) and investors who contribute capital becoming limited partners (LPs). As a GP, the PE firm is responsible for managing the fund, selecting, executing, and monitoring the investments. GPs are rewarded with an annual management fee usually set at 2 percent of assets under management and a share in the profits of the fund set at 20 percent, widely known as *carried interest*. Further, GPs charge monitoring and transaction fees on the companies in which they invest. According to Metrick and Yasuda (2010), PE firms earn most of their revenue by fixed revenue components.

PE funds have a fixed life, usually 10 years during which investors cannot withdraw their capital. Typically during the first three to five years of the investment period, the GP identifies promising targets for LBOs and executes acquisitions. During the next seven to five years, defined as the *holding period*, the PE firm seeks to maximize the value of the investments and eventually exit them through an IPO, a secondary buyout of the target company to another PE buyer, or a sale to a strategic buyer.

LPs are prohibited from managing the fund. Nonetheless, partnership agreements contain specialized provisions seeking to curb potential opportunism of GPs such as restrictions

on the total amount a fund can invest in a company and periodic disclosures about the fund's performance (Gompers and Lerner 1996). Also, to ensure aligning interests with their investors, GPs invest a portion of their own capital in the PE fund (Kaplan and Strömberg 2009). To avoid applying heavy regulations, PE funds are open only to sophisticated investors. Participation in PE funds is subject to a high minimum subscription (Payne 2011). As a result, investors in PE are high net worth individuals and institutional investors such as pension funds, university endowments, insurance companies, and fund of funds.

To exit their investments profitably and reap the associated profits, PE buyers apply their skills seeking to increase firm value. A major source of value creation is reducing agency costs between managers and shareholders in widely held corporations (Masulis and Thomas 2009). The PE investor may obtain majority control of the target company thus emerging as a major shareholder. Shleifer and Vishny (1986) note the enhanced incentives of blockholders to discipline and monitor management. As a major shareholder, the PE investor appoints most of the target company's board of directors. Furthermore, to ensure an alignment of managerial interests, the PE investor compensates post-buyout executives with a large equity stake requiring them to invest a part of their personal wealth in the company. As Jensen (1986) notes, the highly indebted structure of the target companies after the buyout motivates the management team to reduce costs, operate the company efficiently, and pay out cash flows more than that required to fund positive net present value (NPV) projects.

Apart from reducing agency costs, PE firms can increase the value of target companies by applying their industry and operating expertise. Kaplan (1989a) and Harris, Siegel, and Wright (2005) find that post-buyout firms in the United States and United Kingdom experience an increase in operating performance. Additionally, Kaplan (1989b) documents the large tax benefits emanating from the tax deductibility of interest on debt used for financing buyouts. In his study of public-to-private buyouts between 1980 and 1986, he estimates the use of leverage creates tax benefits ranging from 21 to 143 percent of the premium paid by the PE bidders.

Market Developments in the United States and Europe

The period between 2003 and 2007 can be described as the golden age of PE both in the United States and Europe. The availability of cheap debt substantially boosted buyout activity enabling PE firms to finance multi-billion buyout deals (Axelson, Jenkinson, Ströberg, and Weisbach, 2013). However, the financial crisis of 2007–2008 and the following sovereign debt crisis severely affected PE activity. Deal volumes declined sharply while PE bidders experienced severely curtailed access to financing. Nonetheless, PE activity started to revive in 2012 aided by the extraordinary measures of central banks in the United States and Europe aimed at boosting credit and the stock markets. Favorable market conditions continued in 2013 allowing PE bidders to return record amounts of cash to their investors and complete new acquisitions. Nonetheless, PE activity still has not recovered to its pre-crisis levels. Furthermore, the nascent recovery of the industry crucially depends on continuing favorable market conditions in the future.

MARKET DEVELOPMENTS IN THE UNITED STATES

The U.S. buyout market remains the largest in the world accounting for 54 percent of global buyout deals and 59 percent of global deal value. The attractiveness of the U.S. market is based on the presence of large institutional investors and renowned PE firms (Preqin 2012a). Besides, a deep and liquid stock market provides PE bidders with an attractive exit opportunity from their investments through an IPO (Black and Gilson 1999). Jerome Kohlberg, Henry Kravis, and George Roberts engineered the modern LBO model in the United States in the late 1960s while working at Bear Stearns (Kaufman and Englander 1993). They would later leave Bear Stearns to establish KKR, which remains one of the largest PE firms in the world.

The exponential growth in buyout activity between 2003 and 2007 came to an abrupt halt with the onset of the financial crisis of 2007–2008. Frozen credit markets and the slump in stock prices forced PE bidders to end or renegotiate their pending acquisitions and shy away from new deals (Davidoff 2009). The total value of LBOs fell from more than $400 billion in 2007 to about $100 billion in 2008 falling further in 2009 when the leveraged buyout market collapsed (Private Equity Growth Capital Council 2013). The unwillingness of banks to finance LBOs and tightened credit markets forced PE bidders to increase their equity contribution to more than 50 percent of the total purchase price in 2009 (Bain and Company 2010). Besides, mega-deals completed during the boom years such as the $48 billion buyout of TXU, the largest buyout completed so far, had to be renegotiated with creditors suffering steep losses (Anderson and Creswell 2010).

Buyout activity in 2010 started to recover from its 2009 lows aided by accommodating credit markets (Bain and Company 2011). The benign conditions in financial markets deteriorated in the second half of 2011 with the escalation of the sovereign debt crisis. Fears of a disorderly break-up of the Eurozone threw markets into turmoil. Volatile markets and economic uncertainty halted the rebound of LBO activity (Bain and Company 2012). Nonetheless, U.S. buyout activity accelerated in 2012 despite uncertainty caused by the clash between the two major political parties in the United States over raising the federal debt limit. Record low-interest rates, investor optimism about the growth prospects of the U.S. economy, and the stability of U.S. financial markets spurred the increase in buyout activity (Bain and Company 2013).

Continuing loose monetary policy by the Federal Reserve in 2013 led to buoyant credit and stock markets with valuations of companies hitting record levels and stock prices witnessing a spectacular rise. PE firms took advantage of market conditions exiting their investments through IPOs, refinancing the debt of portfolio companies, and adding debt to companies to fund payouts to themselves (Dezember 2013). As a result, PE firms could return a record amount of cash to their investors. Also, 2013 saw the return of PE mega-deals such as the $24 billion buyout of computer maker Dell Inc. by its founder, Michael Dell, and PE firm Silver Lake Management LLC and the $23 billion buyout of food company Heinz by Warren Buffett and Brazilian PE firm 3G. Even though 2014 was notable for the absence of mega-deals, PE activity remained robust with investors piling into PE funds (Primack 2014). Furthermore, PE firms massively exited their investments via sales to corporate acquirers (Canada 2014).

Overall, several general trends in the U.S. PE market are worth noting. An important development is the transformation of the largest PE firms into more broad-based asset management firms. PE firms have expanded their line of business apart from LBOs into investments in real estate, hedge funds, credit extension, and financial advisory services (Roumeliotis and Meads 2012). Expanding their product offerings allows PE firms to deliver superior returns to their investors and to diversify their source of income and benefit from economies of scale. Also, more PE firms choose to become or are considering becoming listed on a public stock exchange after Blackstone's successful IPO in 2007.

Some still criticize the public listing of PE firms for allowing them to raise permanent capital, which makes continuously raising of funds in the market unnecessary and weakens market discipline (Jensen 2007). A more widely criticized development is the increase in secondary buyouts as a means of exiting PE investments. In a secondary buyout, the PE investor owning the firm sells it to another PE investor. Some criticize secondary buyouts for aggravating the agency costs between investors and managers. Toward the end of the investment period, PE managers who usually receive management fees on the invested portion of the fund's capital have an incentive to "burn" cash and invest in deals contrary to the interests of investors. Consistent with this hypothesis, Degeorge, Martin, and Phalippou (2013) report that secondary buyouts made late in a fund's investment period underperform similar primary buyouts.

MARKET DEVELOPMENTS IN EUROPE

Europe has traditionally been the second biggest market for PE investments after the United States (Preqin 2012b). Buyout activity in Western Europe between 2000 and 2004 surpassed activity in the United States reaching about 48.9 percent of transaction value worldwide (Kaplan and Strömberg 2009). European countries show a wide diversity in developing their buyout markets (Andres 2012). The United Kingdom, the first European country to experience a buyout boom during the 1980s, represents the biggest buyout market in Europe with London serving as a global hub for PE firms and professionals (Gilligan and Wright 2010). Germany and France are the next most important markets for buyout activity in Europe distantly following the United Kingdom (Center for Management and Buyout Research 2013). Spain and Italy also witnessed large growth in buyout activity after 1996 (Wright et al. 2006). Nonetheless, the financial crisis of 2007–2008 put an abrupt end to the rise of LBO activity with deal value and volume suffering an almost 50 percent drop compared to its pre-crisis level (MacFarlane 2013).

Europe experienced its own buyout boom between 2003 and 2007. Some of the biggest European buyouts completed during the height of the LBO boom in 2006 and 2007 include the management buyout of the U.K. pharmacy company Alliance Boots, the leveraged acquisition of TDC (a Danish telecommunications company), and the sale of Philips Semiconductors (the semiconductor business of Royal Philips Electronics) to a consortium of PE buyers. The financial crisis of 2007–2008 caused a steep decline in buyout activity across Europe as credit markets froze and risk aversion took hold. Although buyout activity reached its lowest level in 2009 (Preqin 2012b), it substantially picked up in 2010 and continued growing in the first half of 2011 despite the gradual escalation of the sovereign debt crisis (PricewaterhouseCoopers 2012). Market conditions worsened sharply during the second half of 2011 as fears spread about the ability of European governments to honor their debt obligations. As a result, the European buyout recovery came to a standstill with buyout activity remaining weak during 2012 especially in southern European countries (Bain and Company 2013).

Signs of stabilization in the Eurozone economy and a revival of credit markets due to the aggressive monetary policy of the European Central Bank led to a sharp rise in buyout activity in 2013. Further, a vibrant IPO market allowed PE sponsors to exit their investments while the availability of credit led to a surge in refinancing and dividend recapitalizations (Husband 2013). The revival of buyouts was strong in Germany reaching to the levels witnessed before the financial crisis of 2007–2008 and reflecting Germany's position as the dominant and most resilient economy in Europe (Pritchard 2013). Furthermore, PE firms are aggressively raising funds for potential buyouts in southern European countries such as Spain and Italy lured by improving fundamentals and dispositions of corporate noncore assets (MacFarlane 2013).

On the future of buyout activity in Europe, market participants consider that opportunities in Europe lie in areas outside the LBO market such as real estate, consumer loans, distressed assets, and dispositions of assets by European banks seeking to downsize their operations due to regulatory requirements and market pressure (Pritchard 2013). Indeed, banks in Europe sold approximately $75 billion of commercial and residential property loans in 2014, with PE firms being among the biggest buyers (Patnaude 2015). The sovereign debt crisis and the resulting recession have substantially impeded buyout activity in Europe. Besides, the tremendous growth of buyout activity in the Asian-Pacific region and Latin America is threatening Europe's long-standing position as the second most important market globally for PE buyouts (Preqin 2012b). The growing importance of emerging markets such as Brazil, India, and China in the world economy has attracted PE investors seeking to capitalize on the growth potential in these markets.

Regulatory Developments after the Financial Crisis

A complete overhaul of financial regulation in the United States and Europe followed the financial crisis. Despite the absence of evidence about its contribution to the financial crisis, U.S. and European regulators quickly determined that the previously unregulated and opaque alternative investment funds sector posed a major threat to financial stability and aggravated systemic risk in the financial markets. The result was the adoption of the Dodd-Frank Act in the United States and the AIFM Directive in Europe, regulations that substantially affect the PE industry. The Dodd-Frank Act brings the PE industry under the regulatory radar forcing PE fund managers to register with the SEC for the first time and introduces the Volcker Rule banning banking entities from investing or sponsoring PE funds. The AIFM Directive seeks to create a harmonized regulatory framework for alternative investment fund managers operating in Europe. It requires their registration with a supervisory authority and compliance with various requirements, which seek to ensure the protection of investors and to tackle the issue of systemic risk. European regulators adopted an interventionist stance toward the PE industry raising its compliance costs and altering the structure of PE deals in Europe.

REGULATORY DEVELOPMENTS IN THE UNITED STATES

The financial crisis of 2007–2008 started in the U.S. subprime market, spread throughout the financial system, and led to the adoption in 2010 of the Dodd-Frank Act, an ambitious effort to overhaul U.S. financial regulation. The Act mainly targets systemic risk. According to Skeel (2010, p. 4), the Dodd-Frank Act has two primary objectives: "its first objective is to limit the risk of contemporary finance . . . and the second is to limit the damage caused by the failure of a large financial institution." The Act contains terms seeking to improve transparency in the PE industry and reduce concerns about the potential contribution of PE to systemic risk. Title IV of the Dodd-Frank Act requires PE firms to register with the SEC under the Investment Advisers Act of 1940 (hereinafter called the "Advisers Act") and comply with heightened disclosure requirements and provisions seeking to protect investors in PE funds. Section 619 of the Act, the so-called Volcker Rule, forbids banking entities from sponsoring or investing in a PE fund subject to limited exceptions. Finally, systemically important PE firms or funds may be brought under the supervision of the Federal Reserve on their designation as systemically important financial institutions by the FSOC. *Systemically important financial institutions* are those institutions whose failure could significantly jeopardize financial stability and adversely impact the real economy.

Title IV abolishes section 203(b)(3) of the Advisers Act, which allowed PE fund managers to avoid registration as investment advisers with the SEC. Section 203(b)(3) provided an exemption from registration under the Advisers Act for an investment adviser who had fewer than 15 clients, did not hold itself out to the public as an investment adviser, and did not serve as an investment adviser to a registered investment company or business development company. Because of abolishing 203(b)(3), fund managers who previously relied on this exemption are now required to register with the SEC. However, the Dodd-Frank exempts from registration advisers to family offices, venture capital funds, investment advisers advising private funds with less than $150 million assets under management in the United States, and foreign private advisers. A *foreign private adviser* is any investment adviser who has no place of business in the United States, has fewer than 15 clients and investors in the United States in private funds advised, and has less than $25 million assets under management invested in private funds advised by the adviser by clients in the United States and investors in the United States. Furthermore, the adviser must not hold itself out to the public as an investment adviser or act as an investment adviser to any registered investment company or a business development company.

Section 113 of the Dodd-Frank Act introduces a novel regulatory framework for nonbank systemically important financial institutions aimed at safeguarding financial stability. In response to the failures of the previous regulatory regime, which mainly focused on micro-prudential regulation (i.e., the regulation of individual financial institutions), the Dodd-Frank Act establishes FSOC to monitor and respond to systemic risks in U.S. financial markets. The FSOC may designate nonbank financial companies including PE firms and/or their funds as systemically important financial institutions. In making such designations, the FSOC considers various factors including the company's degree of leverage, its size and interconnectedness with the rest of the U.S. financial system, and the liquidity risk and maturity mismatch between the company's assets and liabilities. Other factors include whether the company is already subject to regulatory oversight and whether it is a dominant provider of services in that such a loss of access to its services could cause financial distress. Once designated as a systemically important financial institution, a nonbank financial company is brought under the supervision of the Federal Reserve Board, which has the authority to develop and impose prudential standards.

The Volcker Rule introduced by section 619 of the Dodd-Frank Act bans banking entities from sponsoring or investing in PE funds. The definition of sponsorship includes serving as a GP; managing member or trustee of a fund; selecting or controlling the funds' directors, trustees, or management; or sharing the same name as the fund. Banking entities are allowed, however, to organize and offer a PE fund with the provision of bona fide trust, fiduciary, or investment advisory services provided the fund is offered solely to customers of such services. The investment should not exceed 3 percent of the outstanding ownership interests in the fund one year after its establishment. Banking entities are permitted to invest in such funds up to 3 percent of their *Tier 1 capital*, which refers to a bank's core equity capital composed mainly of common stock and retained earnings. Regulators may prohibit organizing and offering of PE funds if doing so poses a threat to the financial stability of the banking entity or involves material conflicts of interests or results in a material exposure of the banking entity to high risk assets or trading strategies. Nonbank financial companies sponsoring or investing in PE funds and designated by the FSOC as systemically important financial institutions may be subject to additional capital requirements and quantitative limits with respect to such activities.

Overall, regulating PE in the United States is premised on the potential contribution of the industry to systemic risk. The PE industry can be a source of systemic risk through the widespread failure of PE-backed companies and its effects on the banking system, which finances LBOs and the real economy. Nonetheless, no widespread failure of PE-backed companies occurred during the financial crisis of 2007–2008 and the failure of these companies did not jeopardize the real economy. Also, even a comprehensive study by the European Central Bank (2007) recognized the debt exposures of banks to the EU leveraged buyout market are sufficiently covered by their capital buffers. Although the PE industry is unlikely to be a source of systemic risk, the registration, and reporting requirements introduced by Dodd-Frank Act will only have a minor impact on the PE industry in compliance costs (Kaal 2012). A PE firm or fund is unlikely to fulfill FSOC's criteria for designation as a systemically important financial institution.

Although the failure of standalone PE firms and funds is unlikely to pose a threat to the financial system, systemic risk may emanate from banks' ownership and sponsorship of PE funds. The failure of internal PE funds may adversely affect the reputational capital of the parent banking organization and result in its failure, which may destabilize the financial system if the parent is systemically important. Further, bank-affiliated PE funds may be able to take advantage of the explicit and implicit government guarantees of their parent companies to finance their investments at a lower cost. Consistent with this hypothesis, Fang, Ivashina, and Lerner (2012) find that deals completed by bank-affiliated PE funds and financed by the parent bank are financed at substantially better terms than deals completed by standalone funds even though they do not show better performance. As a result, adopting the Volcker Rule by U.S. regulators is based on a sound rationale and responds adequately to the systemic risk of internal PE funds.

REGULATORY DEVELOPMENTS IN THE EUROPEAN UNION

The financial crisis of 2007–2008 and the failures of the EU financial regulatory framework resulted in an overhaul of EU financial regulation. One of the first targets of European regulators was the opaque alternative investment fund industry. EU politicians regularly criticized the PE industry for breaking-up companies, slashing jobs, and promoting a short-term thinking inside corporate boardrooms at the expense of long-term value creation. The result was the adoption of the AIFM Directive in November 2010 after a lengthy and heated negotiation. The Directive's main goals are protecting investors in alternative investment funds and tackling systemic risk. The AIFM Directive seeks to achieve these goals by creating a harmonized EU regulatory framework for alternative investment funds (AIFs). An AIF is any "collective investment undertaking" that raises capital from investors for investing it according to a defined investment policy and does not require authorization under Article 5 of Directive 2009/65/EC, commonly known as the "UCITS Directive."

The AIFM Directive regulates alternative investment fund managers (AIFM) established in the European Union that manage AIFs, whether established in the European Union or not, and non-EU-based AIFMs that manage EU funds or market funds in the European Union. An AIFM is any entity managing AIFs as a regular business. As a result, managers of PE funds, hedge funds, commodity funds, and real estate funds fall within the ambit of the Directive. PE fund managers covered by the Directive are required to become authorized by the competent authorities of their home Member States. Nonetheless, the Directive creates an exemption for PE fund managers of unleveraged AIFs and does not grant investors redemption rights for five years and whose assets do not exceed EUR 500 million.

Covered fund managers must comply with modest initial and continuing capital requirements, devise appropriate risk and liquidity management systems, and implement procedures to identify and manage conflicts of interest that could adversely affect the funds managed or their investors. To curb excessive risk-taking, the Directive requires fund managers to adopt sound remuneration policies and introduces remuneration restrictions for staff whose activities may adversely affect the risk profile of the funds managed. Furthermore, the AIFM Directive introduces depositary and valuation requirements. A fund manager must appoint a single depositary for each fund managed that will be responsible for safekeeping the fund's assets and monitoring its cash flows. Additionally, an independent valuation of fund assets must take place at least once per year.

To increase the transparency of the AIF industry, the AIFM Directive introduces mandatory reporting requirements toward investors and national supervisors. Fund managers must make available to investors specific information both before and periodically after their investment in the fund. Fund managers must also produce an annual audited report for each fund and provide it to the competent national authority and investors on request. These managers must disclose more information to supervisory authorities for assessing systemic risk. The disclosures includes the primary markets in which the fund manager trades, principal exposures, concentrations of each fund managed, the risk profile of the funds managed, and main categories of assets in which the funds managed are invested.

The AIFM Directive also imposes disclosure obligations at the portfolio company level. Acquisitions of major holdings in non-listed EU companies above certain thresholds (starting at 10 percent) must be disclosed to national regulatory authorities. Also, the Directive introduces provisions aimed directly at LBOs of EU companies. If a PE fund acquires control of a non-listed company (control for a non-listed company is defined as a 30 percent ownership interest or more), the PE fund manager must notify the company, the shareholders and its regulators of gaining control. A PE fund manager who acquires control of a non-listed company or control of a listed company must disclose certain information to the company, its shareholders, and its regulator. These disclosures include the policy for preventing and managing conflicts of interest and the policy for external and internal communication about the company in particular on employees. For a listed company, the control is defined by reference to the EU Takeover Directive and varies between Member States but a substantial number of Member States defines control as a 30 percent or more ownership interest. Furthermore, in case of an acquisition of control of a non-listed company, the fund manager must disclose its intentions on the company's future business and the likely effects on employment. The fund manager must also disclose information on financing the acquisition of the non-listed company. The annual reports of a non-listed company controlled by a PE fund or the annual report of the fund itself must contain a fair review of the development of the company's business.

Finally, the Directive seeks to protect companies against short-term investment strategies used by PE investors. The most notable strategy involves depleting the target company's assets for repaying the debt incurred to finance the acquisition, a practice commonly referred to as *asset stripping*. A fund manager who acquires control of a non-listed or listed EU company shall not for two years after the acquisition facilitate, support, instruct, or vote in favor of any distribution, capital reduction, share buyback, or acquisition of own shares by the portfolio company. The restrictions are applicable only if the distributions made to shareholders would cause net assets to fall below the subscribed capital or would exceed available net profits. The asset stripping prohibitions substantially affect exits and deal structuring in Europe and limit the options available for returning value to PE investors. For instance, dividend recapitalizations and redemptions of shares including preference shares granted to the PE investor would be restricted during the first two years after the acquisition.

As Payne (2011) notes, adopting the AIFM Directive reflected the desire of European legislators to regulate the hedge fund industry. However, in the general climate of mistrust and hostility toward the opaque AIFs sector after the financial crisis, EU regulators decided to extend the application of the AIFM Directive to the PE industry. The premise underlying the Directive was on the need to improve investor protection and tackle the systemic risk posed by the AIFs industry including the PE industry. As previously mentioned, the PE industry is unlikely to be a source of systemic risk. Also, investors in PE funds are sophisticated market players able to protect themselves and enter mutually favorable bargains with PE firms. The AIFM Directive is expected to substantially increase compliance costs for PE firms operating in Europe (Malcom, Tilden, Wilsdon, Resch, and Xie 2009). Moreover, the restrictions on distributions to shareholders are likely to have a profound impact on deal structuring and exits.

Summary and Conclusions

In the aftermath of the financial and the sovereign debt crises, the PE industry has undergone a deep transformation. Market and regulatory developments are challenging the continuous growth of the industry. The effects of these developments will be adverse in Europe. The European banking sector is still recovering from the sovereign debt crisis with severely curtailed sources of LBO financing. Furthermore, although the European economy has managed to exit from the recession caused by the sovereign debt crisis, growth in the real economy is likely to remain sluggish for the coming years. These adverse market developments are complemented by a particularly interventionist and burdensome regulatory approach toward the PE industry. In contrast, U.S. regulators have adopted a measured approach toward the risks posed by the PE industry and have recognized its crucial role in rejuvenating the U.S. economy. Moreover, the U.S. real economy has been recently showing signs of revival indicating the largest economy of the world is finally exiting the recession caused by the financial crisis of 2007–2008. Finally, as central banks around the world exit the extraordinary measures adopted to combat the financial and sovereign debt crises, PE investors will faced tighter capital markets and a more modest increase in stock prices.

Discussion Questions

1. Discuss how actions taken by central banks in the late 2000s and early 2010s in the United States and Europe that influenced PE activity.
2. Discuss general trends in the U.S. PE industry.
3. Compare the regulatory approach of the United States and the European Union toward the PE industry.
4. Discuss the future of PE in the United States and Europe.

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