

REGULATORY REFORM OF PRIVATE EQUITY: THE AIFMD AND ITS IMPLICATIONS

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by

Robert K. Rajczewski, LL.M.

under the supervision of

The Late Professor Dr. Brigitte Haar, LL.M. (Chicago)

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Abstract

Private equity has grown remarkably in the last 30 years. Given its rise to prominence, exceptional profitability and a more prolific and publicly visible buyout activity, regulation in the private equity space seemed inevitable. The 2007 global financial crisis furnished an opportunity to doubt the industry's role and magnify the key concerns, providing momentum for calls to regulate the industry more aggressively. Ultimately, the regulatory change came from the Alternative Investment Fund Managers Directive (AIFMD), which has been described as one of the most rigorously debated and controversial pieces of financial regulation to ever emerge from the European Union (EU).

The AIFMD is unique and unprecedented, yet there has been very little written about it in the context of private equity. Therefore, this thesis makes a contribution to this area of research by examining the implications of AIFMD for private equity and arguing that this EU Directive has a re-shaping effect on the industry that inevitably marks the end of the light-touch regulation in this area. Whilst the desire of policymakers to act and intervene decisively during market downturns is understandable, there is a risk that the response may not be appropriate and result in a crisis-induced over-reaction.

This thesis demonstrates, amongst other things, that the AIFMD has created a particularly complex regulatory regime which for the hitherto unregulated or lightly regulated fund managers has had a significant effect in the EU and beyond. Examples of the most impactful provisions relate to authorisation, marketing, depositaries, acquisition of control, remuneration, and transparency and disclosure. The implications are wide-ranging, and there is a clear conflict between the opportunities (e.g. EU passport, AIFMD as a global brand) and threats (e.g. excessive compliance costs, exodus of fund managers from the EU), which depend on a firm's size, domicile and the gap needed to be aligned between the pre- and post-AIFMD regime. Although there will be no stark triumph of one position over another in the assessment of the AIFMD until all of its elements are fully implemented, overall the impact of the Directive has been material, requiring substantial work to comply with (or adapt to) the requirements, which in some cases are not only particularly onerous and costly, but also a bit misguided, discouraging, or fairly irrelevant.

Declaration

I have only used the sources and aids that I have stated in preparing the submitted work and have marked the passages taken from other works. I have written my work independently.

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Last, but not least, I express my sense of gratitude to one and all who have directly or indirectly lent their helping hand in this academic venture.

List of Abbreviations

AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
AIM	Alternative Investment Market of the London Stock Exchange
APER	Statements of Principle and Code of Practice for Approved Persons Sourcebook
AUM	Assets Under Management
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (German Federal Financial Supervisory Authority)
BIMBO	Buy-In Management Buyouts
BVCA	British Venture Capital Association
BVI	British Virgin Islands
CA 2006	Companies Act 2006
CAD	Capital Adequacy Directive
CEO	Chief Executive Officer
CJA	Criminal Justice Act 1993
CMU	Capital Markets Union
COBS	Conduct of Business Sourcebook
CRA	Charles River Associates
CRD	Capital Requirements Directive
DA	Delegated Act
DTR	Disclosure Rules and Transparency Rules Sourcebook
ECB	European Central Bank
ECJ	European Court of Justice
ECFIN	Economic and Financial Affairs Council
EEA	European Economic Area
EEC	European Economic Community
EMU	Economic and Monetary Union
ESMA	European Securities and Markets Authority
EU	European Union
EVCA	European Venture Capital Association
EY	Ernst & Young
FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FIT	Fit and Proper test for Employees and Senior Personnel Sourcebook
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSA 2012	Financial Services Act 2012
FSAP	Financial Services Action Plan
FSMA	Financial Services and Markets Act 2000
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GMG	Guidelines Monitoring Group
GP	General Partner
GWU	George Washington University

HMRC	Her Majesty's Revenue & Customs
IAS	International Accounting Standards
IBO	Investor-Led Buyout
IFRS	International Financial Reporting Standards
IOSCO	International Organisation of Securities Commissions
IPO	Initial Public Offering
IPRU(INV)	Interim Prudential Sourcebook for Investment Businesses
IRR	Internal Rate of Return
KAGB	Kapitalanlagegesetzbuch (German Capital Investment Act)
KKR	Kohlberg Kravis Roberts
LBO	Leveraged Buyout
LLP	Limited Liability Partnership
LP	Limited Partner
LSE	London Stock Exchange
MAR	Market Conduct Sourcebook
MBI	Management Buy-In
MBO	Management Buyout
MEBO	Management-Employee Buyout
MiFID	Markets in Financial Instruments Directive
MoU	Memorandum of Understanding
MS	Member State of the European Union
NPPR	National Private Placement Regime
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
PE	Private Equity
PEF	Private Equity Finance
PES	Party of European Socialists
PLC	Practical Law Company
PPM	Private Placement Memorandum
PRA	Prudential Regulation Authority
PRIN	Principles for Business Sourcebook
PTP	Public-to-Private
R&D	Research and Development
RLBO	Reverse Leveraged Buyout
SEC	Securities and Exchange Commission
SIPO	Second Initial Public Offering
SME	Small and Medium-sized Enterprise
SOX	Sarbanes-Oxley Act
S&P 500	Standard & Poor's 500 Index
SPV	Special Purpose Vehicle
SWF	Sovereign Wealth Funds
SYSC	Senior Management Arrangements, Systems and Controls Sourcebook
TFEU	Treaty on the Functioning of the European Union
UCITS	Undertakings for Collective Investment in Transferable Securities Directive 2009/65/EC
UCLA	University of California, Los Angeles
UK	United Kingdom
US	United States
U.S.C.	The Code of Laws of the United States of America

List of Journal Abbreviations

ACAD. MANAGE. REV.	Academy of Management Review
AM. ECON. REV.	American Economic Review
B.P.E.A.	Brookings Papers on Economic Activity
BELL J. ECON.	Bell Journal of Economics
BUS. HIST.	Business History
C.J.E.L.	Columbia Journal of European Law
C.L.J.	Cambridge Law Journal
C.M.L.J.	Capital Markets Law Journal
C.O.B.	Compliance Officer Bulletin
COLUM. L. REV.	Columbia Law Review
CORP. GOV.	Corporate Governance: An International Review
DEL. J. CORP. LAW	The Delaware Journal of Corporate Law
E.C.F.R.	European Company and Financial Law Review
ECON. INNOVATION NEW TECH.	Economics of Innovation and New Technology
ECON. SOC.	Economy and Society
ENTREP. THEORY PRACT.	Entrepreneurship Theory and Practice
EUR. FIN. MANAGE.	European Financial Management
EUR. J. LAW ECON.	European Journal of Law and Economics
EURO. LAW.	European Lawyer
EUROPEAN BUS. L. REV.	European Business Law Review
EUROPEAN BUS. ORGANIZATION L. REV.	European Business Organization Law Review
F.M.I.I.	Financial Markets, Institutions & Instruments
FIN. TIMES	Financial Times
FINANC. MANAGE.	Financial Management
FINANCIER WORLDWIDE MAG.	Financier Worldwide Magazine
FLA. J. INT'L L.	Florida Journal of International Law
FORDHAM J. CORP. & FIN. L.	Fordham Journal of Corporate & Financial Law
GAME. ECON. BEHAV.	Games and Economic Behavior
GEO. L.J.	Georgetown Law Journal
GEO. WASH. L. REV.	George Washington Law Review
HARV. BUS. REV.	Harvard Business Review
HOUS. L. REV.	Houston Law Review
I.C.L.Q.	International and Comparative Law Quarterly
INT. J. MANAG. REV.	International Journal of Management Reviews
INT. J.L.M.	International Journal of Law & Management
INT'L CORP. RESCUE	International Corporate Rescue
INT'L FIN. L. REV.	International Financial Law Review
INT'L J. ECON. BUS.	International Journal of the Economics of Business
INT'L REV. L. & ECON.	International Review of Law and Economics
J. ACCOUNT. AUDIT. FINANCE	Journal of Accounting, Auditing & Finance
J. ACCOUNT. ECON.	Journal of Accounting and Economics
J. APPL. CORP. FINANCE	Journal of Applied Corporate Finance
J. BUS. FINANCE ACCOUNT.	Journal of Business Finance & Accounting
J. BUS. R.	Journal of Business Research

J. BUS. VENTURING	Journal of Business Venturing
J. CORP. FINANCE	Journal of Corporate Finance
J. CORP. L.	Journal of Corporation Law
J. ECON. PERSPECT.	Journal of Economic Perspectives
J. EMPIR. FINANCE	Journal of Empirical Finance
J. FINANC. ECON.	Journal of Financial Economics
J. FINANCE	Journal of Finance
J. IND. ECON.	Journal of Industrial Economics
J. INV. C.	Journal of Investment Compliance
J. INV. MANAGE.	Journal of Investment Management
J. LAW ECON.	Journal of Law & Economics
J. MANAGE. STUD.	Journal of Management Studies
J.L. & COM.	Journal of Law and Commerce
J. NEUROPHYSIOL.	Journal of Neurophysiology
J. POLIT. ECON.	Journal of Political Economy
J.C.M.S.	Journal of Common Market Studies
J.F.E.P.	The Journal of Financial Economic Policy
J.I.B.F.L.	Journal of International Banking and Financial Law
J.I.B.L.R.	Journal of International Banking Law and Regulation
J.M.G.	Journal of Management & Governance
J.P.E.	Journal of Private Equity
MARQ. L. REV.	Marquette Law Review
MICH. ST. L. REV.	Michigan State Law Review
N. POL. ECON.	New Political Economy
N.L.R.	New Left Review
N.Y. TIMES	New York Times
Q. J. ECON.	Quarterly Journal of Economics
R.I.S.	Review of International Studies
RESEARCH POL'Y	Research Policy
REV. ECON. STAT.	The Review of Economics and Statistics
SCOTTISH J. POLIT. ECON.	Scottish Journal of Political Economy
SMALL BUS. ECON.	Small Business Economics
STRAT. MANAGE. J.	Strategic Management Journal
U. CHI. L. REV.	University of Chicago Law Review
WALL ST. J.	The Wall Street Journal
WASH. POST	Washington Post
YALE L.J.	Yale Law Journal
YALE. J. on REG.	Yale Journal on Regulation

Contents

Abstract.....	i
Declaration.....	ii
Acknowledgements.....	iii
List of Abbreviations.....	iv
List of Journal Abbreviations	vi
Chapter I Introduction	1
Chapter II Private Equity: A Précis.....	10
1. Introduction	10
2. Private Equity Explained.....	13
2.1 Taxonomy of Buyouts and Investment Phases.....	16
2.2 Cyclicalities: Between Bubbles and Crashes.....	19
3. Private Equity: Common Critique and Industry Defence.....	21
4. The Effects of Buyouts.....	26
4.1 Wealth Gains and Value Creation	26
4.2 Elimination of the Agency Problem.....	28
4.3 Employment and Wages.....	31
4.4 Productivity	37
4.5 Performance of Portfolio Companies	38
4.6 Investor and Target Shareholder Returns	40
4.7 Ownership Change and Management Practices	45
4.8 Risk of Bankruptcy and Distress	49
4.9 Long Term Investment: R&D and Patents	51
4.10 Longevity of PE Investments	54
5. Conclusion.....	56
Chapter III The EU Pre-AIFMD Regime	59
1. Introduction	59
2. The European Single Market.....	59
2.1 Development of the European Single Market	60
2.2 The Single Market in Time of Crisis.....	62
3. The EU Financial Regulation	63

3.1	The Takeover Directive	65
3.2	The Directive on Transfer of Undertakings	66
3.3	The Transparency Directive	67
3.4	MiFID	68
3.5	The Prospectus Directive	69
3.6	The Market Abuse Directive	70
3.7	EU Company Law Directives	70
3.8	The Capital Requirements Directive	71
4.	The Effects of Divergent National Transposition	71
5.	Conclusion	73
Chapter IV The UK Pre-AIFMD Regime		76
1.	Introduction	76
2.	English Limited Partnership Funds	78
3.	Regulation under the FSMA	81
4.	Regulation by the UK Regulator	83
4.1	High Level Standards	85
4.2	Prudential Standards	87
4.3	Conduct of Business Requirements	88
5.	Investing in Listed Companies	89
6.	Insider Dealing and Market Abuse	89
7.	Disclosure and Transparency Rules	90
8.	Conclusion	91
Chapter V Towards the AIFMD		92
1.	Introduction	92
2.	Engagement with the PE Industry prior to the Crisis	93
2.1	The European Institutions and the ECB	94
2.2	The UK Experience	96
2.3	Others: Trade Unions, Politicians and IOSCO	100
3.	The Post-Crisis EU Regulatory Response	102
3.1	The Rasmussen and Lehne Reports	103
3.2	The EU Commission's Response	106
3.3	Industry Response (EVCA, BVCA) and IOSCO	109
4.	Directive Proposal	115
5.	Conclusion	118

Chapter VI AIFMD: Technical Analysis	120
1. Introduction	120
2. AIFMD Overview	121
2.1 Scope	122
2.2 Authorisation	124
2.3 Operating Conditions for AIFMs	126
2.4 Disclosure and Reporting	131
2.5 Acquisition of Control of Non-Listed Companies	133
2.6 Marketing and Passporting	135
3. The Lamfalussy Process	139
4. The AIFMD Review	139
5. Conclusion	140
Chapter VII AIFMD: Implications for Private Equity	141
1. Introduction	141
2. Negative Implications and Potential Threats	143
2.1 Transitional Arrangements	144
2.2 Authorisation Process	146
2.3 Depositaries	147
2.4 Remuneration	151
2.5 Risk Management	153
2.6 Transparency and Disclosure	154
2.7 Acquisition of Control	160
2.8 Valuation	164
2.9 Minimum Capital Requirements	166
2.10 Delegation	167
2.11 Third Country Marketing Rules	169
2.12 Compliance Costs	178
2.13 Exodus of Fund Managers from Europe	180
3. Positive Implications and Opportunities	183
3.1 EU Passport	184
3.2 Increased Investor Protection and Confidence	185
3.3 AIFMD as a Global Brand	188
4. Conclusion	190

Chapter VIII Regulating in the Crisis.....	194
1. Introduction	194
2. Regulation of Finance and Financial Investments.....	196
2.1 Post-Crisis Reforms.....	199
2.2 Bubble Laws: SOX and Dodd-Frank	204
2.3 Lessons from the Past.....	207
3. Systemic Risk and the Impact of Private Equity on Financial Stability.....	209
4. Conclusion.....	215
Chapter IX Conclusion	217
Bibliography	228
1. Primary Sources	228
2. Secondary Sources	231
2.1 Books.....	231
2.2 Journal articles.....	239
2.3 Online materials	250
2.4 Other materials (magazines, newspapers, dictionaries, lectures, forums, industry publications).....	275

Chapter I

Introduction

Private equity (PE) is the business of buying and selling whole companies. It has entered the economic mainstream and become ubiquitous of late due to a sharp increase in acquisitions of the ever larger and more prominent public companies, but also the fallout from the 2007 financial crisis and Mitt Romney's 2012 presidential campaign in the United States (US).¹ Whilst these particular developments have caught the public's attention and exposed the industry's existence, outside the financial realm, the scope and influence of private equity, or the sheer scale of products and services offered by private equity-backed companies, is not commonly known. This might be surprising as there is some link to private equity in virtually every product, shop or technology application.²

Private equity is omnipresent in the US, but Europe has also a developed and successful private equity industry.³ The surge in buyouts that have rapidly grown in volume and size has led to a situation where '[y]ou can't pick up the paper or turn on the TV and not hear about PE.'⁴ This illustrates that the industry has transformed extensively since its inception, like the 'Cinderella of the M&A world.'⁵ As observed by Valdez and Molyneux (2013), it is rare to observe transactions below \$100 million but common to observe ones exceeding \$1 billion.⁶ The trend

¹ Mitt Romney is a co-founder of Bain Capital, a private partnership focused on private equity investing, which has become one of the world's largest private, multi-asset investing firms. Romney's presidential campaign of 2012 emphasised, amongst others, his highly profitable career in the business world. *See also Unlocking Global Value. Future Trends in Private Equity Investment Worldwide 3* (Apax Partners & The Economist Intelligence Unit, Apr. 2006), <https://www.apax.com/news-views/apax-partners-publishes-report-on-the-future-of-private-equity-unlocking-global-value/> (report available upon request).

² The industry's big footprint is best summarised by a Wall Street Journal reporter who described in detail her experience of spending a week in London trying to avoid anything touched by private equity; *see* Becky Pritchard, *Could You Live Without Private Equity?* (WALL ST. J., Nov. 15, 2013), <https://www.wsj.com/articles/could-you-live-without-private-equity-1384538352>.

³ PE firms raised EUR 49 billion in the first half of 2020, backing 3,401 companies across Europe. *See Investing in Europe: Private Equity Activity H1 2020 – Statistics on Fundraising, Investments and Divestments* (Invest Europe, Oct. 23, 2020), <https://www.investeurope.eu/research/activity-data/>.

⁴ Andrew Ross Sorkin, *Of Private Equity, Politics and Income Taxes* (N.Y. TIMES, Mar. 11, 2007), <http://www.nytimes.com/2007/03/11/business/yourmoney/11deal.html?fta=y&r=0> (quoting Mr. Bonderman, senior partner at Texas Pacific, at the 2007 Super Returns conference in Frankfurt).

⁵ Robert Rajczewski, *Private Equity Transactions and the Bankruptcy Rate* (June 23, 2014), <http://www.kslr.org.uk/blogs/commercial/2014/06/23/private-equity-transactions-and-the-bankruptcy-rate/>.

⁶ STEPHEN VALDEZ & PHILIP MOLYNEUX, *AN INTRODUCTION TO GLOBAL FINANCIAL MARKETS* 252 (7th ed. 2013).

of going private transactions extends to any public company and ‘there isn’t a public board out there that hasn’t talked once about private equity;’⁷ and even large companies that once rejected the idea of private equity are now keen to consider doing business with them.⁸ This is because buyouts have proven to create value and improve financial performance through triggering a corporate restructuring process which revises, redefines and refocuses a company’s key strategic variables, promotes much more aspirational target setting, and revitalises its entrepreneurial spirit and innovation. In 2001, it was reported that 84 per cent of responding companies in the pan-European private equity survey conducted by the European Venture Capital Association (EVCA) stated unequivocally that without the buyout and the involvement of private equity they would either have ceased to exist or have grown less rapidly.⁹ Kaplan and Strömberg (2009) reported that in total 17,171 PE-sponsored buyouts occurred between 1 January 1970 and 30 June 2007, with a huge fraction of the buyout activity taking place between 2004 and 2006,¹⁰ a period which could be described as the zenith of the private equity story.

Market conditions that used to be congenial to the buyout activity in the 2000s got abruptly disrupted in 2007 as a result of the financial crisis and the ensuing global economic shock. Although it was unlikely the PE transactions would disappear completely, there were numerous contingencies that could precipitate a partial eclipse of private equity, including the risk of new regulatory measures emerging that would affect various constituents of the PE business under multiple angles.¹¹ The intention would be to systematise and strengthen regulatory oversight of market sectors exposed by the crisis as being lightly regulated or unregulated in an attempt to improve financial stability.

Regulation in the private equity space seemed inevitable in any event, as the sector has traditionally been exempt from many of the oversight treatments, such as periodic reporting requirements and registration with national financial regulators. Although light regulation (or lack of it) was favourable to private equity in the past, this was about to change in light of

⁷ David Cho, *Firms Go Private in Search of Deeper Pockets* (WASH. POST, Jan. 31, 2007), <http://www.washingtonpost.com/wp-dyn/content/article/2007/01/30/AR2007013002038.html>.

⁸ *Private Equity: Capitalism’s New King* (ECONOMIST, Nov. 27, 2004).

⁹ Reported in *European Buyout Success Stories 3* (EVCA, Special Paper, 2001), <https://silo.tips/download/european-buyout-success-stories>; *Survey of the Economic and Social Impact of Venture Capital in Europe 3* (EVCA, Research Paper, June 2002), https://www.researchgate.net/publication/324156458_The_economic_impact_of_venture_capital. Note the EVCA rebranded as Invest Europe on 1 October 2015.

¹⁰ Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23(1) J. ECON. PERSPECT. 121, 126 (2009).

¹¹ *2010 EVCA Buyout Report 4* (EVCA Research Paper, Oct. 2010), <https://silo.tips/download/2010-evca-buyout-report-an-evca-research-paper-october-2010>.

intensifying industry critique focused around the ever increasing size of leveraged buyouts (LBOs), transparency deficit, perceived negative knock-on effects on target companies, and exorbitant remuneration levels of fund managers that became socially unacceptable in the post-financial crisis world. Meanwhile, the industry itself had never been vocal about the advantages it brings to the portfolio companies and the wider economy. As put by Cendrowski and Wadecki (2012), ‘To understand the PE arena is to understand the “man behind the curtain” in *The Wizard of Oz*.’¹² Therefore, private equity operates within a specific mystery bubble, which makes it difficult to evaluate the industry’s performance and impact on the well-being of PE-backed companies, their employees and society as a whole, as many details associated with industry operations are shrouded in secrecy. This strong attachment to privacy had only exacerbated negative perceptions and suspicions intensified by the crisis.

Arguably private equity has become a victim of its own success – the industry became too big to hide in the post-crisis world and its spectacular rise to prominence, exceptional profitability and a more prolific and publicly visible buyout activity instigated regulatory and legislative change debates. Even before the crisis, the political environment in Europe was particularly chilly for private equity and the animosity directed at the industry was quite palpable in some quarters. For instance, in the context of the 2007 draft tax reform bill which was criticised by private equity groups in Germany for possibly lowering investment returns, the country’s finance minister Peer Steinbrück responded by saying if the reform has an ‘impact on this particular sector, then so be it. That’s the point.’¹³ Trade unions also started to accuse private equity more vocally of asset stripping, lack of transparency, and shedding employees to the long-term detriment of the acquired companies. This resulted in more pressure on EU policymakers to extend regulatory reach to include the PE industry. Therefore, the traditionally lightly scrutinised private equity industry, which was in its infancy when most nations’ financial regulatory architectures were designed, had fallen under the gaze of regulators.¹⁴ The frenetic pace of private equity activity in the last two decades and especially during the unprecedented merger wave of 2004-2007, which generated untold wealth for the largest, most prominent

¹² Harry Cendrowski & Adam A. Wadecki, *Introduction to Private Equity*, in PRIVATE EQUITY: HISTORY, GOVERNANCE, AND OPERATIONS 3, 5 (Harry Cendrowski et al. eds., 2012).

¹³ *German Tax Law Could Undermine Private Equity Returns* (FIN. TIMES, Mar. 13, 2007), <https://www.ft.com/content/ea31e82-ec76-3c1d-a593-649c69b8e0ec>.

¹⁴ JOSH LERNER, ANN LEAMON & FELDA HARDYMON, VENTURE CAPITAL, PRIVATE EQUITY, AND THE FINANCING OF ENTREPRENEURSHIP: THE POWER OF ACTIVE INVESTING 322 (2012).

private equity firms, only intensified calls to regulate the industry more aggressively¹⁵ in order to restrain possible abuses and address the main concerns.

The 2007 financial crisis furnished an opportunity to doubt the industry's viability and even its role, magnifying the concerns and consequently providing momentum for far-reaching and game-changing regulatory initiatives. Slowly but surely, private equity firms around the world commenced to witness a fair share of disruptive changes evolving and shifts in the overall financial regulatory activity. The reinforcement of the coordinated action at global level in order to construct a more resilient and less pro-cyclical financial system represented one of the principal novelties in the aftermath of the crisis.¹⁶ Compliance and regulation have always remained an eternal challenge for the industry; however, the intensified regulatory efforts, particularly in Europe, where the regulatory perimeter had been enlarged to include PE fund managers, distinguished 2013 as an *annus horribilis* for the industry, with too much regulation happening too fast.¹⁷ Consequently, the private equity sector was set to face a terrain that it had not seen before, both locally and globally, requiring it to fully digest and assimilate a true myriad of new standards and conditions layered on top of each other, with the added complication of cross-border inconsistencies and divergence. The post-2007 re-regulation momentum did not give the industry much respite in absorbing all the new changes, some of which did not have final clarity, many of which overlapped, and a number of which required simultaneous implementation. This unprecedented amount of tumultuous regulation consequent to the financial crisis would definitely have a significant impact on the activities of PE fund managers.¹⁸

In Europe, the regulatory change came from the Alternative Investment Fund Managers Directive (AIFMD).¹⁹ Although the EU Commission acknowledged that private equity was not

¹⁵ Elizabeth de Fontenay, *Private Equity Firms as Gatekeepers* 3 (Apr. 3, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245156.

¹⁶ Enrico Baffi et al., *Extending the EU Financial Regulatory Framework to AIFM, Credit Derivatives, and Short Selling* 2 (Mar. 23, 2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1792993.

¹⁷ *10 Challenges Facing the Private Equity Industry in 2013* 6 (ALTIUS Associates, White Paper, Jan. 2013), <https://www.hitc.com/en-gb/2013/01/22/altius-annual-report-ten-challenges-facing-the-private-equity-se/>. New regulation of private equity awkwardly coincided with transformation of the UK Financial Services Authority and a range of EU level developments, such as Solvency II, Basel III, MiFID II and the consultation on the EU Pensions Fund Directive (IORP II).

¹⁸ *Navigating the Headwinds: 2014 Global Private Equity Survey* 3 (Ernst & Young, 2014), https://www.slideshare.net/DealMarket_com/ernst-young-private-equity-primed-for-new-opportunities.

¹⁹ Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (Text with EEA relevance) [2011] OJ L174/1. Across the Atlantic, the Dodd-Frank Act has been the most prominent change to the financial regulation in a generation, making changes to the country's financial regulatory environment that affected almost the entire US financial services industry, including private

amongst the drivers responsible for the financial crisis²⁰ and that the arguments in favour of the AIFMD were largely predicated on the risks posed by hedge funds, an expression of political desire emerged to directly regulate the whole alternative investment fund industry. The EU's aspirations in this regard are best captured by Jose Manuel Barroso (2010), who stated that '[t]he adoption of the directive means that...private equity will no longer operate in a regulatory void outside the scope of supervisors. The new regime brings transparency and security to the way these funds are managed and operate, which adds to the overall stability of our financial system...today's directive - which coincides with the G20 Summit meeting in Seoul - is another example of how the EU is leading the way in implementing our G20 commitments.'²¹

The Directive is one of the most rigorously debated and controversial pieces of financial regulation to ever emerge from the EU.²² Proposed in the wake of the financial crisis, it was heralded as a measure that would create for the first time a comprehensive and effective regulatory and supervisory framework in the alternative investment fund space. It represents a special product of its own geopolitical landscape that will – by means of its broad coverage – have a significant effect on the private equity industry in the EU and beyond. The AIFMD reflects the notion that alternative investment fund managers (AIFMs), whilst largely beneficial, may spread or amplify risks through the financial system (AIFMD, Recital 2), therefore its overall motivation and aim is to provide for an internal market for AIFMs and a harmonised and stringent regulatory and supervisory framework for AIFMs' activities within the European Union (EU) (AIFMD, Recital 4).

In order to achieve its primary goal and systematise and increase regulatory oversight of AIFMs, the Directive has introduced various regulatory requirements and restrictions which

equity which had hitherto not been regulated (now PE funds are required to be registered with the Securities and Exchange Commission (SEC)); *see, e.g.*, Oscar David & Rachna Misra, *SEC Fixes Gaze on Private Equity*, 112 EURO. LAW. 8, 10 (2012) (discussing the path to more regulation in the private equity space), and The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 401-419, 124 Stat. 1376, 1570-80 (2010) (codified in scattered sections of the U.S.C.). It must be noted that there are not many similarities between the two legislations, despite the motivating influences of the financial crisis. The AIFMD is much more detailed and broader in scope than the Dodd-Frank Act; *see* Barbara Crutchfield George & Lynn Vivian Dymally, *The End of an Era of Limited Oversight: The Restructured Regulatory Landscape of Private Investment Funds Through the U.S. Dodd-Frank Act and the E.U. Alternative Investment Fund Managers Directive*, 25 FLA. J. INT'L L. 207, 257-258 (2013).

²⁰ *Explanatory Memorandum 3* (Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/.../EC {SEC(2009)576} {SEC(2009)577}, EU Commission, Apr. 30, 2009, <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2009:0207:FIN:EN:PDF>.

²¹ Jose Manuel Barroso, *European Commission Statement at the Occasion of the European Parliament Vote on the Directive on Hedge Funds and Private Equity* (Nov. 11, 2010), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_10_573.

²² Phoebus Athanassiou, *The AIFM Directive: An Overview of the Final Rules*, 26(5) J.I.B.L.R. 237, 237 (2011).

will not only create additional (often substantial) burdens for PE fund managers, but also result in major changes for depositaries, external valuers, administrators and other constituents in the PE value chain. In addition, given only limited distinction between different alternative asset classes, some of the requirements are not specifically tailored to private equity. Since the alternative investment sector has traditionally been lightly regulated, the AIFMD is likely going to represent something of a paradigm shift, and the work necessary to adapt to the new requirements will be significant, involving changes to the operating models of PE fund managers. In return for increased regulation, they will be rewarded with an EU marketing passport,²³ the Directive's biggest value.

This thesis critically and objectively examines the impact of AIFMD on private equity, arguing that this EU Directive has a re-shaping effect on the industry that inevitably marks the end of the light-touch regulation in this area. The AIFMD, and especially its first draft, attracted sharp criticism from many quarters for being considered unduly intrusive, out of tune with regulatory recommendations, too ambiguous, inconsistent and incoherent, and providing a challenge to the industry's future prospects. Therefore, this thesis aims to examine the specific implications for private equity and determine whether there is a compelling case for such a disruptive regulatory intervention. According to Leleux (2010), '[w]hat private equity needs is less regulation, not more...limiting or constraining private equity activities can lead...to...less growth and ultimately less wealth for all. This is not what the economy needs today.'²⁴ The unquestionable salience of this unique, unprecedented regulatory response warrants thorough investigation of its adequacy and ability to address the concerns and risks allegedly posed by the industry. The systematic evidence and the wider literature indicate that private equity brings particularly important economic and social benefits, therefore it becomes even more critical to assess the AIFMD and its effect on private equity. Whilst the desire of policymakers to act and intervene decisively during market downturns is understandable, the regulatory response may not always be appropriate, particularly when prone to political opportunism. The Directive's implications are far-reaching and potentially harmful. Thus, this thesis explores whether the 2007 financial crisis was used in an opportunistic manner to achieve unrelated goals, resulting in a crisis-induced regulatory over-reaction that is rather ill-suited to regulating private equity.

²³ *Preparing for AIFMD – Requirements Overview and Implementation Implications 3* (KPMG, Apr. 24, 2013).

²⁴ Benoit Leleux, *Private Equity as a Wealth Recycler*, in *PROGRESS-DRIVEN ENTREPRENEURS, PRIVATE EQUITY FINANCE AND REGULATORY ISSUES* 147, 161 (Zuhayr M. Mikdashi ed., 2010).

There has been very little written about the AIFMD in the context of private equity, the Directive's likely impact and whether it represents the right policy choice for the industry. Hence, how private equity and its investment activities might be affected by the AIFMD is a question of great significance, one that is worth being answered to properly frame the broader debate regarding the PE phenomenon. In this context, the thesis provides early insight into the implications of the private equity-specific provisions and whether these are justified given the industry's critical role in the European economy. This contributes to the field and the existing (very limited) literature, adding an important piece to the jigsaw puzzle that enriches the overall picture of the industry and shows where it stands in its evolution.

There is a visible knowledge-based gap in literature regarding the AIFMD's impact on private equity specifically. This might be explained by the very nature of the Directive and its (relatively) recent implementation date, but also the fact that hedge funds have captured most of the attention. Earlier academic works tended to look at the AIFMD through a much broader lens, with most of the academic papers published before the implementation of the Directive in July 2013. Therefore, the wider implications on private equity have not been widely explored, making this thesis potentially a unique piece of research for anyone interested in the subject-matter.

The thesis is subject to a number of limitations and delimitations. In particular, the analysis concentrates on private equity alone and does not evaluate the Directive's impact on other types of alternative investment fund managers. The apposite information regarding private equity was extracted from an extensive range of materials, a task of unusual difficulty as hedge funds and private equity tend to be discussed together, often without a clear distinction between the two. Based on research, it was found that hedge funds have clearly dominated the majority of documents covering the implications of the AIFMD, often treating private equity as a mere afterthought. This observation is valuable in itself as it has almost universally been accepted that hedge funds, not private equity, had amplified the consequences of the crisis. Further, when analysing different variables of the private equity business, the focus was primarily on academic literature from a variety of areas (law, economics, finance, strategic management and entrepreneurship), with limited recourse (as far as possible) to studies commissioned by industry bodies and associations which could suffer from bias in their approach. This should enhance the objectivity of the current work. Moreover, the emphasis was placed on the legal (regulatory) dimension of private equity, with tax and other considerations intentionally omitted. Further, despite the AIFMD's operation for a number of years now, it is still too early

at this stage to assess its full impact with satisfying accuracy (the third country regime is still evolving, for example). Accordingly, the assessment is limited due to the availability of data. Last, but not least, the current work exhibits a strong inclination towards the UK, which is explained by the prominence of private equity activity in that country.

The reminder of this thesis is organised as follows: Chapter II places special attention on the objective description of the PE industry, which has recently faced sharp criticism from politicians, lawmakers, labour unions and the public. This should facilitate a more substantial and fact-based discussion about private equity and possible negative and positive consequences of buyouts in Europe by strictly providing data-driven insights into how the industry functions, how it performs and affects portfolio companies and their employees. One must bear in mind that data in the presented studies might be imperfect despite the gathering efforts of independent institutions and academic experts. This is a result of a variety of methodologies as well as the industry's common attachment to secrecy and the resulting reluctance to disclose information in respect of the characteristics and performance of their investments. Accordingly, some biases will invariably continue to influence the findings. Chapters III and IV briefly examine a sample of key measures at both EU level and national level (based on a UK example due to the prominence of private equity activity in that country), respectively, seeking to illustrate a regulatory universe of rules that applied directly or indirectly to the activities of private equity firms in the pre-AIFMD world. Chapter V depicts the route towards the AIFMD, presenting the pre- and post-crisis developments that had led to the creation of this unique piece of EU law. The chapter is valuable in its description of debates taking places in Europe and elsewhere as to the need to regulate private equity. Chapter VI is devoted to the detailed technical analysis of the AIFMD, focusing specifically on provisions relevant to private equity. The Directive represents the EU's first attempt to provide a bloc-wide regulatory framework governing alternative investment fund managers, and aims to mark the end to the fragmented national private placement regimes (where these existed) and introduce an integrative EU-wide approach, with robust standards and comprehensive regulatory oversight mechanisms. Chapter VII constitutes the heart of the current thesis. It goes to great lengths in discussing the most immediate, medium and long-term implications for private equity, recognising both threats and opportunities presented by the Directive. The analysis helps to assess whether the AIFMD is misguided, ominous, or maybe encouraging. The AIFMD establishes a particularly restrictive legal environment for private equity in Europe and was even criticised as being an 'odd,

political piece of law making.’²⁵ Thus, it is critical to analyse the Directive’s actual impact on the industry. Subsequently, Chapter VIII focuses on regulating in the crisis and, based on prominent recent examples from the US, provides hints as to the consequences of rushed regulatory response. This places the AIFMD, a crisis-era regulatory measure, in a specific context to allow further analysis as to whether it is an appropriate regulatory response. The thesis concludes in the following chapter with a summary of key findings and observations.

²⁵ Walter R. Henle & Allan Murray-Jones, *Alternative Investment Fund Managers Directive* (Skadden, Arps, Slate, Meagher & Flom LLP, Nov. 29, 2010), <https://www.skadden.com/insights/alternative-investment-fund-managers-directive>.

Chapter II

Private Equity: A Précis

1. Introduction

The rise of private equity represents another milestone in the growth of entrepreneurship that is advancing since the industrial revolution.²⁶ It can be traced back to the founding of Kohlberg, Kravis Roberts (KKR), a prominent US buyout firm, in the mid-1970s and the development of the leveraged buyout (LBO).²⁷ The profile of the private equity industry has recently increased dramatically owing to active investing in companies across a broad spectrum of sectors. This was not the case ten or 15 years ago when private equity very much operated at the fringes of corporate finance and corporate activity.²⁸ However, over the last two decades, the PE industry has grown to become a sizable asset class, representing a new stage in capitalism.²⁹ At its most ebullient peak of the last cycle in the 2000s, it was responsible for almost a quarter of global mergers and acquisitions (M&A) and as much as half of the leveraged loans in the capital markets, being able to acquire ever larger public companies and deliver extraordinary returns not only to its investors and fund managers,³⁰ but also portfolio firm managers, shareholders and providers of debt finance alike.

The US has traditionally been the main driving force of private equity growth, together with Canada, accounting for 60 per cent of all new private equity funds raised globally in 2005. Europe hosts a vast bulk of the world's remaining PE transactions, with the UK being the largest

²⁶ Justin Bickle, *The Place of Private Equity in Corporate Finance and M&A*, in PRIVATE EQUITY: A TRANSACTIONAL ANALYSIS 11, 11 (Chris Hale ed., Globe Law and Business 2007).

²⁷ GEORGE P. BAKER & GEORGE DAVID SMITH, THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE (2005) provides the definitive commentary.

²⁸ Chris Hale, *Introduction*, in PRIVATE EQUITY: A TRANSACTIONAL ANALYSIS 5, 5 (Chris Hale ed., Globe Law and Business 2007).

²⁹ Stephen F. Diamond, *Beyond Berle and Means Paradigm: Private Equity and the New Capitalist Order*, in THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR, AND FINANCE CAPITALISM 151-176 (Cynthia A. Williams & Peer Zumbansen eds., Cambridge University Press 2011).

³⁰ ELI TALMOR & FLORIN VASVARI, INTERNATIONAL PRIVATE EQUITY 3 (2011).

and most active European market.³¹ Strömberg (2007)³² estimated that by 2007 private equity firms globally had acquired almost 14,000 companies worth nearly \$3.6 trillion. Nevertheless, it is not only the sheer volume of transactions that has grown significantly over the years, especially in Europe from almost nothing in the 1980s to levels not very different from those in the US, but also the value of individual and aggregate transactions which have grown strikingly in recent years.³³ This demonstrates that buyout markets in the EU have developed substantially over the past two decades, with the combined value of all buyouts in Europe having risen more than fivefold during 1996-2005 and, following a sharp drop in activity during the financial crisis, bouncing back from 2013 onwards and reaching EUR 94 billion invested in European companies in 2019, the highest level ever recorded.³⁴ Private equity's significance and impressive buyout record demonstrate the PE industry has become a major player in the global market for corporate control and hence could prompt one to see confirmation in Michael Jensen's provocative 1989 prediction that the eclipse of the public corporation is near.³⁵ That said, despite substantial increases over recent years in the amount of equity invested by European funds, the PE industry still remains a relatively small component of the overall economy, representing less than 0.6 per cent of European GDP at its peak in 2006, 0.337 per cent in 2011 and 0.54 per cent in 2019.³⁶

The growth of the buyout industry has triggered anxiety in Europe and beyond. The industry's profile has risen tremendously and the sheer magnitude of recent activity and private equity's chequered reputation since the *Barbarians at the Gates* era of the 1980s³⁷ reasonably led to a

³¹ *Unlocking Global Value. Future Trends in Private Equity Investment Worldwide*, *supra* note 1, at 11. The latest statistical data confirm that within Europe the UK is the largest PE market, with average deal sizes far higher than in any other European country; *European Private Equity - Statistics & Facts* (Statista, Nov 17, 2020), <https://www.statista.com/topics/6318/private-equity-in-europe/#:~:text=2019%20has%20seen%20the%20highest,far%20the%20largest%20PE%20market>.

³² Per Strömberg, *The New Demography of Private Equity* 4 (Swedish Institute for Financial Research, Dec. 18, 2007), https://www.researchgate.net/publication/254345211_The_New_Demography_of_Private_Equity.

³³ Viral V. Acharya et al., *Private Equity: Boom and Bust?*, 19(4) J. APPL. CORP. FINANCE 44, 44-45 (2007).

³⁴ M. Wright et al., *Leveraged Buyouts in the U.K. and Continental Europe: Retrospect and Prospect*, 18 J. APPL. CORP. FINANCE. 38 (2006); *Investing in Europe: Private Equity Activity 2019 – Statistics on Fundraising, Investments and Divestments* 7 (Invest Europe, May 20, 2020), <https://www.investeurope.eu/research/activity-data/#login-modal>.

³⁵ Michael C. Jensen, *Eclipse of the Public Corporation* (HARV. BUS. REV., Sept.-Oct. 1989), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=146149.

³⁶ *Yearbook 2012: Activity Data on Fundraising, Investments and Divestments by Private Equity and Venture Capital Firms in Europe* 28-29 (EVCA, May 9, 2012), https://webcache.googleusercontent.com/search?q=cache:Fg_7cnlzILYJ:https://www.investeurope.eu/news-opinion/newsroom/evca-yearbook-2012-pan-european-private-equity-and-venture-capital-activity/+&cd=1&hl=en&ct=clnk&gl=uk; *Investing in Europe: Private Equity Activity 2019 – Statistics on Fundraising, Investments and Divestments*, *supra* note 34, at 49.

³⁷ This refers to the private equity boom in the 1980s which culminated in a hostile takeover of the US listed foods and tobacco giant RJR Nabisco by Kohlberg, Kravis, Roberts (KKR), recounted and chronicled by Bryan Burrough

greater focus placed on the industry's business. With the advent of the financial crisis, the industry had to weather through difficult times, resulting in a dramatic fall in a number of new investments and subdued and challenging deal activity.³⁸ The confluence of global geopolitical and economic instability in tandem with patchy recovery created an uncertain business environment with a significant reduction in the amount of leverage available. The global nature of the crisis and associated recession eventuated in much slower fundraising as investor confidence deteriorated sharply amid fears of the uncertain macroeconomic outlook, increasing taxes and regulatory concerns, amongst other issues.³⁹

It may be posited that the industry has become a victim of its own success since the exceptional performance in past decades certainly attracted more capital into the industry. By pushing into the ever larger deal territory and acquiring more high-profile companies, private equity has been brought into the public domain, spurring discussion in national political debates and ultimately resulting in calls to re-evaluate and regulate the industry. Initiatives such as the AIFMD may prove to be the beginning of an increasingly onerous regulatory process.

This chapter is organised as follows: first it starts with an overview of the private equity ecosystem, buyout types and a brief description of PE boom and bust cycles. This is followed by some major lines of criticism levelled against the industry and its subsequent defence. The next section constitutes the heart of this chapter and surveys the empirical literature in economics and finance on real effects of private equity investments, stretching back to the 1980s. The focus on the real effects of buyouts is especially important in view of their potential of affecting static efficiency (for example, productivity), dynamic efficiency (for example, innovation) and imposing positive or negative externalities on various stakeholders in the acquired companies (for example, the employees). The presented academic studies provide hints on the likely social welfare implications of an active private equity market. The chapter ends with a summary of key findings.

and John Helyar in the book *BARBARIANS AT THE GATES: THE FALL OF RJR NABISCO* (1990). The deal defined the zeitgeist of an age and represented the high watermark for PE investing. It continues to be the single transaction most associated with the industry as an asset class in the educated consciousness of the public. As a 'mother of all corporate takeover battles,' the deal remained the largest PE buyout ever consummated until recently and led to the pejorative linguistic practice of calling PE firms 'barbarians;' see *Barbarians at the Gate 2.0* (ECONOMIST, Oct. 28, 2008), <http://www.economist.com/node/12499201>.

³⁸ See, e.g., *Yearbook 2012: Activity Data on Fundraising, Investments and Divestments by Private Equity and Venture Capital Firms in Europe*, supra note 36 (presenting recent data on fundraising and investments by private equity firms in Europe).

³⁹ Lina Saigol & Miles Johnson, *M&A Hit by Fall in Confidence* (FIN. TIMES, Oct. 17, 2010), <http://www.ft.com/cms/s/0/f7d407a6-da10-11df-bdd7-00144feabdc0.html#axzz2gP79MTz4>.

2. Private Equity Explained

The PE industry has grown symbiotically with the public markets and is now organised as an ecosystem which is able to finance companies at every stage of their development,⁴⁰ including growth, rescue/turnaround, replacement capital, and buyout situations. One might be surprised to learn that Christopher Columbus was structuring a venture capital operation when trying to convince the Spanish Kings to sponsor his trip towards the West, given that this project involved finance from an external investor, high risk and a high return potential.⁴¹ This example illustrates that private equity existed throughout history in one form or another.

The PE industry can be subdivided into buyouts and venture capital. The distinction between the two implicates a range of interrelated features, such as public perception, leverage and fund operations, fund and investment size, and attitudes towards regulation,⁴² although the former is conspicuously more leverage friendly and regulation insensitive. Buyouts normally focus on established and mature companies and use both debt and equity financing, whilst venture capitalists invest – typically without obtaining majority control – in start-ups, providing expansion capital for these immature, early stage companies.⁴³

Within the financial world, private equity represents a subset of alternative assets, typically including private equity funds, real estate funds and hedge funds. More specifically, private equity refers to the part of the asset management industry which invests into securities that are typically not quoted in the public markets (unquoted companies with growth potential at different stages of life), or take target companies private by acquiring their publicly traded

⁴⁰ CYRIL DEMARIA, INTRODUCTION TO PRIVATE EQUITY 137 (2010).

⁴¹ CYRIL DEMARIA, INTRODUCTION TO PRIVATE EQUITY: VENTURE, GROWTH, LBO AND TURN-AROUND CAPITAL 11 (2d ed. 2013).

⁴² David Mangum, *Private Equity and Venture Capital: What's the Difference?* 9 (July 1, 2012), <http://ssrn.com/abstract=2286148>. The reason for this is that, compared to private equity, venture capital has a better public image. For instance, Davidoff wrote, 'No one talks of taxing venture capital billionaires the way they do about equity barons. Venture capital is viewed as a creative industry, while the world considers private equity as finance, money men who do not create;' Steven M. Davidoff, *In Silicon Valley, a Culture Clash Sullies a Romance* (DEALBOOK, July 5, 2011), http://dealbook.nytimes.com/2011/07/05/in-silicon-valley-a-culture-clash-sullies-a-romance/?_php=true&_type=blogs&_r=0. Further, the trope of 'venture capital is good, private equity is bad' exists and when people think 'venture capital' they think Google or Apple, when they think 'private equity' they think Steve Schwarzmenn's \$3bn birthday party; see Martin T. Sosnoff, *The \$3 Billion Birthday Party* (FORBES, June 21, 2007), http://www.forbes.com/2007/06/21/sosnoff-blackstone-ipo-oped-cx_mts_0621sosnoff.html.

⁴³ Private equity is construed differently in Europe and the Anglo-American world. For the purposes of this thesis, private equity shall be synonymous with different categories of buyouts.

shares.⁴⁴ Accordingly, the target starts a new life away from public scrutiny, typically disappearing from the public forum.⁴⁵

PE firms take several organisational forms and funds themselves differ depending on their investment specialisation or source of capital.⁴⁶ Independent limited partnerships are established and managed by professional PE firms or buyout associations; captive funds obtain their funding from a parent financial institution, typically banks, insurance companies, pension funds and investment trusts; semi-captives receive their finance from their parent and partly by raising closed-ended funds (that is funds with a fixed number of shares); and, finally, public sector funds. Private equity houses can be further broken down into two main categories, that is, generalist firms, which invest in a wide range of industries, and specialist firms, which invest only in certain sector areas⁴⁷ or particular geographical locations.⁴⁸

Private equity firms are evolving and have grown significantly over time. Jensen (1989)⁴⁹ implied that buyout firms were positioned to generate superior performance partly due to the reason that they were lean and focused organisations. However, the industry has concentrated today⁵⁰ and private equity firms employ hundreds of professionals of varied backgrounds conducting a wide range of deals around the world. For instance, Blackstone, a premier global investment and advisory firm, describes itself as a firm of nearly 2,000 employees in 24 offices worldwide, with portfolio companies employing nearly 700,000 people across the globe, making them a major factor in economies around the world.⁵¹ Therefore, one could wonder whether some private equity firms are today's conglomerates. Some firms hold a portfolio of companies in different industries resembling conglomerates that dominated takeover activity in the 1960s and 1970s by diversifying across several unrelated businesses. These conglomerates

⁴⁴ Isaac Fox & Alfred Marcus, *The Causes and Consequences of Leveraged Management Buyouts*, 17 ACAD. MANAGE. REV. 62, 63 (1992).

⁴⁵ Luc Renneboog, *Leveraged Buyouts and Public-to-Private Transactions*, in THE OXFORD HANDBOOK OF PRIVATE EQUITY 89, 110 (Douglas Cumming ed., Oxford University Press 2012).

⁴⁶ ELI TALMOR & FLORIN VASVARI, *supra* note 30, at 22-23.

⁴⁷ James Dow, *The Role of Private Equity*, in PRIVATE EQUITY: LAW AND PRACTICE 1, 2 (Darryl J. Cooke ed., 4th ed. 2011).

⁴⁸ JAMIE MORGAN, PRIVATE EQUITY FINANCE: RISE AND REPERCUSSIONS 5 (2009).

⁴⁹ Michael C. Jensen, *supra* note 35. The scholar explained that private equity firms are more decentralised allowing direct monitoring by headquarters. For instance, KKR had only 16 professionals and 44 additional employees in 1986, whereas the headquarters of RJR Nabisco employed 470 people when it was taken private by KKR in the same year. The author argued that this lean organisational structure allows fund managers to become intimately involved in daily decisions of their portfolio companies and maximise firm value without bureaucratic oversight.

⁵⁰ Peter Cornelius et al., *Big is Better: Growth and Market Structure in Global Buyouts*, 19 J. APPL. CORP. FINANCE 109 (2007).

⁵¹ Blackstone, *The Firm Overview* (Nov. 2013), <http://www.blackstone.com/the-firm/overview>.

are mostly gone,⁵² giving credence to the notion that private equity is a superior financial technology for doing tasks that conglomerates tended to do.⁵³ However, it must be stressed that private equity firms do not function as conglomerates. Buyouts are archetypes of unrelated acquisitions,⁵⁴ and investments are kept separate by PE firms, operating as stand-alone entities without cross-subsidising each other (as commonly prescribed by the statutes of the partnership).⁵⁵

At its simplest, the industry is driven by a strong desire to increase the value of the target company over its original purchase price. There are a couple of typical characteristics of the private equity industry,⁵⁶ and the investments are usually made through special purpose fund structures which are of finite life, established to follow a particular investment strategy to deploy more effectively firm assets to their most productive and profitable uses. There are many reasons why the private equity industry exists and the circumstances that give rise to buyouts, for example, the retirement or death of a company's owners in which case a buyout may be the most attractive avenue of continuing operations; divestments of business or subsidiaries by a parent company; privatisation of a nationalised industry; or restructuring of an insolvent company through scaling-down or spin-offs of viable subsidiaries. Moreover, some private and public companies turn to private equity firms following a takeover threat⁵⁷ as a way to ensure managerial jobs,⁵⁸ or in times of recession in order to be rescued.⁵⁹ Newly floated companies

⁵² Most of these conglomerates were broken up in the 1980s and 1990s due to the explosion of hostile takeovers and leveraged buyouts.

⁵³ RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 916 (McGraw-Hill, 9th ed. 2007).

⁵⁴ Oliver Gottschalg, *Private Equity and Leveraged Buy-outs* 3 (Study IP/A/ECON/IC/2007-25 for the European Parliament, 2007), [http://www.europarl.europa.eu/RegData/etudes/etudes/join/2007/393515/IPOL-ECON_ET\(2007\)393515_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/etudes/join/2007/393515/IPOL-ECON_ET(2007)393515_EN.pdf).

⁵⁵ JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 47-48 (2006).

⁵⁶ Investments by dedicated professional teams in cash-rich, low-growth companies; active ownership driving value creation; capital drawn from a defined pool; a contractual relationship with professional investors; profit-sharing schemes; strong self-regulation; stand-alone management of portfolio companies; medium to long-term strategies and holding periods; and a focus on financial gain through a variety of exit options; *Report of the Alternative Investment Expert Group: Developing European Private Equity* 10-12 (EU Commission Internal Market and Services DG, July 1, 2006), http://www.cmvm.pt/pt/Legislacao/ConsultasPublicas/ComissaoEuropeia/Documents/03547fc9bb194fb782b1f06c46365f85equity_en.pdf.

⁵⁷ K. Lehn & A. Poulsen, *Free Cash Flow and Stockholder Gains in Going Private Transactions*, 44 J. FINANCE 771 (1989); P.H. Eddey et al., *What Motivates Going Private?: An Analysis of Australian Firms*, 36 ACCT. & FINANC. 31 (1996).

⁵⁸ Jana P. Fidrmuc, Alessandro Palandri, Peter Roosenboom & Dick van Dijk, *When Do Managers Seek Private Equity Backing in Public-to-Private Transactions?*, 17(3) REV. FINANC. 1099-1139 (2013).

⁵⁹ Louise Scholes & Mike Wright, *Leveraged Buy-outs and Recession* (QFinance, 2009), <https://www.yumpu.com/en/document/read/25610118/leveraged-buyouts-and-recession-qfinance>.

may equally decide to go private if they struggle to attract investor interest and bear the high cost of stock exchange listing without benefiting enough from public ownership.⁶⁰

2.1 Taxonomy of Buyouts and Investment Phases

Private equity represents a broad category comprising many investment types, generally referring to bigger funds that do later-stage deals,⁶¹ committing capital to help unquoted companies grow and succeed⁶² through reorganisation and streamlining. Buyouts can take a number of forms to purchase a controlling stake in a target company, or a division thereof, for a limited time by means of a combination of debt and equity financing and the involvement of specialised financial investment companies.⁶³

The term ‘going private’ refers to revising a public company’s capital structure so that its stock is acquired by a small number of investors and is no longer traded – in other words, a reverse process of going public.⁶⁴ In many public-to-private transactions, the incumbent management group obtains equity ownership of the surviving private company and, in some cases, subsequently shares this equity ownership with outside private investors (fund managers) who help finance the acquisition or reorganisation. Sometimes this type of transaction is labelled ‘minority freezout’ as minority shareholders are cashed out of their investment in the company.⁶⁵ Going private can be effected through a variety of legal vehicles, frequently including leveraged buyouts (LBOs) that have become a quantitatively significant component of the overall M&A activity in the 1980s.

Due to the use of financial, legal and tax levers to acquire a company, LBOs are deemed to be the result of financial innovation.⁶⁶ They incorporate a particularly high, sometimes

⁶⁰ In this regard, it was found that young IPO firms are more likely to revert to their original private status after failing to sustain sufficient investor recognition and financial visibility as proxied by the growth in analyst coverage; Hamid Mehran & Stavros Peristiani, *Financial Visibility and the Decision to Go Private*, 23(2) REV. FINANC. STUD. 519 (2010).

⁶¹ ANDREW METRICK & AYAKO YASUDA, VENTURE CAPITAL AND THE FINANCE OF INNOVATION 6-9 (2d ed. 2007).

⁶² Bastian Bergmann et al., *Listed Private Equity* 3 (Jan. 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362390.

⁶³ Lisa Meulbroek & Joanne Chng, *Note on European Buyouts* 4 (Harvard Business School Industry and Background Note No. 296051, Jan. 16, 1996), <https://www.thecasesolutions.com/note-on-european-buyouts-16923>; BRIAN COYLE, VENTURE CAPITAL AND BUYOUTS 34 (2000).

⁶⁴ JOAO AMARO DE MATOS, THEORETICAL FOUNDATIONS OF CORPORATE FINANCE 177 (2001); Isaac Fox & Alfred Marcus, *supra* note 44, at 62, 63.

⁶⁵ Harry DeAngelo et al., *Going Private: Minority Freezeouts and Stockholder Wealth*, 27(2) J. LAW ECON. 367 (1984).

⁶⁶ CYRIL DEMARIA, *supra* note 40, at 87.

disproportionate,⁶⁷ level of debt (anywhere between 60 and 90 per cent⁶⁸) secured against the assets of the acquired company. They typically apply to undervalued public companies whose value can be increased significantly, but also those firms in mature industries with strong and predictable cash flows which will help service the high debt payments. LBOs are almost by definition diet deals,⁶⁹ making companies leaner and meaner. High leverage can be justified in several ways – it disciplines managers so that they maximise cash flows on projects and firm value, and helps magnify fund returns, amongst other things. In theory, every public company in the world is a potential target,⁷⁰ and even the largest and most famous companies have become ‘playthings of the capital markets.’⁷¹ With the ever increasing transaction values, clubs or syndicates of private equity firms are formed to bid for companies as the escalating size of acquisition targets requires commitments on a scale beyond the resources of individual firms.⁷² On its own, a single PE firm would be unable to fund a large, headline grabbing deal involving a FTSE 100 company.⁷³ The main financial characteristics of LBOs include high debt which is designed to be paid down by: shedding unneeded assets, curbing wasteful investments, selling divisions (possibly in the form of management buyouts) and forcing improvements in operating efficiency; incentives that give managers a greater stake in the business through direct ownership of shares and stock options; and private ownership.⁷⁴ Fund managers intervene actively in key strategic decisions, operating at arm’s length *vis-à-vis* everyday operating choices.⁷⁵

Management buyouts (MBOs) are typically employed on divestitures of divisions or subsidiaries, or acquisitions of family-owned companies by a new company in which the existing management takes a substantial proportion of equity. The management of the company

⁶⁷ In the 1980s, the leverage level could often be as high as 90 or 95 per cent of the capital structure. These extreme levels of debt have not been repeated during later buyout booms as some learning has taken place from one boom to another, without history automatically repeating itself.

⁶⁸ Steven N. Kaplan & Per Strömberg, *supra* note 10, at 124. Further, Talmor and Vasvari reported that the amount of debt is usually around 65 to 70 per cent of the target company’s purchase price – this falls within the brackets provided by Kaplan and Strömberg; ELI TALMOR & FLORIN VASVARI, *supra* note 30, at 255.

⁶⁹ RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *supra* note 53, at 919.

⁷⁰ Stephen F. Diamond, *supra* note 29, at 161.

⁷¹ Robin Blackburn, *Finance and the Fourth Dimension*, 39 N.L.R. 42 (2006). Even Microsoft was named as a possible target; see *Private Equity Folk Could Do Wonders with Microsoft* (FIN. TIMES, Aug. 18, 2006), <https://www.ft.com/content/bde5bae8-2e17-11db-93ad-0000779e2340>.

⁷² The rise of the mega funds of \$10 billion-plus is one trend which has increasingly become marked recently. One feature is the propensity of the larger PE funds to form consortia in order to buy ever-larger public and private entities.

⁷³ FTSE 100 represents a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalisation.

⁷⁴ RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *supra* note 53, at 921.

⁷⁵ Jensen found an average staff of 13 professionals and 19 non-professionals in an LBO partnership. At the time of his study, the world’s largest LBO partnership, KKR, had 16 professionals and 44 additional employees.

remains the same following the buyout but the manner in which financing, investment and dividend decisions are made may change. This is due to the fact that managers become company's owners and that being so they are much more concerned with maximising company value.⁷⁶

Management buyins (MBIs) are MBOs in which the main members of the management team are outsiders. MBIs seem to be more proactive and aim to create successful businesses, achieve growth and be innovative.⁷⁷ Thus, they often focus on firms which require turnaround and restructuring and which have significant potential unrealised by incumbent management. These tend to be riskier as the incoming management has no inside knowledge of the business. This problem is sometimes alleviated by putting together hybrid buy-in management buyouts (BIMBOs) which provide the benefit of the entrepreneurial expertise of outside managers and the specific inside knowledge of the existing management.

Investor-led buyouts (IBOs) involve company or division acquisitions led by a private equity firm. IBOs are similar to LBOs, but tend to have lower leverage. Management-employee buyouts (MEBOs) occur where it is necessary to tie in a specific human capital of the employees as the company is widely spread geographically, making direct management complicated. The alternative use of a MEBO is on privatisations to encourage trade unions to support the transfer of ownership.⁷⁸

Buyouts typically go through four stages: (i) a fundraising phase during which investors pledge capital to the fund; (ii) an investment phase during which GPs source, identify, evaluate and execute investment opportunities; (iii) a holding period during which GPs implement reorganising and consolidating strategies and processes to increase the acquired company's profits and cash flows; and, finally, (iv) a harvesting/divestment phase during which GPs exit investments. Only a few investments are made each year as due diligence and general assessment of a possible target is time-consuming. Since PE funds have a limited contractual lifetime, fund managers operate under significant pressure to create enough value to achieve the desired target returns. This motivates them to work hard to improve the acquired business before a timely exit typically within three to seven years, depending on the industry. This shows

⁷⁶ ASWATH DAMODARAN, *CORPORATE FINANCE: THEORY AND PRACTICE* 868 (2d ed. 2001).

⁷⁷ K. Robbie et al., *Management Buy-Ins in the UK*, 20(4) OMEGA 445 (1992).

⁷⁸ Mike Wright & Hans Bruining, *Private Equity and Management Buyouts: International Trends, Evidence and Policy Implications*, in *PRIVATE EQUITY AND MANAGEMENT BUYOUTS* 3, 5 (Mike Wright & Hans Bruining eds., Edward Elgar 2008).

that PE firms invest from medium to long term. The three core exit options for the buyout company are returning it to the public market through an IPO, carrying out a secondary (tertiary or even quaternary) buyout by selling it to another PE firm,⁷⁹ or selling it in a trade sale to a corporate buyer without recourse to a public offering.⁸⁰ There exists also a fourth exit option which has become more prevalent post-2008, namely, exit by means of liquidation.⁸¹ Each exit route has different ramifications for fund managers and investors as well as the management of the acquired company.⁸² For instance, an IPO is often the preferred exit option as it offers results in the highest valuation of a company and gives the company continued access to capital, whereas a private sale has very different consequences – it provides payment in cash or marketable securities for the PE fund’s managers and investors, but may be unwelcome for the company’s management as their company cannot remain independent. At the end of the investment cycle when the investments are liquidated, proceeds are distributed to fund investors in the form of cash or in kind (that is, shares), and when all investments are divested, the limited partnership can be terminated or wound up.

2.2 Cyclicalities: Between Bubbles and Crashes

A few words are apposite on the significance of cyclicalities. Private equity follows recurring boom and bust cycles⁸³ – economic, financial and industry-specific – which are a defining element that has been part of the buyout landscape since their earliest days and shows little sign of abating. Each boom has witnessed a dramatic boost in the amount of funds raised and a flurry of financing activity, then being followed by a painful correction eventuating in a sharp decline in the level of financing, failed investments and predictions that the days of private equity are numbered. We can distinguish three major cycles – in the late 1980s and 1990s (which both saw a significant increase in deal activity and size in the US and Europe, especially the UK)

⁷⁹ See *Buy-In Barons* (ECONOMIST, Jan. 18, 2014), <http://www.economist.com/news/finance-and-economics/21594331-buy-out-firms-selling-each-other-much-their-investors-annoyance-buy> (discussing so-called second-hand deals and reasons for their rise).

⁸⁰ Jelic and Wright found that the most popular exit routes for buyouts in the UK are: IPOs on the LSE (25 per cent), trade sales (19 per cent), secondary buyouts (18 per cent) and flotation on the AIM (17 per cent); Ranko Jelic & Mike Wright, *Exits, Performance, and Late Stage Private Equity: The Case of UK Management Buy-Outs*, 17(3) EUR. FIN. MANAGE. 560 (2011). The reported popularity of IPO exits in the UK is due to the fact that the UK has the most liquid private equity and stock markets in Europe and is one of the most successful second tier markets in the world; Ranko Jelic, *Staying Power of UK Buy-Outs*, 38 J. BUS. FINANC. ACCOUNT. 945, 983 (2011).

⁸¹ *Buyout Report 2010, An EVCA Research Paper* 45-46 (EVCA, Oct. 2010), <https://qx.manuh.site/download.php?file=evca+reporting+guidelines+2010+pdf>.

⁸² George Fenn, Nellie Liang & Stephen Prowse, *The Private Equity Market: An Overview*, 6 F.M.I.I. 1, 56 (1997).

⁸³ Han Smit & Ward A. van den Berg, *Private Equity Waves* (Tinbergen Institute Discussion Paper No. 06-053/2, Aug. 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=909169.

and the mid-2000s (which were characterised by a worldwide explosion in the private equity activity).⁸⁴

The scale and frequency of deals was exceptional between 2006 and 2007, but the second half of 2007 saw the end of the private equity wave. Naturally, this does not mean private equity has gone or died, it has just retreated and been in hiding. This sudden change and the resulting hiatus in the PE activity can be well illustrated by the following juxtaposition: in mid-2007 KKR's Henry Kravis and others celebrated the "golden age" of private equity and six months later the Carlyle Group's David Rubenstein remarked at the World Economic Forum that the golden age was over and the industry had entered a "purgatory age" in which it would have to atone for its sins.⁸⁵ Only a few years later, in 2013, signs started to surface on the horizon that the industry was emerging from its crisis hangover and was posed for a positive investing window, given that the global economies began to recover, subsequently pushing up valuations that enabled successful exits and return of profits to investors.⁸⁶

These ebbs and flows in the global economy seem to be a crucial driver in the buyout case. Cycles affect the amount of funds raised, volume of investments made and their performance. An up cycle includes acceleration in the investment pace, higher valuations and a breakdown of investment discipline as oftentimes there are lowered standards for investing combined with a greater ease of fund raising.⁸⁷ Stock prices are soaring and there are more IPOs, a felicitous environment that boosts PE investments. Consequently, limited partners increase their investment rate, investors pursue the same 'hot' sector that has done best in the past and PE firms try to raise new funds following successful exits. During periods when the stock prices and valuations are falling, a reverse dynamics come into play. The burst of the credit bubble in 2008 significantly affected completed private equity deals and had an impact on the deal volume, size and the type concluded ever since.⁸⁸

⁸⁴ This internationalisation of PE activities can be illustrated by the fact that during the first peak in the 1980s, ninety-three per cent of all buyouts occurred in the US and the UK. This percentage has been reduced to fifty-three per cent at the peak of the most recent boom; Joacim Tåg, *The Real Effects of Private Equity Buyouts*, in THE OXFORD HANDBOOK OF PRIVATE EQUITY 271, 271 (Douglas Cumming ed., 2012).

⁸⁵ K.H. Wruck, *Private Equity, Corporate Governance, and the Reinvention of the Market for Corporate Control*, 20 J. APPL. CORP. FINANCE 8, 8 (2008).

⁸⁶ *Private Equity and the New Era: Co-Investments, Club Deals, and Direct Investments* 12 (PRIVATE EQUITY.COM, Nov. 2013), <http://privateequity.com/New-Private-Equity-Era.pdf>.

⁸⁷ JOSH LERNER, ANN LEAMON & FELDA HARDYMON, *supra* note 14, at 374.

⁸⁸ The global crisis manifested itself in a number of ways: (i) debt became scarce and expensive, dampening the buyout activity to its lowest level since 2001; (ii) the size of buyouts decreased, marking an end to the blockbuster transactions that grabbed headlines prior to mid-2007; (iii) private equity firms readjusted their focus on carve-outs and divestitures of non-core assets by cash-strapped parent companies and started to increase their presence

Investment cycles are unavoidable and have implications for policymakers. Public intervention has a tendency to try to fix the industry's shortcomings through regulation, sometimes problematic, during the time when an economic downturn leads to poor or dismal returns and a greater number of bankruptcies. In the aftermath of the recent financial crisis, lightly scrutinised private equity industry had fallen under the gaze of regulators. The questions arose as to whether the industry could increase volatility; pose a risk to investors, the financial market and the broader economy; and the nature of impact on investee companies. These issues are assessed further down in this chapter.

3. Private Equity: Common Critique and Industry Defence

The heterogeneity of private equity transactions raises questions regarding the industry *per se* and its approaches to creating value in portfolio firms. Nowadays, the PE activity is found nearly everywhere and the industry seems to have prospered whilst almost every other approach to business has faltered.⁸⁹ The significant growth and geographical spread of private equity phenomenon has not escaped criticism⁹⁰ and the industry has long been charged with all sorts of iniquity and been plagued by negative perceptions.⁹¹ Is this matched by reality? Private equity industry trade associations have responded to these contentions and provided industry-sponsored evidence indicating that PE funds outperform public equity indices and have positive effect, for example, on employment.⁹² Academic findings are mixed in relation to a variety of private equity-related variables, but for the most part the relevant literature concludes that private equity's overall effect appears to be on net a positive phenomenon. This illustrates that

in emerging markets; (iv) fundraising decreased significantly and new funds took longer to close; and, finally, (v) private equity firms commenced to use less debt, with deals using far bigger infusions of equity; ELI TALMOR & FLORIN VASVARI, *supra* note 30, at 7-8.

⁸⁹ *Private Equity: The Barbarian Establishment* (ECONOMIST, Oct. 22, 2016), <http://www.economist.com/news/briefing/21709007-private-equity-has-prospered-while-almost-every-other-approach-business-has-stumbled>.

⁹⁰ See, e.g., David Teather & Jill Treanor, *Corporate Buccaneers Caught in a Political Storm* (GUARDIAN, Feb. 24, 2007), <http://www.theguardian.com/business/2007/feb/24/4>; or *The Trouble with Private Equity* (ECONOMIST, July 5, 2007), <http://www.economist.com/node/9441256>. Also, for a scathing view of private equity, see Poul Rasmussen, *Taming the Private Equity "Locusts"* (Apr. 4, 2009), <http://www.project-syndicate.org/commentary/taming-the-private-equity--locusts>.

⁹¹ For instance, PE firms were described as 'job-destroying vultures, who scavenge the meat from...companies and leave their carcasses by the side of the road,' James Surowiecki, *Private Inequity* (NEW YORKER, Jan. 30, 2012), http://www.newyorker.com/talk/financial/2012/01/30/120130ta_talk_surowiecki.

⁹² *Employment Contribution of Private Equity and Venture Capital in Europe* (EVCA, Nov. 2005), http://www.evca.eu/UploadedFiles/c2_evca_exec_employment_contribution_pe_2005_english.pdf; *The Economic Impact of Private Equity in the UK* (BVCA, Feb. 2008), http://www.bvca.co.uk/Portals/0/library/Files/News/2007/2007_0009_economic_impact_of_pe_uk.pdf; A.T. Kearney, *Creating New Jobs and Value with Private Equity* (2007), <http://www.atkearney.com/documents/10192/3a76c86f-6ed3-474c-97b6-3fa65aa0759c>; Robert J. Shapiro & Nam D. Pham, *American Jobs and the Impact of Private Equity Transactions* (SONECON, Jan. 2008), http://www.sonecon.com/docs/studies/0108_JobsPrivateEquityTransactions.pdf.

the two sides of the argument are diametrically opposed and arbitrating between them is far from simple.

Negative public sentiment towards the industry is derived from the sense that its success comes exclusively at the expense of others. On this view, private equity is an ingenious kind of wealth transfer from less sophisticated parties (such as workers) to the pockets of PE professionals, thus allowing buyout firms to privatise the profits and socialise the losses.⁹³ Private equity's loudest critics – labour unions, worker representatives and socialist political parties, have a strong attitude towards the rise of the industry, which they view as the dark side of capitalism that employs financial gimmickry undermining job security and union power.⁹⁴ Not surprisingly, they notoriously accuse buyouts of cutting salaries and jobs *en masse* in order to generate greater returns to investors, and the media appear to gleefully participate in the allegations regarding labour shedding. Industry critics are also concerned about the lack of transparency and secrecy relating to information on the funds and their investors, damaging effects of special dividends and 'quick flips' (investments lasting less than two years).⁹⁵ Other major arguments against private equity boil down to claims that the industry benefits the wealthy; that target companies are weakened by stripping them of assets and saddling them with mountains of debt; that targets are done more harm than good in the process of reaping short-term profits at the expense of long-term performance; that private equity's sheer size gives a bubblish feel that creates both big risks for the financial system and systemic risk for the economy; and that PE firms use complex structures to reduce or eliminate tax and take advantage of unfair tax loopholes in the form of carried interest. The scepticism regarding bankruptcies, the harming of workers and pocketing unjustified tax subsidies is deemed to reduce social welfare.

Furthermore, there is an argument regarding firm size. Kaplan and Lerner (2010) observed that 'fund size is the enemy of persistence,'⁹⁶ meaning that top performance may be hard to repeat.

⁹³ Anthony Luzzatto Gardner, *Romney's Bain Yielded Private Gains, Socialized Losses* (July 16, 2012), <http://www.bloomberg.com/news/2012-07-15/romney-s-bain-yielded-private-gains-socialized-losses.html>.

⁹⁴ Stephen F. Diamond, *supra* note 29, at 157.

⁹⁵ 'It's debatable how many things within a corporation can get turned around in less than a year, but one thing is certain among the recent spate of quick flips: Bottom-line financial performance hasn't improved, because the companies are returning to market loaded with debt from their short-lived private buyouts. The IPO proceeds are often being used to pay down the debt incurred from going private...to pay millions of dollars in special dividends to the private-equity firms;' *Private-equity Turnarounds are Flipping Fast* (CEDAR VALLEY BUSINESS MONTHLY ONLINE, Feb. 1, 2005), http://wcfcourier.com/business/local/private-equity-turnarounds-are-flipping-fast/article_bef358cc-8f71-5b9d-9bd5-87680eb02854.html.

⁹⁶ S.N. Kaplan & J. Lerner, *It Ain't Broke: The Past, Present, and Future of Venture Capital*, 22 J. APPL. CORP. FINANCE 36, 44 (2010).

This is supported by economic literature. For instance, Williamson (1975)⁹⁷ identified organisational diseconomies as a potential mechanism of diseconomies of scale; Holmström and Roberts (1998)⁹⁸ highlighted that problems associated with knowledge transfer may influence scale diseconomies; and Garicano (2000)⁹⁹ argued that as a firm scales up it is penalised by greater communication needs. In general, running a private equity firm is not risk free and growth itself can be characterised as a challenge rather than a source for celebration.¹⁰⁰ For instance, growth might necessitate moving into unknown arenas and making investments in unfamiliar industries which in turn could affect performance. In this context, getting big can be associated with disappointment as raising larger, multiple, successive funds may lead to lower returns, whereas performance may deteriorate when the scope of investments broadens.

In addition, the flight of public companies into the arms of private equity can be seen as a dangerous trend,¹⁰¹ generating concerns regarding financial markets, investors and the ethical operation of business. A significant privatisation of US and EU economies can fuel speculation about private equity displacing the public company and so reducing management's accountability to the public at large and denying smaller investors the opportunity to acquire shares in these companies¹⁰² as investment capital is sought only from investors with substantial financial wherewithal. Moreover, rumours of buyouts – often negotiated behind closed doors – push up the share price of potential targets and the sole process of drawing the best blood out of the stock exchanges could lead within 10 years to a 'world where no company making real things or marketing real services is listed.'¹⁰³ Although this is a hugely unlikely prediction, the marginalisation of the public company sparks views about compromised business ethics. Public companies vanish after the buyout. Then they operate outside the public gaze and do not have to comply with stringent regulation and disclosure requirements associated with being a public company, hence leading to an information blackout.¹⁰⁴ Therefore, privacy that has been the

⁹⁷ OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES, ANALYSIS AND ANTITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION* (1975).

⁹⁸ B. Holmström & J. Roberts, *The Boundaries of the Firm Revisited*, 12 J. ECON. PERSPECT. 73 (1998).

⁹⁹ L. Garicano, *Hierarchies and the Organization of Knowledge in Production*, 108 J. POLIT. ECON. 874 (2000).

¹⁰⁰ JOSH LERNER, ANN LEAMON & FELDA HARDYMON, *supra* note 14, at 349.

¹⁰¹ Lynn Stout, *Democracy by Proxy* (WALL ST. J., Mar. 2008, 2007), <http://online.WALL ST. J..com/news/articles/SB117332105336230436>.

¹⁰² Francesco Guerrera, *Hidden Value: How Unlisted Companies are Eclipsing the Public Market* (FIN. TIMES, Dec. 15, 2006), <https://www.ft.com/content/1170cff2-8ba3-11db-a61f-0000779e2340>.

¹⁰³ Graham Searjeant, *Private Equity Takes Over the World* (TIMES, Jan. 27, 2006), at 59. For the potential economic consequences of a shrinking stock market, see Alexander Ljungqvist, Lars Persson & Joacim Tåg, *Private Equity's Unintended Dark Side: On the Economic Consequences of Excessive Delistings* (Nov. 23, 2016), <https://ssrn.com/abstract=2714916>.

¹⁰⁴ *Invading the Privacy of Private Equity* (FIN. TIMES, Feb. 24, 2007).

hallmark of private equity becomes a source of its major critique since buyout firms are less open to scrutiny by investment analysts, the press and the public.¹⁰⁵ Consequently, the rise of public-to-private transactions has been argued to be reducing the population of public companies which are transparent and ethical corporate citizens, conducting their business in a socially responsible manner.¹⁰⁶

The industry, to varying degrees depending on the region, has tried to respond to the assaults, claiming private equity investments create better, healthier companies, more employment and long-term productivity.¹⁰⁷ Buyout firms adopt a more growth-oriented strategy as the new management pursues strategic innovation, responds to perceived opportunities and threats, stimulates research and learning and allows new strategies to emerge. Such firms achieve financial targets by eliminating unprofitable operations and foregoing wasteful expenditures.¹⁰⁸ Given the escalating bouts of criticism, the private equity industry has recently increased its efforts to articulate the benefits it brings to the acquired companies and started public relations campaigns¹⁰⁹ with the aim to burnish its image. One example to improve the industry's reputation has been by means of joining respectable industry bodies, like the European Venture Capital Association (EVCA) in Europe, the British Venture Capital Association (BVCA) in the UK or the Private Equity Council in the United States (US), which conduct research and publish information about private equity to policymakers, investors and anyone else interested in the industry.

In Europe, EVCA went to great lengths to explain the advantages of private equity to the press, investors, the general public and policymakers through digital media, publications, massaging and industry events.¹¹⁰ In the US, *the American Investment Council*,¹¹¹ promotes the merits of

¹⁰⁵ Eli Noam, *Private Equity is a Problem for Public Media* (FIN. TIMES, Feb. 20, 2007), <http://www.ft.com/cms/s/2/50ca3cb0-c01e-11db-995a-000b5df10621.html>.

¹⁰⁶ Brian Cheffins & John Armour, *The Eclipse of Private Equity* 3 (European Corporate Governance Institute Law Working Paper No. 082/2007, Apr. 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=982114.

¹⁰⁷ See, e.g., Ann-Kristin Achleitner & Oliver Kloeckner, *Employment Contribution of Private Equity and Venture Capital in Europe* (Nov. 2005), <http://ssrn.com/abstract=1113782>; and *The Economic Impact of Private Equity in the UK*, *supra* note 92.

¹⁰⁸ For instance, a recent study by Edgerton (2011) measured the use of corporate jet fleets in public companies and those controlled by private equity funds, finding that the latter average approximately 40 per cent smaller jet fleets than observably similar public companies; see Jesse Edgerton, *Agency Problems in Public Firms: Evidence from Corporate Jets in Leveraged Buyouts*, 67 J. FINANCE 2187 (2012).

¹⁰⁹ See Kevin Roose, *Private Equity's YouTube Defense* (DEALBOOK, Feb. 24, 2012), <http://dealbook.nytimes.com/2012/02/24/private-equitys-youtube-defense>.

¹¹⁰ *Annual Report 2012/13* 8-11 (EVCA, 2013), <https://www.investeurope.eu/about-us/who-we-are/annual-reports-other-reporting/>.

¹¹¹ *What is Private Equity?* (American Investment Council, May 2021), <https://www.investmentcouncil.org/private-equity-at-work/>.

the industry and defends it against media and political mischaracterisations by addressing fictional accusations¹¹² and posting short videos illustrating success stories.¹¹³ These featured case studies demonstrate that PE firms invest in promising companies poised for growth or those struggling in need of repair and through making operational improvements and implementing effective growth strategies they strengthen these companies so they are better positioned to compete – successfully and for the long term – in the global marketplace. This highlights the industry’s ability to provide the necessary capital, resources, expertise and long-term vision, as well as its critical role in eliminating the survival of *un-fittest* company boards and directors.

Clinical case studies of private equity transactions¹¹⁴ also appear to confirm situations in which target companies achieved substantial productivity gains, enhanced profitability, improved existing operations and created value. For example, Denis (1994)¹¹⁵ compared a leveraged recapitalisation of Kroger Co. with a Safeway Stores, Inc. LBO and found that the LBO was not only about leveraging the business, but also offered a completely different organisational form with its own value-improving characteristics, such as better monitoring and control, boardroom change and improved managerial equity ownership.

The increasing role and importance PE plays in portfolio companies generates considerable interest, especially in assessing the industry’s economic impact, financial returns for the investee companies and investing funds as well as on the society as a whole.¹¹⁶ The financial crisis has raised even more concerns pertaining to the effects of buyouts. Are these effects real? Who is right: industry critics or its proponents? This is examined in the following passage.

¹¹² *Private Equity Across America* (American Investment Council, May 2021), <https://www.investmentcouncil.org/private-equity-at-work/in-your-state/>.

¹¹³ *Featured Case Studies* (American Investment Council, May 2021), <https://www.investmentcouncil.org/?s=case+study>.

¹¹⁴ For instance, the Hertz buyout resulted in addressing inefficiencies by way of reducing overhead costs and cutting noncapital investments (Timothy A. Luehrman & Douglas Scott, *The Hertz Corporation (B)*, Harvard Business School Case 208-031 (Oct. 2007), <http://hbr.org/product/The-Hertz-Corporation--B-/an/208031-PDF-ENG>); and the O.M. Scott & Sons buyout resulted in significant operating improvements through increased incentives for the management and valuable suggestions of PE investors (George P. Baker & Karen Wruck, *Organisational Changes and Value Creation in Leveraged Buyouts: The Case of the O.M. Scott & Sons Company*, 25 J. FINANC. ECON. 163 (1989)).

¹¹⁵ D.J. Denis, *Organisational Form and the Consequences of Highly Leveraged Transactions: Kroger’s Recapitalisation and Safeway’s LBO*, 36 J. FINANC. ECON. 193 (1994).

¹¹⁶ K.G. Palepu, *Consequences of Leveraged Buyouts*, 27(1) J. FINANC. ECON. 247 (1990).

4. The Effects of Buyouts

One of the major criticisms against private equity is that it allegedly leaves behind companies that are crippled, anorexic and struggling for survival. Is this true? Maybe, by contrast, the industry revitalises buyout companies and equips them with strategies and resources for profitability in the long term? To answer these important questions some empirical evidence is presented next, examining the impact of the private industry on the fates of firms and the overall economic landscape.¹¹⁷ As opposed to the public discourse that tends to be characterised by a low ratio of facts to opinion, this survey of literature sheds light on the actual effects of buyouts and helps refine our comprehension of what works and what does not in private equity.

4.1 Wealth Gains and Value Creation

We can distinguish a number of hypotheses which motivate the going-private decision and explicate wealth gains from public-to-private transactions.¹¹⁸ They pertain to reduction of agency costs, wealth transfers from stakeholders to shareholders, tax savings, reduction of transaction costs, takeover defences and corporate undervaluation. Slightly in more detail, incentive realignment hypothesis suggests that shareholder wealth gains result from the incentives that provide higher rewards for managers acting in line with the investors' interests.¹¹⁹ Free cash flow hypothesis suggests that shareholder wealth gains result from debt-induced mechanisms that force managers to pay out free cash flows.¹²⁰ Control hypothesis suggests that shareholder wealth gains result from an improved monitoring system that is imposed on the management team.¹²¹ Welfare transfer hypothesis suggests that shareholder wealth gains result from the expropriation of pre-transaction bondholders, employees and other

¹¹⁷ It must be borne in mind, however, that despite academic and practitioner scrutiny, the data on private equity remains obscure and uncertain due to uneven, periodical disclosure of information regarding the industry. Private equity investors eschew disclosing information concerning financial and operational performance of the acquired companies as well as restructuring activities they undertake. In spite of these obstacles, the literature from the early 1980s up until present day has managed to report interesting results and observations regarding effects of buyouts and how changes synonymous with private equity transactions affect employees, productivity and long-run investments, amongst other things.

¹¹⁸ Luc Renneboog, *supra* note 45, at 89, 91-97; Luc Renneboog, Tomas Simmons & Mike Wright, *Why do Public Firms Go Private in the UK? The Impact of Private Equity Investors, Incentive Realignment and Undervaluation*, in PRIVATE EQUITY AND MANAGEMENT BUYOUTS 101-150 (Mike Wright & Hans Bruining eds., Edward Elgar 2008).

¹¹⁹ ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANC. ECON. 305 (1976).

¹²⁰ *Id.*

¹²¹ Sanford J. Grossman & Oliver D. Hart, *One-Share One-Vote and the Market for Corporate Control*, 20 J. FINANC. ECON. 175 (1988); F.H. Easterbrook & D.R. Fischel, *Voting in Corporate Law*, 26 J. LAW ECON. 395 (1983); Harry DeAngelo et al., *supra* note 65.

stakeholders.¹²² Tax benefit hypothesis suggests that shareholder wealth gains result from tax benefits brought about by the financial structure underlying the transaction.¹²³ Transaction costs analysis suggests that shareholder wealth gains result from the elimination of the direct and indirect costs associated with the fact of being listed on the stock exchange.¹²⁴ Takeover defence hypothesis suggests that shareholder wealth gains result from the management team's willingness to pay a premium to acquire other shareholders to retain control.¹²⁵ Finally, undervaluation hypothesis suggests that shareholder wealth gains result from the fact that the assets are undervalued in the eyes of the acquirer.¹²⁶ A recent study by Renneboog, Simons and Wright (2008)¹²⁷ found the strongest results in support of this last hypothesis.

Berg and Gottschalg (2005)¹²⁸ provided a detailed and comprehensive synopsis of more than two decades of research on the determining factors in this area, pulling together arguments from a variety of different academic areas such as finance, strategic management, economics and entrepreneurship. According to the authors, value generation in buyouts consists of value capturing and value creation levers. The first set of levers includes factors that do not have a direct impact on the financial performance of the portfolio company, such as financial arbitrage (based on changes in market valuation, private information about the portfolio company, and through superior market information, superior deal making capabilities and/or optimisation of corporate sector). The second set of levers is composed of primary levers which are directly linked to improvements in financial engineering (optimisation in portfolio company's capital structure and minimisation in its corporate tax), operational effectiveness (through cost cutting, margin improvements, reduction of capital requirements and removal of managerial inefficiencies) or strategic distinctiveness (due to corporate refocusing); and secondary levers, that is, the reduction of agency costs (by improving incentive alignment and improving

¹²² M. Weinstein, *Bond Systemic Risk and the Option Pricing Model*, 38 J. FINANCE 1415 (1983); A. Shleifer & C.H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (A. Auerbach ed., University of Chicago Press 1988).

¹²³ L. Lowenstein, *Management Buyouts*, 85 COLUMBIA L. REV. 730 (1985); Steven Kaplan, *Management Buyouts: Evidence on Taxes as a Source of Value*, 44 J. FINANCE 611 (1989).

¹²⁴ Harry DeAngelo et al., *supra* note 65.

¹²⁵ ALLEN MICHEL & ISRAEL SHAKED, TAKEOVER MADNESS: CORPORATE AMERICA FIGHTS BACK (1986).

¹²⁶ K. Lehn, J. Netter & A. Poulsen, *Consolidating Corporate Control: Dual Class Recapitalisations Versus Leveraged Buyouts*, 27 J. FINANC. ECON. 557 (1990).

¹²⁷ Luc Renneboog, Tomas Simons & Mike Wright, *supra* note 118.

¹²⁸ Oliver Gottschalg & Achim Berg, *Understanding Value Generation in Buyouts* (Journal of Restructuring Finance 2(1), Jan. 2005), https://www.researchgate.net/publication/4816134_Understanding_Value_Generation_in_Buyouts.

monitoring and control) and mentoring (the parenting advantage associated with advising and enabling).

In addition to optimising portfolio companies' operations and providing them with a governance advantage, private equity fund managers also confer the benefit of an increasingly valuable borrowing advantage stemming from their ability to broker financing on much more highly favourable terms than standalone companies. As repeat players in the debt markets, PE firms have built reputation with lenders which certifies the creditworthiness of their portfolio companies *ex ante* and ensures good performance *ex post*. Recent papers find that more prominent buyout firms tend to obtain cheaper loans and looser covenants compared to public companies.¹²⁹ Thus, PE firms act as gatekeepers in the debt markets, creating value by affording portfolio companies access to unprecedented levels of debt. Arguably, this evinces the industry's evolution from Barbarians at the Gate into Keepers of the Gate.¹³⁰

4.2 Elimination of the Agency Problem

Ever since Berle and Means (1932),¹³¹ the classic agency problem is how investors control managers. The authors were first to identify the extraordinary nature of the public company which, according to them, resided in the fact that it exhibited a complete separation of ownership and control. The controlling managers of public companies (agents), who direct the daily functions of the firm, hold a small or even negligible ownership stake, whilst the ownership of these companies is increasingly becoming vested in a multitude of small-scale individual investors or financial intermediaries (principals) who lack both the resources and incentives to undertake effective control over company managers.¹³² This led Berle and Means to argue that '[t]he separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappeared.'¹³³ The authors described corporate managers as 'economic autocrats,' whose ability in effect to perpetuate their own

¹²⁹ Victoria Ivashina & Anna Kovner, *The Private Equity Advantage: Leveraged Buyout Firms and Relationship Banking* (EFA 2008 Athens Meetings Paper, Apr. 5, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017857; Cem Demiroglu & Christopher James, *Lender Control and the Role of Private Equity Group Reputation in Buyout Financing* (University of Florida Working Paper, Nov. 2007), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106378.

¹³⁰ See Elizabeth de Fontenay, *supra* note 15 (presenting a novel conception on value creation in portfolio companies).

¹³¹ ADOLF A. BERLE & GARDINER C. MEANS, *supra* note 119.

¹³² M.T. Moore & A. Reberlioux, *Revitalizing the Institutional Roots of Anglo-American Corporate Governance*, 40 ECON. SOC. 84 (2011).

¹³³ ADOLF A. BERLE & GARDINER C. MEANS, *supra* note 119, at 7.

existence had promoted them to the position of ‘the new princes,’ assuming unchecked control over their ‘economic empires.’¹³⁴

In his seminal paper, Michael Jensen – the main theorist of LBOs – argued that LBO firms constitute a superior organisational form to public companies because of the better incentives they offer to managers, which rely on pay for performance, decentralisation of control, high leverage, a range of bonding or pre-commitment agreements together with reputational concerns of fund managers.¹³⁵ Changes to the acquired firms can be categorised as financial engineering, governance engineering and operational engineering.¹³⁶ This effectively reduces agency cost problems that are inherent in the structure of the public company. The renowned scholar claimed that in a public company dispersed ownership makes it feasible for managers to refrain from taking hard and unpopular decisions like laying off employees and cutting wages; moreover, there are no right incentives and careful monitoring and so managers engage in empire building by hiring too many employees, acquiring too many companies or diversifying activities too much.¹³⁷ Thus, Jensen argued that private equity is a superior business model when compared to a publicly listed company: equity is radically concentrated through leverage and the sole existence of debt is a necessary adjunct of an LBO exercising a positive discipline on the acquisition function and diminishing margin for error.

The particular characterisation of public companies as large, wasteful and typically conglomerated, as well as the proclaimed superiority of private equity firms was subsequently challenged. Rappaport (1990)¹³⁸ argued that public companies are ‘vibrant, dynamic institutions – capable of long periods of underperformance, to be sure, but also fully capable of self-correction.’ In the US and the UK, the public company is deemed a social invention of huge historical significance, frequently believed to have considerable advantages over its private counterpart.¹³⁹ There are several reasons behind its genius;¹⁴⁰ nevertheless, divergent

¹³⁴ *Id.* at 116.

¹³⁵ Michael C. Jensen, *supra* note 35.

¹³⁶ Steven N. Kaplan & Per Strömberg, *supra* note 10, at 130-136.

¹³⁷ Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76(2) AM. ECON. REV. 323 (1986); OLIVER E. WILLIAMSON, *THE ECONOMICS OF DISCRETIONARY BEHAVIOUR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM* (1974).

¹³⁸ A. Rappaport, *The Staying Power of the Public Corporation*, 68 HARV. BUS. REV. 96, 101 (1990).

¹³⁹ Luc Renneboog, Tomas Simmons & Mike Wright, *supra* note 118, at 101, 101.

¹⁴⁰ By way of example, being listed enables companies to raise funds in capital markets, increases the share liquidity for investors, allows the diversification of wealth for company founders and entrepreneurs, facilitates the use of options in relation to remuneration packages, offers a degree of visibility and media exposure which can be an effective marketing tool, and gives CEOs and top managers more prestige, enhancing their social prominence and political power.

objectives and conflicts of interest between agents and principals can jeopardise a firm's performance. Without a change in the principal-agent relationship, as provided for instance by a buyout, non-owner managers would have little motivation to perform restructuring activities unless forced to do so.¹⁴¹

The advocates of the agency theory contend that performance improvements observed following a buyout eventuate from management's increased ownership stake in the firm,¹⁴² making the interests of owners and managers more likely to coincide. Jensen and Meckling (1976),¹⁴³ Holmström (1979)¹⁴⁴ and Jensen and Murphy (1990)¹⁴⁵ claimed that pay for performance aligns the interests of owners and managers and can subsequently lead to improvements in productivity. Murphy (1985)¹⁴⁶ confirmed that firm performance is strongly and positively related to managerial remuneration. The agency costs can be further reduced by increased leverage which steers efficiency and forces managers to pay out free cash flows to the owners (instead of investing them in projects with a negative net present value). Jensen (1986 and 1989)¹⁴⁷ argued that LBOs provide a 'carrot' and 'stick' mechanism to ameliorate the agency costs associated with free cash flow – first, share ownership of managers largely increases, giving them incentives to work harder (the 'carrot'), then the firm assumes lots of debt to finance the purchase of company shares so that the ensuing heavy debt burden compels managers to efficiently run the company in order to avoid default (the 'stick').¹⁴⁸ Overleveraging makes commercial and economic sense in relation to some business activities and helps refocus company energies on a few core operations and, through creating a crisis atmosphere, impels managers to adopt desirable and effective changes, prompts a rethink of strategy and structure and accelerates response – managers cannot waste money as they must make interest and principal payments, and this helps enforce cost efficiency.¹⁴⁹ Further support

¹⁴¹ J.E. Bethel & J. Liebeskind, *The Effects of Ownership Structure on Corporate Restructuring*, 14 STRATEGIC MANAGE. J. 15 (1993).

¹⁴² Michael C. Jensen, *supra* note 35.

¹⁴³ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FINANC. ECON. 305 (1976).

¹⁴⁴ Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979).

¹⁴⁵ Michael C. Jensen & Kevin J. Murphy, *Performance, Pay and Top Management Incentives*, 98 J. POLIT. ECON. 225 (1990).

¹⁴⁶ Kevin J. Murphy, *Corporate Performance and Managerial Remuneration: An Empirical Analysis*, 7 J. ACCOUNT. ECON. 11 (1985).

¹⁴⁷ Michael C. Jensen, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, 76(2) AM. ECON. REV. 323 (1986); Michael C. Jensen, *supra* note 35.

¹⁴⁸ James F. Coffer & Sarah W. Peck, *The Structure of Debt and Active Equity Investors: The Case of the Buyout Specialist*, 59 J. FINANC. ECON. 101, 102 (2001).

¹⁴⁹ ANDREW FARLOW, CRASH AND BEYOND: CAUSES AND CONSEQUENCES OF THE GLOBAL FINANCIAL CRISIS 22 (2013).

in this respect is provided by Grossman and Hart (1982)¹⁵⁰ who similarly argue that since the high level of leverage makes the probability of default larger, it leads to increased efforts by the managers.¹⁵¹

In sum, private equity firms seem to be mitigating one of the perennial problems long associated with the Anglo-American capitalism, namely, the separation of ownership and control.¹⁵² They introduce a more decisive, pro-active and flexible decision-making style, where the top management (insiders) are only responsible to the private equity fund, rather than thousands of dispersed shareholders (outsiders), who have ‘sacrificed powers of direct control over professional (non-proprietary) managers in favour of gaining the practical benefits of liquidity.’¹⁵³

4.3 Employment and Wages

The combined portfolio companies of Carlyle and KKR, two of the world’s largest PE firms, employ 725,000 and 720,000 people respectively, making them both bigger than any US public company other than Walmart;¹⁵⁴ in the UK, there are around 3,000 private equity-backed companies employing a total of around 490,000 people.¹⁵⁵ Yet, employment is one of the most contentious issues with regards to the operation of private equity. In most cases, employees and labour unions respond to news of a buyout with a certain degree of concern, fear and trepidation as buyouts have somewhat become synonymous with downsizing, massive cuts and company shutdowns, the idea which has been imparted to the popular consciousness through the 1980s movies such as *Wall Street*. Given recent heated policy debate about private equity and its

¹⁵⁰ Sanford J. Grossman & Oliver D. Hart, *Corporate Financial Structure and Managerial Incentives*, in *THE ECONOMICS OF INFORMATION AND UNCERTAINTY* 107-140 (John J. McCall ed., University of Chicago Press 1986); Jeffrey Zwiebel, *Dynamic Capital Structure Under Managerial Entrenchment*, 86 AM. ECON. REV. 1197 (1996).

¹⁵¹ It is recognised that leverage can also have negative consequences. There is evidence of a negative correlation between research and development (R&D) spending and employee wages (see Charles P. Himmelberg & Bruce C. Petersen, *R&D and Internal Finance: A Panel Study of Small Firms in High-Tech Industries*, 76 REV. ECON. STAT. 38 (1994)); the buyout firm can threaten not to undertake new investments unless wages are reduced (see Enrico C. Perotti & Kathryn E. Spier, *Capital Structure as a Bargaining Tool: The Role of Leverage in Contract Renegotiation*, 83 AM. ECON. REV. 1131 (1993)); too much debt can result in debt overhang which decreases future investment incentives (‘discretionary expenditures’) (see Stewart Myers, *Determinants of Corporate Borrowing*, 5 J. FINANC. ECON. 147 (1977)); and it can increase the risk of bankruptcy or even bring about a full shutdown of operations (see Joacim Tåg, *supra* note 84, at 271, 276).

¹⁵² Stephen F. Diamond, *supra* note 29, at 151 & 153.

¹⁵³ M.T. Moore & A. Reberioux, *supra* note 132, at 84, 85.

¹⁵⁴ *Private Equity: The Barbarian Establishment*, *supra* note 89.

¹⁵⁵ *Brexit Bad for UK Businesses and the Economy Say Private Equity-Backed Business Leaders* (BVCA, Mar. 9, 2016), <https://www.bvca.co.uk/media-and-publications/news/bvca-press-releases/details/Brexit-bad-for-UK-businesses-and-the-economy-say-private-equity-backed-business-leaders>.

effects and ensuing regulatory changes it is crucial to shed light on the effects of PE transactions on employment and wages.

In relation to US evidence, Smith (1990)¹⁵⁶ found small increases in total firm employment in the post-LBO stage which did not match industry averages. Likewise, Kaplan (1989)¹⁵⁷ analysed a sample of 48 large MBOs which occurred between 1980 and 1986, finding that median employment increased by 0.9 per cent if divestures are regarded as job losses. Nevertheless, compared to the industry median, buyout firms had a 12 per cent lower growth. Muscarella and Vetsuypens (1990)¹⁵⁸ reported similar results. They analysed a sample of 72 US LBO firms between 1976 and 1987, finding a decline in employment of 0.6 per cent between the time the buyout occurred and when the firm was subsequently listed on the stock exchange. The decrease in employment could be attributed to divestures as the authors found an increase in median employment by 17 per cent for the 12 LBO firms that did not do divestures. Opler (1992)¹⁵⁹ found small increases in the level of employment following LBO transactions.

Using plant-level data on 1,108 plants which underwent an LBO or MBO over the period 1983-1986, Lichtenberg and Siegel (1990)¹⁶⁰ reported an 8.5 per cent cumulative decrease in non-production workers over three years (one year pre- and two years post-buyout); blue-collar employment declines were not statistically significant. The authors observed that the relative quantities of labour employed in plants involved in LBOs were declining for several years before and after the buyout, but the rate of decline was smaller and less significant post-buyout. Moreover, LBOs appeared to be preceded or followed by meaningful and differential changes in wages of production (blue-collar) and non-production (white-collar) workers. The former's hourly and annual wage rates increased after the buyout, whereas the employment and wages of non-production workers declined sharply post-buyout. This suggests that LBOs are production-labour-using and non-production-labour-saving organisational forms with the main effect on white-collar workers who appear to draw the shortest straw.

¹⁵⁶ Abbie J. Smith, *Corporate Ownership Structure and Performance: The Case of Management Buyouts*, 13 J. FINANC. ECON. 143 (1990).

¹⁵⁷ Steven N. Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FINANC. ECON. 217 (1989).

¹⁵⁸ Chris J. Muscarella & Michael R. Vetsuypens, *Efficiency and Organisational Structure: A Study of Reverse LBOs*, 45 J. FINANCE 1389 (1990).

¹⁵⁹ Tim C. Opler, *Operating Performance in Leveraged Buyouts: Evidence from 1985-1989*, 21 FINANC. MANAGE. 27 (1992).

¹⁶⁰ Frank R. Lichtenberg & Donald S. Siegel, *The Effects of Leveraged Buyouts on Productivity and Related Aspects of Firm Behaviour*, 27(1) J. FINANC. ECON. 165 (1990).

One area that has rekindled controversy about buyouts is that they allegedly strip assets of acquired businesses which in turn must reduce employment. As already indicated, leveraged buyouts are often involved in significant divestment. For instance, Bhagat, Shleifer and Vishny (1990)¹⁶¹ reported the sale of 43 per cent of assets, Kaplan (1991)¹⁶² 34 per cent, whilst Seth and Easterwood (1993)¹⁶³ documented that 43 per cent of companies divested parts of the business, especially in larger deals which presented the greatest opportunities for identifying non-core elements. How does this affect employment? Davies and co-authors (2013)¹⁶⁴ examined recently the impact of buyouts on employment and productivity and their key findings paint an interesting picture. Target companies are bulking up prior to the deal – their employment rate grows 2 per cent faster over the five years before the buyout relative to the control group and they employ more workers in the year of the transaction to bolster production and, perhaps, to avoid the buyout. The authors found sizable reductions in earnings per worker in the first two years post-buyout and a rapidly shrinking employment after the buyout which stays depressed – 3 per cent over two years post-buyout and 6 per cent over five years relative to controls. Nevertheless, it is worth noting that buyout firms created more new jobs at newly opened establishments at a faster pace than control firms, and they acquired and divested establishments more rapidly. Accordingly, job losses are largely offset by job gains and, taking into account all adjustment margins, relative net job loss remains a mere 1 per cent of employment over two years post-buyout.

In the UK, early evidence suggests that job losses occur most substantially during the ownership change phase.¹⁶⁵ Whilst this is not always the case, it needs to be recognised that for MBI

¹⁶¹ S. Bhagat, A. Shleifer & R. Vishny, *Hostile Takeovers in the 1980s: The Return to Corporate Specialization* (Brookings Papers on Economic Activity, 1990), https://scholar.harvard.edu/files/shleifer/files/hostile_takeovers_80s.pdf.

¹⁶² S.N. Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. FINANC. ECON. 287 (1991).

¹⁶³ A. Seth & J. Easterwood, *Strategic Redirection in Large Management Buyouts: The Evidence from Post-Buyout Restructuring Activity*, 14(4) STRAT. MANAGE. J. 251 (1993).

¹⁶⁴ Steven J. Davis et al., *Private Equity, Jobs, and Productivity* (National Bureau of Economic Research Working Paper Working Paper No. w19458, Sept. 2013), <http://ssrn.com/abstract=2328504>. The authors analysed a new dataset covering US buyouts from 1980 to 2005 and tracked 3,200 target firms and their 150,000 establishments before and after acquisition, comparing them to controls defined by industry, size, age and prior growth. This is one of the most authoritative studies on the topic demonstrating that portfolio companies create more greenfield jobs (that is, new jobs in new establishments) than their non-private equity counterparts. This “creative destruction” process in the labour market has only a modest net impact on employment; the greenfield job creation may be explained by the non-restrictive nature of concentrated ownership that allows investments in areas that were barred pre-buyout by the entrenched idea of previous management, particularly in large, complex firms in which entrepreneurial opportunities could be limited by a bureaucratic decision-making process; see Ian Clarke, *The Regulation of Private Equity and the Alternative Investment Fund Managers Directive – Parts I and II* (INT’L CORP. RESCUE, 2013), <http://www.chasecambria.com/site/journal/article.php?id=739>.

¹⁶⁵ M. WRIGHT, S. THOMPSON, B. CHIPLIN & K. ROBBIE, *BUY-INS AND BUY-OUTS: NEW STRATEGIES IN CORPORATE MANAGEMENT* (1991).

targets, which have typically been underperforming, they require restructuring to restore viability and this means that pre-buyout employment levels may not be sustainable for the business to survive.¹⁶⁶ Where there is little alternative except closure of underperforming business or a division, even a trimmed workforce may have its attractions – such a restructuring action might reduce the likelihood of the firm failing, resulting in even higher loss of employment. Wright and co-authors (1992)¹⁶⁷ analysed 182 LBOs at the firm level for 1983-1986 and reported an initial decline in employment of around 6.3 per cent post-buyout which recovered over time to 4.5 per cent below the pre-buyout level. This highlights a modest employment decline.

Amess and co-authors (2007)¹⁶⁸ have also found interesting results, having examined a sample of 1,350 MBOs and MBIs between 1999 and 2004. They reported that employees in UK MBO companies have more discretion over their work practices and that skilled employees had very low levels of supervision. They also found that employment in MBO firms falls initially after the buyout, but then continues to rise. This, however, was not the case for MBIs which witnessed employment levels remaining below the pre-buyout levels. These findings correspond with the notion that the former type of buyouts leads to the exploitation of growth opportunities which result in higher employment growth. MBI firms do not follow the same pattern as they are more problematic and require considerable restructuring. The study further found that wages in both MBOs and MBIs are lower than their non-buyout industry counterparts; that said, the authors did not examine the *status quo ante* – wages before the buyout. Therefore, it is not possible to state whether the position was worse, better or the same following the MBO or MBI transaction.

Amess and co-authors (2008),¹⁶⁹ who analysed 232 LBOs that took place between 1996 and 2006, showed that PE-backed buyouts had no effect on employment or wage growth as compared to the comparison group. This contrasts with the findings of Cressy and co-authors

¹⁶⁶ K. Robbie & M. Wright, *Managerial and Ownership Succession and Corporate Restructuring: The Case of Management Buy-Ins*, 32(4) J. MANAGE. STUD. 527 (1995).

¹⁶⁷ Mike Wright, Steve Thompson & Ken Robbie, *Venture Capital and Management-Led leveraged Buyouts: A European Perspective*, 7 J. BUS. VENTURING 47 (1992).

¹⁶⁸ Kevin Amess & Mike Wright, *The Wage and Employment Effects of Leveraged Buyouts in the UK*, 14 INT'L J. ECON. BUS. 179 (2007).

¹⁶⁹ Kevin Amess, Sourafel Girma & Mike Wright, *What are the Wage and Employment Consequences of Leveraged Buyouts, Private Equity and Acquisitions in the UK?* (Nottingham University Business School Research Paper No. 2008/1, Sept. 19, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1270581.

(2011)¹⁷⁰ who studied 57 buyouts over the period of 1995-2002. The authors found that over the first year after the transaction employment fell by 7 per cent relative to the comparison group. This grew to 23 per cent below that of the comparison group over the first four years. However, in fifth year, employment increased relative to the comparison group. Weir, Jones and Wright (2008),¹⁷¹ based on their analysis of 122 UK buyouts (PTPs) between 1998 and 2004, found no evidence of shedding jobs in the pre-deal period, significantly greater job losses for the first two years after going private (compared to firms which remained public) and no significant difference in the employment change in the third, fourth and fifth year. The authors observed that the picture regarding the change in employment is quite complex and the overall employment effect of going private is unclear. Presenting a more negative picture, Goergen, O'Sullivan and Wood (2012)¹⁷² found a significant decrease in employment in acquired UK IBO firms *ex post*. The authors did not observe any subsequent increase in profitability or productivity, suggesting that downsizing is not effective in disciplining staff – this could be due to the fact that a threat of a job loss may have a knock on effect on the morale of other employees¹⁷³ or because the newly imposed management will simply lack detailed insider knowledge as to the company's 'cognitive assets.'¹⁷⁴

There is only scarce evidence on employment effects outside the core PE markets consisting of the US and UK. According to Bergström and co-authors (2007),¹⁷⁵ buyouts in Sweden have no effects on employment and wages. This contrasts markedly with evidence from France where Boucley and co-authors (2011)¹⁷⁶ studied 830 French buyouts that occurred between 1994 and 2004 and found a remarkable employment growth of 13 per cent in the period three years prior to the buyout to four years thereafter. The authors argued that buyouts in France work as a substitute for weak capital markets and operate in industries where external financing is frequently needed for growth. Similarly, for Spain, Pellon and co-authors (2007) documented

¹⁷⁰ R. Cressy, F. Munari & A. Malipieor, *Creative Destruction? Evidence that Buyouts Shed Jobs to Raise Returns*, 13(1) VENTURE CAPITAL 1 (2011).

¹⁷¹ Charlie Weir, Pete Jones & Mike Wright, *Public to Private Transactions, Private Equity and Performance in the UK: An Empirical Analysis of the Impact of Going Private* (May 30, 2008), <http://ssrn.com/abstract=1138616>.

¹⁷² M. Goergen, N. O'Sullivan & G. Wood, *Private Equity Takeovers and Employment in the UK: Some Empirical Evidence*, 19 CORP. GOV. 259 (2011).

¹⁷³ Tom Redman & Adrian Wilkinson, *Downsizing*, in CONTEMPORARY HUMAN RESOURCE MANAGEMENT: TEXT AND CASES 356–381 (Tom Redman & Adrian Wilkinson eds., 2d ed. 2005).

¹⁷⁴ MASAHIKO AOKI, CORPORATIONS IN EVOLVING DIVERSITY: COGNITION, GOVERNANCE, AND INSTITUTIONS 30–31 (2010).

¹⁷⁵ Clas Bergström, Mikael Grubb & Sara Jonsson, *The Operating Impact of Buyouts in Sweden: A Case Study of Value Creation*, 11 J.P.E. 22 (2007).

¹⁷⁶ Quentin Boucley, David Sraer & David Thesmar, *Growth LBOs*, 102 J. FINANC. ECON. 432 (2011).

average annual growth in employees of 6.2 per cent in the three years post-buyout¹⁷⁷ and, for Belgium, Toubau (2006) found that the average number of employees grew more than 13 per cent two years after a PE-backed buyout.¹⁷⁸ These studies further indicate that the employment impact differs depending on the development stage of the public capital market and the buyout activity in a given country.¹⁷⁹

To encapsulate, the empirical studies on employment effects of private equity transactions tend to find, on average, no or weakly negative effects on employment (with the exception of France, Spain and Belgium where the effect is strongly positive) and slightly positive effects on wages. This demonstrates that the impact of private equity on employment is rather mixed¹⁸⁰ and varies from one country to the next. Ultimately, it is not feasible to label buyout firms as either angels or demons, for such depiction would not take account of the complex and heterogeneous effects on employees following the buyout. Of interest is a recent paper by Bernstein and co-authors (2010)¹⁸¹ presented at the World Economic Forum. The authors examined the macroeconomic impact of PE investments (LBOs) across 20 industries in all OECD countries between 1991 and 2007. Their analysis did not find evidence supporting the negative effects of private equity as industries in which PE fund managers were active had grown more rapidly than other sectors in terms of employment, value added and total production. These findings run counter to some of the assertions that have been motivating regulatory action about private equity's detrimental impact on the economy as a whole.

¹⁷⁷ Marti Pellon et al., *Economic and Social Impact of Venture Capital & Private Equity in Spain* (ASCRI Research Paper, Madrid, 2007), reported in Eva Lutz & Ann-Kristin Achleitner, *Angels or Demons? Evidence on the Impact of Private Equity Firms on Employment* 8-9 (Zeitschrift für Betriebswirtschaft, Special Issue Entrepreneurial Finance, No. 5, pp. 53-81, May 1, 2009), <http://ssrn.com/abstract=1420638>.

¹⁷⁸ Valentin Toubau, *Private Equity Firms in Belgium – Value Creators or Locusts?* (Working Paper, Unpublished Document, Solvay Business School, Brussels, 2006), reported in *Private Equity* 124 (House of Commons Treasury Committee, Tenth Report of Session 2006-07, Volume II, Oral and Written Evidence, July 24, 2007), <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/567/567ii.pdf>.

¹⁷⁹ Since the capital markets and buyout activities are less mature in Spain, Belgium and France, private equity plays a complementing role to the capital market by providing companies with external growth finance. Moreover, a traditionally higher commitment to employees in these countries (due to a more stakeholder-oriented approach) explains why the employment impact is highly positive as contrasted with the US or the UK.

¹⁸⁰ See *Globalization of Alternative Investments Working Papers Volume 1: The Global Economic Impact of Private Equity Report 2008* ix & 43-64 (World Economic Forum, Jan. 2008), <https://www.slideshare.net/WorldEconomicForumDavos/the-global-economic-impact-of-private-equity-report-2008>.

¹⁸¹ Shai Bernstein et al., *Private Equity and Industry Performance* (National Bureau of Economic Research Working Paper No. 15632, Jan. 2010), http://www.nber.org/papers/w15632.pdf?new_window=1. See also, *Globalization of Alternative Investments Working Papers Volume 3: The Global Economic Impact of Private Equity Report 2010* 3-22 (World Economic Forum, Dec. 2009), <https://fddocuments.in/document/wef-iv-private-equity-report-2010.html>.

4.4 Productivity

Can private equity firms genuinely improve the companies they acquire? It has been contended that buyouts have real effects on companies being acquired which correlate with enhanced productivity due to reorganising company operations. Lichtenberg and Siegel (1990)¹⁸² found that US plants involved in LBOs, and especially MBOs, have a substantially higher (around 14 per cent) rate of productivity growth over a span of five years than other plants within the same industry not going through a buyout. It was found that LBO and MBO plants enhanced their economic performance without reducing research and development, capital investment, wages or making blue-collar personnel redundant. Moreover, the authors speculated that two factors may have contributed to the relative increase amongst LBO plants, namely, (i) increased intensity of both labour effort and utilisation of all employed inputs as a result of enhanced sensitivity of their financial rewards to their performance, and (ii) reduced proportions of resources misallocated to inefficient activities as a result of curtailing free cash flows and more intensive monitoring of managers by investors. The foregoing is consistent with a more recent study by Davis and co-authors (2009)¹⁸³ which found productivity growth to be 2 per cent greater at targets than the comparison group within two years after the buyout and labour productivity which was on average approximately 5.2 per cent higher. The authors estimated that PE transactions resulted in an additional real output of up to \$15 billion in 2007. This represents an economically significant effect of buyouts.

Amess (2002)¹⁸⁴ studied a firm-level sample of 78 UK MBOs that occurred between 1986 and 1997 and found that these MBOs tended to increase relative productivity in manufacturing firms and output by 16.13 per cent due to reduced agency costs, debt bonding and monitoring by buyout specialists. In a further study, using a similar data set, Amess (2003)¹⁸⁵ found that the technical efficiency of firms that underwent an MBO was higher two years before the transaction and reached efficiency levels of 7, 7.5, 4 and 7 per cent in the four years after the MBO. This is consistent with MBOs creating managerial incentives that improve firm-level

¹⁸² Frank R. Lichtenberg & Donald S. Siegel, *supra* note 160.

¹⁸³ Steve J. Davis et al., *Private Equity, Jobs and Productivity* (Dec. 22, 2008), http://econ-server.umd.edu/~haltiw/P_e_productivity_Dec_2008_submitted.pdf.

¹⁸⁴ Kevin Amess, *Management Buyouts and Firm-Level Productivity: Evidence from a Panel of UK Manufacturing Firms*, 49 SCOTTISH J. POLIT. ECON. 304 (2002).

¹⁸⁵ Kevin Amess, *The Effect of Management Buyouts on Firm-Level Technical Inefficiency: Evidence from a Panel of UK Machinery and Equipment Manufacturers*, 51 J. IND. ECON. 35 (2003). The results are based on the period 1986-1997.

performance. Harris and co-authors (2005)¹⁸⁶ extended the Lichtenberg and Siegel (1990) study and, having assessed 35,752 manufacturing establishments before and after the MBO, found that the buyout firms experienced a substantial increase in productivity (70.5 to 90.3 per cent) and that post-buyout productivity gains were pervasive across industries. The increase in productivity happened due to outsourcing of intermediate goods and materials which reduced labour intensity of production. Evidence presented by these studies suggests that management buyouts are a useful tool for enhancing economic efficiency of companies and reducing agency costs between new owner-managers and new shareholders.

4.5 Performance of Portfolio Companies

The 1980s research on US LBOs indicates substantial mean improvements in profitability and cash flow measures. For instance, Kaplan (1989)¹⁸⁷ and Smith (1990)¹⁸⁸ demonstrate evidence that the post-buyout operating performance increases more than the industry median from the year before the acquisition to two years after it. The classic study of that period by Kaplan examined a sample of 76 large management buyouts of public companies that took place between 1980 and 1986. He found that these transactions added value to the firms by improving their operations and providing new incentives to managers, and this happened without expropriating wealth from the acquired company's employees or shareholders. The analysis demonstrates significantly better post-buyout operating performance than other firms in the same industry, increased cash flows and reduced capital expenditures in the three years following the buyout. Kaplan also found that tax advantages were an important, but not exclusive, source of value creation in buyouts.¹⁸⁹ Smart and Waldfogel (1994)¹⁹⁰ revisited Kaplan's sample a few years later. They compared performance against pre-buyout expected performance and equally showed that MBOs enhance corporate performance.

Across the Atlantic, UK evidence similarly indicates that the vast majority of buyouts demonstrate visible improvements in profitability and working capital management.¹⁹¹ Moreover, buyouts generate significantly higher increases in return on assets than comparable

¹⁸⁶ Richard Harris, Donald Siegel & Mike Wright, *Assessing the Impact of Management Buyouts on Economic Efficiency: Plant-Level Evidence from the United Kingdom*, 87 REV. ECON. STAT. 148 (2005).

¹⁸⁷ Steven N. Kaplan, *supra* note 157.

¹⁸⁸ Abbie J. Smith, *supra* note 156.

¹⁸⁹ Steven Kaplan, *supra* note 123.

¹⁹⁰ S.B. Smart & J. Waldfogel, *Measuring the Effect of Restructuring on Corporate Performance: The Case of Management Buyouts*, 76 REV. ECON. STAT. 503 (1994).

¹⁹¹ Mike Wright, Steve Thompson & Ken Robbie, *supra* note 167.

firms, and LBO firms in France were found to be more profitable and less risky than comparable firms in the same industry before and after the buyout.¹⁹² More recent evidence on buyout performance highlights superior risk-adjusted performance relative to industry benchmarks¹⁹³ – buyout returns are significantly enhanced due to various corporate governance mechanisms such as manager incentives, active board representations by private equity firms and unwavering commitment to debt servicing. The effect of these mechanisms can be well illustrated by comparing buyouts to alternative organisational forms. For instance, leveraged recapitalisations¹⁹⁴ and defensive employee stock ownership plans (ESOPs)¹⁹⁵ do not have the same performance impacts as LBOs. Gill and Visnjic (2013)¹⁹⁶ from Goethe University Frankfurt analysed 303 international LBOs between 1980 and 2006, also finding that strong equity incentives, frequent asset restructuring, tight monitoring and investor's experience drive operational performance during the restructuring period.

In addition, there are studies which have investigated post-buyout and post-exit mid- and long-term operating performance of buyout transactions. For instance, Jelic and Wright (2011)¹⁹⁷ examined 1,225 UK MBOs during the period 1980-2009 and found strong evidence for improvements in both output and employment as well as no material changes in profitability and efficiency after IPO exits. Scellato and Ughetto (2012)¹⁹⁸ also examined the buyout effects on the *ex-post* performance of target companies. Based on a sample of 241 buyout transactions involving European companies in the years 1997-2004, the authors revealed a positive impact on the growth in employment and total assets in the short- and mid-term (up to three years after the deal) but this was not so evident in terms of productivity and profitability. It was observed, however, that turnaround specialists can be associated with increases in operating profitability (as opposed to generalist funds) and that the co-localisation of both investors and target companies in the same country is positively correlated, improving company *ex-post* profitability. Further, Cao and Lerner (2007)¹⁹⁹ sought to comprehend the long-run performance

¹⁹² P. Desbrières & A. Schatt, *The Impacts of LBOs on the Performance of Acquired Firms: The French Case*, 29 J. BUS. FINANCE ACCOUNT. 695 (2002).

¹⁹³ Mike Wright & Hans Bruining, *supra* note 78, at 3, 41.

¹⁹⁴ D.J. Denis & D.K. Denis, *Causes of Financial Distress Following Leveraged Recapitalisations*, 37 J. FINANC. ECON. 129 (1995).

¹⁹⁵ A.H. Chen & J.W. Kensinger, *Beyond the Tax Effects of ESOP Financing*, 1 J. APPL. CORP. FINANCE 67 (1988).

¹⁹⁶ Andrej Gill & Nikolai Visnjic, *Insight Private Equity* (SAFE Working Paper Series No. 23, June 20, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2281229.

¹⁹⁷ Ranko Jelic & Mike Wright, *supra* note 80.

¹⁹⁸ Giuseppe Scellato & Elisa Ughetto, *Real Effects of Private Equity Investments: Evidence from European Buyouts*, 66(12) J. BUS. R. 2642 (2013).

¹⁹⁹ Jerry Cao & Josh Lerner, *The Performance of Reverse Leveraged Buyouts*, 91(2) J. FINANC. ECON. 139 (2009).

of reverse LBOs (RLBOs) by analysing stock performance of 496 RLBOs between 1980 and 2002. The authors reported that RLBOs consistently outperformed non-buyout backed IPOs and the stock market as a whole, with economically meaningful positive returns. The RLBO performance was particularly strong in the first, fourth and fifth year after the offering in the 1980s, 1990s and 2000s. This study provides evidence that private equity adds value in the long term.

Finally, it is worth looking at how PE firms have performed on the onset of the 2007 crisis. Wilson and co-authors (2012)²⁰⁰ assessed the economic and financial performance of UK PE-backed buyouts, finding that they achieved superior economic and financial performance both prior to and during the global recession, relative to non-buyout firms. The authors reported positive differentials of approximately 3-5 per cent in profitability and 5-15 per cent in productivity as well as increases in employment and growth. This appears to be consistent with the notion of buyout firms adding more value to portfolio companies. A study by Serdar Aldatmaz (2012)²⁰¹ is very interesting in demonstrating that positive spillover effects of private equity-backed companies on the rest of the industry are concentrated in countries with a stronger legal environment. The author found profitability, employment and labour productivity increase as well as growth in capital expenditures in public companies in the industry in which PE had invested. A country's legality was measured by the quality of legal institutions and intellectual property rights on the basis of PE investments in 19 industries in 48 countries (both developed and developing). The study reported that PE-backed companies need a strong legal environment in order to implement governance practices which result in more efficient portfolio companies.

4.6 Investor and Target Shareholder Returns

One of the principal reasons that explains the popularity and explosive growth of private equity is the investor expectation of financial returns that are deemed to be substantially higher than those of other investment options. Is this truly the case for private equity? An accurate and proper measurement of industry performance has historically been a relatively complicated task as the industry has never been subject to the same disclosure requirements and regulations as

²⁰⁰ Nick Wilson et al., *Private Equity Portfolio Company Performance During the Global Recession*, 18 J. CORP. FINANCE 193 (2012). The financial performance of a sample of PE-backed buyouts is for the period 1995-2010 and compared to a matched sample of private companies, non-PE-backed buyouts and listed companies. The data includes 302,385 company-year observations, of which 15,392 are observations from PE-backed buyouts.

²⁰¹ Serdar Aldatmaz, *Private Equity in the Global Economy: Evidence on Industry Spillovers* (UNC Kenan-Flagler Research Paper No. 2013-9, Dec. 14, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189707.

the public markets. In addition to the usual absence of detailed information regarding PE investments and their returns there are also several computational issues.²⁰² Thus, measuring PE performance is far from obvious.²⁰³

The academic literature on private versus public returns is mixed and depends on the assumptions made in academic papers. Performance investigations are subject to selection biases as some of the studies use funds that are larger, more US-focused, more experienced, or with different degree of financial leverage. Moreover, data limitations and the long investment cycle further complicate performance assessment. Irrespective of this, it is feasible to get some insights into the matter. Lyungqvist and Richardson (2003)²⁰⁴ analysed cash flow data provided by one of the largest institutional investors in private equity in the US between 1981 and 1993 and found that private equity funds generated on average excess returns of 5 to 8 per cent per annum relative to the aggregate public equity market. The authors also documented that it takes several years for the capital to be invested and slightly less than seven years for it to be returned to the investors. Kaplan and Schoar (2005)²⁰⁵ investigated the characteristics of fund performance in the private equity industry, using a data set from Thomson Venture Economics which included a large sample of 746 funds covering the years 1980-2001. The authors reported a number of interesting findings: (i) average private equity fund returns net of fees are roughly equal to that of the S&P 500;²⁰⁶ (ii) venture funds outperformed the S&P 500 whilst buyout funds did not, however, gross of fees, both types of private equity partnerships earned returns exceeding the S&P 500; (iii) performance increased with fund size and with the partnership's experience and a partnership's track record positively affected its ability to attract capital into

²⁰² For instance the fact that: (i) there are no widely accepted benchmarks for the PE asset class so that investors cannot fully comprehend the risk and return; and (ii) PE investments are more illiquid than other assets so that comparisons between the performance of PE funds and alternative investment benchmarks present a difficult challenge; ELI TALMOR & FLORIN VASVARI, *supra* note 30, at 39.

²⁰³ The industry typically computes two sets of measures to determine the fund performance, namely, the investment multiple and the internal rate of return (IRR). The former is probably the most popular measure to assess the performance of a PE fund investment. It measures fund proceeds plus the valuation of any remaining investments divided by the capital provided by the investors. The latter measure takes into account the timing of cash contributions and distributions to and from the fund partnership as well as the investment duration. IRR is calculated on an annualised rate and is defined as the net return to investors after carried interest and other fees are accounted for.

²⁰⁴ Alexander Ljungqvist & Matthew P. Richardson, *The Cash Flow, Return and Risk Characteristics of Private Equity* (Jan. 9, 2003), <http://ssrn.com/abstract=369600>.

²⁰⁵ Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, 60 J. FINANCE 1791 (2005).

²⁰⁶ The S&P 500, or the Standard & Poor's 500, is a stock market index based on the market capitalisations of 500 large US companies having common stock listed on the New York Stock Exchange (NYSE) or the NASDAQ stock exchange.

new funds; and, finally, (iv) funds raised in boom times were less likely to raise a follow-on fund.

Phalippou and Gottschalg (2007)²⁰⁷ argued that private equity funds underperformed with respect to the S&P 500 by about 3 per cent annually, but gross-of-fees performance was above that of the S&P 500 by 3 per cent per year, indicating that fund managers may generate substantial added value, but high fees capture an excessive rent. The authors also confirmed that inexperienced funds have lower performance when compared with more experienced funds which deliver superior returns to their investors. Kaserer and Diller (2004)²⁰⁸ analysed cash flow data of 777 European private equity funds over the period 1980 to 2003 provided by Thomson Venture Economics and found mixed performance results. Over the period 1980-2003, private equity funds generated an over-performance with respect to the bond index and two of their three samples an underperformance with respect to the equity index. Over the period 1989-2003, private equity funds over-performed both indexes. Further, it transpired that limited partners on average get the invested money back slightly after seven years. Kaplan and Strömberg (2008) reported that private equity returns are still robust despite the onset of the financial crisis, quoting in their paper *Venture Economics* that as of September 2007 private equity returns over the previous three years were 15.3 per cent against S&P's 500 returns of 12.7 per cent.²⁰⁹

Guo, Hotchkiss and Song (2011)²¹⁰ studied a sample of 192 LBOs that occurred between 1990 and 2006. The authors demonstrated that, on average, LBO firms experienced large increases in total value from the moment of the buyout to exit, generating large returns to invested debt and equity capital. Median market- and risk-adjusted returns to pre- and post-buyout capital was estimated to be 72.5 and 40.9 per cent, respectively. According to the authors, increased returns and firm value could potentially stem from firm-specific improvements in operating performance (better profitability, elimination of unproductive assets and more efficient use of remaining assets like working capital and value-increasing acquisitions), rising market or industry sector valuation multiples during the time when the firm remained private, or larger tax shields (as a result of substantial leverage) which boost cash flows.

²⁰⁷ Ludovic Phalippou, *The Performance of Private Equity Funds* (Apr. 2007), <http://ssrn.com/abstract=871082>.

²⁰⁸ Christoph Kaserer & Christian Diller, *European Private Equity Funds - A Cash Flow Based Performance Analysis* (May 2004), <http://ssrn.com/abstract=547142>.

²⁰⁹ Steven N. Kaplan & Per Strömberg, *supra* note 10, at 143.

²¹⁰ S. Guo, E.S. Hotchkiss & W. Song, *Do Buyouts (Still) Create Value?*, 66 J. FINANCE 479 (2011).

Harris and co-authors (2012)²¹¹ made use of a new, high-quality cash flow data set from Burgiss in order to comprehend private equity and the returns the industry provides to investors. The authors examined the performance of nearly 1,400 US buyout and venture capital funds and found better buyout fund performance than has previously been documented. It transpired that buyout funds had consistently outperformed public markets, particularly the S&P 500, net of fees and carried interest, in the 1980s, 1990s and 2000s, and each dollar invested in the average fund returned at least 20 per cent more than a dollar invested in the S&P 500. This worked out to an outperformance of more than 3 per cent annually.²¹² The authors also found no significant relation between performance and fund size for buyout funds.²¹³ In an updated study published in 2016,²¹⁴ the business-school professors found that, despite failing to outperforming stock market averages in recent years, the buyout funds raised between 1984 and 2005 had done better than the S&P 500 and its equivalent European benchmarks by 3 to 4 per cent annually after fees.

In a recent study, Lopez-de-Silanes and co-authors (2009)²¹⁵ examined a sample of 7,453 investments made in 81 countries by 254 private equity firms between 1971 and 2005, finding a dramatic dispersion of returns: one in ten investments did not return any money, one in four had an IRR²¹⁶ above 50 per cent and quick flips provided the highest returns. The authors documented a strong negative association between performance and duration – short holding periods of less than two years generated an average IRR of 79 per cent, whereas for the investments held longer than four years the IRR was 10 per cent. This implies that the highest returns were generated by the cyclical quick flips and not the long-lived investments.²¹⁷ The

²¹¹ Robert S. Harris, Tim Jenkinson & Steven N. Kaplan, *Private Equity Performance: What Do We Know?* (National Bureau of Economic Research Working Paper No. 17874, Feb. 2012), http://www.nber.org/papers/w17874.pdf?new_window=1.

²¹² This finding appears to be consistent with the 2013 quarterly performance update released by the Private Equity Growth Capital Council which shows that private equity returns (net of fees) outperformed the S&P 500 (including dividends) for 3-year, 5-year and 10-year horizons by 2.6, 2.2 and 6.1 percentage points, respectively. This emphasises further the superior investment performance of private equity; see *Private Equity Performance Update* (Private Equity Growth Capital Council, Nov. 2013), <http://www.pegcc.org/wordpress/wp-content/uploads/2013-Q1-Performance-Update.pdf>.

²¹³ *Id.*

²¹⁴ Tim Jenkinson, Robert Harris & Steven Kaplan, *How Do Private Equity Investments Perform Compared to Public Equity?*, 14(3) J. INV. MANAGE. 1 (2016).

²¹⁵ Florencio Lopez-de-Silanes, Ludovic Phalippou & Olivier Gottschalg, *Giants at the Gate: Investment Returns and Diseconomies of Scale in Private Equity* (Aug. 2, 2013), <http://ssrn.com/abstract=1363883>.

²¹⁶ Performance is frequently reported as the annualised rate of return of all corresponding cash flows, namely, IRR.

²¹⁷ One could yield to temptation and claim that PE fund managers sacrifice long-term investments in favour of more short-term gains. Nevertheless, it is plausible to argue that temporary owners would have no incentives to sacrifice long-run value and investments as this would subsequently depress the exit valuation of their portfolio company. Whilst companies that are quickly flipped have the capacity to generate profits and this strategy may be

study also illuminated substantial underperformance of investments in emerging countries (which may be surprising due to their recent spectacular growth), the fact that small investments outperform large ones and that substantial diseconomies of scale are present in private equity (returns fall as the number of simultaneous investments increases). In view of the last finding, it appears that structural features curtail information flows, suggesting that less hierarchical private equity firms with significant pools of money and few investments should produce high returns.

In relation to shareholder returns, a range of US studies in the 1980s found a large abnormal gain for the target's shareholders in public-to-private LBO announcements. DeAngelo and co-authors (1984)²¹⁸ examined the average effect on public shareholder wealth of going-private proposals made by 72 New York Stock Exchange (NYSE) and American Stock Exchange (Amex) firms over the period 1973-1980. The authors reported that the proposal to take a company private increased the wealth of its public shareholders by an average of 30.4 per cent and decreased by an average of 8.8 per cent at withdrawal of going-private proposal. This reflects the potential gains that the transaction can generate by reducing registration, listing and other shareholder servicing costs and by introducing an ownership structure that improves incentives for the decision-makers.²¹⁹ Other US studies on premiums paid in public-to-private transactions include: Lowenstein (1985)²²⁰ who reported a 56 per cent mean premium based on 28 MBOs between 1979 and 1984; Amihud (1989)²²¹ who reported a 42.9 per cent mean premium based on 15 MBOs between 1983 and 1986; Asquith and Wizman (1990)²²² who reported a 37.9 per cent mean premium based on 47 going private transactions between 1980 and 1988; Harlow and Howe (1993)²²³ who reported a 44.9 per cent mean premium based on 121 going private transactions between 1980 and 1989; Travlos and Cornett (1993)²²⁴ who reported a 41.9 per cent mean premium based on 56 going private transactions between 1975

viable under certain circumstances (e.g. to reduce losses as financial economy deteriorates in time of crisis), the majority of studies in this area unequivocally demonstrate that PE investments are held for a medium to long term and quick flips display no increase in frequency over time; see Per Strömberg, *supra* note 32.

²¹⁸ Harry DeAngelo et al., *supra* note 65.

²¹⁹ Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698 (1982).

²²⁰ L. Lowenstein, *supra* note 123.

²²¹ YAKOV AMIHU, *LEVERAGED MANAGEMENT BUYOUTS AND SHAREHOLDERS' WEALTH* (1989).

²²² P. Asquith & T. Wizman, *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts*, 27 J. FINANC. ECON. 195 (1990).

²²³ W.V. Harlow & J.S. Howe, *Leveraged Buyouts and Insider Nontrading*, 22 FINANC. MANAGE. 109 (1993).

²²⁴ N.G. Travlos & M.M. Cornett, *Going Private Buyouts and Determinants of Shareholders' Returns*, 8 J. ACCOUNT. AUDIT. FINANCE 1 (1993).

and 1983; and Easterwood and co-authors (1994)²²⁵ who reported a 32.9 per cent mean premium based on 184 MBOs between 1978 and 1988.

More recently, Renneboog, Simons and Wright (2007)²²⁶ analysed 177 UK public-to-private transactions (MBOs, MBIs and IBOs) from 1997 to 2003 and reported that pre-transaction shareholders on average received a premium of about 41 per cent and the share price reaction to the public-to-private announcement was about 30 per cent. The authors explained that the wealth gains resulted from the undervaluation of the pre-transaction target company, incentive realignment and increased interest tax shields. The findings of this study are in line with the previous US evidence from the 1980s where the premium was documented to range from 33 to 56 per cent and a different relatively recent UK study by Weir and co-authors (2000)²²⁷ which showed a premium of 45 per cent. Regarding long-run performance of IPOs backed by PE funds, von Drathen and Faleiro (2007),²²⁸ using a sample of 128 LBO-backed IPOs and 1,121 non-LBO-backed IPOs that listed in the UK during 1990 and 2006, found that the former outperformed the stock market and other IPOs, creating wealth for equity holders in the long run (three years following the IPO exit).

4.7 Ownership Change and Management Practices

Private equity is an asset class that has received considerable attention recently because of its perceived exceptional returns. The industry has become a mammoth, both in terms of assets under management and transaction size, and has been termed the new king of capitalism in a 2004 cover story of *The Economist*.²²⁹ Buyout firms provide a solution to the corporate governance problems which have blighted many of the listed companies. Henry Kravis once remarked, 'If you examine all the major corporate scandals of the past 25 years, none of them occurred where a private equity firm was involved.'²³⁰ The empirical evidence on the operating performance and managerial practices of private equity portfolio companies (LBOs) is largely

²²⁵ J. Easterwood et al., *Controlling the Conflict of Interest in Management Buyouts*, 76 REV. ECON. STAT. 512 (1994).

²²⁶ Luc Renneboog, Tomas Simmons & Mike Wright, *supra* note 118.

²²⁷ M. Wright et al., *The Development of an Organisational Innovation: Management Buy-outs 1980-1997*, 42(4) BUS. HIST. 137 (2000).

²²⁸ Christian von Drathen & Flaviano Faleiro, *The Performance of Leveraged Buyout-Backed Initial Public Offerings in the UK* (London Business School Working Paper, Second Version, Dec. 2007), https://www.researchgate.net/publication/228256033_The_Performance_of_Leveraged_Buyout-Backed_Initial_Public_Offerings_in_the_UK.

²²⁹ *Private Equity: Capitalism's New King*, *supra* note 8.

²³⁰ Henry Kravis at The Private Equity Conference in New York (Sept. 22, 2004), reported in ROBERT A.G. MONKS & NELL MINOW, *CORPORATE GOVERNANCE* 125 (5th ed., 2011).

positive. But exactly what type of changes follow from private equity ownership and management?

Buyouts can increase returns by implementing ownership change and renewed mechanisms of corporate governance.²³¹ Denis (1994)²³² provided evidence that higher managerial ownership and improved incentive compensation arranged by a specialised fund manager lead to greater post-LBO value creation. This finds confirmation in a paper by Holthausen and Larcker (1996)²³³ who argued that it was the organisational form created by the LBO that engendered the managerial incentive to create shareholder wealth. Cuny and Talmor (2006)²³⁴ concluded their paper by stating that where the board chooses to go the private equity route, it is more likely that a turnaround will be successful. New owners are temporary and do not have a close relationship with the incumbent managers. This gives them an advantage in considering all turnaround possibilities, including those that would lead to the replacement of the existing managers.

Certainly, buyouts involve radical changes in the corporate governance of portfolio firms as fund managers become active investors through taking board seats and requiring detailed reports from the incumbent management.²³⁵ They not only provide advice, transactional dexterity, technical support and direction drawing on their prior restructuring experience and contacts they have with law firms, consultants and accountants, but also use their power to replace executives. The replacement of inefficient management teams frequently leads to improvements in operational effectiveness.²³⁶ Poor performance, which fits in the logic of the market for corporate control,²³⁷ may be the result of such inefficient management teams. Thus, buyouts can be seen as a vehicle to take over sub-performing companies and change their management teams, hence eliminating the cause of this type of underperformance.

Boards of portfolio companies tend to be smaller than comparable boards in quoted companies and meet more frequently. This in turn leads to a more dynamic and challenging boardroom

²³¹ Miguel Meuleman, Kevin Amess, Mike Wright & Louise Scholes, *Agency, Strategic Entrepreneurship, and the Performance of Private Equity-Backed Buyouts*, 33 ENTREP. THEORY PRACT. 213 (2009).

²³² D.J. Denis, *supra* note 115.

²³³ R.W. Holthausen & D.F. Larcker, *The Financial Performance of Reverse Leveraged Buyouts*, 42 J. FINANC. ECON. 293 (1996).

²³⁴ Charles J. Cuny & Eli Talmor, *A Theory of Private Equity Turnarounds*, 13 J. CORP. FINANCE 629 (2006).

²³⁵ Geoffrey Wood & Mike Wright, *Private Equity: A Review and Synthesis*, 11(4) INT. J. MANAG. REV. 361 (2009).

²³⁶ George Anders, *The Barbarians in the Boardroom*, 70(4) HARV. BUS. REV. 79 (1992).

²³⁷ Henry G. Manne, *Mergers and the Market for Corporate Control*, 73(2) J. POLIT. ECON. 110 (1965).

style. Cotter and Peck (2001)²³⁸ found, amongst other things, that buyout specialists have greater board representation on boards they control, especially smaller ones. This is suggestive of the fact that they monitor managers more effectively due to having more seats. These findings support a statement that buyout specialists are more active monitors than other outside controlling investors, and Yermack (1996)²³⁹ provides evidence that smaller boards are more elective than larger ones. In a different study, Acharya and Kehoe (2008)²⁴⁰ confirmed that private equity firms frequently bring in new management, reporting that one-third of chief executive officers (CEOs) were replaced in the first 100 days and two-thirds were replaced at some point over a four-year period. PE investors did not hesitate to lay off poorly performing managers also. What is more, the authors reported that companies in a PE firm's portfolio have 12 formal meetings a year and many more informal contacts.

Further, Cornelli and Karakas (2008)²⁴¹ analysed the size, composition and evolution of boards in 142 UK public-to-private firms between 1998 and 2003. The authors found that after the transaction, CEO turnover increased in 45 per cent of LBO companies, suggesting that LBOs occur in companies that underperform and the CEO often loses his job following the change. Gong and Wu (2011)²⁴² reported CEO turnover rate of 51 per cent within two years of leveraged buyout. The authors argued that buyout firms play a disciplinary role by removing entrenched CEOs or those who cause agency problems, subsequently appointing the most skilled and talented executives as CEOs to lead the portfolio companies. Fund performance is significantly related to the experience of the individual fund managers, especially in later-stage buyouts (MBOs).²⁴³

What is important is the fact that buyout firms do not maintain their private ownership status indefinitely.²⁴⁴ Rather, the private owners execute a reverse buyout by returning the privately

²³⁸ James F. Cotter & Sarah W. Peck, *supra* note 148, at 101, 102. The authors used a sample of 64 leveraged buyouts completed between 1984 and 1989.

²³⁹ D. Yermack, *Higher Market Valuation of Companies with a Smaller Board of Directors*, 40 J. FINANC. ECON. 185 (1996).

²⁴⁰ Viral V. Acharya & Conor Kehoe, *Corporate Governance and Value Creation: Evidence from Private Equity* (May 31, 2008), <https://www.jstor.org/stable/23356858?seq=1>. The results are for the United Kingdom in respect of 59 large buyouts (with a median transaction value of over \$500 million) from 1996 to 2004.

²⁴¹ F. Cornelli & Ö. Karakas, *Private Equity and Corporate Governance: Do LBOs Have More Effective Boards?* (The Global Economic Impact of Private Equity Report, 2008), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102467.

²⁴² James Jianxin Gong & Steve Yuching Wu, *CEO Turnover in Private Equity Sponsored Leveraged Buyouts*, 19(3) CORP. GOV. 195 (2011).

²⁴³ Daniel Schmidt, Eric Nowak & Alexander Knigge, *On the Performance of Private Equity Investments: Does Market Timing Matter?*, (Mar. 2004), <http://ssrn.com/abstract=492982>.

²⁴⁴ S.N. Kaplan, *supra* note 162.

held firm to public trading.²⁴⁵ The IPO of the previously privately held LBO firm is known as a second initial public offering (SIPO), whereby a firm makes its first public offering after previously completing an LBO.²⁴⁶ Bruton, Keels and Scifres (2002)²⁴⁷ traced the performance and restructuring activities of 39 firms from the time preceding the buyout through the private buyout period and into the public reverse buyout period. The authors found that a substantial percentage of these privately held buyouts ultimately returned to public trading, implying that a buyout firm typically goes through a public–private–public cycle of ownership. It was found that buyouts had led to positive performance changes whilst the firm was privately held due to improvements in ownership. What is worthy of note is that agency costs that were eliminated or minimised during the buyout period did not reappear immediately following a reverse buyout – the authors reported that it took reverse buyout firms several years to experience performance declines associated with the agency costs of public ownership.

Gottschalg and Wright (2008)²⁴⁸ showed recently that some PE firms repeatedly create real and lasting value through their investments, finding that buyouts enhance the competitive position and long-term prospects of the acquired companies. Fund managers work actively with the management of their portfolio companies in order to improve strategy and operational effectiveness. The study found that fund managers help their targets build better businesses due to their deep expertise in executing buyout transactions, making the important decisions right during the deal and post-completion. An additional factor that improves business performance is a clear strategic focus on the target industry which allows fund managers to develop and leverage expertise. Further, clear and honest communication facilitates the creation of motivation which is necessary to meet ambitious business plans and helps to forge a strong and trust-based relationship between the target company management and private equity investors. Similarly, Bruining, Vervaaal & Wright (2011) discovered that private equity firms can be viewed as an ambidextrous financier, in the sense that they significantly increase entrepreneurial management to create more economic value and simultaneously facilitate administrative management to reduce the risks of high leverage.²⁴⁹ Both management practices

²⁴⁵ S. Mian & J. Rosenfeld, *Takeover Activity and the long-Run Performance of Reverse Leveraged Buyouts*, 22(4) FINANC. MANAGE. 46 (1993).

²⁴⁶ R.W. Holthausen & D.F. Larcker, *supra* note 233.

²⁴⁷ Garry D. Bruton, J. Kay Keels & Elton L. Scifres, *Corporate Restructuring and Performance: An Agency Perspective on the Complete Buyout Cycle*, 55(9) J. BUS. R. 709 (2002).

²⁴⁸ Oliver Gottschalg & Mike Wright, *Understanding the Buyers' Role in Private Equity Returns – The Influence of Skills, Strategy and Experience* (The Private Equity Forum in Paris, Mar. 4, 2011).

²⁴⁹ Hans Bruining, Ernst Verwaal & Mike Wright, *Private Equity and Entrepreneurial Management in Management Buy-Outs*, 40(3) SMALL BUS. ECON. 591 (2013).

allow PE-backed buyouts to benefit from greater strategic orientation, reward philosophy, resource and growth orientation, management structure and entrepreneurial culture.

Finally, an increase in employment, productivity and long-run investment can be achieved through additional capital and improved knowledge of management practices. Do private equity firms offer such benefits? Boucly and co-authors (2011)²⁵⁰ found that PE firms contribute with knowledge regarding management practices and this could subsequently lead to improvements in productivity. Bloom, Sadun and van Reenen (2009)²⁵¹ examined recently management practices across 4,000 PE-owned and other firms in a sample of medium-sized manufacturing firms in Asia, Europe and the US and tried to determine whether PE ownership improves management practices by introducing new managers and better practices. The authors found that PE-backed firms are on average the best managed group, significantly better managed than government-, family- and privately-owned firms, and they tend to be particularly apt at operational management practices.²⁵² Accordingly, buyout firms were particularly strong at adopting modern lean manufacturing practices and using continuous improvements. What is significant, even when companies with strong operations management practices were acquired PE owners did not degrade them.

4.8 Risk of Bankruptcy and Distress

A stable financial system is a central element of a healthy corporate sector. By contrast, a distressed corporate sector can deteriorate the health of the financial system. One of the criticisms of private equity includes the increased risk of bankruptcy which arises from high levels of debt. Thus, it is worth analysing whether there is a study that would report a clear connection between a private equity deal and an increase in the probability of bankruptcy.

To start with, bankruptcy is costly for fund managers since this means losing reputation and the benefits of control.²⁵³ For this reason, high level of leverage and increased risk of default can create an incentive for private equity managers to work harder, make better investment decisions, consume fewer perquisites and adopt actions and behaviours that reduce the

²⁵⁰ Quentin Boucly, David Sraer & David Thesmar, *supra* note 176.

²⁵¹ Nick Bloom, Rafaella Sadun & John van Reenen, *Do Private Equity-Owned Firms Have Better Management Practices?* (July 2009), <http://cep.lse.ac.uk/pubs/download/occasional/op024.pdf>.

²⁵² These findings have also been reported in *Globalization of Alternative Investments Working Papers Volume 2: The Global Economic Impact of Private Equity Report 2009* 1-24 (World Economic Forum, Jan. 2009), http://www3.weforum.org/docs/WEF_IV_PrivateEquity_Report_2009.pdf.

²⁵³ Sanford J. Grossman & Oliver D. Hart, *supra* note 150.

likelihood of bankruptcy. In one of the earlier studies, Jensen (1989) stated that LBOs do get into financial trouble more frequently than their public counterparts, but he also stressed that only few LBOs ever enter formal bankruptcy.²⁵⁴ Several years later, it was found that only a fraction of buyouts have negative consequences, resulting predominantly from transactions orchestrated by less capable investors who lack the requisite ability to guide the acquired company through the restructuring and growth process.²⁵⁵

More recently, Kaplan and Strömberg (2009)²⁵⁶ examined 17,171 buyouts undertaken on a global scale between 1970 and 2007. They found that 6 per cent of all transactions has ended in reorganisation or bankruptcy. The annual bankruptcy rate of 1.2 per cent was lower than the average default rate of 1.6 per cent for US corporate bond issuers between 1980 and 2002, but higher than the 0.6 per cent bankruptcy rate for US public companies reported by Wright and co-authors (2009).²⁵⁷ Further, a study of 839 buyouts in France during 1994 and 2004 by Boucly and co-authors (2011)²⁵⁸ revealed no increase in bankruptcy rates following a buyout as compared to their control group. According to the paper, 3.5 per cent of both buyout firms and those in the comparison group ended up in bankruptcy within three years of the transaction. A study by Kaplan and Stein (1993)²⁵⁹ shows that bankruptcy rate varies with the business cycle. The authors analysed 41 US MBOs between 1980 and 1984, finding that only 2 per cent (one firm) defaulted, and in a sample of 83 MBOs between 1985 and 1989 27 per cent defaulted and almost 11 per cent ended up in bankruptcy. The authors attributed the defaults to poorly designed capital and incentive structures. Jensen (1991)²⁶⁰ argued that regulatory shocks and an economic downturn may also play a role, which is in line with Singh (1990, 1993)²⁶¹ who argued that unforeseen shocks can result in a dramatic corporate failure. Andrade and Kaplan (1998)²⁶² demonstrated that even if a default on debt takes place, it may not have any real effect. The authors found that 23 per cent of highly leveraged transactions of the 1980s defaulted at

²⁵⁴ Michael C. Jensen, *supra* note 35.

²⁵⁵ Oliver Gottschalg, *supra* note 54.

²⁵⁶ Steven N. Kaplan & Per Strömberg, *supra* note 10, at 121.

²⁵⁷ Mike Wright, John Gilligan & Kevin Amess, *The Economic Impact of Private Equity: What We Know and What We Would Like To Know*, 11(1) VENTURE CAPITAL 1 (2009).

²⁵⁸ Quentin Boucly, David Sraer & David Thesmar, *supra* note 176.

²⁵⁹ Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and Financial Structure in the 1980s*, 108 Q. J. ECON. 313 (1993).

²⁶⁰ Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4 J. APPL. CORP. FINANCE 13 (1991).

²⁶¹ Harbir Singh, *Management Buyouts: Distinguishing Characteristics and Operating Changes Prior to Public Offering*, 11 STRAT. MANAGE. J. 111 (1990); Harbir Singh, *Challenges in Researching Corporate Restructuring*, 30 J. MANAGE. STUD. 147 (1993).

²⁶² Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence From Highly Leveraged Transactions that Became Distressed*, 53 J. FINANCE 1443 (1998). The authors studied the effects and sources of financial distress for 31 highly leveraged transactions from Kaplan and Stein (1993).

some point; however, these buyout firms experienced a small increase in value from pre-transaction to distress resolution, suggesting that the net effect of the buyout and distress left value slightly higher.

For the UK, Wilson and co-authors (2012)²⁶³ found that PE-backed companies performed more strongly than a matched sample of listed and private companies before and during the recession (in terms of productivity and profitability) and that the failure rate for PE-backed buyouts was lower than for non-PE-backed buyouts and no worse than the population of companies as a whole. A study by Lopez-de-Silanes and co-authors (2013)²⁶⁴ adopted a more global approach and reported that approximately 10 per cent of all transactions in their sample ended up in bankruptcy. The bankruptcy rate varied from country to country, with 5 per cent in Scandinavian countries, 8 per cent in France, 9 per cent in the UK, 12 per cent in the US and 13 per cent in Germany. Last, but not least, Demiroglu and James (2010)²⁶⁵ reported that buyouts sponsored by high reputation PE firms are less likely to experience financial distress during the five years following the transaction. Thus, the evidence on private equity distress and bankruptcy is mixed and probably more time is needed to obtain a full picture of the effects of the recent downturn on buyouts, especially that not all investments have been exited.

4.9 Long Term Investment: R&D and Patents

The empirical evidence tends to be contradictory as to the impact of buyouts on long-run investments which can be expressed through expenditures on research and development and patenting intensity. Seth and Easterwood (1993)²⁶⁶ argued that heavy debt influences R&D investments negatively because of its constraining effect on both strategic and financial flexibilities. Reich (1989)²⁶⁷ claimed that the high level of debt associated with an LBO forces companies to reduce needed capital and R&D investments to service debt payments, consequently damaging their long-run efficiency and competitive position. Further, Long and Ravenscraft (1993)²⁶⁸ found a negative effect of LBOs on R&D expenditures. The study was

²⁶³ Nick Wilson et al., *supra* note 200.

²⁶⁴ Florencio Lopez-de-Silanes, Ludovic Phalippou & Olivier Gottschalg, *supra* note 215.

²⁶⁵ Cem Demiroglu & Christopher M. James, *The Role of Private Equity Group Reputation in LBO Financing*, 96(2) J. FINANC. ECON. 306 (2010).

²⁶⁶ John Easterwood & Anju Seth, *Strategic Restructuring in Large Management Buyouts*, 6(1) J. APPL. CORP. FINANCE 25 (1993).

²⁶⁷ Robert B. Reich, *Leveraged Buyouts: American Pays the Price* (N.Y. TIMES, Jan. 29, 1989), <http://www.nytimes.com/1989/01/29/magazine/leveraged-buyouts-american-pays-the-price.html?src=pm&pagewanted=1>.

²⁶⁸ William F. Long & David J. Ravenscraft, *LBOs, Debt and R&D Intensity*, 14 STRAT. MANAGE. J. 119 (1993).

based on 72 LBOs with R&D spending and 126 LBOs without any R&D spending between 1981 and 1987. The authors found that LBOs tended to occur in less R&D-intense companies and the decrease in R&D expenditures after the buyout was around 40 per cent. The companies that reduced their R&D spending tended to do worse than those that did not. The reduction in innovation effort was mainly attributable to the increase in financial leverage following the deal, rather than a short-term strategy pursued by investing funds. Further, Hao and Jaffe (1993)²⁶⁹ found that more debt reduced R&D spending only for the very smallest firms, whereas for larger firms the causal relationship was ambiguous.

By contrast, Lichtenberg and Siegel (1990)²⁷⁰ found that the average R&D-intensity of LBO firms increased substantially during 1978-1986, casting doubt on the hypothesis that LBOs are associated with reductions in the firm's propensity to invest in R&D. Similarly, Hall (1990),²⁷¹ who analysed 80 LBOs between 1977 and 1988, found that buyouts have the tendency to occur in sectors with little R&D investment and innovation, and where this sort of firm undergoes a buyout, the same pattern of R&D spending is maintained following the deal (contrary to reductions resulting from corporate acquisitions with high leverage). Smith (1990)²⁷² examined post-buyout performance of around 58 MBOs completed during 1977-1986 and found that after the transaction, the acquired firms' cash flows increased significantly, without negatively impacting other operating key variables, such as R&D. This is consistent with the findings of Opler (1992)²⁷³ who arrived at the same conclusion having studied 44 public-to-private LBOs between 1985 and 1989.

Further support for the hypothesis that private equity investments are not detrimental to long-term investments in R&D and innovation is given by Zahra (1995).²⁷⁴ His study of 47 US MBOs found no negative effects on R&D spending – private ownership solves the agency problem and so has a positive impact on innovation as managers have strong incentives to create more wealth for themselves and the firm. Thus, MBO firms make a more effective use of R&D

²⁶⁹ Kenneth Y. Hao & Adam B. Jaffe, *Effect of Liquidity on Firms' R&D Spending*, 2 ECON. INNOVATION NEW TECH. 275 (1993).

²⁷⁰ Frank R. Lichtenberg & Donald S. Siegel, *supra* note 160.

²⁷¹ Bronwyn Hall, *The Impact of Corporate Restructuring on Industrial Research and Development*, 1 B.P.E.A. 85 (1990).

²⁷² Abbie J. Smith, *supra* note 156. The author's study found that operating returns increased significantly from the year before to the year after the buyout as measured by operating cash flows, and that the increase was not attributable to layoffs or reductions in expenditures in relation to R&D, maintenance and repairs, advertising or property, plant and equipment.

²⁷³ Tim C. Opler, *supra* note 159.

²⁷⁴ Shaker A. Zahra, *Corporate Entrepreneurship and Financial Performance: The Case of Management Leveraged Buyouts*, 10 J. BUS. VENTURING 225 (1995).

expenditure and new product development, giving credence to the view that private equity fund managers provide superior managerial and technical expertise that enables acquired firms to seize new opportunities. This finding is similar to one by Wright and co-authors (1992)²⁷⁵ who showed that 62 per cent of surveyed UK buyout firms reported that the buyout enabled them to develop new products that would otherwise not have been developed. Therefore, the two aforementioned studies seem to demonstrate that buyouts significantly increase new product development and other aspects of corporate entrepreneurship which take place following the buyout.

Regarding investment in innovation, Lerner, Sorensen and Strömberg (2011)²⁷⁶ examined 495 US LBOs undertaken between 1983 and 2005 and linked them to patents and patent citations from the US Patent and Trademark Office. The authors' main finding was that firms pursue more influential innovations, as measured by patent citations, in the years following private equity investments. Investigated buyout firms displayed no deterioration in their research, as measured by patent originality and generality, and the level of patenting did not seem to change after LBOs. What is more, the patent portfolios became more focused following the buyout, and the increase in patent quality was found to be largest in the patent classes where the buyout firm had been focused historically. This study – in showing that PE investments seem to beneficially refocus firms' innovative portfolios – is inconsistent with the hypothesis that PE fund managers sacrifice long-run investments and more sustained long-term growth by promoting policies that boost the firm's short-run performance.

Last, but not least, Ughetto (2010)²⁷⁷ used a cross-country sample and analysed the patenting activity of 681 Western European manufacturing firms which underwent a buyout between 1998 and 2004. The author found that out of the 681 firms studied, 200 were granted a European patent in the timeframe considered and 55 per cent of these patenting firms were granted a patent after the buyout. It emerged from the study that 57 per cent of the sample firms had up to 4 patents, 19.5 per cent had between 5 and 10 patents and 23.5 per cent had more than 10 patents. The highest number of firms with at least one patent granted was found in the UK (25.5%) – which is not surprising given that it is the largest buyout market in Europe – followed by France (24.5%) and Germany (23%). The patenting activity increased the most in syndicated

²⁷⁵ Mike Wright, Steve Thompson & Ken Robbie, *supra* note 167.

²⁷⁶ Josh Lerner, Morten Sorensen & Per Strömberg, *Private Equity and Long-Run Investment: The Case of Innovation*, 66 J. FINANCE 445 (2011).

²⁷⁷ Elisa Ughetto, *Assessing the Contribution to Innovation of Private Equity Investors: A Study on European Buyouts*, 39 RESEARCH POL'Y 126 (2010).

buyouts, and the co-location of the target firm and PE investors in the same country did not correlate with patenting intensity.

4.10 Longevity of PE Investments

There is a widespread belief that buyouts are not only synonymous with downsizing, layoffs and restructurings, but also short-term time horizons for their investments. It is examined next whether private equity only offers a short-term strategy.

Based on a sample of 183 large US public-to-private transactions from 1979 to 1986, Kaplan (1991)²⁷⁸ found that as time since the buyout increases, the percentage of LBO firms that return to public ownership increases too. The median time an LBO remained private equalled 6.7 years, suggesting that LBOs are neither short-lived nor permanent, but represent a transitory organisational form. The author documented that almost 50 per cent of LBOs became publicly owned by eighth year following the buyout. This finding debunks the view that PE investments are short-lived.

Van de Gucht and Moore (1998),²⁷⁹ having examined a sample of 343 LBOs that were completed during the period 1980-1992, ambiguously support Kaplan's findings. The authors investigated the duration of the LBOs and their probability of eventual reversal and found that not all LBO firms will reverse. The reversal probabilities were found to increase over the first seven or eight years after the transaction and thereafter this probability declines and goes to zero for some LBO firms. It was further found that the climate of the financial markets significantly influences the reversion moment. Wright and co-authors (1994)²⁸⁰ also analysed the duration of UK buyouts, buy-ins and non-quoted firms, showing results in line with US findings.

A 2007 study by Gottschalg²⁸¹ identified 4,701 individual buyouts (realised and ongoing) made between 1971 and 2004 and found that two-thirds of them were re-sold in less than six years and the average holding period of the 2,798 realised buyouts was 5.3 years. Worthy of note is the fact that quick flips were the exception rather than the rule. The author also observed that PE fund commitments compared favourably to investors in public equity and, interestingly, at

²⁷⁸ S.N. Kaplan, *supra* note 162.

²⁷⁹ L.M. van de Gucht & W. T. Moore, *Predicting the Duration and Reversal Probability of Leveraged Buyouts*, 5 J. EMPIR. FINANCE 299 (1998).

²⁸⁰ Mike Wright et al., *Longevity and the Life Cycle of Management Buy-Outs*, 15 STRAT. MANAGE. J. 215 (1994).

²⁸¹ Oliver Gottschalg, *supra* note 54.

the end of the fifth year, in more than 45 per cent of cases, buyout investors were still involved as majority shareholders, whereas 88 per cent of the initial blockholders (who own more than 5 per cent of the issued equity) disappeared from the blockholder base of the public company.²⁸²

Strömberg (2007)²⁸³ assessed the consequences of buyout investments having examined the exit strategy and holding periods for an international sample comprising 21,397 LBOs during 1970-2007. The author reported that the holding period for the secondary buyout (a sale of a portfolio firm from one PE firm to another) is remarkably long – more than nine years, suggesting that holding periods have increased since the 1980s. Further, he observed that holding periods have increased over time, that is, six to seven years in the 1980s and nine years between 1995 and 1999; MBOs remain in private ownership for more than 10 years, whereas LBOs in continental Europe are less likely to leave the private status. The exceptions with short longevity are divisional LBOs and those backed by experienced funds.

Last, but not least, Jelic (2011)²⁸⁴ presented UK evidence on the duration of private equity-backed and pure buyouts, finding evidence to support the view that buyouts offer a long- rather than short-term organisation form. The longevity of buyouts is influenced by a range of factors, such as buyout characteristics (for example, size and industry), characteristics of private equity backing (for example, syndicated and highly leveraged transactions), source of the buyouts (for example, privatisation and receivership), together with stock market and private equity market conditions. The authors reported that 56 per cent of pure buyouts remained in private ownership for at least seven years following the original transaction, and 36 per cent of buyouts remained in any buyout organisational form at least 10 years following the original transaction. This evidence seems to disprove the alleged short-termism of UK PE firms, with early exits being associated with AIM²⁸⁵ IPOs of relatively small buyouts.

To encapsulate, the above empirical studies appear to suggest that buyout firms use the change in organisational form over the medium to long term to achieve gains and generate performance improvements. This runs counter to claims that PE firms are mere corporate raiders striving for high short-term profits at the expense of long-term prospects of their portfolio companies.

²⁸² *Id.* at 22.

²⁸³ Per Strömberg, *supra* note 32.

²⁸⁴ Ranko Jelic, *supra* note 80, at 945, 983. The author examined 1,089 private-equity-backed and non-private equity backed UK buyouts between 1966 and 2004.

²⁸⁵ UK Alternative Investment Market (AIM) is the junior market to the London Stock Exchange, designed for small, fast-growing companies.

5. Conclusion

The arrival of private equity is a relatively new stage in capitalism. The industry, however, has quickly positioned itself at the centre of corporate finance and M&A activity globally. It remains a source of mystery and so may appear unusual and perplexing, offering an approach to managing a company that is distinct from the Berle and Means paradigm firm with its fundamental separation of ownership and control.²⁸⁶ It has been argued that private equity eliminates the gap between ownership and control and the agency problems and costs that result from it, hence resolving the failings of public companies that Berle and Means first identified. This is done by concentrating ‘agents’ (managers) and ‘principals’ (owners, outside shareholders) in a single institution,²⁸⁷ so that management in a firm are no longer under-incentivised and weakly monitored and controlled. This marks an evolution in the efforts of a group of sophisticated players in the economy who engage in new methods of managing and controlling the process of creating and appropriating value from the company’s workers on behalf of fund investors (that is, limited partners).

Therefore, private equity addresses a ‘critical vacuum in governance’²⁸⁸ where no one actually takes on the responsibility of company ownership. This is succinctly encapsulated in the words of Paul Myners CBE who, having chaired an unlisted company financed by private equity, had been struck by the degree to which private equity ownership model leads to strong and effective governance focused on the aligned interest of company owners and management. He observed that everyone was working to a common agenda with shareholders fully engaged on strategic matters and in receipt of complete and timely management information.²⁸⁹ This contrasts with a public company where shareholder engagement on strategy is ‘almost non-existent (reactive at best) and reporting is formulaic and limited in its inter-activity.’²⁹⁰ The concentration of control allows a far greater degree of control, and fund managers not only have expertise and deep understanding of the market, but they also adopt a heuristic-based approach to decision-making, allowing them more quickly to make sense of uncertain and complex situations where information is limited and to navigate a plethora of problems and irregularities which are inherent in the development of new opportunities. Notably, private equity firms tend to hire

²⁸⁶ ADOLF A. BERLE & GARDINER C. MEANS, *supra* note 119.

²⁸⁷ This is an Anglo-American model of capitalism. Interestingly, in continental Europe and Asia, companies continue to rely on state, family and closely networked ownership forms.

²⁸⁸ Paul Myners CBE, *Perspectives on Corporate Governance* (lecture, Cambridge, May 8, 2003).

²⁸⁹ *Id.*

²⁹⁰ *Id.*

senior personnel or distinguished individuals from established blue-chip companies who are then parachuted in to existing portfolio companies to augment the skills of the incumbent managers.²⁹¹ This indubitably helps maximise company value.

Private equity has an isomorphic force. It increasingly influences public markets and in the same fashion the boards and management teams of many public companies start to effect changes in their behaviour and emulate some of the techniques successfully deployed by PE fund managers.²⁹² Since a company's structure is not immutable, it may reorganise and alter its capital structure as well as implement changes in its ownership and control. Thus, private equity business will continue to function until a new, better form of organising economic activity is established. For now, however, sophisticated private equity players combine financial expertise with operational know-how to engineer greater returns. For instance, KKR has rewarded its investors over a span of 20 years with a 23.5 per cent annual return, compared with approximately 15 per cent for the stock market index (S&P 500),²⁹³ and LBOs have created a new and superior form of corporate governance for mature industries characterised by active monitoring by external management and high-powered executive compensation, both of which have facilitated the increase of the acquired company's overall efficiency.

Overall, the literature reviewed suggests that PE firms are an important part of the economy by providing finance and good corporate governance for the efficient revitalisation of underperforming companies. The poorly performing transactions are predominantly carried out by less experienced and capable fund managers who lack the requisite ability to manage the acquired business through the restructuring and growth phases. Further, the negative image of PE firms is not supported by academic literature,²⁹⁴ and there is no compelling evidence to suggest that buyouts significantly increase the bankruptcy rate, even at the time of crisis, or

²⁹¹ Justin Bickle, *supra* note 26, at 14. The PE industry attracts some of the world's most talented managers. For instance, Jack Welch, former CEO of General Electric has joined Clayton, Dubilier & Rice (one of the world's oldest private equity firms founded in 1978), and Lou Gerstner, who revived IBM, has joined The Carlyle Group (one of the world's largest private equity firms); see *Private Equity: Capitalism's New King*, *supra* note 8.

²⁹² Chris Hale, *supra* note 28, at 7 (quoting Sally Dewar, director of markets division at the FSA). Moreover, there is evidence that private equity investments have significant industry spillovers. Positive externalities created by PE firms are absorbed by other companies in the same industry, especially in relation to employment, profitability and labour productivity, and the effects are especially pronounced in countries that have stronger legal institutions as this is where fund managers can better implement their value-adding strategies; see Serdar Aldatmaz, *supra* note 201.

²⁹³ *ECONOMIST* (Aug. 2, 1997), at 77.

²⁹⁴ See Sebastian Ernst & Christian Koziol, *Are Private Equity Investors Boon or Bane for an Economy? – A Theoretical Analysis* 2-3 (Oct. 2009), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2208338.

contribute to significant declines in employment. Therefore, most of the typical concerns expressed by industry critics appear unwarranted.

The next two chapters examine a sample of key measures at both EU level and national level (based on a UK example due to the prominence of private equity activity in that country), respectively, providing evidence that a wide regulatory universe of rules applied directly or indirectly to the activities of private equity firms in the pre-AIFMD world.

Chapter III

The EU Pre-AIFMD Regime

1. Introduction

The establishment of a truly integrated European single market, in particular in financial services with a single regulatory approach, has been a long-standing strategic objective of the European Union (EU). The European Commission has been looking into ways in which it can further enhance the framework for financial services firms operating across European borders and facilitate the development of European business. The EU Commission's White Paper on Financial Services Policy 2005-2010 emphasised that the EU financial services industry has strong untapped economic potential and that 'a better functioning risk capital market is needed to promote new and innovative firms.'²⁹⁵

This chapter provides a European dimension to the regulation of PE firms' activity in Europe, and focuses on EU measures governing the financial and corporate elements of the PE business. This gives verticality to the parallel horizontal regulatory structures existing at national level across Member States. The discussion begins by presenting the genesis and development of the European Single Market and the central tenets upon which it impinges. Then follows an overview of the relevant examples from the European regulatory framework that governed certain areas of private equity before the AIFMD was introduced. The chapter closes with the discussion regarding the effects of divergent national transposition of EU directives.

2. The European Single Market

Private equity firms have largely benefited from the EU's overriding goal of achieving a single market through sedulous economic integration efforts, which allowed those firms to operate on a more transnational scale.²⁹⁶ The single market has been described by the EU Commission as 'one of the EU's biggest assets.'²⁹⁷ The advent of the 2007 crisis and the following recession

²⁹⁵ *White Paper on Financial Services Policy 2005-2010* 5 (EU Commission, COM(2005) 629, Dec. 1, 2005), <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52005DC0629&from=EN>.

²⁹⁶ RICHARD WHISH & DAVID BAILEY, *COMPETITION LAW* 23 (7th ed. 2012).

²⁹⁷ *Report on Competition Policy* 12 (EU Commission, 2009), http://ec.europa.eu/competition/publications/annual_report/2009/en.pdf.

strengthened the EU Commission's determination to act as a guardian of the single market in order to prevent a retreat into economic nationalism.²⁹⁸ Accordingly, this section provides an account of the European integration through the achievement of the single market and the design of the European Monetary Union (EMU), which in turn facilitated the rapid development of PE activity across continental Europe.

2.1 Development of the European Single Market

After the Second World War the vision of European integration shifted towards reality, with greater political and economic cooperation viewed as the means to achieve a harmonious development of economic activities, an increase in stability and a continuous and balanced expansion. The founding states – Belgium, France, Germany, Italy, Luxembourg and the Netherlands – were driven by high ideals, political determination and economic objectives to establish ‘an ever closer union among the peoples of Europe’ and to ‘preserve and strengthen peace and liberty’ through a pooling of resources.²⁹⁹ The Soviet Union's expansionist policy and the resulting Cold War changed the political landscape dramatically and provided further impetus for European integration.

The single market is central to the EU and continues to be its principal economic rationale.³⁰⁰ The concept involves bringing down barriers and simplifying existing rules to enable everyone in the EU, including financial entities, to make the most of the opportunities offered to them.³⁰¹ With no more internal frontiers within the EU, the common market has become a reality. It had been talked about since the Treaty of Rome, which established the European Economic Community (EEC) in 1957. This gave Europe a new boost, laid down foundation for further integration and removed obstacles to the free movement of goods, capital, services and people between Member States.³⁰² These are the famous “four freedoms” that are the cornerstone of the single market, allowing the movement of the factors of production to the area(s) where they are most valued, thereby maximising wealth-creation in the EU.³⁰³

²⁹⁸ RICHARD WHISH & DAVID BAILEY, *supra* note 296, at 51.

²⁹⁹ The preamble of the Treaty establishing the European Economic Community (TEEC or the Treaty of Rome), signed on 25 March 1957.

³⁰⁰ PAUL CRAIG & GRAINE DE BURCA, *EU LAW. TEXT, CASES AND MATERIALS* 581 (5th ed. 2011).

³⁰¹ *The European Single Market* (EU Commission, May 28, 2021), https://ec.europa.eu/growth/single-market_en.

³⁰² It was on these four fundamental freedoms that the six founding Member States decided to build a genuine European economic community.

³⁰³ PAUL CRAIG & GRAINE DE BURCA, *supra* note 300, at 582.

The first notable advance occurred in 1968, a year that marked the complete eradication of customs duties on goods circulating between Member States. However, it was not until 1985 when the single market was realised in response to a long-standing international recession in the aftermath of the oil crisis, resulting in inflation and rising prices and unemployment rates. The response presented by the EU Commission under Jacques Delors was to complete the construction of the great internal market in stages. The idea of an economic and monetary union was revived and written into the Single European Act of 1986 which aimed to complete the internal market by 31 December 1992. Consequently, internal barriers and borders within the European Community were gradually dismantled, leading to the adoption of European laws to help establish the single market. The EU wanted to achieve its ambitious goal in a number of areas, including financial markets, by introducing a greater degree of rules harmonisation. The EU Commission's White Paper (1985)³⁰⁴ announced a new strategy under which the harmonisation of integral standards and conditions would lead to mutual recognition by the Member States of each other's laws, regulations and administrative practices which had not been harmonised at the EU level. Such recognition would be premised on minimum harmonisation, resulting in the creation of the conditions under which the assumption of equivalence between the laws of a home and a host state would be factually correct, allowing Member States to tolerate differences.³⁰⁵

The Delors Committee was instructed by the European Council in 1988 to examine ways of realising Economic and Monetary Union. Although the initial plan did not work out, subsequent developments led to the negotiations for the Treaty on European Union (so-called Maastricht Treaty), signed in 1992 by twelve Member States. It established the European Union and went further than the Community's initial economic goal since it envisioned an evolution towards the monetary union through three stages,³⁰⁶ with the end effect that the European Central Bank (ECB) would be established and the new euro coins and notes would come into use ten years

³⁰⁴ *Completing the Internal Market: White Paper from the Commission to the European Council* (EU Commission, June 1985), http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf.

³⁰⁵ HAL S. SCOTT, *INTERNATIONAL FINANCE: LAW AND REGULATION* 163-164 (2d ed. 2008).

³⁰⁶ In Stage One, the borders between EU countries disappeared physically and the common market facilitated the European Single Market. EU governments coordinated their economic policies in order to converge their economies, complete the Single Market and adopt a stronger common competition policy. Stage Two, lasting between 1994 and 1998, was dedicated to the technical preparations for the single currency. The Member States tried to reach common inflation rates, long-term interest rates, government deficits and currency fluctuations within the European exchange rate mechanism. Stage Three began on 1 January 1999 with the irrevocable fixing of exchange rates, the transfer of monetary policy competence to the ECB and the introduction of the Euro as the single currency. This effectively created EMU in Europe and is considered one of the major events in recent international finance history, having a radiating impact from foreign exchange markets to markets for bonds, banking, equity and derivatives. *See Id.* at 205.

later in the countries forming the Eurozone. A single currency would remove transaction costs and the uncertainty associated with exchange rate variability. With the Euro elevated to the rank of a major international (reserve) currency, EU stakeholders, such as banks, firms and investors, would be able to conduct more of their business across borders in their own currency. This was certainly a contributing factor that helped the EU become the world's second most developed PE market after the US.

The conversion to the Euro is a *fait accompli*. The currency is strong and has reinforced the integration of the EU financial markets, being a key factor in the EU's competitiveness both economically and politically. The single currency is a significant component of a common financial system and a strong promoter of financial integration.³⁰⁷ The individual European countries are now part of a larger, much more self-contained economy; and the size of the euro area makes it comparable with other major economies like the US and Japan.³⁰⁸ The depth and quality of an integrated financial market provides a broader range of investment choices, allowing PE firms to tap a very large capital market in order to finance their business, seek investors and enhance the management of their respective investments.

2.2 The Single Market in Time of Crisis

The European Single Market transformed the way business is conducted in the EU. It opened up opportunities for investors and firms to expand across EU borders and successfully on the global market. However, negative developments in the credit and financial markets around the world as a result of the 2007 financial crisis led to extreme disruption. This included, for example, extreme volatility in security prices, severely diminished liquidity and credit availability, rating downgrades and declining valuations of both investments and companies. These challenges were also palpable in the private equity sector as a result of suppressed fundraising levels and deal activity. Although there was a pick-up in the global macroeconomic outlook, countries were recovering at different rates, with advanced economies experiencing a sluggish, U-shaped recovery.³⁰⁹ The European Single Market was seen as Europe's main asset

³⁰⁷ Daniel Stavárek et al., *Theory of Financial Integration and Achievements in the European Union*, in FINANCIAL INTEGRATION IN THE EUROPEAN UNION 1 (Roman Matousek & Daniel Stavárek eds., 2012).

³⁰⁸ *The European Central Bank, the Eurosystem, the European System of Central Banks* 7 (ECB, Apr. 2009), http://www.ecb.europa.eu/pub/pdf/other/escb_en_weben.pdf.

³⁰⁹ *The European Private Equity Market Outlook* 6 (EIF & EVCA, Jan. 7, 2011), http://www.eif.org/news_centre/research/eif_jp_2011_001_European_Private_Equity_Market_outlook.pdf.

in coming out of the crisis, and the EU Commission's strive for its better functioning was viewed as a necessary precondition for the EU growth initiative.

The integrated market has led to significant macroeconomic achievements and made an impact on growth, employment, competition policy, trade and investment flows.³¹⁰ The crisis had exposed structural weaknesses in several Member States, emphasising a need for more coordinated economic policies. A series of important actions and emergency measures were taken in order to stimulate recovery, boost real economy, create jobs, strengthen confidence and further develop the Single Market and exploit its untapped potential as an engine for growth. Moreover, the EU and its Member States installed better oversight of national economic policies, and the EU Commission launched regulatory initiatives for changing the financial industry's regulatory landscape. Therefore, the crisis opened a new chapter not only for the Single Market, but also its participants.

3. The EU Financial Regulation

This section details the progress in the development and integration of EU financial markets. The EU commenced its quest for financial market integration in the 1980s, but the first attempts failed. In the 21st century, the EU has once again turned to harmonisation, this time through rules established at the EU level. The financial market is the core of the economy, having profound impact on many of its sectors and having various instruments created to fulfil the needs of its participants.³¹¹ Some aspects of the markets, which have in recent years become more integrated and complex, do not need specific legal provisions as they are self-regulating; the law cannot be too detailed as this would limit the freedom of action of economic entities. On the other hand, some matters require stricter regulation to protect investors, increase transparency and improve fairness of the markets.

The EU has sought to develop the integrated financial market based on the four Treaty freedoms. However, in many areas, the relevant EU law was only liberalised and not yet fully harmonised in accordance with the EU directives. It was not until the implementation of the Financial Services Action Plan (FSAP), the five-year programme of action announced by the EU Commission in May 1999, that we could speak for the first time of a systematically created

³¹⁰ *20 Years of the European Single Market - Together for New Growth* (EU Commission, 2012), <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELLAR:c505dbb4-64f1-40a6-8062-ebdea6240bd4>.

³¹¹ IZABELA PRUCHNICKA-GRABIAS, FINANCIAL MARKET INSTRUMENTS. IN CASE STUDIES 9 (2007).

European ‘capital markets law’.³¹² The ambitious programme described what needed to be done in order to ensure constant stability and competitiveness of the financial markets in Europe, gave an account of the relevant EU directives, and proposed amendments in view of its stated objectives.³¹³ Consequently, a new generation of directives was created, significantly furthering EU integration in the securities area.³¹⁴ The key measures included the Market Abuse Directive (MAD),³¹⁵ the Prospectus Directive, the Markets in Financial Instruments Directive (MiFID),³¹⁶ the Takeover Directive³¹⁷ and the Transparency Directive.³¹⁸

In the wake of FSAP, in July 2000, the EU’s Economic and Finance Ministers (ECOFIN) requested that the so-called Wise Men Committee, chaired by Baron Alexandre Lamfalussy, recommend regulatory changes. This resulted in the *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, published on 15 February 2001. The Report found that the development and regulation of EU securities market was held up by many factors, including a lack of basic essential legislation, erratic implementation, insufficient prioritisation, ineffective and obstructive regulatory framework and other factors rendering the regulatory system too slow, too rigid and producing too much ambiguity.³¹⁹ It was proposed by the Committee that these hindrances are overcome by concentrating on a four-level regulatory

³¹² EILIS FERRAN, BUILDING AN EU SECURITIES MARKET 8-57 (2004).

³¹³ Beat D. Speck & Joseph Tanega, *Private Equity Placements: Comparing the Laws in Switzerland, the European Union, the United Kingdom and the United States: Part I*, 21(4) J.I.B.L.R. 213, 222 (2006).

³¹⁴ John Armour & Wolf-Georg Ringe, *European Company Law 1999-2010: Renaissance and Crisis* 25 (European Corporate Governance Institute Law Working Paper No. 175/2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1691688.

³¹⁵ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) [2003] OJ L96/16.

³¹⁶ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1.

³¹⁷ Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids [2004] OJ L142/12.

³¹⁸ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38.

³¹⁹ *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets* 13-15 (EU Commission, Feb. 15, 2001), https://www.esma.europa.eu/sites/default/files/library/2015/11/lamfalussy_report.pdf.

approach.³²⁰ The EU Parliament approved this new procedure in February 2002 subject to some ‘democratic safeguards.’³²¹

A string of EU directives helped to stimulate securities markets and achieve the single market in financial services. This was feasible by introducing a greater degree of harmonised standards. Whilst at no point was there a private equity specific regulatory framework at European level, other bedrock principles governed various aspects of PE activity. Relevant examples include but are not limited to those presented below.

3.1 The Takeover Directive

Private equity firms engage in takeovers, public to private transactions where an acquired public company is delisted and taken into private ownership, investments in the capital base of a company whereby investors buy company shares and are involved in the overall business of the enterprise, and different categories of buyouts. The context within which mergers and acquisitions (M&A) are conducted is governed at EU level by the Takeover Directive that is largely modelled on the UK’s market for corporate control which, unusually for the rest of Europe, is much more open and competitive.

Much ink has been spilled analysing the Directive and the Byzantine route to its introduction. Suffice to say that after an ‘amazing 15-year saga,’³²² the Directive was adopted in 2004 and had to be transposed into national law until 2006. It aimed to introduce common rules for takeovers in order to create a level playing field, increase the efficiency of the EU market for corporate control and improve the protection of minority shareholders in the event of takeover. This was a minimum standards directive, framed in a way not imposing extensive harmonisation of takeover rules throughout the EU. Consequently, the Directive was

³²⁰ The Lamfalussy process was launched in 2001 for the purpose of strengthening the European regulatory and financial sector supervision framework. It consists of the adoption of the framework legislation (Level 1); the preparation of detailed technical requirements (delegated acts and implementing measures) which are secondary, non-legislative acts utilised to amplify or amend parts of the Level 1 legislative act (Level 2); advice and guidance by committees of national supervisory authorities regarding the technical preparation of the implementing measures (Level 3); and the timely transposition of EU legislation into national law (Level 4). *See Review of the Lamfalussy process* (EU Commission, June 10, 2008), http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_general_framework/132056_en.htm.

³²¹ HAL S. SCOTT, *supra* note 305, at 169.

³²² BEN G. PETTET, JOHN LOWRY & ARAD REISBERG, *PETTET’S COMPANY LAW: COMPANY AND CAPITAL MARKETS LAW* 422 (3d ed. 2009).

implemented differently in each Member State, leading some commentators to view it as a failure with regards to the maximisation of value-creating takeovers in Europe.³²³

The main changes of the Directive were the introduction of the mandatory bid (art 5), breakthrough rule (art 11), squeeze-out and sell-out rule (arts 15 and 16) and board neutrality – the anti-frustration rule contained in Article 9 of the Directive. While the mandatory bid and sell-out rule intended to increase investor protection, the aim of the squeeze-out rule, board neutrality and the breakthrough rule was to facilitate takeovers.³²⁴ Harmonisation was weakened by a political compromise which made Articles 9 and 11 merely optional under Article 12 and as a corollary the majority of Member States opted out of these rules.³²⁵ The former Article prohibited a target company from taking frustrating action which could hinder or discourage a takeover bid without shareholder approval. This was predicated on the fundamental principle that it should be for the shareholders, not the management of the target company, to decide on the merits of the takeover bid. The latter Article intended to eliminate certain restrictions on the transfer of securities and on voting rights which could hamper takeover bids. The rule facilitated hostile takeovers by allowing the bidder to bypass the incumbent blockholder and break through existing pre-bid defences which rendered the takeover more difficult.

3.2 The Directive on Transfer of Undertakings

With regards to the companies acquired by PE firms concerns arise with respect to employee protection and rights. At European level, this was addressed via the Directive on Transfer of Undertakings³²⁶ which applied where legal transfer of the company or a merger was taking place. Specifically, the Directive intended to ‘promote the harmonisation of the relevant national laws ensuring the safeguarding of the rights of employees and requiring transferors

³²³ Luca Enriques, *European Takeover Law: The Case for a Neutral Approach*, 22(5) EUROPEAN BUS. L. REV. 623 (2011); Mark Humphery-Jenner, *The Impact of the EU Takeover Directive on Takeover Performance and Empire Building*, 18(2) J. CORP. FINANCE 254 (2012).

³²⁴ Matthias Kohler, *Ownership Structure, Regulation and the Market for Corporate Control in the EU Banking Sector*, 34 EUR. J. LAW ECON. 173, 183 (2012).

³²⁵ Jennifer G. Hill, *Takeovers, Poison Pills and Protectionism in Corporate Governance*, in Festschrift für Klaus J. Hopt zum 70. Geburtstag am 24. August 2010, at 795, 805 (Stefan Grundmann, Brigitte Haar, Hanno Merkt et al. eds., 2010). This regulatory arrangement is highly complex, prone to inconsistencies and probably not functional; see Jonathan Rickford, *The Emerging European Takeover Law from a British Perspective*, 15 EUROPEAN BUS. L. REV. 1379, 1421 (2004) (regarding this outcome of a political process as a substantial failure and probably worse than no Directive at all); and Matteo Gatti, *Optionality Arrangements and Reciprocity in the European Takeover Directive*, 6 EUROPEAN BUS. ORGANIZATION L. REV. 553-579 (2005).

³²⁶ Directive 2001/23/EC of 12 March 2001 on the Approximation of the Laws of the Member States Relating to the Safeguarding of Employees' Rights in the Event of Transfers of Undertakings, Businesses or Parts of Undertakings or Businesses [2001] OJ L82/16.

and transferees to inform and consult employees' representatives in good time' (Recital 6). Ultimately, the Directive was not implemented consistently across the EU – some Member States adopted particular articles verbatim, others adopted variations, and in some cases certain articles were not adopted at all.³²⁷

The Directive for Consulting and Informing Employees³²⁸ was also applicable in the area of employee protection. It established a general framework for informing and consulting employees in Europe on significant changes to the company business, especially if there was a threat to employment. It defined 'information' as 'transmission by the employer to the employees' representatives of data in order to enable them to acquaint themselves with the subject matter and to examine it' (art 2(f)), and 'consultation' as 'the exchange of views and establishment of dialogue between the employees' representatives and the employer' (art 2(g)).

3.3 The Transparency Directive

Whilst private equity firms typically acquire controlling stakes in companies, they also make investments in minority stakes in listed companies. Such stake-building and empty voting by minority shareholders gave rise to genuine concerns, as activist shareholders could exert disproportionate influence on the company's management with the purpose to maximise short-term gains at the expense of the long-term health of the company. The lack of transparency in stake-building techniques, such as the use of derivatives or securities lending and borrowing to influence voting rights, could potentially lead to abusive behaviour and cause harm to a company's employees and other stakeholders.

Crucial in this area was the Transparency Directive, which attempted to establish EU-wide requirements for the publication of information on publicly traded companies. Its purpose was to protect minority shareholder rights by setting minimum transparency requirements concerning the publication of periodic financial information and the notification of the acquisition and disposal of major shareholdings held both directly by investors and indirectly by third parties.³²⁹ The Directive set forth the rules in order to maintain a flow of information to the investing public once securities had been admitted to trading on a regulated market. This

³²⁷ See Malcolm Sargeant, *Implementation Report Directive 2001/23/EC on the Approximation of Laws of the Member States Relating to the Safeguarding of Employees' Rights in the Event of Transfers of Undertakings, Businesses or Parts of Businesses* (Jan. 31, 2006), <http://ec.europa.eu/social/BlobServlet?docId=2938&langId=en>.

³²⁸ Directive 2002/14/EC of the European Parliament and of the Council of 11 March 2002 establishing a general framework for informing and consulting employees in the European Community – Joint Declaration of the European Parliament, the Council and the Commission on Employee Representation [2002] OJ L080/29.

³²⁹ Matthias Kohler, *supra* note 324, at 173, 181.

enabled investors to know who had ultimate control of the company in which they wanted to invest. The Directive tightened up the disclosure rules for significant holdings by reducing the floor to the basic threshold of 5 per cent, introducing additional thresholds at 15, 20 and 30 per cent (art 9(1)), and making disclosure a requirement for financial instruments which led to an entitlement to acquire existing shares.³³⁰ This requirement aimed generally at increasing transparency and making it easier for regulators, minority shareholders and the takeover market to monitor large shareholders.

The Directive imposed only minimum harmonisation requirements, meaning that Member States were allowed to adopt more stringent notification requirements to increase transparency as they thought fit. This is exactly what happened – for example, Germany, Spain, Ireland and the UK applied the threshold of 3 per cent, and Italy and Portugal applied an even lower threshold of 2 per cent.

3.4 MiFID

In the pre-AIFMD world, the Markets in Financial Instruments Directive (MiFID) was a far-reaching and controversial piece of EU legislation which carried forward many of the basic ideas of its predecessor, Investment Services Directive (ISD).³³¹ The Directive was concerned primarily with home state authorisation and prudential supervision of investment firms and regulated markets. It included a large measure of harmonisation and improved the passport for investment firms by way of including the cross-border right to do business in other Member States (art 31) and allowing opening up branches in the EU without going through a separate authorisation process (art 3) in order to promote a single market for transactions in financial instruments.³³² The Directive reflected the developments in financial services and markets and, in particular, extended the scope of ‘core’ investment services and activities that firms could passport around the EU.³³³ The Directive promoted the objective of capital market integration within the EU, recognising the growing role that market-based financing, both debt and equity, was playing in the financing of investments. It gave a more prominent role to alternative markets which provided valuable competition to regulated markets.³³⁴ The MiFID regime could

³³⁰ Holger Fleischer & Klaus Ulrich Schmolke, *Legislative Comment: The Reform of the Transparency Directive: Minimum or Full Harmonisation of Ownership Disclosure?*, 12 EUROPEAN BUS. ORGANIZATION L. REV. 121, 125 (2011).

³³¹ Directive 93/22/EEC of 10 May 1993 on investment services in the securities field [1993] OJ L141/27.

³³² The revised MiFID Directive (MiFID II), implemented in July 2015, aims to further strengthen and ensure the resilience of the single market.

³³³ BEN G. PETTET, JOHN LOWRY & ARAD REISBERG, *supra* note 322, at 365-366.

³³⁴ IAIN G. MACNEIL, AN INTRODUCTION TO THE LAW ON FINANCIAL INVESTMENT 56 (2d ed. 2012).

be broadly separated into three categories (organisational, conduct of business, and capital adequacy), with an overall effect of enhanced investor protection and increased transparency by providing for mandatory information and disclosure requirements applicable to a range of financial instruments, including funds and securities issued by listed companies.³³⁵

Private equity firms were subject to MiFID only when they were engaging in a regulated activity,³³⁶ which could include discretionary portfolio management, provision of investment advice, or arranging deals in investments.

3.5 The Prospectus Directive

An EU regime for public cross-border offers of transferrable securities exists through the Prospectus Directive. The Directive required a prospectus (that is, a harmonised disclosure document) to be published when securities were offered to the public or admitted to trading on a regulated market. It was a Level 1 Lamfalussy directive made under the EU Financial Services Action Plan and provided for a single regime throughout the EU to govern the requirement for a prospectus and its content, format, approval and publication. It came into force on 31 December 2003 and had to be implemented in Member States by 1 July 2005. The 2003 Directive was amended by Directive 2010/73/EU,³³⁷ which aimed to simplify and improve the application of the Prospectus Directive and aid legal certainty.³³⁸ New rules made it easier and cheaper for companies to raise capital throughout the EU on the basis of gaining approval from a regulatory authority in any of the Member States. The principle of automatic recognition signified that companies would no longer have to ask each Member State for regulatory approval of their prospectus.³³⁹

³³⁵ ALASTAIR HUDSON, *THE LAW OF FINANCE* 155-156 (2009). It is worth adding that in the area of transparency and the occupational pension arrangements, the European IORP Directive 2003/41/EC was relevant. Specifically, it required the occupational pension institutions to make certain disclosures to scheme members and/or employees; see Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision [2003] OJ L235/10.

³³⁶ Eddy Wymeersch, *The Regulation of Private Equity, Hedge Funds and State Funds* 24 (Financial Law Institute Working Paper No. 2010-06, Apr. 30, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685202.

³³⁷ Directive 2010/73/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market Text with EEA relevance [2010] OJ L327/1.

³³⁸ *Prospectus Directive* (PLC, 2013), <http://uk.practicallaw.com/8-200-9274?sd=plc>.

³³⁹ Beat D. Speck & Joseph Tanega, *supra* note 313.

The Prospectus Directive applied to private equity firms; however, they could gain exemption for closed-ended funds.³⁴⁰

3.6 The Market Abuse Directive

The development of dependable financial markets requires a large amount of investor confidence and hence the removal of abusive practices, insider dealing, and market manipulation. In this space, the Market Abuse Directive (MAD) directly applies to any participant in a private equity transaction.

The Directive replaced the 1989 Insider Dealing Directive.³⁴¹ It was designed to prevent the misuse of inside information and curb market manipulation in order to preserve market integrity. The Directive was agreed in 2003 and implemented in Member States in 2005, and was subsequently supplemented by three implementing directives and an implementing regulation. The Directive was not a maximum harmonising measure.

The common thread running through the Directive and its implementing measures is the objective of promoting investor confidence in the securities markets and, in particular, ensuring that those participating in the markets do so on an equal informational footing.³⁴² This finds expression in the preamble which clarifies that the purpose of this EU legislation is to afford an ‘assurance...to investors that they are placed on an equal footing and that they will be protected against improper use of inside information.’ Hudson (2009) argues that there is an ethical dimension to the preservation of market integrity which is subordinate to its economic goal, namely whatever harms market integrity harms the productivity of the EU capital markets, which in turn harms the real economy.³⁴³

3.7 EU Company Law Directives

One of the key policy concerns regarding private equity is in relation to the sustainability of debt assumed by portfolio companies. In the area of acquisition of control of companies, the most relevant EU level measure of that time was the Company Law Directive (as later amended

³⁴⁰ Private equity firms would be freed from the requirement to produce a prospectus where: the offer was made solely to qualified investors; made to fewer than 150 natural or legal persons other than qualified investors; made to investors who acquired the securities for total consideration of at least €100,000; and the total consideration was less than €100,000 calculated over a period of twelve months (Article 1(3) of the amending Directive 2010/73/EU); *see also Report of the Alternative Investment Expert Group: Developing European Private Equity supra* note 56, at 31.

³⁴¹ Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing [1989] OJ L334/30.

³⁴² Stuart Willey, *Market Abuse Update*, 93(Feb) C.O.B. 1, 1-2 (2012).

³⁴³ ALASTAIR HUDSON, *supra* note 335, at 265.

by Directive 2006/68/EC).³⁴⁴ It provided a framework for capital formation, maintenance and alteration of a company.³⁴⁵ In the private equity context, the net assets of a company owned by private equity had to comply with the Directive's capital adequacy regime. This acted as a safeguard against asset stripping.

3.8 The Capital Requirements Directive

The use of leverage is an integral part of PE transactions; this is also one of the major policy concerns in relation to the excessive debt burden put on portfolio companies. At EU level, the Capital Requirements and Capital Adequacy Directives³⁴⁶ (CRD) required risk based capital for investment firms and credit institutions. Private equity firms were exposed to these regulations indirectly through requirements imposed on the lending institutions (banks) for the purposes of leveraged acquisitions.³⁴⁷

4. The Effects of Divergent National Transposition

As illustrated above, many of the EU directives were not maximum harmonising and therefore gave national regulators discretion with regard to implementation. This resulted in misaligned national regulatory regimes.³⁴⁸ Specifically, legal, tax and operating environment in which private equity firms operated was largely determined at national (local) level. This covered fund management, placement of eligible investors, tax incentives and restrictions, as well as fund terms and conditions.³⁴⁹ The many differences in regulatory measures enforced by national regulators hampered the activities and conduct of private equity firms. For instance, local fiduciary relationships and obligations differed widely from Member State to another, and there were national restrictions ranging from quantitative and qualitative limits to total prohibition on which institutional investors could invest in private equity funds.³⁵⁰ Therefore, even where

³⁴⁴ Directive 2006/68/EC of the European Parliament and of the Council of 6 September 2006 amending Council Directive 77/91/EEC as regards the formation of public limited liability companies and the maintenance and alteration of their capital [2006] OJ L264/32.

³⁴⁵ *Impact Assessment* 103 (EU Commission Staff Working Document Accompanying the Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and Amending Directives 2004/39/EC and 2009/.../EC {COM(2009) 207} {SEC(2009) 577}, Apr. 30, 2009), <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex%3A52009SC0576>.

³⁴⁶ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177/1; and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) [2006] OJ L177/201.

³⁴⁷ *Impact Assessment*, *supra* note 345, at 99.

³⁴⁸ *Report of the Alternative Investment Expert Group: Developing European Private Equity*, *supra* note 56, at 22.

³⁴⁹ *Hedge Funds and Private Equity - A Critical Analysis* 80 (PES Report, Apr. 1, 2007), http://www.nyrup.dk/cgi-bin/nyrup/uploads/media/Hedgefunds_web.pdf.

³⁵⁰ *Report of the Alternative Investment Expert Group: Developing European Private Equity*, *supra* note 56, at 22.

EU legislation had offered possibilities for a broadly consistent approach, national transposition varied and most Member States regulated part or all of the private equity value chain in their own manner. The sluggish and idiosyncratic transposition of legislation from Brussels reflected both the diversity of the European Union and resistance from national regulators and local politicians.³⁵¹ The EU Commission itself admitted that the activities of alternative fund managers were not wholly unregulated as many Member States had relevant legislation in place; it was the scope and content of national measures that varied to a large extent, providing different rules for registration, authorisation, prudential regulation, regulatory reporting, investor disclosure and risk management.³⁵² Regulatory mapping reveals that private equity regimes existed in France, Luxembourg, Ireland, Italy and Spain; and private placement regimes³⁵³ existed in the UK and Germany (noting that the latter imposed specific requirements for fund management and placed limitations on investments).³⁵⁴

The absence of coherence between different national regulations had consequences for public authorities, investors, businesses and fund managers. European buyout firms were ambitious and played an important role in strengthening European economies, even in time of economic turbulence.³⁵⁵ A favourable regulatory setting would enable private equity firms to enhance their economic contribution. The 2008 EVCA study *Benchmarking European Tax and Legal Environments*³⁵⁶ assessed the ‘friendliness’ of EU national environments for funds, managers and investors. The evaluated criteria were split into thirty variables that were determinant for the well-functioning of the private equity and venture capital ecosystem. For each country, a score was allocated per variable: ‘1’ was the best score, accorded to a favourable environment, and ‘2’ and ‘3’ indicated less favourable conditions with room for improvement. The 2008

³⁵¹ Stanislav Poloucek, *Integration of Financial Markets in the European Union: Regulation and supervision Framework*, in FINANCIAL INTEGRATION IN THE EUROPEAN UNION 64 (Roman Matousek & Daniel Stavárek eds., 2012).

³⁵² *Impact Assessment*, *supra* note 345, at 13-14.

³⁵³ Private placement means that there is an officially recognised distribution method which enables designated market participants to buy and sell financial products without complying with rules that usually apply to public/retail investors. It is more suitable for investments that are less suitable for wider public, like distributing new private equity funds.

³⁵⁴ *Impact Assessment*, *supra* note 345, at 16-17.

³⁵⁵ The private equity industry has been struggling recently as investments have been failing or underperforming, but potentially it can restore the balance by acquiring and reviving failing EU companies. Pursuant to the EVCA Yearbook 2012, the overall amount of €36.5bn was invested in EU companies in 2012; the number of private equity backed companies remained stable at almost 5,000 EU companies. About 43 per cent of the companies that received investment in 2012 were backed by private equity for the first time. See 2012 *Pan-European Private Equity and Venture Capital Activity. Activity Data on Fundraising, Investments and Divestments* (EVCA, May 2012), <https://cupdf.com/document/european-private-equity-venture-capital-association.html>.

³⁵⁶ *Benchmarking European Tax and Legal Environments* (EVCA, Oct. 1, 2008), <http://docplayer.net/8230544-Benchmarking-european-tax-and-legal-environments.html>.

ranking of European countries showed the total European average is at 1.85. Although the total average for 2003 was at 2.03, the 2008 result was relatively unchanged compared to 2006 with the total average at 1.84.³⁵⁷ This indicates that not much convergence was taking place despite a raft of new harmonising measures.

Europe's fragmented regulatory environment and an overly complex fund-structuring regime hamstrung the efficiency of the EU private equity industry and was not conducive to cross-border investing. Accordingly, the PE industry could not realise its full potential in Europe and was less effective than it could have been, in particular relative to the US.³⁵⁸ Over the years, some of the difficulties had been overcome through partial legal harmonisation, but major differences between regulatory arrangements continued to exist. Inconsistent national provisions governing distribution of alternative funds across the EU resulted in legal and regulatory obstacles and marketing restrictions. These nationally-fragmented regulatory approaches not only impeded market integration and the creation of the single market for cross-border distribution of alternative funds but also inhibited effective regulation, supervision and macro-prudential oversight of the activities conducted by European fund managers.³⁵⁹ This regulatory patchwork created differences leading to the situation where the UK traditionally had a vibrant PE market, but the industry tended to struggle in Germany. This illustrates that two main variants of capitalism still persisted in Europe:³⁶⁰ the liberal market economy characterised by arms-length market transactions, and the coordinated market economy characterised by the dominance of non-market, long-term relations. The durability of these different systems was present despite numerous interventions at EU level and the internationalisation of finance which should have fostered a more liberalised market-based approach.

5. Conclusion

This chapter demonstrates that numerous EU laws applied to private equity activities in one way or another in the pre-AIFMD world. Financial stability concerning capital requirements

³⁵⁷ Moreover, the gap between the best country (France) at 1.23 and the European average at 1.85 is bigger than the 2006 gap (1.27/1.84); and the composite score for the lowest country (Czech Republic) in the ranking at 2.40 is farther away from the 2008 European average (1.85) than the measured gap in 2006 (2.35/1.84).

³⁵⁸ Laura Bottazzi, *Private Equity in Europe*, in PRIVATE EQUITY: FUND TYPES, RISKS AND RETURNS, AND REGULATION 437, 456 (Douglas Cumming ed., 2010).

³⁵⁹ *Impact Assessment*, *supra* note 345, at 14.

³⁶⁰ P.A. Hall & D. Soskice, *An Introduction to Varieties of Capitalism*, in VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 1-68 (P.A. Hall & D. Soskice eds., Oxford University Press 2001).

and risk-based capital was safeguarded by the Company Law Directives, MiFID and CRD; market integrity and market stability were addressed through MAD and the Money Laundering Directive;³⁶¹ transparency and disclosure were also covered – investment strategies, risk management and valuation by the Company Law Directives, MiFID, Prospectus Directive and IORP Directive, whilst management and disclosure of conflicts of interest by MiFID; last, but not least, social economy concerning asset stripping was addressed by the Company Law Directives, whilst employees consultation and information was covered by the Directive on Transfer of Undertakings and the Framework Directive for Consulting and Informing Employees. This was all in addition to national legislation as well as a number of national, European and international self-regulatory codes and guidelines governing PE behaviour with respect to ethics, transparency, reporting, and valuation. This evidences that almost all aspects of private equity business had to comply with some legal measure in the pre-AIFMD world. The two recognisable elements that were not covered at EU level were registration/authorisation of the alternative investment fund managers and excessive leverage of PE portfolio companies.

The European Union has set itself an ambitious goal of creating a competitive, knowledge-based economy capable of nurturing, incubating and sustaining world-class companies. Crucial to the realisation of this vision is a genuine Single Market predicated on the free movement of capital and services. Accordingly, the overall legal and regulatory setting should be designed to facilitate each link in the financing chain of companies in Europe. Nevertheless, the national transposition of EU directives proved to be cumbersome and took a while to accomplish. As said by Charles McCreevy, the Member States ‘persistently fail’ to implement the laws and regulations that underpin the EU’s internal market.³⁶² Naturally some legislation had generated unintended consequences because of its drafting, or incorrect/inappropriate implementation.³⁶³ Further problems were encountered by private equity firms operating cross border. The very different national approaches to regulation resulted in legal fragmentation within the EU, which in turn led to higher operating costs as well as administrative and legal fees.

Some developments took place to combat this situation, such as the Lamfalussy process, which sought to expedite the directive process in the formative and implementing stages, or the EU

³⁶¹ Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing [2005] OJ L309/15.

³⁶² Tobias Buck, *Members ‘Persistently’ Ignoring EU Market Laws* (FIN. TIMES, Jan. 28, 2005).

³⁶³ This could be illustrated by certain features of International Financial Reporting Standards (IFRS) which did not accommodate the structure of PE funds, the EU Commission’s definition of small and medium-sized enterprises (SMEs), and MiFID provisions; see *Report of the Alternative Investment Expert Group: Developing European Private Equity*, *supra* note 56, at 23-24.

Commission, which sought to reduce barriers and obstacles to cross-border investments to promote various business models. A tailor-made EU regulation would enable private equity firms to leverage their role in EU companies, foster innovation and deliver meaningful financial returns to investors in this asset class. A friendlier legal and regulatory environment would also promote investments across Member States.³⁶⁴ Therefore, the introduction of the AIFMD could be seen as a measure to harmonise the rules across Europe and facilitate the activities of alternative investment fund managers. This is examined in later chapters.

³⁶⁴ *Id.* at 24 & 31.

Chapter IV

The UK Pre-AIFMD Regime

1. Introduction

Although originally developed in the US, private equity firms quickly expanded across the Atlantic to establish a base of operation in London. The UK is the largest and most active PE market outside the US.³⁶⁵ It grew from the venture capital and development capital industry that was established to assist the needs of growing businesses. It started to develop in the 1980s against a backdrop of regulatory and company law changes,³⁶⁶ as well as financial market liberalisation.³⁶⁷ The evolution of UK private equity was similar to that in the US, which is often true of the two economies, tracking each other over time with differences in size and timescale. The emergence of private equity in the UK took however ten to 15 years longer to transpire and required leading American PE houses to act as catalyst.³⁶⁸ The dominant US PE firms started to open offices in London in the late 1990s, and the migration was rapid and broad-based, with firms gradually moving from the outer fringe to the centre of the capitalist system. This was mostly due to London's pre-eminence as a financial centre and the Treaty of Maastricht which accelerated the concept of the European Community as a single exploitable market based on the four freedoms, allowing the solidification of a unified financial market which in turn created the necessary conditions for a pan-European junk bond market necessary to facilitate the financing of European buyouts. The 1990s UK was the most attractive destination for the transfer of US firms and funds since it already had a developed buyout market and London's financial infrastructure provided a nodal point for liquidity that could be

³⁶⁵ James Kirkbride, *Private Equity and the UK Market: Some "Real" Concerns*, 50 INT. J.L.M. 93, 93 (2008); for 2019 data, see *European Private Equity - Statistics & Facts*, *supra* note 31;

³⁶⁶ Before 1981 it was not legal to utilise assets of a target company to give security to its acquirer. This rule was designed to prevent asset stripping that had been witnessed in the late 1960s, but the unintended consequence was that this prevented the rescue of failing companies. A change to the law was made in the Companies Act 1981, which allowed companies to give financial assistance in certain circumstances, to help acquire and rescue viable businesses.

³⁶⁷ Colin Ellis, *Private Equity in the United Kingdom - Market Development and Recent Trends*, in PRIVATE EQUITY: LAW AND PRACTICE, at xv, xviii (Darryl J. Cooke ed., 4th ed. 2011).

³⁶⁸ Simon Walker, *Speech to the Private Equity, Entrepreneurial Ventures, and Venture Capital Club* (University of Chicago Booth Business School, Sept. 15, 2009).

successfully exploited.³⁶⁹ Today, even despite concerns around Brexit,³⁷⁰ the country's attractiveness continues based on a stable environment which is favourable to business,³⁷¹ well-developed debt and equity markets, highly innovative financial sector, a large pool of highly skilled, international talent in a flexible labour market,³⁷² exceptionally high level of M&A activity, sophisticated third party advisers, and a positive attitude towards entrepreneurial risk.

The UK is the most mature market of all the European regions,³⁷³ and has traditionally been the largest and most developed buyout market both by volume and value.³⁷⁴ A large share of headquarters/main offices of PE firms operating in Europe is located in the UK. The amalgamation of the right conditions allowed for the dynamic development of the PE industry and provided a springboard for investments across Europe.³⁷⁵ The UK-based buyout firms raised more than 50 per cent of European funds by country of management and nearly 50 per cent of investments made during 2007 were by funds managed from the UK.³⁷⁶ In the first half of 2007, completed LBOs were worth over £25 billion and the total value of public-to-private (PTP) buyouts was at record £14 billion,³⁷⁷ whereas investments in buyouts accounted for 79 per cent of all PE and venture capital investments in Europe in 2007. The European buyout

³⁶⁹ JAMIE MORGAN, *supra* note 48, at 68-69.

³⁷⁰ A word used as a shorthand way of saying the UK leaving the EU formed by merging the words "Britain" and "exit."

³⁷¹ There are a number of hallmarks indicating an environment favourable to private equity. For example, this can be due to governmental light touch in the corporate arena, a particularly good legal and policy climate, as well as little state intervention. In general, private equity will struggle without enabling legislation. For instance, domestic fund sources increase dramatically when pension funds are allowed or encouraged to invest in private equity. Government policies promoting economic stability and the rule of law also help create a general environment that benefits the PE sector; see *Unlocking Global Value. Future Trends in Private Equity Investment Worldwide*, *supra* note 1, at 16.

³⁷² Employment protections restrict buyout activity as they may act like a tax on a PE firm's ability to adjust hiring at its portfolio companies and when deciding to close them down if necessary. This restricts the execution of active investing, as operational improvements inevitably lead to staff reductions in the short term; see Ant Bozkaya & William R. Kerr, *Labor Regulations and European Private Equity* 21 (HBS Working Paper No. 08-043, Jan. 27, 2010), <http://www.hbs.edu/faculty/Publication%20Files/08-043.pdf>.

³⁷³ Mike Wright et al., *The Implications of Alternative Investment Vehicles for Corporate Governance: A Survey of Empirical Research* 13 (2007), <https://www.oecd.org/corporate/ca/39005553.pdf>.

³⁷⁴ For instance, 2007 saw the buyout of the first FTSE 100 company, Alliance Boots (a healthcare and beauty retail firm), in a deal led by Kohlberg Kravis Roberts (KKR), one of the most prominent American multinational private equity firms, for over £11 billion. In addition to this deal, other largest UK private equity deals in the period of 2000-2008 included MEPC with the transaction value of £3.5bn, Acromas (AA & Saga) worth £3.4bn, EMI worth £3.2bn and Spirit Amber worth £2.5bn; David Gregory, *Private Equity and Financial Stability* 40 (Bank of England Quarterly Bulletin 2013 Q1, Mar. 14, 2013), <http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2013/qb130104.pdf>.

³⁷⁵ BVCA members invested £12.2bn globally in 2012. UK-based companies received the largest amount of investment from BVCA members at £5.7bn, whereas European companies received a combined investment of £4.6bn. Fifty-four per cent of overseas investment came from MBOs and MBIs; *Private Equity and Venture Capital Report on Investment Activity 2012* (BVCA, May 2013), http://bvca.co.uk/Portals/0/library/Files/News/2013/RIA_2012.pdf.

³⁷⁶ *Impact Assessment*, *supra* note 345, at 6 & 60.

³⁷⁷ Christian von Drathen & Flaviano Faleiro, *supra* note 228, at 7.

market reached a record €177 billion from almost 1,500 transactions by the end of 2007 and the buyout market in the UK was by far the largest contributor to this total, with €101 billion from 677 buyouts.³⁷⁸

The success of the industry has been based on a number of variables, and the broader legal environment has been a crucial indicator in the decisions concerning buyout transactions. The legal conditions in which private equity industry had initially developed in Europe were largely determined at national level. This chapter provides a high-level overview map of the UK regulatory regime underpinning the conduct and activities of private equity firms in the world before the AIFMD. At that time, there was no specific tailor-made private equity regulation. Therefore this chapter focuses on most relevant aspects of the UK regulatory material relevant to private equity activities, covering the basics of the fund's legal structure as well as the relevant aspects of regulation under the Financial Services and Markets Act 2000 (FSMA)³⁷⁹ and the UK regulator, the Financial Services Authority (FSA) (currently, the Financial Conduct Authority, FCA).

As an EU member, the UK has also been subject to EU regulations. The national regulator generally has reproduced the EU Commission's technical regulations in full or as appropriate. Consequently, many elements of the UK financial services regulation are predicated on EU law and therefore this chapter is indelibly linked to the previous one.

2. English Limited Partnership Funds

Private equity funds are closed-ended funds with a limited lifespan usually of 10 years. They are managed by a professional investment manager. Fund capital is directly solicited from certain restricted categories of investor (primarily institutional investors and ultra-wealthy individuals³⁸⁰), but not from the general public. This demonstrates that private equity is

³⁷⁸ Louise Scholes & Mike Wright, *supra* note 59.

³⁷⁹ Financial Services and Markets Act 2000, <http://www.legislation.gov.uk/ukpga/2000/8/contents>.

³⁸⁰ According to EVCA, main sources of private equity funds in Europe for 2007-2012 were: pensions funds (25.2%), funds of funds (15.3%), banks (12.9%), insurance companies (8.1%), government agencies (6.4%), high-net-worth individuals (6.3%), sovereign wealth funds (5.5%), family offices (5.5%), endowments and foundations (3.2%), corporate investors (3.2%), capital markets (2%), academic institutions (0.3%) and other asset managers (6.2%); *see The Facts* (EVCA, 2013), <http://evca.eu/facts/>. Key motivations for institutional investors to invest in private equity include financial returns (the improvement of the absolute returns to the asset portfolios); strategic goals for banks, nonbank financial institutions like securities firms and corporations (access to businesses to cross-sell products, gain insights on new technologies and to limit competitive threats); and public-policy goals for national and regional government entities (promoting economic growth and employment); *see* Grant Fleming, *Institutional Investment in Private Equity: Motivations, Strategies, and Performance*, in PRIVATE EQUITY: FUND TYPES, RISKS AND RETURNS, AND REGULATION 9, 9-13 (Douglas Cumming ed., 2010).

predominantly a wholesale rather than retail market. The minimum subscription fee is relatively high, frequently in the region of £5-10m for mid- to large-cap funds and £500,000 for smaller funds.³⁸¹ Eligible investors attend private presentations ('road shows') during which the fund's specific investment focus is marketed.³⁸² A PE firm will manage one or more funds at once, and each fund will usually hold several companies. PE funds, especially international ones marketed to international investors, are most commonly established as limited partnerships, although a number of different structures for raising funds was used before May 1987. This included offshore companies, investment trusts, unit trusts and direct investment plans, which are now largely superseded in the institutional private equity environment.³⁸³ Typically the legal form of the fund is motivated by a variety of factors, amongst which regulation and taxation are most important.

Limited partnerships are an efficient structure for investment activity. They are vehicles for individuals to associate with each other to pursue a common business purpose,³⁸⁴ and offer limited liability and centralised management.³⁸⁵ PE firms organise limited partnerships in order to finance their activity. The funds typically raise equity at the time they are formed and raise additional capital, usually in the form of debt, when investments are made and collateralisable, such as in buyouts.³⁸⁶ In order to be an English limited partnership, a partnership must be registered with the registrar of limited partnerships in England and Wales under the Limited Partnerships Act 1907 (LPA 1907).³⁸⁷ The limited partnership is often combined with offshore feeder vehicles to enable day-to-day management of the assets to take place onshore without prejudicing the general tax status of the structure.

Limited partnerships have proven to be a successful business form for private equity investment funds, providing a well understood, flexible and tax transparent structure. They are a type of partnership with special characteristics and must consist of two or more partners who may be

³⁸¹ *Private Equity: A Discussion of Risk and Regulatory Engagement* 23 (DP06/6) (FSA, Nov. 2006), https://www.treasurers.org/ACTmedia/dp06_06.pdf; Jennifer Payne, *Private Equity and Its Regulation in Europe*, 12(4) EUROPEAN BUS. ORGANIZATION L. REV. 559, 563-64 (2011). The high minimum subscription capital reduces the number of investors fund managers have to deal with, which in turn lowers administrative costs.

³⁸² JAMIE MORGAN, *supra* note 48, at 136-137.

³⁸³ Jonathan Blake & Lorraine Robinson, *Private Equity Fund Structures - The Limited Partnership*, in PRIVATE EQUITY: A TRANSACTIONAL ANALYSIS 33, 34 (Chris Hale ed., 2d ed. 2010).

³⁸⁴ ANDREAS CAHN, COMPARATIVE COMPANY LAW: TEXT AND CASES ON THE LAWS GOVERNING CORPORATIONS IN GERMANY, THE UK AND THE USA 48 (2010).

³⁸⁵ LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 60 (2010).

³⁸⁶ Laura Bottazzi, *supra* note 358, at 437, 439.

³⁸⁷ Limited reforms were made to the Limited Partnership Act in 2009, and more substantial updates to the statutory legal framework are expected in 2017.

individuals, companies or other vehicles. At least one partner must be a general partner (GP), with all of the remaining partners being limited partners (LPs). The GP is responsible for the management of the limited partnership and has unlimited liability for all its debts and obligations, therefore it is always established as a special purpose vehicle, like a limited liability partnership or limited company, in order to protect against the potential adverse consequences of its unlimited liability. The LPs are investors (“sleeping partners”) who contribute capital at the time of entering into the partnership, but their liability for debts and obligations is limited to the amount of their capital commitment (LPA 1907, s 4(2)). GPs manage the partnership and have authority to bind it, whilst LPs do not have such power (LPA 1907, s 6(1)). If the partnership is not validly registered, LPs will be deemed to be GPs with unlimited liability (LPA 1907, ss 5 and 15). Thus, the fund leverages the expertise of a fund manager and the capital of its investors.³⁸⁸ Following their roles and responsibilities, the GPs work in overlapping cycles of fundraising, investing in companies, building value, exiting investments and liquidating funds as appropriate, whilst the LPs supply the vast majority of the capital, often following the 99/1 rule which represents the ratio of capital ultimately provided by the LPs to that provided by the GPs.

Private equity funds are regulated by contract. The Limited Partnership Agreement is a heavily negotiated primary contractual agreement governing the relationship between the GPs and passive LP investors, seeking to cover every aspect of the formation, operation and termination of the partnership. Its terms are generally influenced by a range of market-standard expectations and negotiated by lawyers representing both sides in relation to the rights, duties and obligations of the partners, fund characteristics,³⁸⁹ restrictions on the types of investment that may be made, costs and fees, as well as fund management and other commercial, constitutional and administrative terms.³⁹⁰ The presence of legal counsel increases the probability of restrictive covenants. Cumming and Johan (2006)³⁹¹ found evidence that the quality of law and other institutional and legal practice factors are positively correlated with the number of covenants appurtenant to fund operations. In general, LPs do not intervene in the GP’s investment decisions as long as the basic covenants of the fund agreement are followed. The contractual

³⁸⁸ JAMES M. KOCIS ET AL., *INSIDE PRIVATE EQUITY: THE PROFESSIONAL INVESTOR’S HANDBOOK* 16 (2009).

³⁸⁹ For instance, the minimum and maximum fund size, fund life and capital commitment of each GP and LP.

³⁹⁰ BVCA provides explanatory notes which are designed to clarify the provisions commonly found in the Limited Partnership Agreement; see *Limited Partnership Agreement: Explanatory Notes* (BVCA, Oct. 2002), <http://www.bvca.co.uk/Portals/0/library/Files/StandardIndustryDocuments/LPAAgreement.pdf>.

³⁹¹ Douglas Cumming & Sofia Johan, *Is It the Law or the Lawyers? Investment Covenants Around the World*, 12 EUR. FIN. MANAGE. 535 (2006).

flexibility enables the managers and investors to enter into covenants that align their incentives and reduce opportunism and agency costs.³⁹² In addition to direct control mechanisms stipulated in the partnership agreement, the proper alignment of interest between LPs and GPs is achieved through reputation (that is, GPs' favourable track record in raising new funds), equity interest (that is, GPs' 'skin in the game,' having contributed their own commitment to the fund) and incentive schemes (that is, GPs operate under a detailed pay-for-performance scheme which includes carried interest).³⁹³ PE funds that are not structured as limited partnerships are typically governed by an Investment Agreement. In all material respects, the agreement will adopt the same commercial terms as the Limited Partnership Agreement.³⁹⁴

Overall, a limited partnership is a relatively simple and practical structure which has grown in complexity in recent years. It has not been very popular for business and professional purposes, but due to its flexibility, ease of use and accounting and tax advantages it has been utilised as a vehicle for investments.³⁹⁵ The structure allows distributing profits to investors as capital rather than as income profits and offers only very few, if any, redemption rights which are particularly suitable to long-term investments in illiquid assets.³⁹⁶ Thus, the structure's versatility and tax efficiency will likely make it remain a standard onshore structure in the UK for raising private equity funds.³⁹⁷

3. Regulation under the FSMA

Historically, there was less inclination to introduce statutory regulation in the UK due to a strong tradition of self-regulation. This ended with the creation of a single regulator in 2001 and the enactment of the Financial Services and Markets Act 2000 (FSMA).³⁹⁸ The Act has been the most important and wide-ranging piece of legislation affecting private equity. At the

³⁹² Erik P. M. Vermeulen & Joseph A. McCahery, *Private Equity Regulation: A Comparative Analysis*, 16(2) J.M.G. 197, 198 & 210 (2012). According to the 2016 Preqin report, 70 per cent of investors agree that the interests of LPs and GPs are properly aligned, with recent changes in fund terms and conditions being in favour of LPs; see *Global Private Equity & Venture Capital Report* 147 (Preqin, 2016), <https://www.preqin.com/format/private-equity-publications/1/1>.

³⁹³ ELI TALMOR & FLORIN VASVARI, *supra* note 30, at 23-25.

³⁹⁴ *Private Equity and Venture Capital in the European Economy. An Industry Response to the European Parliament and the European Commission* 231 (EVCA, Feb. 25, 2009), <https://www.scribd.com/document/185867773/Private-Equity-and-Venture-Capital-in-the-European-Economy-An-Industry-Response-to-the-European-Parliament-and-the-European-Commission>.

³⁹⁵ DEREK FRENCH, MAYSON, FRENCH & RYAN ON COMPANY LAW 10 (29th ed. 2012); JOSH LERNER, ANN LEAMON & FELDA HARDYMON, *supra* note 14, at 31.

³⁹⁶ *How to Start a Private Equity Fund* 2 (Cummings Solicitors, Feb. 2013), <https://www.slideshare.net/ClaireCummings1/how-to-start-a-private-equity-fund-cummings-final-23284683>.

³⁹⁷ This is because English limited partnerships are approved by HM Revenue & Customs (HMRC) and consequently are tax transparent for the purposes of UK taxation on income and chargeable gains.

³⁹⁸ IAIN G. MACNEIL, *supra* note 334, at 20.

heart of financial regulation in the UK is the rule that all persons that carry on a ‘regulated activity,’ or purport to do so, in or from the UK are required to seek authorisation (FSMA, s 19). Conducting a regulated activity without authorisation will contravene the general prohibition and constitute a criminal offence under section 23(1).

The definition of regulated activities is central to the system of regulation. It defines the sphere of activity in respect of which authorisation is required.³⁹⁹ The complicated aspect with functional regulation is that ‘for every firm engaged wholly in business involving investments...there are probably at least 10 which engage in it either in other ways...or only incidentally as part of another business.’⁴⁰⁰ This results in very broad definitions of activities relating to investment with numerous relatively narrow activities that are excluded.⁴⁰¹ Within the scope of financial services regulation there are seven categories of regulated activity which are identified in Part I of Schedule 2 to the FSMA. Specified activities and investments are detailed in the secondary legislation under Part II and III of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO),⁴⁰² which constitutes the UK regulatory perimeter. When entering into a transaction, private equity firms are likely to conduct some or all of the following regulated activities depending on the fund structure employed:⁴⁰³ dealing in investments as principal (art 14 RAO) or as agent (art 21 RAO); arranging transactions in investments (art 25 RAO); managing investments (art 37 RAO); safeguarding and administering investments, or arranging for the safeguarding and administration of investments (art 40 RAO); establishing or operating a collective investment scheme (art 51 RAO); and advising on investments (art 53 RAO).⁴⁰⁴

Firms which wish to avoid coming within the purview of FSMA must ensure that any activity that takes place on the UK territory is not a significant part of a regulated activity. This was confirmed in *FSA v Fradley and Woodward*,⁴⁰⁵ where the communications with existing and prospective clients and the maintenance of a UK bank account and address were deemed

³⁹⁹ *Id.* at 84.

⁴⁰⁰ 1985 White Paper, para 4.8, reported in PAUL NELSON, CAPITAL MARKETS AND COMPLIANCE: THE IMPLICATIONS OF MiFID 79 (2008).

⁴⁰¹ *Id.*

⁴⁰² The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, <http://www.legislation.gov.uk/uksi/2001/544/contents/made>.

⁴⁰³ Stephen Drewitt, *United Kingdom*, in THE PRIVATE EQUITY REVIEW 470, 480-481 (Stephen L. Ritchie ed., 3d ed. 2014).

⁴⁰⁴ Relevant investments include: shares (art 76 RAO); debentures and other loan stock (art 77 RAO); warrants (art 79 RAO); options (art 83 RAO); futures (art 84 RAO); contracts for differences (art 85 RAO) and units in a collective investment scheme (art 81 RAO).

⁴⁰⁵ *Financial Services Authority v Fradley (t/a Top Bet Placement Services)* [2005] EWCA Civ 1183.

business activities sufficiently regular and substantive to constitute the carrying on of business in the UK.

4. Regulation by the UK Regulator

The FSMA (primary legislation) is not the only source of financial regulation applicable in the context of private equity in the UK. The UK regulator equally prescribes a wide catalogue of rules (secondary legislation) that directly regulate the industry. Since the FSMA is an enabling statute that contains a basic framework for financial regulation, much of the detail is subject to rules made and supervision adopted by the national regulator.

Between 2001 and 2013, the FSA was an independent non-governmental body that was given statutory powers and obligations by the FSMA⁴⁰⁶ and assumed overall responsibility for regulating the financial services industry in the UK. The FSMA required the FSA to pursue four statutory objectives in discharging its general functions to ensure ‘market confidence, public awareness, the protection of consumers, and the reduction of financial crime’ (FSMA, s 2(2)) in its role as regulator.⁴⁰⁷ As a result of these powers, the FSA had a coercive-regulatory role, an economic role and an educational role.⁴⁰⁸ As the UK’s principal financial regulator, it recognised the significance of the competitiveness of the UK capital markets, of which the private equity industry forms an important part. The FSA’s risk-based regulatory framework in the private equity context involved maintaining a close and continuous relationship with the largest and highest-impact private equity firms (primarily from the perspective of market surveillance and the maintenance of financial stability⁴⁰⁹), developing risk mitigation programmes for the managed firms, engaging in frequent dialogues with market participants on issues relating to the industry and including private equity firms in thematic reviews on market issues.⁴¹⁰ The risk-based approach was firmly embedded within the regulatory system established under the FSMA and the FSA had made a deliberate choice to adopt it.⁴¹¹ Such regulation had two significant implications with regard to enforcement: not all contraventions necessarily led to enforcement action, and specific priority areas could be targeted for action

⁴⁰⁶ *Memorandum by the Financial Services Authority* (UK Parliament, Dec. 2008), <https://publications.parliament.uk/pa/cm200809/cmselect/cmcomloc/164/164we19.htm>.

⁴⁰⁷ Neil Matthews & Nicholas Narraway, *Securities Law in the United Kingdom*, in INTERNATIONAL SECURITIES LAW HANDBOOK 481, 483 (Jean-Luc Soulier & Marcus Best, 2005).

⁴⁰⁸ ALASTAIR HUDSON, *supra* note 335, at 168.

⁴⁰⁹ HOWARD DAVIES & DAVID GREEN, GLOBAL FINANCIAL REGULATION: THE ESSENTIAL GUIDE 240 (2008).

⁴¹⁰ *Private Equity and Venture Capital Regulation* (PLC, Jan. 2013), <http://uk.practicallaw.com/1-383-9670>.

⁴¹¹ There is nothing in the statutory framework that explicitly or implicitly requires the UK regulator to adopt a risk-based approach.

due to the implications they carried in relation to risk to the FSA's achievement of its statutory objectives.⁴¹²

As a single regulator, the FSA was deemed one of the most powerful financial services regulators in the world in terms of scope, powers and discretion.⁴¹³ Nevertheless, the regulator has recently undergone a significant strategic and operational change⁴¹⁴ which resulted in splitting the FSA between two separate regulatory bodies,⁴¹⁵ namely the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).⁴¹⁶ On 19 December 2012, the Financial Services Bill 2012-2013 received Royal Assent and became the Financial Services Act 2012 (FSA 2012).⁴¹⁷ The Act delivered the fundamental reform by abolishing the FSA with effect of 1 April 2013. The upshot of this institutional re-ordering was that the FSA ceased to exist in its form and the majority of its functions passed on to two separate regulators, thereby establishing a 'twin peaks' model, consisting of prudential regulation and conduct of business regulation.⁴¹⁸

Prior to the AIFMD, private equity firms were subject to the relevant parts of the FSA Handbook (currently, the FCA Handbook), which set out the regulatory requirements made under powers given to the regulator by the FSMA.⁴¹⁹ In general, the Handbook incorporates material contained in UK statute, EU directives and Commission technical regulations, and aims to harmonise, consolidate and rationalise the regulator's principles, rules and guidance.⁴²⁰

⁴¹² JUSTIN O'BRIEN, *PRIVATE EQUITY, CORPORATE GOVERNANCE AND THE DYNAMICS OF CAPITAL MARKET REGULATION* 147 (2008).

⁴¹³ Beat D. Speck & Joseph Tanega, *Private Equity Placements: Comparing the Laws in Switzerland, the European Union, the United Kingdom and the United States: Part II*, 21(4) J.I.B.L.R. 252, 253 (2006).

⁴¹⁴ Further information on the Government's regulatory reform programme is at www.hm-treasury.gov.uk/consult_finreg_blueprint.htm.

⁴¹⁵ *Policy Options for Implementing the Alternative Investment Fund Managers Directive* 4 (HM Treasury, Mar. 14, 2012), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81544/condoc_policy_options_implement_aifmd.pdf; Charlotte Hill, *Fund Management Update*, 104(Mar) C.O.B. 1, 29 (2013).

⁴¹⁶ The PRA is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms and aims to promote their safety and soundness as well as to contribute to the securing of an appropriate degree of protection for policyholders. See The PRA, <http://www.bankofengland.co.uk/PRA/Pages/default.aspx>.

⁴¹⁷ Financial Services Act 2012, <http://www.legislation.gov.uk/ukpga/2012/21/contents/enacted>.

⁴¹⁸ This new structure responds to perceived deficiencies in the old system. Under the new regulatory model, the FCA has become the competent authority of interest to most, if not all, alternative investment fund managers (AIFMs) falling within the purview of the AIFMD's provisions.

⁴¹⁹ *Consultation Paper CP12/24* (FSA, Sept. 2012), <https://www.fca.org.uk/publication/consultation/cp12-24.pdf> (confirming that the majority of the FSA Handbook provisions will be carried forward and subsequently amended as necessary by the FCA and PRA to match their respective functions and objectives).

⁴²⁰ *FSA Handbook of Rules and Guidance* (PLC, Mar. 31, 2013), <http://uk.practicallaw.com/6-502-0962?source=relatedcontent>. The FCA Handbook is divided into seven Blocks – High Level Standards (Block 1), Prudential Standards (Block 2), Business Standards (Block 3), Regulatory Processes (Block 4), Redress (Block 5), Specialist Sourcebooks (Block 6) and Listing, Prospectus and Disclosure Rules (Block 7); each Block is

The FSA was a strong proponent of the principles-based approach, which consisted of six tiers of regulatory principles (high-level principles, generally applicable regulatory standards, supervisory rules, prudential rules, specific market regulation, and complaints and compensatory mechanisms).⁴²¹ The overarching regulations applied to all forms of business and different types of business with their own regulatory code. The approach was widely viewed as successful before the crisis and its lawfulness was endorsed by the High Court in *R (ex parte British Bankers Association) v FSA*.⁴²²

The Financial Services Register demonstrates that private equity firms, such as 3i, were authorised and regulated by the FSA long before the AIFMD. Therefore, examples of some of the most essential FSA rules and regulatory principles applicable to private equity at that time are presented below.

4.1 High Level Standards

Block 1 contained seven sourcebooks which were known as the FSA's High Level Standards. Overall, Block 1 prescribed the requirements for all authorised firms and approved persons, and contained general interpretative material.⁴²³

The Principles for Business rulebook (PRIN) contained eleven Principles⁴²⁴ which set forth fundamental obligations of all firms under the regulatory system and underpinned the remainder of the FSA Handbook. Breaching a Principle made a firm liable to disciplinary sanction (PRIN 1.1.7G), and the regulator was increasingly using breach of a Principle as the grounds for taking enforcement action against a firm.

The Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) outlined the FSA's management requirements. SYSC aimed to control risk-taking, and placed emphasis on the responsibilities of directors and senior management in order to ensure a firm had

subdivided into themed modules (sourcebooks or manuals) relating to the regulation of various areas of the financial services market. The status of each provision in the Handbook is indicated by a letter attached to it (e.g. R for rules and G for guidance given by the FCA), resulting in diverse provisions having different effects.

⁴²¹ ALASTAIR HUDSON, *supra* note 335, at 178.

⁴²² 'The Principles are the overarching framework for regulation, for good reason' (Ousely J, para 161); *R (ex parte British Bankers Association) v FSA* [2011] EWHC 999 (Admin).

⁴²³ *Reader's Guide: An Introduction to the Handbook 6* (FCA, Mar. 2013), <http://www.fca.org.uk/your-fca/documents/handbook/handbook-readers-guide>.

⁴²⁴ The Principles are as follows: integrity (which is the core principle governing financial regulation in the UK); skill, care and diligence; management and control; financial prudence; market conduct; customers' interests; communications with clients; conflicts of interest; customers (relationships of trust); clients' assets; and relations with regulators.

appropriate control, supervision and accountability systems in place, including appropriate operational risk systems and controls.⁴²⁵ For instance, a firm had to take reasonable care to establish and maintain such systems and controls as were appropriate to its business (SYSC 3.1.1R). The nature and extent of the systems and controls which a firm needed to maintain would depend upon a variety of factors (SYSC 3.1.2G).⁴²⁶ SYSC 6.3 contained provisions relevant to financial crime. Under SYSC 6.3.1R, a private equity firm had to ensure that its policies and procedures included systems and controls that enabled it to identify, assess, monitor and manage money laundering risk. SYSC 6.3.4G provided for compliance with relevant legal requirements, in particular the Money Laundering Regulations 2007⁴²⁷ which required a private equity firm to, *inter alia*, conduct customer due diligence on a risk-sensitive basis, depending on the type of customer, business, relationship or transaction. Money laundering and bribery are closely related, therefore a firm would need to be cognisant of and adopt procedures in order to prevent infringing the provisions of the Bribery Act 2010. This would satisfy a firm's obligation under Principle 3 (Management and Control) of PRIN. SYSC 8 contained provisions appurtenant to outsourcing that were likely to be relevant to many private equity firms. Under these provisions, a firm that outsourced critical functions was required to take reasonable steps to avoid undue additional operational risk and could not undertake the outsourcing if that would materially impair the quality of its internal control or the regulator's ability to monitor the firm's compliance with its regulatory obligations (SYSC 8.1.1R). Under SYSC 10.1, a private equity firm was required to identify and manage conflicts of interest, and to have effective arrangements in place with a view to taking all reasonable steps to prevent conflicts of interest giving rise to a material risk of damage to the interests of the clients. Prior to UK implementation of the AIFMD, the FSA's Remuneration Code, SYSC 19A (effective from 1 January 2010), was relevant only to a handful of private equity firms. The Code established general requirements, supported by 12 remuneration principles (SYSC 19A.3), for firms within its scope to have remuneration practices in place, to contribute to successful risk management.

The Statements of Principle and Code of Practice for Approved Persons (APER) and the Fit and Proper test for Approved Persons (FIT) were also specified under the FSA's High Level

⁴²⁵ *Reader's Guide: An Introduction to the Handbook*, *supra* note 423, at 8.

⁴²⁶ This included: (i) the nature, scale and complexity of its business; (ii) the diversity of its operations, including geographical diversity; (iii) the volume and size of its transactions; and (iv) the degree of risk associated with each area of its operation.

⁴²⁷ The Money Laundering Regulations 232007 (SI 2007/2157).

Standards. Although both did not directly apply to private equity firms, they were relevant for any employee who carried out a ‘controlled function’ (such as governing functions) on behalf of a private equity firm.⁴²⁸ APER set out standards of behaviour that the FSA expected of approved persons, focusing on the competence and integrity of individuals who performed a range of controlled functions, whilst FIT set out the FSA’s minimum standards for becoming and remaining an approved person.⁴²⁹ It was important that all personnel were aware of, and complied with, these regulatory obligations. The regulator had a number of disciplinary measures at its disposal should a private equity firm breach any of the rules, including public censure, financial penalties, prohibiting individuals from performing controlled functions and varying or cancelling the firm’s licence.⁴³⁰

4.2 Prudential Standards

All authorised firms were required to maintain a certain level of regulatory capital that was commensurate to the risks to which they were exposed. This means that a firm’s capital had to be sufficient in terms of quantity, quality and availability in order to act as a buffer to accept losses and to prevent these losses from impacting the creditors. In the pre-AIFMD world, the prudential requirements for a private equity firm would depend on whether or not it was within the scope of MiFID. This would ultimately vary from firm to firm based on its classification and activities. A private equity firm that was outside the scope of MiFID would be subject to the requirements of the Interim Prudential sourcebook for Investment Businesses (IPRU(INV)). If it acted as operator of collective investment schemes, the regulatory capital requirements would be relatively low, that is, £5,000 provided the firm did not deal with retail customers. A firm within the scope of MiFID but whose MiFID business was limited to receiving and transmitting orders and/or providing investment advice⁴³¹ and which did not hold client assets would be required to hold initial capital of €50,000 or professional indemnity insurance representing at least €1,000,000 applying to each claim and in aggregate €1,500,000 per year for all claims, or a mixture of the two that provided equivalent coverage (IPRU(INV) 9.2.4R).

Most private equity firms would come within one of the two categories, although a private equity firm carrying on a broader range of activities than those mentioned above would

⁴²⁸ A full list of controlled functions can be found in the FCA’s Supervision Manual (SUP), 10A.4.

⁴²⁹ *Reader’s Guide: An Introduction to the Handbook*, *supra* note 423, at 8-9.

⁴³⁰ IAIN G. MACNEIL, *supra* note 334, at 113-115.

⁴³¹ *The UK Regulatory Environment for Funds and Private Equity Firms - Private Equity Regulation Briefing* (Kaye Scholer LLP, July 11, 2011).

normally be subject to higher regulatory capital requirements. A fraction of firms which did not fall within those categories would be subject to the Prudential sourcebook for Banks, Building Societies and Investment Firms, BIPRU, which largely reflected the requirements of CRD.⁴³²

4.3 Conduct of Business Requirements

Conduct of business regulation relates to the proper treatment of customers by regulated firms. This part of financial regulation changed with the coming into effect of MiFID, which had established general principles with which regulated firms had to comply. For a private equity firm acting as a manager of a fund, the client(s) would be the fund, and not the individual investors in the fund. Accordingly, the fund would be categorised as a professional client under MiFID.⁴³³ The treatment of such clients was affected by the regulator's Conduct of Business sourcebook (COBS), in force from 1 November 2007, which implemented relevant MiFID provisions to ensure that investors are protected. The principles supplemented the ordinary contract rules by imposing positive obligations on regulated firms when acting with different types of customers.

As a corollary, relevant firms needed to provide retail and professional clients with best execution and apply the suitability test to their professional clients where they were supplying investment advice or portfolio management services. In the private equity context, 'best execution' would mostly apply to stakebuilding in listed companies, as contrasted with investing in unquoted companies where the price agreed would be the only price available. With respect to the suitability test, firms would need to establish whether the transaction to be recommended or entered into meets the professional client's investment objectives and that the client has the necessary experience and knowledge in order to understand the risks involved in the transaction (COBS 9.2.2R and COBS 9.2.8R). It remained possible, *albeit* more complicated, for a private equity firm to promote its funds (unregulated collective investment schemes) to inexperienced retail clients. Such clients would have to undergo an adequate assessment to satisfy the qualitative test, namely sufficient expertise, experience and knowledge, to demonstrate they are capable of making own investment decisions and understand the risks involved in each transaction or service envisaged (COBS 4.12.1R(4), Category 8).

⁴³² *FCA and PRA Handbooks* (PLC, May, 2014), <http://uk.practicallaw.com/2-525-0988?source=relatedcontent>.

⁴³³ *The UK Regulatory Environment for Funds and Private Equity Firms - Private Equity Regulation Briefing*, *supra* note 431.

5. Investing in Listed Companies

The private equity business encompasses a range of transactions of different type; however, the term ‘private equity’ somewhat became synonymous with buyouts, where majority control of an existing firm is bought.⁴³⁴ In this realm, public to private transactions were very common, and in the pre-AIFMD world detailed regulation was in place to govern situations where public companies were taken into private hands. Such transactions were much more heavily regulated than private transactions, therefore a private equity firm would be subject to a stringent set of rules when acquiring, or building stakes in, public companies. The two principal mechanisms for structuring these transactions were a traditional takeover offer and a court-approved scheme of arrangement.⁴³⁵ The keystone in this space was the City Code on Takeovers and Mergers (the Code),⁴³⁶ but the parties involved would also need to comply with the relevant requirements of the FSMA, the Companies Act 2006 (CA 2006),⁴³⁷ the Model Code on Directors’ Dealings, the Criminal Justice Act 1993 (CJA), and the Listing Rules of the Financial Services Authority, comprising the Disclosure and Transparency Rules, the Prospectus Rules, the Combined Code on Corporate Governance and the Admission and Disclosure Standards.⁴³⁸

6. Insider Dealing and Market Abuse

Any share dealings in the UK constituted an offence under the insider dealing legislation contained in the Criminal Justice Act 1993 (CJA). In contemplating arrangements involving the purchase of shares on a UK regulated market, offences were committed by individuals, not the firms themselves, and therefore it was the knowledge and actions of those individuals which was important. The three principal (criminal) offences included: dealing in price-affected

⁴³⁴ Jennifer Payne, *supra* note 381, at 559, 570.

⁴³⁵ Graham Gibb & Charles Martin, *Public-to-privates*, in *PRIVATE EQUITY: A TRANSACTIONAL ANALYSIS* 199, 199 (Chris Hale ed., 2010). A scheme of arrangement is a statutory procedure pursuant to Part 26 of the Companies Act 2006, whereby a company may make an arrangement with its members or creditors, or a class of creditors or members, which will be enforced by the court. The scheme only applies to recommended offers, as the court does not want to get involved in the conflict between two companies following an unwanted hostile bid.

⁴³⁶ The main principles regulating issues specific to a takeover offer are covered by a set of general rules contained in the Code, which shapes the form, structure and timetable of takeovers in the UK and is administered by the Panel on Takeovers and Mergers (the Panel). The Code applies to offers for all public companies resident in the UK. The Panel will provide guidance with regard to the application of the Code to the advisers to private equity investors, Bidco and Target, each of whom will liaise closely with the Panel in order to ensure that the transaction structure and conduct are consistent with the Code; see GEOFF YATES & MIKE HINCHLIFFE, *A PRACTICAL GUIDE TO PRIVATE EQUITY TRANSACTIONS* 286 (2010).

⁴³⁷ For instance, national safeguards against asset stripping (substantial asset transactions) existed under sections 190-196; directors’ duties, such as a duty to promote the success of the company or a duty to disclose interests in a proposed transaction or arrangement, were covered under sections 171-177; and there were detailed provisions regulating the distribution of dividends under Part 23.

⁴³⁸ Amanda Onions, Andy Treavett & Sarah Stewart, *Private Equity in UK (England and Wales): Market and Regulatory Overview* (PLC, Nov. 1, 2011), <http://uk.practicallaw.com/4-500-5750?source=relatedcontent>.

securities by using inside information, encouraging others to deal in price-affected securities, and disclosing inside information to others (CJA, section 52). A criminal offence of engaging in misleading statements or practices was set out in section 397 of the FSMA.

Those criminal offences overlapped significantly with the FSA's parallel civil law powers to impose sanctions on companies or individuals whose behaviour fell within the description of market abuse contained in section 118 of the FSMA.⁴³⁹ These civil offences had empowered the regulator to impose penalties outside the mainstream of criminal law. The section 118 powers were a controversial innovation of FSMA designed to make it easier for the regulator to police the markets. Under section 118, a lower civil standard of proof, 'on the balance of probabilities,' applied and therefore it was not necessary to prove knowledge or intent. Moreover, the regulator itself was the decision-maker imposing the penalties for civil market abuse, thereby avoiding the protracted criminal prosecution process and the uncertainties associated with criminal courts with a lay jury as a final decision-maker.⁴⁴⁰

In addition, the regulator issued a Code of Market Conduct in order to specify with greater exactitude behaviours that would or would not constitute market abuse. The Code was referred to as MAR 1 in the FSA Handbook.

7. Disclosure and Transparency Rules

The relevant provisions applied only where the shares were admitted to trading on a regulated or prescribed market in the UK, including the Alternative Investment Market (AIM) of the London Stock Exchange and markets for listed securities. Pursuant to Chapter 5 of the FSA's Disclosure Rules and Transparency Rules (DTR), a share purchase could incur an obligation to notify the voting rights with regard to those shares, even if a takeover was not contemplated. The basic disclosure obligation was set out in DTR 5.1.2R – a firm had to notify the issuer of the percentage of the voting rights it held as shareholder, or held or was deemed to hold through its direct or indirect holding of financial instruments, if the percentage of those voting rights reached, exceeded or fell below certain percentage thresholds.

⁴³⁹ The basic market abuse offence is detailed in section 118 of the FSMA and involves the following types of behaviour: insider dealing, improper disclosure of inside information, misuse of information, manipulating transactions and devices, disseminating information likely to give a false or misleading impression, and misleading behaviour or market distortion.

⁴⁴⁰ Angela Hayes, *Market Abuse*, 75(Apr) C.O.B. 1, 2-3 (2010).

Where a notification was required, it had to be effected as soon as possible. If the shares were admitted to trading on a regulated UK market, a firm making a notification to an issuer also had to file a copy of such notification with the UK regulator (DTR 5.9.1R). The regulator could impose a penalty if it considered that a firm had contravened the DTR.

8. Conclusion

This chapter has surveyed the UK pre-AIFMD environment in which private equity firms operated. Contrary to the aphorism that the ‘private equity business is unregulated,’ there is evidence that the industry’s activities were governed by a wide net of measures. Most notably, private equity firms were regulated by the FSA and, as a result, had to comply with the relevant sections of the FSA Handbook. In addition, financial stability was addressed via minimum capital requirements; market integrity and efficiency was covered by the market abuse and market conduct rules; and the provisions of UK company law applied to corporate governance issues, company acquisitions and transparency/disclosure requirements towards investors and the UK regulator. Last, but not least, Limited Partnership Agreements dealt with issues, such as managers’ remuneration, investment strategies, risk management, and conflicts of interest.

The prominent rise of private equity firms raised the game on the alternative investment side and led to the perception that closer and deeper regulatory controls are required. Consequently, the next chapter depicts the route towards the AIFMD, focusing on the pre- and post-crisis developments that took place in Europe and elsewhere.

Chapter V

Towards the AIFMD

1. Introduction

Private equity has grown so much that it stopped being regarded as a niche sector⁴⁴¹ that operated at the fringes of corporate finance and corporate activity.⁴⁴² New buyout records were set continuously and given superb performance, private equity began to be seen by some as a rival to public markets as a source of financing. This buyout boom initially occurred in the US, then moved across to Europe and the Asia-Pacific region. The pre-2007 crisis world was awash in cheap money and a number of factors fuelled a virtual circle of supportive, fertile economic environment.⁴⁴³ However, in the summer of 2007, private equity found itself in the subprime whirlwind, which resulted in a ‘cooling off’ period for the PE industry and subsequently the worst Siberian weather it had ever experienced. Suddenly, all the factors that were responsible for boosting the industry, like favourable credit terms with persistently low interest rates or the continuing demand from investors for steadily larger PE funds, collapsed simultaneously.⁴⁴⁴

The crisis naturally manifested itself in various ways; however, it is the unusually intensified regulatory activity that had become one of the major concerns for private equity firms. Prior to the crisis, the general view – *albeit* ill-founded as shown in the previous chapters – was that PE firms were largely exempt from many of the supervisory requirements that other types of investments faced. Since 2008, the volume and value of PE transactions had reduced substantially, but the calls to regulate the industry did not diminish. Due to the worsening situation in the global financial markets, private equity had to come to terms with more regulatory oversight which inevitably took the form of new financial regulations containing additional requirements and restrictions on PE fund management and marketing. In Europe, the major regulatory development in this domain has been the AIFMD. The claimed benefits of the Directive, like augmented transparency, do not come for free and are likely to result in significant compliance costs.⁴⁴⁵ Given the lack of evidence that the industry played an actual

⁴⁴¹ Jennifer Payne, *supra* note 381, at 559, 559-560.

⁴⁴² Chris Hale, *supra* note 28, at 5.

⁴⁴³ ELI TALMOR & FLORIN VASVARI, *supra* note 30, at 5.

⁴⁴⁴ Benoit Leleux, *supra* note 24, at 154-160.

⁴⁴⁵ ELI TALMOR & FLORIN VASVARI, *supra* note 30, at 14.

role in the emergence of the 2007 financial turmoil, it appears that the crisis might have been used opportunistically to push through reforms that had little real connection to the crisis itself.⁴⁴⁶ Accordingly, this new EU legislation might be considered as a paragon of a crisis-induced regulatory over-reaction.

This chapter traces the European developments which led to the adoption of the AIFMD and examines how EU institutions and other parties had influenced the EU policy formation process in this area. The focus is first placed on both EU level and individual actions, as well as proposals that had taken place before the full onset of the crisis. The discussion then moves to the post-crisis policy debate and the industry response to the new pan-European regulatory framework for AIFMs.

2. Engagement with the PE Industry prior to the Crisis

The alternative sector has somewhat successfully escaped the full scrutiny of regulators and lawmakers, which – one could claim – had subsequently an impact on the industry’s success in attracting investors and generating untold wealth. The pre-crisis industry trends, such as the ever increasing size and volume of LBOs and the growing risk of price fixing associated with ‘club deals’ by mega funds, resulted in the perception that the PE industry needed greater attention. Even before the financial crisis, there was a division of opinion regarding the benefits of private equity. Irrespective of these divergent views, there was no major regulatory overhaul undertaken at the EU level or in any individual Member State.

This section looks at the early stage in the general debate regarding the necessity of EU regulation in the private equity sector. First, an early assessment of the industry by the European institutions is provided, highlighting the risks and areas of potential harm associated with the industry’s operations that fuelled the need to adopt regulatory measures. Second, to provide an example, steps taken by the UK regulator and the British Venture Capital Association (BVCA) are presented, to demonstrate how some of the principal concerns were addressed in the UK. This is then followed by other examples of pre-crisis engagement with the industry to shed more light on the evolution of the policy discussion in relation to private equity in Europe.

⁴⁴⁶ Eilís Ferran, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU*, 12(3) EUROPEAN BUS. ORGANIZATION L. REV. 379, 380 (2011).

2.1 The European Institutions and the ECB

In the period between the completion of Financial Sector Assessment Program (FSAP) 2005 and the emergence of the post-crisis regulatory reform agenda, the attention of European policymakers turned to the alternative investment fund industry and the fashioning of an appropriate EU-wide regulatory response. Many commentators described the industry as ‘unregulated,’ although the previous chapters evinced that private equity was in fact subject to numerous regulatory requirements, including registration with regulators, some reporting and varying forms of supervision (especially in the UK, the European private equity hotspot). The problem, however, was that these regulatory regimes across Member States did not represent a coherent, consistent, comprehensive EU-wide framework. On the contrary, everything looked like a patchwork of Member State requirements and differing levels of supervisory oversight applying to alternative investments, and this did pose a barrier in itself to cross-border investments.

The EU Commission had recognised before the crisis that the proliferation of sophisticated alternative investment vehicles had the potential to create a need for a non-fragmented, enlightened European approach to the sector, with adequate quantification and control. Early deliberations regarding initiating a new EU legislation could be found in the Commission’s Green Paper (2005) which observed that ‘[t]he investment fund industry has grown over the space of a decade to become a key actor in European capital markets,’⁴⁴⁷ offering new diversification benefits for different categories of fund managers, higher returns for investors and an increased overall market liquidity.⁴⁴⁸ The Green Paper equally recognised that this alternative investment industry, comprising hedge funds and private equity funds, employs strategies that are more complex and involve higher risks for investors when juxtaposed with, for instance, mainstream undertakings for collective investment in transferable securities (UCITS). Divergent national regimes were deemed to pose the risk of regulatory fragmentation that could hamper the development of the business models concerned and hence a new approach was increasingly becoming more desirable. Subsequently, the Commission established diverse groups of industry experts in order to report on ways how to increase the efficiency of the EU investment fund market. The Commission’s rhetoric initially revealed a pro-market tone to

⁴⁴⁷ *Green Paper on the Enhancement of the EU Framework for Investment Funds (SEC(2005) 947)* 2 (EU Commission, July 12, 2005), <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52005DC0314&from=EN>.

⁴⁴⁸ *Id.* at 9.

foster the development of private equity and hedge fund activity within the EU. This stance was to a large degree influenced by personal preferences of the then Internal Market Commissioner, Charlie McCreevy. Meanwhile other parties were gradually turning to the role of regulatory intervention and its potential in reducing the troubling elements of industry practice, particularly the lack of transparency and accountability.

In the run-up to the financial crisis, influential groups within the EU Parliament were prominent critics of alternative investments, in particular hedge funds, but the critique of private equity was becoming more palpable as well. The two sectors have invariably been treated together at the European level, which is somewhat controversial and unfortunate as risks posed by both AIFM types are far from being equal. Notwithstanding this, a range of resolutions was passed in order to call on the EU Commission to examine more closely the two industries and to adopt a more critical approach in assessing them.

A notable contribution to the debate was a report published by the Parliamentary Socialist Group,⁴⁴⁹ traditionally hostile towards Anglo-Saxon capitalism, which noted that private equity posed serious questions to the European real economy and policymakers. The fundamental concerns related to the effect of LBOs⁴⁵⁰ on job creation; corporate governance and economics; protection of minority shareholders; management policy and shareholder activism; effects on public finances due to the use of tax havens; and investor protection, in particular pension funds and insurance companies. The report disagreed with the industry's endeavours to demonstrate its positive effects (on job creation, for example), arguing this was 'contradicted by well-based studies and logical reflections.'⁴⁵¹ The report identified several areas that required regulatory intervention⁴⁵² and proposed regulations to address problems associated with private equity – a rather complicated task given the widely differing impact of PE activities which, on the one hand, stretch from the 'scandalous and even criminal' asset stripping, the looting of pension funds and crass personal enrichment at the expense of workers and society at large to, on the other hand, the vital function of helping small and medium-sized enterprises (SMEs), succession issues and the provision of growth capital.⁴⁵³ The immediate proposal referred to the creation of a pan-European alternative investment regulation oriented towards balancing

⁴⁴⁹ *Hedge Funds and Private Equity - A Critical Analysis*, *supra* note 349.

⁴⁵⁰ LBOs in particular were accused of having serious negative consequences and massively destroying value of portfolio companies.

⁴⁵¹ *Hedge Funds and Private Equity - A Critical Analysis*, *supra* note 349, at 83.

⁴⁵² These included lack of transparency, short-termism, distorted remuneration incentives and threat to financial stability.

⁴⁵³ *Hedge Funds and Private Equity - A Critical Analysis*, *supra* note 349, at 83.

investor protection, corporate governance and society's interest in maintaining or increasing the value of companies over the long term, without closing the door to desirable investment strategies.⁴⁵⁴

The period preceding the crises witnessed a considerably greater criticism of hedge funds than private equity, as the former was believed to pose systemic risk and was seen as part of the shadow banking system. Private equity was criticised to a lesser degree. For instance, the ECB took a relatively sanguine view of potential systemic threats due to the activity of PE firms.⁴⁵⁵ In the 2007 Report on large banks and PE-sponsored LBOs in the EU, the Banking Supervision Committee found that 'the likelihood of LBO activity posing systemic risks for the banking sector appears remote at the EU level';⁴⁵⁶ and the results of a survey of large banks' participation in the financing of LBO transactions in the EU showed that the debt exposure of the banks concerned was not large relative to their capital buffers.⁴⁵⁷ The Report, however, identified some potential sources of risk for banks as regards recent trends in the LBO market. These vulnerabilities in the LBO market could warrant further monitoring by authorities tasked with financial supervision, but the Report refrained from prescribing any specific recommendations for possible regulatory reactions to LBO-related risks.

2.2 The UK Experience

Motivated by the growing scale and significance of the PE industry to the United Kingdom and its economy, the previous UK financial regulator, the FSA, deemed it necessary to look closer at the industry. In general, the regulatory interest in private equity predated the financial crisis and the UK financial regulator considered the regulatory risks in respect of private equity in a November 2006 Discussion Paper (DP06/6).⁴⁵⁸ The DP06/6 was published following a wide-ranging thematic review of private equity markets and sought to assess what was the appropriate level and form of regulatory engagement with the private equity sector. The private equity industry in the UK had gained a high public profile and generated an extensive debate which incorporated the interests of a broad group of stakeholders. The FSA outlined six reasons for the need to publish the discussion paper on private equity. They were the following: significant growth in the capital flowing into PE funds; increase in leveraged finance provision to PE

⁴⁵⁴ *Id.* at 178-179.

⁴⁵⁵ *Large Banks and Private Equity-Sponsored Leveraged Buyouts in the EU* (ECB, Apr. 2007), <http://www.ecb.europa.eu/pub/pdf/other/largebanksandprivateequity200704en.pdf>.

⁴⁵⁶ *Id.* at 5 & 41.

⁴⁵⁷ *Id.* at 4.

⁴⁵⁸ *Private Equity: A Discussion of Risk and Regulatory Engagement (DP06/6)*, *supra* note 381.

transactions; extended reach of private equity due to rise in larger individual funds and undertaking of ‘club deals’ together with the increased availability of debt finance; development of secondary markets in both individual investor commitments to PE funds and PE funds’ holdings of entire companies, which could result in reduced capital flows to the public markets; shrinking of UK equity market capitalisation reflecting, amongst other things, the impact of public-to-private transactions; and, finally, concerns expressed by market participants about a perceived lack of understanding amongst public policymakers, potential investors and commentators as regards the nature of PE business models and their inherent risk.⁴⁵⁹

The above developments prompted the FSA to publish DP06/6 in order to stimulate informed discussion amongst industry participants and policymakers about the evolution of the PE market, to elucidate the risks associated with the industry and to inform key stakeholders how to mitigate these risk areas within and outside the UK.⁴⁶⁰ The key risk areas identified in the Discussion Paper included excessive leverage, unclear ownership of economic risk, reduction in overall capital market efficiency, market abuse, conflicts of interest, market access constraints and market opacity. The FSA’s provisional assessment of the significance of these risks took into account both the possible harm that could be caused (‘impact’) and how likely the event was to crystallise (‘probability’). The DP06/6 highlighted that the huge majority of PE firms have been assessed as ‘Low Impact.’ According to the summary table, the potential impact of risks associated with market abuse and conflicts of interest was most significant and its probability of occurring in the short term merited an overall score of ‘high.’⁴⁶¹ The FSA highlighted, however, that the UK regulatory architecture governing private equity is ‘effective, proportionate and adequately sourced.’⁴⁶² The supervision is risk-based and supplemented by targeted thematic work. The FSA’s revised, risk-based framework used to model the risk of individual firms, Advanced Risk Response Operating Framework II, allowed the regulator to ‘calibrate the degree of intensity of...supervision according to the impact and probability of the risks that are apparent within a particular firm, based on defined criteria.’⁴⁶³ Accordingly, the FSA asserted that the UK regulatory landscape ‘responds effectively to the stratified private equity market.’⁴⁶⁴

⁴⁵⁹ *Private Equity: A Discussion of Risk and Regulatory Engagement (DP06/6)*, *supra* note 381, at 3-4.

⁴⁶⁰ *Id.* at 4.

⁴⁶¹ *Id.* at 10.

⁴⁶² *Id.*

⁴⁶³ *Id.* at 86.

⁴⁶⁴ *Id.* at 10.

In June 2007, the FSA published a Feedback Statement⁴⁶⁵ to DP06/6 in which it stated broad satisfaction with its regulatory approach, but highlighted market abuse and conflicts of interest as the main areas for continued regulatory focus. Also, in 2007, the FSA began a thematic project to review private equity's systems and controls for managing conflicts of interest. This review was completed in July 2008 and its findings were reported in the FSA's Capital Markets Bulletin.⁴⁶⁶ The findings concentrated on the degree to which the private equity business model demonstrated an alignment of interests with fund investors as well as the adequacy and formalisation of private equity firms' approach to conflict identification, management and mitigation.⁴⁶⁷ The FSA observed that size did influence the firm's behaviour and that the vast majority of firms visited operated adequate business models. The bulletin provided a list of key areas for PE firms to consider, including suitable training programmes for new employees with ongoing refreshers and other methods to increase staff awareness for the firm's policies and procedures, legal requirements and expectations concerning ethics and code of conduct, as well as regular and formal reviews of the firm's policies and procedures.⁴⁶⁸

At the beginning of 2007, Sir David Walker, a distinguished banker and former regulator, was asked by the British Venture Capital Association (BVCA) and a group of major private equity firms to undertake an independent review of the adequacy of disclosure and transparency in private equity. He was asked to lead a working group, later known as the Walker Working Group, to develop a set of guidelines for PE firms applicable on a 'comply or explain' basis. This was an industry-led initiative implemented in order to prevent the possibility of increased regulation following the wave of negative comments and suspicions regarding the lack of transparency in the private equity sector. A Consultation Paper⁴⁶⁹ was issued in July 2007, seeking views from the industry and related bodies. Feedback to the Consultation Paper demonstrated widespread endorsement by the PE industry of greater transparency, and respondents noted they did not believe the economic performance of the PE firms would suffer through compliance with a new code on transparency. On 20 November 2007, Sir David's team

⁴⁶⁵ *Private Equity: A Discussion of Risk and Regulatory Engagement. Feedback on DP06/6 (FS07/3)* (FSA, June 2007), <https://www.lexology.com/library/detail.aspx?g=f74b8bae-d40d-49c6-a179-7a2207eda6db>.

⁴⁶⁶ *Thematic Review of the Management of Conflicts of Interest within Private Equity Firms* (FSA, Capital Markets Bulletin – Issue 3, July 2008), <https://www.lexology.com/library/detail.aspx?g=6daba929-de43-41a6-8a96-ab5a0b8d8f0e>.

⁴⁶⁷ *Id.* at 3-4.

⁴⁶⁸ *Id.* at 5.

⁴⁶⁹ Sir David Walker, *Disclosure and Transparency in Private Equity* (Consultation Paper, July 2007), <https://www.privateequityreportinggroup.co.uk/Portals/0/Documents/About%20the%20Guidelines/Consultation-Documents/Document-July-2007.pdf?ver=2019-10-29-171241-397×tamp=1572369215028>.

issued their final report⁴⁷⁰ which included voluntary guidelines, known as the Walker Guidelines, and recommendations on transparency and enhanced disclosure for private equity firms investing in UK companies.

The Walker Guidelines introduced content and timing requirements for enhanced reporting by portfolio companies, communication requirements for PE firms and recommendations for initiative by the BVCA. For the purposes of the Guidelines, a private equity firm was an FSA-authorised firm managing or advising one or more funds that either owned or controlled one or more UK companies or had a designated capability to engage in such investment activity. A portfolio company was defined as a UK company which was acquired or controlled by one or more private equity firms, with market capitalisation exceeding £300 million, generating more than 50 per cent of revenues in the UK, and having 1,000 or more full-time UK employees.⁴⁷¹ The Walker Report recommended that such portfolio companies should publish an annual report and accounts on its website and a summary mid-year update giving a brief account of key developments in the company.⁴⁷² A PE firm should publish, either as an annual review or through regular updating of its website, fund information (that is, a description of its own structure, investment approach, the UK companies in its portfolio, an indication of the leadership of the firm in the UK and confirmation that arrangements are in place to deal with conflicts of interest), a commitment to conform to the soft law on a comply or explain basis, and investor information (that is, a categorisation of its limited partners by geography and type).⁴⁷³

The Guidelines Monitoring Group (GMG) (currently the Private Equity Reporting Group, PERG) was established by the BVCA in November 2007 to keep the Walker Guidelines under review and monitor PE firms' conformity with them.⁴⁷⁴ It meets regularly and has the power to expel from the BVCA any firm that does not comply with the Guidelines.

⁴⁷⁰ Sir David Walker, *Guidelines for Disclosure and Transparency in Private Equity* (Nov. 2007), http://walker-gmg.co.uk/sites/10051/files/wwg_report_final.pdf.

⁴⁷¹ *Id.* at 5.

⁴⁷² *Id.* at 6.

⁴⁷³ *Id.*

⁴⁷⁴ Annual GMG Reports (now PERG Reports) can be found at <https://www.privateequityreportinggroup.co.uk/PERG-Reports>.

Although the Guidelines represented a move forward and confirmed the industry's willingness to self-regulate, the recommendations contained therein were considered to be very modest in scope⁴⁷⁵ and hence failed to satisfy some of public critics.

2.3 Others: Trade Unions, Politicians and IOSCO

Typically private equity activity had not claimed headlines in newspapers or featured in television coverage. This has changed, however, with private equity firms' increasingly audacious bids which started to prompt views that seizing control in quoted household name companies had a damaging impact on the social economy, especially by taking them private in an exercise shrouded in suspicious secrecy. In 2007, a warning was given at the European Trade Union Confederation (ETUC) conference in Seville that private equity transactions, and LBOs in particular, threaten capitalism.⁴⁷⁶ European trade unionists proposed a 'global fightback' to oppose the rapidly growing role of PE in acquiring established companies. The main arguments against private equity revolved around the favourable tax treatment, and the lack of appropriate disclosure rules and labour protection conditions in takeover targets. The unionists argued that an EU-wide campaign was needed to secure appropriate rules. In their view, a 'new super-rich elite can suck value out of companies without even paying proper UK tax on their windfalls or disclosing what they are doing. Meanwhile, the rest of us face possible reduced returns on our pension investments, the risk of economic slowdown if the takeover debt bubble bursts, and – if we are unlucky enough to work for a takeover target – real threats to jobs, pensions and living standards.'⁴⁷⁷

Politicians in some EU Member States became especially vocal in expressing their critique in relation to the industry's activities and enthusiastically joined in the public outcry over asset-stripping and job destruction. No one however had expected within the PE industry that the industry itself could become an election issue. This happened in Germany and stemmed from the announcement of the Grohe redundancy scheme which coincided with the 2005 election campaign.⁴⁷⁸ Franz Müntefering, the Chairman of Social Democratic Party (SPD), condemned in an impassioned interview with *Bild am Sonntag* private equity firms which, like irresponsible locust swarms, had descended on innocent German companies, gobbling them up and squeezing

⁴⁷⁵ Steen Thomsen, *Should Private Equity Be Regulated?*, 10 EUROPEAN BUS. ORGANIZATION L. REV. 97, 100-101 (2009).

⁴⁷⁶ David Hencke & Phillip Inman, *Private Equity Deals Threaten Capitalism* (GUARDIAN, May 23, 2007), <http://www.theguardian.com/business/2007/may/23/politics.privateequity>.

⁴⁷⁷ *Id.*

⁴⁷⁸ PAUL JOWETT & FRANCOISE JOWETT, PRIVATE EQUITY: THE GERMAN EXPERIENCE 451 (2011).

them out of their value before moving on to their next victims.⁴⁷⁹ He referred to financial investors who ‘waste no thoughts on the people and their jobs which they destroy,’ and who remain anonymous and have no face. The politician asserted that SPD would fight against this form of capitalism, a statement which initiated an intense public debate in Germany, addressing capitalism in general. The press naturally leapt into this idea with glee, even though Müntefering had already criticised private equity in a speech given on 22 November 2004 in which he denounced firms that ‘measure success in quarterly intervals, suck off substance and let companies die once they have eaten them away.’⁴⁸⁰ As a result of the article, overnight, all private equity firms were in the ‘dock of public opinion and at the centre of the political spotlight.’⁴⁸¹ Since then, references to private equity became a norm in every edition of any national newspaper or magazine. *Stern* magazine, for instance, produced an article on 28 April 2005 entitled ‘The Names of the Locusts’⁴⁸² which was based on an analysis of an SPD internal memorandum. Surprisingly, the widely popularised locust debate (*Heuschreckendebatte*) was viewed as a good thing for many members of the private equity industry. Despite the aggressive tone of the communication, the large proportion of the press coverage contained articles that explained what the industry was doing and passed judgment on successes and failures.⁴⁸³ However, there was still anecdotal evidence which added more fuel to the public debate in Germany. One such example includes Blackstone’s quick flip of Celanese, a chemicals company, which was acquired in December 2003 and de-listed from the Frankfurt Stock Exchange only to be listed on the New York Stock Exchange in January 2005. In just 13 months, Blackstone made 4.6 times its original investment, but IPO investors did not do so well as the stock quickly fell, underperforming the market.⁴⁸⁴

Germany was not alone in its revolt against alternative investment strategies. Politicians elsewhere in Europe cherished aspects of local corporate cultures and equally sought to take advantage of the widespread negative public perceptions portraying the alternative industry as a threat to employees’ job security.⁴⁸⁵ At the international level, International Organisation of Securities Commissions (IOSCO) took a special interest in seeking to identify possible

⁴⁷⁹ *Interview with Franz Müntefering* (BILD AM SONNTAG, Apr. 17, 2005) (Ger.); ROLF HESS, PRIVATE EQUITY: FINANZIERUNGSAKTIVITÄTEN FÜR DEN MITTELSTAND 23-25 (2007) (Ger.).

⁴⁸⁰ PAUL JOWETT & FRANCOISE JOWETT, *supra* note 478, at 451-452.

⁴⁸¹ *Id.* at 452.

⁴⁸² *Kapitalismusdebatte: Die Namen der "Heuschrecken"* (STERN, Apr. 28, 2005) (Ger.), <http://www.stern.de/politik/deutschland/kapitalismusdebatte-die-namen-der-heuschrecken-539759.html>.

⁴⁸³ PAUL JOWETT & FRANCOISE JOWETT, *supra* note 478, at 453-454.

⁴⁸⁴ Christian von Drathen & Flaviano Faleiro, *supra* note 228, at 2.

⁴⁸⁵ Eilís Ferran, *supra* note 446, at 379, 386.

regulatory concerns stemming from the operation of private equity. The 2007 Consultation Report⁴⁸⁶ observed that growing debt levels taken on by private firms can cause widespread disruption in case of large scale defaults, having a significant impact on the stability of the interdependent global financial markets. It was noted that linkages were developing between private equity and the public markets and consequently IOSCO was undertaking the task of monitoring possible impacts on the capital markets from the plans of some firms specialising in buyouts and in selling shares to retail investors. Moreover, IOSCO informed about conducting a preliminary review to assess whether PE firms were subject to sufficient oversight by regulatory authorities.⁴⁸⁷

3. The Post-Crisis EU Regulatory Response

The financial crisis which engulfed the EU led to a frantic search for corrective actions to address vulnerabilities in the European financial system. It added a new driver to the calls for PE regulation and presented the opportunity for some political leaders of major European economies, in particular Germany and France, to push forward the agenda for the tougher regulation of the alternative investment fund sector. It was believed that Europe should take the leadership and/or enhance international cooperation in order to play an instrumental role in shaping a new global regulatory regime,⁴⁸⁸ given the interconnectedness of global financial markets and the international dimension of funds. In view of the sometimes laxly-structured policy debate, everything was on the same political agenda when the crisis struck. This paved the way for strategic exploitation to achieve various policy objectives and using the crisis, which was primarily concerned with systemic matters, to pursue other objectives as well. There was no immediate consensus as to the regulatory post-crisis response regarding the alternative investment industry, and the period was marked by several intense power struggles in and between the European Institutions as to the appropriate way forward.⁴⁸⁹ The growing concerns regarding the PE industry's perceived impact on the real and social economy resulted in a gradually increasing pressure at the EU and international level to adopt legislative measures to regulate private equity.

⁴⁸⁶ *An Overview of the Work of the IOSCO Technical Committee* (IOSCO, Mar. 2007), <http://www.iasplus.com/en/binary/iosco/0703ioscoworkplan.pdf>.

⁴⁸⁷ *Id.* at 17.

⁴⁸⁸ *Summary Responses to Hedge Funds Consultation Paper 8-9* (EU Commission DG Market Services, Annex VIII, Mar. 12, 2009), <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52009SC0576&from=FR>.

⁴⁸⁹ Eilís Ferran, *supra* note 446, at 379, 395.

In 2008, the European Parliament intensified its calls for more stringent regulation of alternative investments and conducted a review of private equity and hedge funds in order to assess whether action, especially in relation to the better monitoring and comprehending of the related risks and opportunities, was necessary at EU level. The review took its origin in concerns about the build-up of leverage in the financial system and private equity funds, and how this could distort the functioning of the real economy in Europe. As a result of these concerns, two key reports were produced by the European Parliament: the Rasmussen report⁴⁹⁰ and the Lehne report,⁴⁹¹ which contained recommendations to the European Commission on legislative measures appurtenant to, amongst others, the European private equity. The former report called for a series of legislative measures on financial stability and issues related to both hedge funds and private equity; the latter report concentrated in particular on transparency issues affecting these two sectors.⁴⁹² McCreevy, European Commissioner for Internal Market and Services, in his speech to the BVCA on 11 December 2008 acknowledged that ‘there [was] a push to extend the reach of financial regulation to previously unregulated or lightly regulated sectors.’⁴⁹³ According to him, these pressures found their ‘most vocal expression’ in the Rasmussen and Lehne reports.⁴⁹⁴

3.1 The Rasmussen and Lehne Reports

The Rasmussen report⁴⁹⁵ was produced by the EU Parliament’s Committee on Economic and Monetary Affairs. The report recognised that, from a macroeconomic point of view, private equity could play an important positive role in the European economy by increasing Europe’s competitiveness and contributing to job creation, but stressed that this alternative investment fund industry was only lightly regulated. Accordingly, five specific recommendations were made to the EU Commission on the content of the proposal(s) requested.⁴⁹⁶

⁴⁹⁰ Poul N. Rasmussen, *Report with Recommendations to the Commission on Hedge Funds and Private Equity* (Sept. 11, 2008), <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A6-2008-0338+0+DOC+PDF+V0//EN&language=EN>.

⁴⁹¹ Klaus-Heiner Lehne, *Report with Recommendations to the Commission on Transparency of Institutional Investors* (July 9, 2008), <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A6-2008-0296+0+DOC+PDF+V0//EN>.

⁴⁹² Peter Richards-Carpenter et al., *Annual Review for 2008*, 62 C.O.B. 1, 9 (2008/09).

⁴⁹³ Charlie McCreevy, *Private Equity: Progress on Disclosure and Transparency (Walker Guidelines)* 2 (SPEECH/08/701, Dec. 11, 2008), http://europa.eu/rapid/press-release_SPEECH-08-701_en.htm?locale=en.

⁴⁹⁴ *Id.* at 3.

⁴⁹⁵ Poul N. Rasmussen, *supra* note 490.

⁴⁹⁶ *Id.* at 10-12.

Recommendation 1 concerned financial stability, capital and universal regulatory coverage. Notably, it suggested the establishment of a harmonised EU-wide regulatory framework for private equity which would not create additional legal, fiscal and administrative complexities at the EU level. Recommendation 2 dealt with transparency issues. It proposed a new legislative private placement regime in order to allow cross-border distribution of alternative investment vehicles to eligible groups of sophisticated investors. This should contain better disclosure to investors and relevant public authorities, and the information disclosed should relate to general investment strategy and fee policy, source and amount of funds raised, leverage/debt exposure, risk-management, portfolio valuation methods, full transparency of high level executives and senior managers' compensation systems, and identification of shareholders above a certain level. The Recommendation placed particular emphasis on protection of employee interests that was given expression in an obligation to inform and consult employees whenever control of the business was going to be transferred by private equity in takeovers and leveraged buyouts. Moreover, employees or staff representatives of pension funds and insurance companies should be better informed in respect of their holdings in private equity, the way in which their pensions are invested and the associated risks. Recommendation 3 included mandatory restrictions on debt levels so that leverage is sustainable for both the PE fund/firm and the target company. Equally, it included a request to revise existing EU legislation with a view to assess how the capital depletion in target companies might be redressed. This should result in new EU-level measures to prevent unreasonable asset stripping in target companies. Recommendation 4 set out new conflicts of interest measures in order to ensure effective separation between services that investment firms provide for their clients. In Recommendation 5, the EU Parliament requested the Commission to review the existing financial services regulation in order to identify any legislative lacunas with regard to the regulation of private equity. Based on the findings of such examination, legislative proposal(s) should be made to amend existing EU directives where necessary in order to create a purposive regulation pertaining to the target group.

The Lehne report⁴⁹⁷ was produced on its own initiative by the EU Parliament's Committee on Legal Affairs. The Report also recognised that private equity (and hedge funds) are alternative investment vehicles which 'can offer new diversification benefits for asset managers, increase market liquidity and the prospects of high returns for investors, contribute to the price discovery

⁴⁹⁷ Klaus-Heiner Lehne, *supra* note 491.

process, risk diversification and financial integration, and improve market efficiency.⁴⁹⁸ The Report confirmed that said alternative investment vehicles were not the cause of the 2007 financial turmoil and thus a rushed legislative response would be a mistake.⁴⁹⁹ The Report concentrated on the transparency of institutional investors, and made a number of recommendations to the EU Commission, like adopting a directive which would ensure a common standard of transparency to deal with matters concerning private equity, promoting improvements in transparency by way of monitoring the development of self-regulation within private equity industry, and encouraging Member States to lend support to these efforts by engaging in dialogue and exchanging best practices. Appropriate measures should be investigated by the EU Commission to tackle issues covering asset stripping, leverage and employee rights, but any proposals should be universal and not unfairly discriminatory.

The Lehne report made a range of important observations regarding private equity. It emphasised that the industry requires regulation that spans across the EU, but one which respects its innovative strategies. This should enable the EU industry to remain globally competitive, whilst mitigating the effects of ‘potential adverse market dynamics.’⁵⁰⁰ Accordingly, a new regulatory environment should give some scope of flexibility in order not to unduly hamper innovation. National regulatory regimes implement differently EU directives and this results in divergent rules at national level, giving rise to regulatory fragmentation in the European single market. Such a situation may impede the cross-border development of the PE business in the EU. An example of inconsistent transposition provided in the Report related to the Transparency Directive⁵⁰¹ which resulted in divergent levels of transparency within the EU and higher costs for investors. Thus, the Directive did not contribute to the optimal functioning and stability of the European financial markets and greater investor confidence. The significance of industry principles and codes of conduct and best practice had equally been emphasised. They could complement and serve as a model for EU legislation,⁵⁰² but not be a substitute for legislation tackling cases of poor conduct. Private equity firms should be encouraged to comply with these codes on a ‘comply or explain’ basis and explain publicly their choice of action. Such industry-wide reporting and monitoring would address effectively

⁴⁹⁸ *Id.* at 5.

⁴⁹⁹ *Id.* at 15.

⁵⁰⁰ *Id.* at 6.

⁵⁰¹ Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC [2004] OJ L390/38.

⁵⁰² Klaus-Heiner Lehne, *supra* note 491, at 7.

public concerns and enable better understanding of private equity's impact. However, the disclosure requirements for PE portfolio companies should not place them at a disadvantage compared to other private companies. The Lehne report was very clear on the point of asset stripping in order to forbid investors from 'plundering' target companies. It highlighted that the investors' financial power should not be misused to disadvantage a portfolio company in the long run, without having a positive impact on the acquired company's future and its stakeholders (employees, creditors and business partners).⁵⁰³ Therefore, the report asked the EU Commission to examine whether there are national legal measures that counteract asset stripping.

3.2 The EU Commission's Response

The EU Commission was not convinced by the EU Parliament's views and demonstrated resistance against overreaction in any regulatory response. Irrespective of this stance, as part of the EU institution's ongoing review of the financial markets regulation and supervision in the wake of the financial crisis, the regulatory position of private equity firms was duly considered. However, a cautious welcome was given to the Rasmussen and Lehne reports on 22 September 2008 in a speech⁵⁰⁴ given by Charlie McCreevy at the European Parliament plenary session. Commissioner duly noted that the two reports represented 'significant contributions to [the Commission's] ongoing reflection'⁵⁰⁵ and that some of the proposals were 'constructive.'⁵⁰⁶ He emphasised that whatever new approach would be adopted, close collaboration must continue with other regulatory authorities in order to dovetail the most appropriate response. Apart from many issues raised in the speech, the significant aspect was his clear stance on the issue that private equity firms were not the root cause of the turmoil in the financial markets and their activities did not pose prudential or systemic concerns that constituted the *raison d'être* of the new regulatory agenda. Although admitting that it was not necessary at this stage to tar private equity with the same brush as the one used for the regulated sector, he warned that regulators around the world should remain vigilant due to the evolving nature of the private equity business model and its role in the financial markets.⁵⁰⁷ Further, Commissioner made two important remarks:⁵⁰⁸ first, imposing special obligations on the private equity industry would

⁵⁰³ *Id.* at 11.

⁵⁰⁴ Charlie McCreevy, *Intervention on Lehne and Rasmussen* (SPEECH/08/451, Sept. 22, 2008), http://europa.eu/rapid/press-release_SPEECH-08-451_en.htm.

⁵⁰⁵ *Id.* at 5.

⁵⁰⁶ *Id.* at 4.

⁵⁰⁷ *Id.* at 3-4.

⁵⁰⁸ *Id.* at 4.

have discriminatory effect since PE firms' objectives and investment techniques are nowadays in many senses not unique; secondly, Europe's recovery from the turmoil depends on ongoing investments and so harsh regulation of private equity activity would slow down the much needed recovery process.

In a prominent speech⁵⁰⁹ in February 2009, Commissioner McCreevy acknowledged that the convulsions in the financial markets prompted the review of EU financial system and the central role of hedge funds and private equity in the political debate regarding the financial crisis. Nevertheless, he observed that even though these alternative investment vehicles became the 'poster-boys of the new finance' who 'surfed the wave of abundant liquidity and cheap credit,' they should not be made 'scapegoats' for more deep-rooted problems when the financial system is crumbling.⁵¹⁰ He emphasised the need for policy intervention that is proportionate and targeted on clearly identified market failures; reiterated his view that private equity was hardly responsible for the financial crisis; and stated that 'Hedge funds. Private equity. Different industries. Different policy concerns. But part of the same political agenda.'⁵¹¹

Commissioner McCreevy suggested six lessons that should be considered before regulating the alternative investment sector. Specifically, any action should: (i) take into account the differences between different asset classes (that is, hedge funds, private equity and other forms of alternative investment) and any policy intervention should be aimed at trying to solve relevant issues; (ii) leverage existing experience of regulating alternative investment managers and industry in Europe, with a need for a clearer view of how national regulators should supervise alternative investment managers; (iii) with regard to investor protection, observe that PE funds raise capital from experienced/institutional investors; (iv) recognise that the first line of defence against undesirable leverage levels in hedge funds, or excessive lending to PE managed companies, is to limit the credit flow at its source; (v) recognise that most of critique of hedge funds and private equity is not unique to them; and (vi) any action must take into account the highly transnational character of industries concerned.⁵¹²

In his 2008 speech,⁵¹³ Commissioner McCreevy proposed to look first to the industry codes and best practices before embarking upon any formal regulatory intervention. To that end, he

⁵⁰⁹ Charlie McCreevy, *Opening Speech. EC Conference on Private Equity & Hedge Funds* (SPEECH/09/80, Feb. 26, 2009), http://europa.eu/rapid/press-release_SPEECH-09-80_en.htm?locale=en.

⁵¹⁰ *Id.* at 2.

⁵¹¹ *Id.* at 3.

⁵¹² Charlie McCreevy, *supra* note 509, at 3-5.

⁵¹³ Charlie McCreevy, *supra* note 493, at 2.

assured he would conduct a review of the ‘scope, content and performance’ of the industry codes, at both the European and national level.⁵¹⁴ This would concentrate on the coverage of codes, monitoring tools and mechanisms for promoting compliance as well as consistency across Member States. The review would be ‘thorough and critical,’ not a ‘white-wash,’ so that European policymakers and regulators can see the impact and effectiveness of industry codes, and whether they genuinely influence behaviour within the PE industry and prevent undesirable outcomes.⁵¹⁵

Although Commissioner McCreevy was not an enthusiastic supporter of greater regulation, he nevertheless observed that ‘[c]loser, direct regulatory and supervisory oversight of...private equity [was] inevitable.’⁵¹⁶ He was correct. Pressure was mounting on the EU Commission from the direction of Member States. For instance, March 2009 saw a Key Issues Paper published by the European Council in which it was declared that the remit of regulation should cover ‘actors that are relevant for financial stability and have so far not been sufficiently regulated, in particular hedge funds and other alternative investment vehicles.’⁵¹⁷ This sentiment was later endorsed in Presidency Conclusions at a Council meeting of EU Member States’ political leaders at which a financial regulation reform agenda was agreed. It included a proposal for ‘appropriate regulation and oversight of all financial markets, products and participants that may present a systemic risk, without exception and regardless of their country of domicile’ with particular regard to private pools of capital such as private equity.⁵¹⁸

Another important development in 2009 that helped build the momentum for an overhaul of Europe’s financial-regulation system was the carefully-worded *de Larosière Report*.⁵¹⁹ It represented an important contribution to providing a blueprint for the global financial architecture, particularly its proposals for reform of EU regulatory supervision and global coordination. The report observed that ‘[I]liquidity and low interest rates have been the major underlying factors behind the...crisis, but financial innovation amplified and accelerated the consequences of excess liquidity and rapid credit expansion.’⁵²⁰ Accordingly, it called for

⁵¹⁴ *Id.* at 4.

⁵¹⁵ *Id.*

⁵¹⁶ Charlie McCreevy, *supra* note 509, at 5.

⁵¹⁷ *Key Issues Paper 3* (EU Council, 6784/2/09 REV 2, Mar. 13, 2009), <http://www.european-council.europa.eu/council-meetings/documents-submitted-to-the-european-council?lang=en>.

⁵¹⁸ *Presidency Conclusions 19/20 March 2009* 17 (EU Council, 7880/1/09 REV 1, Apr. 29, 2009), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/106809.pdf.

⁵¹⁹ *Report of the High-Level Group on Financial Supervision in the EU* (EU Commission, Feb. 25, 2009), http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf.

⁵²⁰ *Id.* at 7.

‘appropriate’ regulation to be extended in a ‘proportionate manner’ to all firms that conduct potentially systemic financial activities.⁵²¹

3.3 Industry Response (EVCA, BVCA) and IOSCO

In response to the Rasmussen and Lehne reports and in light of the severity of the turmoil in the global financial markets which further catalysed calls for a fundamental review of the whole financial services industry in Europe, the European Private Equity and Venture Capital Association (EVCA) announced in a 2008 press release the creation of an industry Representative Group, comprising some 30 representatives from PE and venture capital funds, EU and national venture capital associations, advisory firms and investors to provide the European PE industry with a single voice in Europe. The Representative Group established a Brussels Task Force in order to formally determine how the industry should react to the EU Parliament’s PE-specific recommendations contained in the above reports and to support the EU Commission in formulating potential EU-wide policy outcomes. The initial submission to the EU Commission was published in November 2008 and a formal Response Document⁵²² on 25 February 2009.

The Response Document to the EU Parliament and the EU Commission contained a detailed technical analysis that had been conducted by the industry and its advisers. It provided an analysis of the framework of obligations stemming from regulation, contract and professional standards in ten European countries that together represented around 95 per cent of private equity activity in Europe. The obligations covered disclosure to investors and regulators, employee protection, asset stripping, leverage limits, compensation structures and capital requirements (that is, all areas highlighted by the European Parliament as requiring more regulatory attention). The submitted document emphasised that the industry played an important role in the development of the European economy and comprised part of the solution to aiding the EU, which was enmeshed in the critical period of unprecedented uncertainty. The industry has been a significant source of long-term capital and expertise throughout all stages of a target company’s growth strategy, leading to the more successful development of companies seeking to achieve their growth aspirations. Consequently, the industry contributes actively to European employment, competitiveness and innovation. However, it was observed

⁵²¹ *Id.* at 23.

⁵²² *Private Equity and Venture Capital in the European Economy. An Industry Response to the European Parliament and the European Commission*, *supra* note 394.

that the industry ‘has not been successful in effectively communicating its business model nor the economic and social benefits which this model brings with it.’⁵²³ Accordingly, the industry stressed its determination to engage more effectively with EU policymakers and to contribute to the establishment of a regulatory regime which would support ‘dynamic and competitive markets in Europe.’⁵²⁴

A significant part of the document was devoted to a detailed description and technical analysis of the risk profile of the private equity industry which sought to find out whether private equity firms had played a ‘material causal role’ in the liquidity crisis or in transmitting stress to other participants in the global financial system. Perhaps unsurprisingly, the document answered both questions in the negative, highlighting that the industry ‘does not pose systemic risks either through its funding model or the companies in which it invests.’⁵²⁵ It was suggested that the term ‘failure’ would be more appropriate in the PE context when the investment performance is poor – as explained, even though the investors suffer and the fund manager is unlikely to raise another fund, the wider financial system is not threatened in any material way.

The findings of the analysis emphasised the heterogenic nature of national regulatory landscapes in the EU. These differences arise not only due to the different level of development in national PE industries, but also due to differing approaches by national legislative bodies, governments and regulators. Therefore, the response document stressed that EU policymakers should ensure the maintenance of a level playing field between private equity firms and other investors, as well as take into account the differences across national PE industries in order to ‘ensure proportionate regulatory framework or professional standards suitable to encourage sustainable investment in high growth, job creating businesses.’⁵²⁶ Above all, any regulation should be purposive and proportionate to its objectives.

The document responded to the main concerns of the EU Parliament which had resulted in specific calls for more regulation. However, having set out existing laws, regulations and professional standards, the document concluded that the industry was already ‘highly-regulated’ at national and EU level (although a great deal of regulation in respect to many areas of concern was not consistent across all European jurisdictions). The industry admitted there

⁵²³ *Id.* at 5.

⁵²⁴ *Id.*

⁵²⁵ *Id.* at 6.

⁵²⁶ *Private Equity and Venture Capital in the European Economy. An Industry Response to the European Parliament and the European Commission, supra* note 394, at 38.

was room for improvement and committed itself to unify the industry's professional standards coverage across Europe and to create an enforcement regime subject to oversight by the appropriate EU and national supervisory bodies within 12 months of the date of submission. More specifically, it was recommended that a regime be created for enforcing a unified set of professional standards which would be principles-based (to accommodate approved local variations) and accountable to EU and national supervisory bodies, safeguarded from conflicts of interest, and proportionate and subsidiary to national legal frameworks. It was further suggested that the standards should include a code of conduct, governing principles and guidelines in relation to reporting, valuation, transparency and disclosure, and corporate governance.

The response document also highlighted existing professional standards and self-regulatory initiatives within private equity sector. At the time of submission, EVCA had over 1,300 members in 53 countries, with EVCA membership creating a responsibility on its members and individuals employed by them to act in a manner that is both ethical and beneficial to the image and interests of the private equity industry and its participants.⁵²⁷ EVCA has been at the forefront of developing industry standards, playing a crucial role in the development of the self-regulatory regime in Europe and increasing awareness and acceptance of PE business in the European society. In 2008, the primary overarching code of broad behavioural principles was created – EVCA Code of Conduct,⁵²⁸ which in general required all EVCA members to comply with six high-level general guiding principles, prescribing to act with integrity, keep promises, disclose conflicts of interest, act in fairness, maintain confidentiality and do no harm to the industry.⁵²⁹ The main objectives of the 2008 Code were to: (i) provide the principles of ethical behaviour that EVCA members had to abide by, (ii) assert on the members' behalf the collective view that high standards of commercial honour and just and equitable principles of trade and

⁵²⁷ *Id.* at 239.

⁵²⁸ The industry's original Code of Conduct (1983) was developed over the years and updated with regard to the Model Code of Ethics: A Report of the SRO Committee for the International Organisation of Securities Commissions (IOSCO) (June 2006), which recommended that firms engaged in the financial services industry adopt ethical principles such as integrity and truthfulness, promise keeping, loyalty-managing and fully disclosing conflicts of interest, fairness to the customer, doing no harm to the customer nor the profession, and maintaining confidentiality. The November 2012 version of the EVCA Handbook integrates several existing EVCA professional standards documents, that is, the EVCA Code of Conduct (October 2008, reprint July 2011), the EVCA Governing Principles (May 2003, updated 2010) and the EVCA Corporate Governance Guidelines (June 2005, updated 2010), which are replaced in their entirety by the 2012 Handbook; see *EVCA Handbook: Professional Standards for the Private Equity and Venture Capital Industry* (EVCA, Nov. 2012), https://www.ikininvest.com/globalassets/files/evca_interactive-handbook.pdf.

⁵²⁹ *Code of Conduct 2* (currently Invest Europe, Mar. 2021), <https://www.investeurope.eu/media/2626/ie-code-of-conduct.pdf>.

investment were observed, and (iii) provide the basis for consideration of and dealing with lapses in professional conduct within EVCA.⁵³⁰ The Code contained enforcement provisions with the ultimate action being expulsion from the EVCA membership.

The 2008 Code was supported by a range of supplementary guidelines that targeted industry-specific issues and activities associated with the interaction between PE fund managers and their investors and the relationships with portfolio companies. EVCA Governing Principles and Sound Practices for Establishment and Management of Private Equity Funds (2003) covered areas governing interactions between fund managers and investors, such as respect of legal requirements, contractual terms and conditions, management of business with integrity and fund with skill, care and diligence. Corporate Governance Guidelines (2005), based on OECD principles, articulated a set of relationships between a portfolio company's management, its board of directors, shareholders and other stakeholders; it ensured conducting business in a responsible and ethical manner, implementing anti-money laundering measures and guaranteeing high governance standard of investment portfolio. Reporting Guidelines (updated in 2006) set out requirements in respect of fund and portfolio reporting, fees and carried interest and performance measurements in order to enable investors to better monitor their investments in an appropriate way. Valuation Guidelines (1993, updated in 2001 and replaced in 2005 by the International Private Equity and Venture Capital Valuation Guidelines) fostered greater comparability across the industry on a global level in relation to investment valuation, ensuring consistency with US Generally Accepted Accounting Principles, GAAP, and international financial reporting standards, IFRS.

EVCA Industry Professional Standards, before and after the crisis, offered multiple advantages and benefits within the self-regulatory framework governing private equity on a pan-European and international basis. The framework was flexible and applied to specific circumstances, complemented the existing regulation and thus bridged the gap in order to achieve high level statutory principles and regulatory objectives, notably in jurisdictions employing principles-based regulation. The EVCA standards were appropriate for institutional investors and other main stakeholders and constituted a foundation for contractual agreements. The compliance has invariably been mandatory, with the commitment being renewed each year as part of the annual membership renewal process. Regarding enforcement, EVCA duly considers all complaints received and, by the time of post-crisis package of regulatory reforms, there was one eviction.

⁵³⁰ *Id.* at 3.

The main enforcement mechanisms, which were based on the supplementary guidelines, were contained in the contractual agreements between investors and individual private equity firms.

UK's BVCA, similarly to other industry trade bodies in Europe, opposed pan-European regulation of the PE industry. This was given expression in a September 2008 speech by Simon Walker, BVCA's Chief Executive, who commented on the success of the Walker Guidelines at the Capital Creation Conference.⁵³¹ He emphasised that the Walker Guidelines on transparency and disclosure were a good template for self-regulation and could act as a model across Europe. Mr Walker criticised the new legislative proposals and, in particular, Poul Nyrup Rasmussen, President of the Party of European Socialists, who clearly intended to 'strip private equity of all the flexibility that private ownership brings and treat it as though it is exactly the same as any public company.' Mr Walker opposed one EU-wide private equity framework, arguing that such measures would reduce the opportunity for competition between jurisdictions. In his opinion, a regulatory move of this kind would be 'economic madness,' especially in times of crisis, since private equity is 'one of the few sources of capital that is still investing and helping to keep the creaking economic machinery oiled.' Therefore, EU policymakers should let the industry 'keep control of its own destiny.'

In a later speech,⁵³² on 26 November 2008, Simon Walker spoke how the implementation of the Walker Guidelines had progressed. He highlighted that the Guidelines' impact was spreading into Europe as some countries (Denmark, France, Germany and Sweden), being inspired by the UK approach, followed suit and subsequently introduced similar enhanced disclosure requirements. Mr Walker reiterated that once the universal pan-European framework was created, it would then be much easier to turn the ratchet. He informed that the BVCA had put forward its views on the Rasmussen and Lehne reports through the EVCA's Brussels Task Force, stating that this 'marked the start of a sustained engagement between the European private equity and European policymakers.' He further stated that the PE industry had taken certain steps in Europe, such as bringing together the economic and financial data to show the industry's effectiveness, separating the industry from hedge funds and investment banks and

⁵³¹ *BVCA Chief Executive Comments on the Success of the Walker Guidelines* (PLC, Sept. 18, 2008), at [https://uk.practicallaw.thomsonreuters.com/4-383-3884?originationContext=document&transitionType=DocumentItem&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/4-383-3884?originationContext=document&transitionType=DocumentItem&contextData=(sc.Default)&firstPage=true).

⁵³² *Walker - A Year On* (BVCA, Nov. 26, 2008), <http://www.bvca.co.uk/Search.aspx?Search=Walker+-+A+Year+On>.

other targets for political rage, and working actively at the EU Parliament level through the national associations to demonstrate that private equity rescues businesses and saves jobs.

At international level, there were also developments in the post-crisis evolution of regulatory policy as regards the alternative investment fund sector. For instance, IOSCO published a final report on private equity⁵³³ which was based on feedback received during the consultation period that started in 2007. That year, the IOSCO Technical Committee mandated a Task Force on private equity to carry out a preliminary review of private equity markets in order to identify any suitable issues which could be addressed through future IOSCO work. The Task Force subsequently identified issues generated by the activity of PE firms which could potentially create risks affecting capital markets and impacting on IOSCO's objectives and principles; it equally formed recommendations as to what work might be considered within the IOSCO and international regulatory framework. Seven specific issues were identified in relation to private equity markets as posing potential risks to financial markets, that is, increasing leverage, market abuse, conflicts of interest management, transparency, overall market efficiency, diverse ownership of economic exposure and market access. Nevertheless, it was recognised that only six of these issue (overall market efficiency excluded⁵³⁴) were directly relevant to IOSCO's remit in protecting investors, ensuring fair, efficient and transparent markets, as well as reducing systemic risk. The Final Report recommended survey of the complexity and leverage of capital structures in LBOs and announced that IOSCO would conduct analysis of conflicts management practice in private equity.

A year later, IOSCO published a Consultation Report⁵³⁵ in which eight principles for effective mitigation of potential conflicts of interest between PE fund managers and third-party investors were proposed. The objective of the report was to outline principles against which both the industry and national regulators could assess private equity firms for best practice in managing conflicts. In addition, the report identified specific conflicts that may arise during the four key stages in a fund's life cycle (fundraising, investment, management/monitoring and exit) and highlighted best practices for managing those conflicts.

⁵³³ *Private Equity Final Report* (IOSCO, May 2008), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD274.pdf>.

⁵³⁴ Whilst overall market efficiency relates to IOSCO's objective with respect to the efficient market operation, this is not relevant to any of the 30 principles of securities regulation. Consequently, the Technical Committee decided that this issue is outside of IOSCO's mandate in terms of consideration for potential mitigation action.

⁵³⁵ *Private Equity Conflicts of Interest Consultation Report* (IOSCO, Nov. 3, 2009), <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD309.pdf>.

Regardless of the existence of numerous European and international professional codes and guidelines, doubts persisted as to their ability to influence the behaviour, actions and working practices of buyout firms. The effectiveness of self-regulatory measures was deemed insufficient in complementing regulatory environment in the EU and in addressing the concerns associated with private equity, like the cross-border character of PE transactions⁵³⁶ and their impact on key stakeholders and the EU economy.

4. Directive Proposal

Protracted political deliberations in Europe resulted in publishing a proposal for a Directive on Alternative Investment Fund Managers⁵³⁷ on 29 April 2009. It was heralded as a measure to create a harmonised European framework for effectively regulating and supervising alternative investments. The draft directive proposed to regulate fund managers rather than funds themselves, even though it would have an impact on both. It intended to regulate alternative investment managers who were not then covered by EU law, and imposed a range of rules regarding authorisation, marketing, disclosure, reporting as well those setting out how fund managers should operate and be organised. The Proposal was designed in response to fears in respect of alternative funds which were blamed for many of the problems associated with the financial crisis and consequently addressed the grave concerns expressed in the Rasmussen and Lehne Reports, but also prior thereto, about the perceived lack of regulation and oversight of alternative fund managers and alternative funds themselves in Europe. Public opinion was reflected by politicians who wanted to put an end to the laissez-fair capitalism. The EU Commission reacted to the widespread generic concerns influenced and intensified by the crisis, exhibiting little political will to assess whether the activities of PE firms had very much to do with the economic difficulties. Moreover, the crisis provided an opportunity for the EU Commission to influence international financial matters and hence become a leader in an area where the US regulators had nothing to say.⁵³⁸

⁵³⁶ It was reported that around 30 per cent of PE funds are invested in companies in Member States other than that of the fund manager and approximately 24 per cent of funds are raised from investors based in Member States other than that of the fund manager; see *Impact Assessment*, *supra* note 345, at 23.

⁵³⁷ Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009/65/EC {SEC(2009)576} {SEC(2009)577}.

⁵³⁸ *European Directive on Alternative Investment Fund Managers: Keep Clam and Carry On 2* (Skadden, Arps, Slate, Meagher & Flom LLP, May 7, 2009), https://www.skadden.com/sites/default/files/publications/European_Directive_on_Alternative_Investment_Fund_Managers.pdf.

The proposed directive was aimed to address risks which were believed to be created by the alternative fund industry and posed a threat to fund investors, counterparties, financial markets and the wider economy. Key areas of risk, according to the Commission's *Impact Assessment*, which accompanied the original draft of the Directive, included macro-prudential (systemic) risks pertaining in particular to the use of leverage; micro-prudential risks in relation to risk management and operational risk; insufficient disclosure and potential conflicts of interest; potential for market abuse and other activities that disrupt market efficiency and integrity; lack of transparency in the context of market for corporate control; and misalignment of interests in acquisition of control (that is, short-termism which leads to asset stripping and heavy recourse to debt financing). Not all these categories of risk apply to private equity, but those of special relevance are operational risks, inadequate investor protection, lack of transparency and accountability for the acquired companies.⁵³⁹ In view of these risks and in order to develop a single market in AIFs and a complete and consistent regime for supervision and prudential oversight of the alternative fund sector, the AIFMD was designed to implement wide-ranging provisions, subjecting private equity fund managers to appropriate authorisation and registration requirements, and to impose monitoring of micro-prudential risks, enhanced investor protection and public accountability of portfolio companies. In addition to the description of the key risks, other main findings shed light on the fragmented regulation which prevents effective monitoring of cross-border risks associated with the AIFMs, continuing uncertainty for investors due to the absence of consistent standards of supervision, and the importance of creating EU-wide regulation that is sensitive to differences in business models and ideally coordinated with international action.

As could be easily predicted, the draft Directive had instantly attracted a good deal of consternation and concern, as well as strong opposition from many corners, including the private equity sector which strongly rejected some of the provisions⁵⁴⁰ which seemed to have been rushed without the benefit of full pre-legislative consultation. The Commission was criticised for not undertaking adequate consultation when preparing the AIFMD and for preparing the *Impact Assessment* that accompanied the proposal that was not sufficiently informed.⁵⁴¹ The infamous Proposal was criticised of being drafted by people with little industry knowledge; it was deemed to be out of tune with regulatory recommendations, sweeping and

⁵³⁹ *Impact Assessment*, *supra* note 345, at 7-8.

⁵⁴⁰ Eddy Wymeersch, *supra* note 336, at 28.

⁵⁴¹ UK PARLIAMENT: HOUSE OF LORDS: EUROPEAN UNION COMMITTEE, DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS VOLUME I REPORT, at 51 (2010).

unduly intrusive,⁵⁴² consequently causing considerable anxiety, given the flaws of many initial ideas,⁵⁴³ their ambiguity and incoherence. Many of the ill-considered provisions, especially a dizzyingly convoluted set of third country rules, were seen as impracticable, likely unworkable and potentially damaging. The Proposal had raised concerns at various levels, primarily in relation to the ‘one size fits all’ approach, its troubled relationship with the then existing pieces of EU legislation and the competition concerns, the EU Commission’s intention to regulate the authorisation and marketing of non-EU domiciled funds, and the lack of a clear regulatory focus.⁵⁴⁴ A transatlantic debate developed as a result of restrictions on marketing of non-EU AIFs, mushrooming into allegations of protectionism and retaliatory measures from the US.⁵⁴⁵

Soon enough the Proposal was described as damaging to the EU economy and counter-productive for the UK where most of the European private equity industry is located. Simon Walker of BVCA said, ‘This proposal has been the cause of intense debate within the European Commission, with a number of key figures doubting its logic. It should be obvious that this is a deeply undesirable and immensely damaging exercise which the British government, in particular, should be doing its utmost to forestall.’⁵⁴⁶ He underlined that the Proposal was ‘irrational’ in that it sought to bring very different asset management classes, like hedge funds and private equity, within the same domain, with the EU Commission addressing sectors it itself regarded as not posing systemic risks to the financial system.⁵⁴⁷ The new regulatory regime would have very significant direct and indirect compliance costs but does not, however, apply to other forms of private ownership placing them at a competitive advantage to private equity. Thus, the Proposal was ‘bad for British business,’ especially when coinciding with the period of deep recession.

⁵⁴² *Response to the Proposed Directive of the European Parliament and Council on Alternative Investment Fund Managers (AIFM)* (EVCA, June 26, 2009), <http://www.bvkap.de/media/file/263.2009-06-26-ResponsepaperAIFM.pdf>.

⁵⁴³ Graham Busby, *The Draft Directive on Alternative Investment Fund Managers*, 25(8) J.I.B.L.R. 381, 381 (2010).

⁵⁴⁴ Phoebe Athanassiou, *The Draft AIFM Directive and the Future of European Alternative Investment Fund Regulation* 10 (CESifo DICE Report 1/2010), http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CCgQFjAA&url=http%3A%2F%2Fwww.cesifo-group.de%2FDocDL%2Fdicereport110-forum2.pdf&ei=3L5CU7CMN-r8ygOeyIGICA&usg=AFQjCNHdogPjBBWnJloSpmC3P8RDUqobZQ&sig2=sxlz6F0EVCe2M_mdQDn7UA&bvm=bv.64125504,d.bGQ.

⁵⁴⁵ Barbara Crutchfield George & Lynn Vivian Dymally, *supra* note 19, at 250.

⁵⁴⁶ Simon Bowers, *Hedge Funds Warn EC Curbs Will Drive Them from London* (The Guardian, Apr. 29, 2009), <https://www.theguardian.com/business/2009/apr/29/hedge-funds-desert-london>.

⁵⁴⁷ Compared with the risks posed by hedge funds and commodity funds, ‘private equity funds, due to their investment strategies and a different use of leverage than hedge funds, did not contribute to increase macro-prudential risks,’ *Explanatory Memorandum*, *supra* note 20, at 3.

This generally negative reception and the controversial nature of the proposed Directive had delayed its progress. Eventually a dense and complicated trilogue procedure ensued to assemble the different positions in order to issue a compromise draft of the AIFMD. However, irrespective of the outcome of final deliberations, it was almost certain that substantial change would occur,⁵⁴⁸ having a huge effect on the management and marketing of alternative investment funds within the EU.⁵⁴⁹

5. Conclusion

Private equity's rapid growth around the world was accompanied by public controversy and calls for decisive regulation. There were particular concerns over the industry's opaqueness, short-termism, excessive leverage and remuneration packages for fund managers, lack of transparency, and increased conflicts of interests. The industry was increasingly presented in negative terms, often accused of destroying an acquired company's value by overloading it with debt, extracting its net value, laying off its employees, selling its 'crown jewel' assets or spinning off its (non-core) divisions, and ultimately selling the reconfigured remainder of the firm to another investor or to the market. This caricature view of the industry, perhaps unsurprisingly, entered the public, political and European debate with great ease and attraction. The catchy, inventive metaphors were employed, such as 'locusts' and 'predatory capitalism,' in order to fuel negative perceptions and stir public outrage.

The industry was cognisant of the likely changes to come and so numerous important attempts of self-policing certainly were targeted at forestalling the threat of an intrusive regulation at the behest of the EU. However, the conditions in the financial market were deteriorating and the light-touch approach towards the Anglo-American model of capitalism became increasingly marginalised and mainstream sentiment shifted towards the need for more rigorous controls. Voluntary best practice codes did not succeed in insulating the industry from proposals for greater supervision and control by European politicians and trade unions. International support for direct regulation of private equity took a while to crystallise; however, all the developments, slowly but surely, smoothed the path for politically-driven EU legislative efforts (led by Germany and France⁵⁵⁰) to secure a more stringent, interventionist policy measure. The

⁵⁴⁸ Charlotte Hill, *supra* note 415, at 1, 2.

⁵⁴⁹ James Tinworth, *A Job Half Done – How the UK Must Prepare Itself for the EU's Alternative Investment Fund Managers Directive* (Legal Week, Mar. 28, 2013).

⁵⁵⁰ In the years preceding the crisis, these two countries in particular, demonstrated political hostility towards new financial phenomena including private equity investment strategies which were seen as disturbing the 'patient' system of capital corporate governance prevalent in Continental Europe.

pertinent question is whether the politicians had sufficient information and technical knowledge to fine-tune activity in the AIF area, without causing undue harm to the industries concerned.

The imminent regulation of hedge funds seemed less controversial; however, it was more of a stretch to link PE funds to the systemic problems in the financial markets. Private equity was added to the list of sectors to regulate even though the industry is fundamentally distinct in character from hedge funds.⁵⁵¹ Most presumably, the industry was swept along by the regulatory tide and wrapped up in the same regulatory net due to its operations in the ‘shadows’ under business models that simply bore some resemblance to hedge funds.⁵⁵²

The intensifying impact of the financial crisis and the critical tone of the Rasmussen and Lehne reports resulted in the EU Commission having had to face enormous political pressure to act on the activities of private equity funds. This led to the controversial and hastily-produced draft Directive of 2009 which would tangle private equity in a ‘restrictive array of largely misconceived bureaucracy.’⁵⁵³ The EU Commission was criticised for the speed of response, which was not a reliable proxy for quality. Ultimately, after intense political debates, an agreement was reached and the EU Parliament eventually voted through a final text of the Directive. The next chapter provides an overview of its contents, with a particular emphasis placed on private equity related provisions.

⁵⁵¹ Private equity tends to be erroneously likened to the activities of hedge funds. For differences between private equity and hedge funds, see John Gilligan & Mike Wright, *Private Equity Demystified. An Explanatory Guide* 33-35 (2d ed., Mar. 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1598585.

⁵⁵² Eilís Ferran, *supra* note 446, at 379, 389.

⁵⁵³ Charles Martin, *The Party’s Over*, 92 EURO. LAW. 10, 10 (2010).

Chapter VI

AIFMD: Technical Analysis

1. Introduction

The financial crisis forced EU regulators to re-evaluate their decisions and how the alternative investment fund industry (AIF) should be regulated. As a result, the AIFMD has established a coordinated and a fairly stringent pan-European regulatory and supervisory framework affecting an important cross-section of alternative investment fund managers (AIFMs) that manage and/or market AIFs across the EU. The Directive applies not only to private equity, but also managers of hedge funds, real estate funds, commodities and infrastructure funds, and has implications for all actors in the fund value chain, whether supervisory authority (regulator), fund manager, investor, depositary or service provider.⁵⁵⁴ Conceived in the aftermath of the global financial crisis, the Directive is a response to the difficulties created in the financial markets. It draws heavily from the UCITS Directive⁵⁵⁵ (UCITS) and MiFID,⁵⁵⁶ and its broad scope is believed to close potential loopholes as well as diminish the risk of regulatory arbitrage.⁵⁵⁷

This regulatory overhaul happened against the backdrop of several years of politically motivated policy debate which related to the regulation of alternative investments.⁵⁵⁸ The first draft of the Directive was proposed in April 2009. Since that date, it had undergone extensive review to respond to and remedy controversial issues, such as the ‘one size fits all’ approach and the relatively short time within which the initial legislation had been drafted. An extensive series of negotiations between EU institutions were aided by compromise suggestions from the

⁵⁵⁴ *AIFMD Changes Europe's Euro 2 Trillion Alternative Investment Fund Industry* (BNY Mellon, May 2013), <https://www.bnymellon.com/emea/en/insights/all-insights.html>.

⁵⁵⁵ Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) [2009] OJ L302/32.

⁵⁵⁶ These concepts include, for example, a common European authorisation, minimum capital requirements and a depositary.

⁵⁵⁷ Thomas M.J. Möllers, Andreas Harrer & Thomas C. Krüger, *AIFM Directive and Its Regulation of Hedge Funds and Private Equity*, 30 J.L. & COM. 87, 90 (2012).

⁵⁵⁸ Alexandros Seretakis, *The New EU Directive on the Regulation of Private Equity*, 18 C.J.E.L. 10 (2012).

Swedish, Spanish and Belgian governments in their successive periods as EU president.⁵⁵⁹ Therefore, the finalisation of the Directive was the result of protracted consultations which involved a number of versions of the Directive and the extensive trilogue procedure encompassing the EU Commission, the EU Parliament and the EU Council. Irrespective of the vast commentary suggesting that it was a deeply ‘flawed knee-jerk political reaction,’⁵⁶⁰ the final Directive was adopted by the EU Parliament on 11 November 2010 and by the EU Council on 27 May 2011, with certain substantive technical requirements being detailed through the articulation of Delegated Regulation (so-called Level 2 measures).⁵⁶¹ The text of the AIFMD was published in the Official Journal on 1 July 2011 and came into force on 21 July 2011. All EU Member States had until 22 July 2013 to transpose the AIFMD into national law, when the majority of its requirements came into effect.⁵⁶² This signalled the end of a fragmented, light-touch regulation for the AIF sector in Europe.

This chapter seeks to condense the main features of the Directive, with a particular focus on PE-related provisions. First and foremost, the technical overview of the AIFMD is set out, followed by a brief description of the implementation timetable with key dates that are relevant for the AIF industry, its stakeholders and investors.

2. AIFMD Overview

The AIFMD recognises that AIFMs can exercise an important influence on markets and companies in which they invest, and the impact is ‘largely beneficial’ (AIFMD, recitals 1 and 2). Whilst AIFMs were not considered to be the cause of the crisis *per se*, nevertheless, the recent turmoil in the financial markets led the EU Commission to determine that the activities of AIFMs may equally contribute to spreading, or even amplifying, risks through the interconnected financial system. Within this context, the uncoordinated national responses

⁵⁵⁹ Charlotte Hill, *The AIFM Directive's Final Furlong* (Dec. 1, 2010), <http://www.compliancemonitor.com/international/european-union/directives/the-aifm-directives-final-furlong--1.htm>.

⁵⁶⁰ Charlotte Hill & Noline Matemera, *Regulatory Worry Beads of 2013* (Jan. 22, 2013), <http://www.ilaw.com/ilaw/doc/view.htm?id=318887>.

⁵⁶¹ Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.

⁵⁶² 22 July 2013 was the deadline for the EU Member States to transpose the Directive into national law. As at 19 August 2013, the AIFMD had been transposed by the following countries: Austria, Croatia, Cyprus, Czech Republic, Denmark, France (partially), Germany, Ireland, Latvia, Luxembourg, Malta, Netherlands, Sweden and the United Kingdom; the rest of EU countries delayed AIFMD transposition; see *AIFMD Transposition. State of Play Across EU Member States* (KPMG, Oct. 1, 2013), <http://www.kpmg.com/LU/en/IssuesAndInsights/Articlespublications/Documents/AIFMD-Transposition-overview-1-October-2013.pdf>.

resulted in difficulties in the efficient management of those risks. The crisis has demonstrated that many of the AIFM strategies are vulnerable to some risks affecting investors, other market participants and markets themselves (AIFMD, Recital 3). Thus, the AIFMD's broad intent is to address those risks and, in so doing, to establish a harmonised and strict regulatory and supervisory regime featuring common requirements governing the activities of AIFMs, so that a comprehensive approach to the relevant risks to, and their ramifications on, investors and markets within the EU can be a reality (AIFMD, recitals 2 and 4).

The Directive is minimum-harmonising. It deals with several key themes which have been segregated into ten chapters, comprising overall 71 articles, as well as 95 recitals and four Annexes. Specifically, Chapter I introduces general provisions, clarifies the Directive's scope, exemptions and definitions; Chapter II deals with the authorisation process and sets out minimum capital requirements; Chapter III is the most diverse and, arguably, significant in the Directive, prescribing a myriad of topics such as remuneration, conflicts of interest, delegation, valuation, depositaries, and risk management; Chapter IV outlines transparency and disclosure requirements, as well as other reporting requirements to investors and regulators; Chapter V prescribes the peculiarities of specific types of funds, including most notably private equity and leveraged funds; Chapter VI deals predominantly with the mechanics of EU passport and the conditions for using it; Chapter VII expands the passport system to include third countries; Chapter VIII briefly considers the issue of marketing to retail investors; Chapter IX sets out the responsibilities of national regulators as well as the powers and competencies of a pan-European regulator, the European Securities and Markets Authority (ESMA); and, finally, Chapter X deals with the implementation timetable. This section outlines key AIFMD provisions.

2.1 Scope

The Directive prescribes the rules for managers of alternative investment funds who manage and/or market alternative investment funds in the EU (AIFMD, art 1). Specifically, it applies to EU AIFMs who manage one or more EU or non-EU AIFs (irrespective of whether they market them in the EU) and non-EU AIFMs who manage EU AIFs or market their AIFs in the EU (AIFMD, art 2(1)). Thus, the Directive directly applies to AIFMs and only indirectly to the operation and constitution of AIFs. This is because a significant number of funds is based in off-shore tax havens that lie outside the EU, whilst the fund's infrastructure and administration

is typically located in Europe, near important financial centres like London.⁵⁶³ This is certainly true in the context of hedge funds, but with regards to private equity firms, real estate and infrastructure funds both the fund manager and the fund itself tend to be domiciled within one jurisdiction.⁵⁶⁴ Further, the AIFMD does not regulate or restrict the assets in which a fund can invest, save in relation to securitisation.

Firms within the ambit of the Directive need to identify the entity that is regarded as the fund manager. An AIFM is a legal person whose regular business is managing one or more AIFs, including investments that raise capital from a number of investors. The key elements of an AIF are that it is a collective investment undertaking which raises capital from a number of investors and invests in accordance with a defined investment policy for the benefit of those investors. The exact parameters remain unclear, although it appears that having two investors in a fund may be sufficient to constitute an AIF. The core concept of collective investment undertaking is undefined, but once it is established, it must have a single AIFM (AIFMD, art 5(1)). The AIFM can be either external, which is the legal person appointed by or on behalf of the AIF to be responsible for managing it, or internal, where the legal form of the AIF permits internal management and therefore its governing body elects not to appoint an external AIFM (AIFMD, arts 5(1)(a-b)).⁵⁶⁵ In this context, managing an AIF by an AIFM means performing investment management functions such as portfolio and risk management, as well as performing additional functions in the course of the collective management of the AIF such as administration, marketing and activities related to AIF assets (AIFMD, Annex I). Whilst the Directive places significant limitations on the activities that AIFMs can carry out, it does not preclude them from continuing most, if not all, of the functions they had traditionally been performing for the investors.

The AIFMD lays down requirements concerning the manner in which AIFMs should manage AIFs under their responsibility, but does not directly regulate AIFs which continue to be regulated and supervised at national level. The legal structure as well as the type of the AIF

⁵⁶³ Rudiger Wilhelmi & Moritz Bassler, *AIFMD, Systemic Risk and the Financial Crisis*, in THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS 21, 31 (Dirk Zetzsche ed., 2012).

⁵⁶⁴ Jeremy Elmore & Emily Clark, *England & Wales: Alternative Investment Funds 2016* (International Comparative Legal Guides, Jun 06, 2016), <https://www.iclg.co.uk/practice-areas/alternative-investment-funds/alternative-investment-funds-2016/england-and-wales>.

⁵⁶⁵ An AIFM which is an internally managed AIF should not be authorised as the external manager of other AIFs (Recital 20).

(open- or closed-ended⁵⁶⁶) and the type of law under which the AIF is constituted are irrelevant for the purposes of the Directive's scope (AIFMD, art 2(2)). This allows the globally widespread limited partnerships to be set up to govern investment relationships in the fund sector.

Article 2(3) AIFMD specifies to which entities the Directive does not apply. These are holding companies, supranational institutions and national governments. In addition to this activity-based segregation, the Directive's scope is determined according to the volume of assets managed by the fund manager. This provides useful partial exemption for two categories of AIFMs, that is, sub-threshold AIFMs who manage funds with assets under management (AUM) not exceeding a threshold of €100 million (including assets acquired through leverage) and AIFMs who manage portfolios of AIFs with assets under management less than €500 million, provided they are unleveraged and offer investors no redemption rights for the first five years (AIFMD, art 2(3)) – the latter category applies primarily to private equity funds. The exemptions do not remove the requirement for authorisation, although sub-threshold AIFMs can opt into the AIFMD regime in order to be treated the same as full-scope AIFMs and to benefit from the marketing passport.

2.2 Authorisation

Chapter II of the Directive sets out the authorisation requirement; it contains provisions relevant for taking up activities as AIFM, application for authorisation, and conditions for granting and withdrawing authorisation by the competent authorities. For an EU AIFM, this is its home Member State regulator (AIFMD, art 4(1)(q)); and for a non-EU AIFM, this is a Member State of reference, that is, a host EU country (AIFMD, art 4(1)(r)). The timing of implementation becomes relevant in this context. The AIFMD had to be transposed into national law of Member States and come into force by 22 July 2013. AIFMs operating before that date had time until July 2014 to obtain authorisation from the competent authorities and comply with the Directive's requirements (AIFMD, art 61(1)).

Article 6(1) AIFMD provides that Member States must ensure that AIFMs manage authorised AIFs in accordance with the Directive. It is emphasised that external AIFMs must engage in appropriate investment management functions as set out in Annex I, and the same applies to internally managed AIFs engaged in functions relevant to their internal management (AIFMD,

⁵⁶⁶ Private equity funds are closed-ended as redemption does not take place on a regular basis, but after a certain lapse of time.

arts 6(2)-(3)). An AIFM which has its registered office in a Member State must be granted authorisation from the competent authorities of its home Member State (AIFMD, art 7(1)); a non-EU AIFM must become authorised in its Member State of reference (AIFMD, art 37(1)). The application process consists of submitting a considerable volume of information to the competent regulator, including details of the persons effectively conducting the business of the AIFM, the identity of the AIFM's members that have qualifying holdings and their amounts, remuneration policies and the AIFM's organisational structure (AIFMD, art 7(2)). Further information may be required to be provided in relation to, *inter alia*, investment strategies, the AIFM's policy on the use of leverage, risk profiles and the AIF rules or instruments of incorporation (AIFMD, art 7(3)).⁵⁶⁷

Article 8 AIFMD prescribes several conditions for granting authorisation, including minimum capital requirements. An AIFM which is fully authorised under the AIFMD and is an internally managed AIF is required to have an initial capital of at least €300,000 (AIFMD, art 9(1)); an authorised AIFM which is an external manager of one or more AIFs is required to have an initial capital of €125,000 (AIFMD, art 9(2)) plus 0.02% of the value of the portfolios of the AIFs it manages in excess of €250 million, subject to a cap of €10 million (AIFMD, art 9(3)). Further, authorised AIFMs must hold a further amount of own funds to cover potential liability for professional negligence and an appropriate professional indemnity insurance (AIFMD, art 9(7)). Since an investment firm cannot be both a MiFID firm and an AIFM, those firms that have become AIFMs are no longer subject to the capital requirements set out in CRD, but only those under the AIFMD.⁵⁶⁸

Provided all AIFMD conditions are satisfied, authorisation will be granted and will be valid across the EU (AIFMD, art 8(1)). Nevertheless, the relevant authorities may restrict the scope of authorisation (AIFMD, art 8(4)) or even withdraw it post-issue where the AIFM no longer meets the conditions under which authorisation was granted, has seriously or systematically infringed the Directive's provisions, or became authorised by making false statements (AIFMD, art 11). Ergo, it is compulsory that the AIFM notifies the competent authorities of its home Member State of any material change(s) appurtenant to the conditions of initial authorisation and information supplied (AIFMD, art 10(1)).

⁵⁶⁷ Article 7(6) states that ESMA may develop regulatory technical standards for what kind of information must be provided and in what form.

⁵⁶⁸ *The AIFM Directive: Capital Requirements for Managers* (PLC, 2013), <http://uk.practicallaw.com/1-503-9737>.

The regulator will inform the applicant in writing within three months of the submission of a complete application whether authorisation has been granted, although that period can be extended by additional three months where the regulator deems it necessary (AIFMD, art 8(5)). Once AIFMD authorisation is granted, the AIFM can start managing its AIF(s) in accordance with the investment strategy specified in the application.

2.3 Operating Conditions for AIFMs

In Chapter III, the Directive prescribes certain general principles that apply to AIFMs in the EU and the manner they organise and control their business.⁵⁶⁹ For instance, AIFMs are required to act in the best interests of the integrity of the market and to promote the best interests of the AIFs they manage or the investors of the AIFs.⁵⁷⁰ AIFMs must act honestly, with due skill, care and diligence, treating all AIF investors fairly, and reasonable steps must be taken to avoid conflicts of interest; they also must comply with all the regulatory requirements applicable to the conduct of their business activities (AIFMD, art 12(1)).

AIFMs must equally comply with a range of high-level organisational conditions. Pursuant to Article 18 AIFMD, fund managers are required to use at all times: adequate and proportionate human and technical resources to ensure the proper management of AIFs; sound administrative and accounting procedures; control and safeguard mechanisms for electronic data processing; record-keeping arrangements for transactions involving AIFs; and adequate internal control mechanisms (AIFMD, art 18(1)).

2.3.1 Remuneration

Of particular significance are restrictions imposed on the amount and form of remuneration for certain senior staff whose professional activities have a material impact on the risk profile of the AIFs they manage. Article 13 AIFMD requires AIFMs to have remuneration policies and practices designed to promote sound and effective risk management and which do not encourage risk-taking inconsistent with the risk profiles and rules of their AIFs.⁵⁷¹ For some

⁵⁶⁹ The operating requirements placed in AIFMs under the Directive are drawn from MiFID and the UCITS Directive, *albeit* certain differences can be observed.

⁵⁷⁰ The two ideas appear to be synonymous.

⁵⁷¹ ESMA published its final report outlining guidelines for the remuneration of AIFMs under AIFMD on 11 February 2013. The report clarifies which staff is regarded as falling within the categories described in the Directive and complies with principles set out in Annex II. The guidelines apply from 22 July 2013; *see Final Report: Guidelines on Sound Remuneration Policies under AIFMD* (ESMA, ESMA/2013/201, Feb. 2013), https://www.esma.europa.eu/sites/default/files/library/2016-411_final_report_on_guidelines_on_sound_remuneration_policies_under_the_ucits_directive_and_aifmd.pdf.

AIFMs, like private equity managers, these requirements are entirely new. The provisions capture, depending on their impact on risk, senior management, risk takers and control functions (both left undefined in the Directive) and employees whose remuneration takes them into the same bracket as senior management and risk takers. The Directive does not define ‘remuneration,’ but states the requirements are applicable to all forms of payments or benefits paid by the AIF, any amount paid directly by the AIF (including carried interest) and any transfer of units or shares of the AIF.

An AIFM must comply with a range of principles set out in Annex II to the AIFMD when establishing and applying its remuneration policies and practices. It is imperative that a remuneration policy is consistent with and promotes sound and effective risk management, includes conflicts avoidance measures, is in line with the business strategy, objectives and interests of the AIFM as well as the AIF or fund investors, and is periodically reviewed.

2.3.2 Conflicts of Interest

Article 14 AIFMD deals with conflicts of interest arising in the course of managing AIFs. There is a positive obligation on an authorised AIFM requiring it to take all reasonable steps to identify conflicts of interest between (i) itself and the AIF it manages (or the investors in the AIF), (ii) two AIFs that it manages (or investors in the AIFs), (iii) an AIF that it manages (or investors in the AIF) and another client of the AIFM, (iv) the AIF (or investors in the AIF) and a UCITS managed by the AIFM (or investors in the UCITS), and (v) two of the AIFM’s clients. (AIFMD, arts 14(1)(a-e)). Appropriate organisational and administrative arrangements must be put in place in order to prevent the conflicts from adversely affecting the interests of the AIFs and their investors (AIFMD, art 14(1)). Furthermore, AIFMs must segregate tasks and responsibilities which may be regarded as incompatible with each other or which have the potential to create systematic conflicts of interest.

2.3.3 Risk and Liquidity Management

AIFMs are required to separate, both functionally and hierarchically, risk management from portfolio management (AIFMD, art 15(1)). This functional and hierarchical separation of the functions of risk management must be reviewed by the AIFM’s home state regulator in accordance with the principle of proportionality. It is important that AIFMs implement appropriate risk management measures to identify, measure, manage and monitor adequately risks associated with each AIF investment strategy and to which each AIF is or can be exposed

(AIFMD, art 15(2)); the risk management systems must be revised with adequate frequency (at least once a year) and adapted whenever necessary. Further, AIFMs must implement a documented and regularly updated due diligence process when investing on behalf of the AIF and ensure that each AIF's risk profile corresponds to its size, portfolio structure, investment strategy and objectives; a maximum level of leverage employed on behalf of the AIF managed must also be set by AIFMs (AIFMD, arts 15(3)-(4)).

As with risk management, AIFMs must be able to demonstrate that adequate and effective liquidity management policies and procedures are in place in order to prevent difficulties arising from illiquid assets, valuation issues and redemption requests. AIFMs should conduct regular stress tests to assess and monitor liquidity risk of the AIFs they manage (AIFMD, art 16(1)).

2.3.4 Valuation

The AIFMD sets out who can value the assets, how and when they should be valued and the AIFM's liability towards the investors for valuations. It requires that an authorised AIFM, for each AIF that it is authorised to manage, has appropriate and consistent procedures so that a proper and independent valuation of the assets can be performed (AIFMD, art 19(1)). The Directive establishes that the rules applicable to the valuation function and the calculation and disclosure to investors of the net asset value per share/unit of the AIF should be set out in the law of the Member State in which the AIF has its registered office and/or in the AIF's instrument of incorporation (AIFMD, art 19(2)). The assets must be valued and the net asset value per unit must be calculated at least once a year and be disclosed to the investors (AIFMD, art 19(3)). In addition, for closed-ended AIFs, such valuations and calculations must be performed every time the AIF's capital decreases or increases.⁵⁷²

The valuation function must be carried out by the AIFM itself or a professional valuer (AIFMD, art 19(4)), and follow numerous conditions set out in Article 19 AIFMD. External valuers cannot sub-delegate the valuation function (AIFMD, art 19(6)). All valuations must be carried out impartially and with all due skill, care and diligence (AIFMD, art 19(8)). The AIFM is responsible for valuations to the AIF and its investors. An external valuer remains liable to the AIFM for any losses suffered conditional upon his negligence or intentional failure to perform its tasks (AIFMD, art 19(10)).

⁵⁷² Capital is not defined for this purpose. However, its increase could correspond to new commitments being made to an AIF and its decrease could take place when an investor stops investing in the AIF.

2.3.5 Delegation

Fully authorised AIFMs are subject to detailed rules regarding delegation. Article 20 AIFMD imposes requirements on an AIFM when delegating to third parties any of the AIFM functions, such as portfolio or risk management, AIF administration, marketing and activities related to the assets of the AIF. Such delegation must be justifiable on objective reasons, such as optimisation of business functions and processes or cost saving. The delegate must be selected with all due care; it must be qualified, capable of performing the delegated tasks and of sufficiently good repute and experience. The Directive's requirements and limitations in this domain are intended to ensure that delegation does not prevent an AIFM from acting in the best interests of investors and that it retains responsibility for the delegated functions.⁵⁷³

The AIFM must monitor the delegate on an ongoing basis and additional restrictions apply when portfolio or risk management is delegated to a party in a non-EU jurisdiction (AIFMD, art 20(1)).⁵⁷⁴ Further, the AIFM must not delegate its functions to the extent that this would effectively make it no longer the manager of the AIF. In other words, an AIFM cannot delegate its functions where delegation would render it a mere letter-box entity (AIFMD, art 20(3)). This would be the case when delegating a substantial portion of AIFM's functions to a third party, which could then be deemed the AIFM for the purposes of the Directive, rather than the delegating person.⁵⁷⁵

Sub-delegation by a delegate is generally permitted, provided the AIFM gives its consent and notifies its own regulator before the sub-delegation becomes effective (AIFMD, art 20(4)). It is required of the delegate to review the services provided by its sub-delegates on an ongoing basis (AIFMD, art 20(5)).

2.3.6 Depositary

Section 4 of Chapter III of the AIFMD deals with depositaries. The AIFM must ensure that for every AIF they manage there is a single depositary appointed (AIFMD, art 21(1)). This must be evidenced by a written contract which will regulate the flow of information considered

⁵⁷³ The Level 2 Regulation specifies the details of the terms which have to be incorporated in contracts with delegates, the applicable selection standards and the AIFM's ongoing review and monitoring duties in relation to the delegated functions.

⁵⁷⁴ Delegation regarding portfolio and risk management must be conferred only to regulated entities and, in case of third-country undertakings, cooperation between the supervisory authority of the delegate and the AIFM's own regulator in the EU must be ensured.

⁵⁷⁵ The Level 2 Regulation contains a list of situations where an AIFM would be considered a letter-box entity and hence no longer be the manager of the AIF.

necessary for the depositary to carry out its functions in relation to the AIF for which it has been appointed as depositary (AIFMD, art 21(2)). A credit institution (i.e. an EU licensed bank) can perform the role, as well as investment firms and other appropriately authorised persons fulfilling the conditions enshrined in Article 21(3) AIFMD. The Directive thus allows appointing professionals such as lawyers, trustees, notaries or registrars as depositaries for certain closed-ended funds, like private equity, which generally do not invest in financial instruments.

For EU AIFs, the depositary must be located in the same jurisdiction as the AIF. For non-EU AIFs, the depositary may be established in the same jurisdiction as the AIF, or the home Member State of the AIFM managing the AIF, or the Member State of reference of the AIFM managing the AIF (AIFMD, art 21(5)). The appointment of a third-country depositary is subject to further conditions as prescribed in Article 21(6) AIFMD.

Article 21 articulates the functions of the depositary. They include obligations to: monitor cash flows in respect of the AIF; safeguard or otherwise verify ownership of AIF assets; ensure that appropriate valuations are applied; ensure that transactions relating to units in the AIF are conducted in accordance with fund documentation; ensure that consideration for AIF assets is received in normal timeframes; ensure that management instructions are carried out; and ensure that an AIF's income is applied appropriately. All the functions performed by the depositary must be honest, fair, professional, independent and in the interest of the AIF and its investors. The depositary must equally not engage in activities that would potentially create conflicts of interest between the AIF, its investors, the AIFM and itself (AIFMD, art 21(10)).

The depositary may delegate its functions provided this is not done to circumvent the AIFMD, when the depositary has an objective reason for the delegation, and when it exercises due skill, care and diligence in the selection, appointment and ongoing monitoring of the sub-delegate (AIFMD, art 21(11)). The depositary remains strictly liable to the AIF for the loss of financial instruments held by it in custody (AIFMD, art 21(12)). It will only be exonerated of liability if it can prove that all conditions for the delegation of its custody functions were met or when a written agreement between the depositary and the third party expressly discharges the depositary's liability or transfers it to the third party, allowing the AIF or its AIFM to make a claim against the third party for the loss of financial instruments (AIFMD, art 21(13)). Furthermore, Article 21(12) AIFMD provides for the 'force majeure' exclusion if the depositary can prove that the loss resulted from an external event beyond its reasonable control

and that the consequences of the event would have been unavoidable regardless of all reasonable efforts to the contrary.

2.4 Disclosure and Reporting

One of the central aims of the AIFMD is to improve transparency for investors and regulators with respect to AIFMs and the AIFs they manage. Accordingly, the Directive imposes a wide range of transparency and disclosure requirements, including regulatory requirements on EU AIFMs pertaining to each AIF they manage and/or market in the EU as well as non-EU AIFMs for each AIF they market to EU investors. In general, the transparency and disclosure requirements can be categorised into three groups, that is, disclosure to investors, annual reports and reporting to EU Member State regulators. An increased information flow is believed and hoped to allow investors and supervisors to properly comprehend the nature and risks of AIFs and associated management infrastructure.

Specific transparency requirements are contained in Chapter IV of the Directive. Article 22(1) AIFMD imposes an obligation on an AIFM to produce an annual report, which must be made available no later than six months following the end of the financial year and provided to the relevant EU competent authorities and, upon request, to investors. The contents of such annual report must include a balance sheet or statement of assets and liabilities, an income and expenditure account, a report on activities, any material changes to the pre-investment disclosure, the total amount of remuneration paid by the AIFM and the aggregate amount of remuneration broken down by senior management and members of staff whose actions have a material impact on the AIF's risk profile (AIFMD, art 22(2)). The accounting information contained in the annual report must be prepared in accordance with the standards of the home Member State of the EU AIF and be audited by an EU auditor (AIFMD, art 22(3)).

Disclosure to investors is described in Article 23 AIFMD. With respect to pre-investment disclosure, an AIFM managing EU and marketing EU or non-EU AIFs is required to make available a long list of items that are, to some degree, similar to those traditionally covered in a fund's Private Placement Memorandum (PPM). The disclosure must include, *inter alia*, a description of the investment strategy and objectives of the AIF; the main legal implications of the contractual relationship entered into for the purpose of investment (jurisdiction, applicable law, enforcement measures); any preferential treatment granted to investors and the type of investors who obtain such treatment and their legal and economic connection to the AIF or the AIFM; all fees, charges and expenses (including their maximum amounts which are borne by

investors); details of how the AIFM ensures the fair treatment of investors; the type of assets in which the AIF can invest; the techniques it may employ and all associated risks; any applicable investment restrictions; circumstances in which the AIF may use leverage, its type and sources and the associated risks, plus any restrictions on the use of leverage, its maximum level and information on any collateral and reuse (rehypothecation) arrangements; details about any delegation of AIFM functions; if possible, the historical performance of the AIF; the AIF's latest annual report; identity of the AIFM together with the AIF's depositary, auditor and other service providers, including the description of their duties and investors' rights; the AIF's subscription and redemption procedures; and information in relation to how the AIFM covers professional liability risks using own funds or professional indemnity insurance (AIFMD, art 23(1)).

Article 23 AIFMD also makes provision for ongoing investor disclosures. Accordingly, an AIFM must periodically disclose to investors the percentage of the AIF's assets which are subject to special arrangements because they are of an illiquid nature, any new liquidity management arrangements, and the AIF's risk profile and the risk management mechanisms used by the AIFM to manage the risks (AIFMD, art 23(4)). The AIFM managing EU AIFs employing leverage,⁵⁷⁶ or marketing them in the EU, must disclose the total amount of leverage employed by the AIF and any changes to the maximum level of leverage employed by the AIF (AIFMD, art 23(5)).

Pursuant to Article 24 AIFMD, an AIFM must regularly report to its regulator on the principal markets and instruments in which it trades through the AIFs it manages. The reports must include the same information as in the case of periodic disclosures to investors, plus information on the main categories of assets in which the AIF invested and the results of the stress tests performed in accordance with the Directive's requirements (AIFMD, art 24(2)).

Article 24(4) AIFMD prescribes additional reporting obligations for an AIFM which manages AIFs employing 'leverage on a substantial basis.'⁵⁷⁷ Reporting is required, amongst others, on the overall level of leverage employed by each AIF, the extent to which each AIF's assets have been reused under leveraging arrangements and the identity of the five largest sources of

⁵⁷⁶ 'Leverage' is defined as 'any method by which the AIFM increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means' (Article 4(1)(v)).

⁵⁷⁷ The Level 2 Regulation explains that 'leverage on a substantial basis' means that AIF's exposure exceeds three times the NAV of the AIF. Leverage must be calculated using both the gross and the commitment method outlined in the Level 2 regulation.

borrowed cash or securities for each AIF together with the amounts of leverage received from those sources. The AIFM must be able to demonstrate that the leverage limits it has set are reasonable and complied with at all times (AIFMD, art 25(3)). The AIFM's own regulator will use the information to identify the extent to which the use of leverage might contribute to the build-up of systemic risk in the financial system, risks of disorderly markets or those pertaining to the long-term growth of the economy (AIFMD, art 25(1)). If it is deemed necessary to ensure stability and integrity of the financial system, the AIFM's home state regulator may impose limits on the leverage that a particular AIFM may employ or set other restrictions on the management of the AIF. The leverage information received by an AIFM's own regulator will be made available to other Member State regulators, ESMA and the European Systemic Risk Board (AIFMD, art 25(2)). Based on the information received, ESMA has the power to determine whether the leverage used by an AIFM, or a group of AIFMs, poses a substantial risk to the stability and integrity of the financial system (AIFMD, art 25(7)). If ESMA makes such determination, it can issue advice to the AIFM's regulator prescribing remedial measures, such as leverage limits. The AIFM's regulator is not obliged to comply with ESMA's advice but every such instance will require it to state its reasons (AIFMD, art 25(8)).

Finally, on request, regulators can require an AIFM to provide an annual report of each EU AIF and a list of AIFs managed by that AIFM for the end of each quarter (AIFMD, art 24(3)). Where necessary, national regulators may require additional information for the effective monitoring of systemic risk and, in exceptional circumstances, ESMA itself may request national regulators to impose additional reporting requirements in order to ensure stability and integrity of the financial system, or to promote long-term sustainable growth (AIFMD, art 24(5)).

2.5 Acquisition of Control of Non-Listed Companies

Section 2 of Chapter V of the Directive applies to the obligations for AIFMs managing AIFs who acquire control of EU unlisted companies (AIFMD, art 26(1)(a)).⁵⁷⁸ Within this context, 'control' means more than 50 per cent of the voting rights of the non-listed company (i.e. an EU-incorporated company without shares admitted to trading on a regulated market). The AIFM is required to notify the competent authorities of its home Member State of the proportion of voting rights of the company held by the fund when it reaches, exceeds or falls below the threshold of 10, 20, 30, 50 and 75 per cent (AIFMD, art 27(1)). The fund's acquisition of control, individually or jointly, must also be notified to the non-listed company itself and its

⁵⁷⁸ Small and medium-sized enterprises are excluded (Article 26(2)(a)).

shareholders (AIFMD, arts 27(2)(a-b)), and must contain information about the number of voting rights, the conditions subject to which control was acquired and the date on which control was acquired (AIFMD, art 27(3)).

When a fund acquires control of a non-listed company, the fund manager must make available to the company, its shareholders and the competent regulator the identity of the manager(s) whose fund(s) acquired control, the policy for preventing and managing conflicts of interest between the manager(s), the fund(s) and the company, and the policy for external and internal communication relating to the company (AIFMD, arts 28(1)-(2)). Fund managers must disclose information on the financing of the acquisition (AIFMD, art 28(5)) and the intentions concerning the non-listed company's future business and the likely repercussions on employment, ensuring to their best efforts that the company's board of directors makes available the requisite information to the employees' representatives or the employees themselves (AIFMD, art 28(4)). Moreover, the annual report of the non-listed company must be made available to its employees and, in addition to the minimum information prescribed in Article 22 AIFMD, it must include a fair review of the development of the company's business, the company's likely future development and indicate any significant events that have occurred since the end of the financial year (AIFMD, art 29(2)).

Article 30 AIFMD contains a provision which is aimed at so-called asset stripping, directly regulating buyouts of EU companies and protecting portfolio firms against short-term investment strategies. This provision therefore aims primarily at private equity funds, and specifically provides that when a fund, individually or jointly, acquires control of a non-listed company, the fund manager is prohibited for a period of 24 months following the acquisition of control from: (i) facilitating, supporting or instructing any distribution, capital reduction, share redemption and/or acquisition of own shares by the company (AIFMD, art 30(1)(a)); and (ii), insofar as the AIFM is authorised to vote on behalf of the fund, not voting in favour of any of these corporate actions (AIFMD, art 30(1)(b)).

The obligations apply to the AIFM, rather than the portfolio company – the AIFM must use its best efforts (AIFMD, art 30(1)(c)) to prevent the aforesaid corporate actions in relation to: (i) any distribution to shareholders by the company, where net assets are or would become lower than the amount of subscribed capital plus undistributable reserves under the law or the statutes (AIFMD, art 30(2)(a)); (ii) any distributions to shareholders which would exceed the amount of the company's distributable profits at the end of the last financial year plus profits brought

forward and sums drawn from reserves, net of any losses and any amount placed to undistributable reserves (AIFMD, art 30(2)(b)); and (iii) any acquisition by the company of its own shares if this would result in the reduction of its net assets below the amount mentioned in point (i) (AIFMD, art 30(2)(c)). Within this context, the term ‘distribution’ includes, amongst others, the payment of dividends and interest relating to shares (AIFMD, art 30(3)(a)).

2.6 Marketing and Passporting

There are two methods for marketing to professional investors⁵⁷⁹ under the AIFMD: the EU marketing passport and the Member States’ private placement regimes. The first marketing method is currently only available for EU AIFMs marketing EU AIFs; any other combination of EU/non-EU AIFM and EU/non-EU AIF must rely on the private placement regime in each EU state the AIFM wishes to market into. The AIFMD contemplated earliest possible extension of the passporting regime in October 2015, but no non-EU jurisdiction has benefitted from any such extension to date. Therefore, whether a particular marketing method is available depends on the jurisdiction of the AIFM and the relevant AIF. The Directive specifies rules for the following combinations of AIFMs and AIFs:

- i. EU AIFM and EU AIF: Chapter VI sets out the rights of authorised EU AIFMs to market and manage EU AIFs in the EU. In order to do so, the AIFM must submit a notification to the regulator in its home Member State with regard to each EU AIF it intends to market, comprising the documents and information set out in Annex III (AIFMD, art 31(2)). Provided the notification is complete, the competent authorities must respond within 20 working days, informing the AIFM whether it may start its marketing activities. A material change of any of the supplied particulars must be given in the form of written notice by the AIFM at least one month prior to the implementation of the change, or as soon as an unplanned change has occurred (AIFMD, art 31(4)).

If an EU AIFM wants to market units of EU AIFs to professional investors in other Member States, it must submit a notification to the competent authorities, complying with Annex IV, which contains a list of material to be provided (AIFMD, art 32(2)).

The regulator of the AIFM’s home Member State will then transmit the complete

⁵⁷⁹ The definition of ‘professional investor’ is adopted from MiFID. It was unsatisfactory in that Directive and is even less appropriate in a fund context where prospective investors will need to meet prescriptive qualitative tests in addition to their investment knowledge, experience and ability to comprehend the risks involved. This will prevent many high-net-worth individuals from being treated as professional; see *The AIFM Directive: Scope, Authorisation and Marketing* (PLC, 2013), <http://uk.practicallaw.com/3-503-9680>.

notification to the regulator of the Member State where the AIF is intended to be marketed (AIFMD, art 32(3)). The transmission of the notification file will be notified to the AIFM concerned who will be able to market cross-border from the date it receives this notification (AIFMD, art 32(4)). The notification letter must be provided in a language customary in the sphere of international finance (AIFMD, art 32(6)), and any material change(s) must be communicated to the AIFM's own regulator (AIFMD, art 32(7)).

With regards to managing EU AIFs established in other Member States, this must be done either directly or by setting up a branch (AIFMD, art 33(1)). This will require providing specific information to the competent authorities of the AIFM's home Member State.⁵⁸⁰ The complete documentation will be subsequently transmitted by the home state regulator to the host state regulator (AIFMD, art 33(4)), which will be prevented from imposing any additional conditions on the AIFM concerned (AIFMD, art 33(5)). If there is any material change to any of the information provided by the EU AIFM, it must give one month's prior written notice of such change to its home regulator (AIFMD, art 33(6)).

- ii. EU AIFM and non-EU AIF: an authorised EU AIFM is allowed to market (without a passport) non-EU AIFs to professional investors in EU Member States via national private placement regimes (AIFMD, art 36), provided that it complies with basic depositary and custody requirements (such as the safe keeping of assets and the supervision of administrative functions), there is a co-operation arrangement⁵⁸¹ in place between the regulator of the AIFM's home Member State and the supervisory authority of the non-EU country where the AIF is established; and the non-EU AIF is not established in a jurisdiction that is designated as non-cooperative by the Financial

⁵⁸⁰ See Article 33(2) AIFMD for managing AIFs directly and article 33(3) AIFMD for managing AIFs by establishing a branch.

⁵⁸¹ ESMA has published a matrix showing which Member States' competent authorities have signed AIFMD cooperation agreements with third country competent authorities, which is available at <https://www.esma.europa.eu/document/aifmd-mous-signed-eu-authorities>. The cooperation agreements facilitate information exchange, cross-border on-site visits and mutual assistance regarding the enforcement of respective supervisory laws. ESMA had negotiated the agreements on behalf of all EU Member State regulators through a common Memorandum of Understanding (MoU), based on IOSCO's Principles Regarding Cross-Border Supervisory Cooperation.

Action Task Force (FATF).⁵⁸² Member States may also impose stricter marketing requirements on the EU AIFM (AIFMD, art 36(2)).

The conditions for marketing in the EU with a passport (when it becomes available) are set out in Article 35. In such case, an AIFM will need to comply with the AIFMD (except for Chapter VI) and ensure that there are appropriate co-operation arrangements in place between the AIFM's regulator and the third country supervisory authority where the non-EU AIF is established, third country is not on a FATF blacklist, and there are OECD tax agreements between the third country where the non-EU AIF is established and the AIFM's Member State and with each Member State where that fund is marketed (AIFMD, art 35(2)). If an AIFM intends to market the non-EU AIF(s) in its home Member State, it will need to submit a notification to the competent authorities of its home Member State in respect of each non-EU AIF that it intends to market. That notification must comprise the documentation and information set out in Annex III (AIFMD, art 35(3)).

- iii. Non-EU AIFM and non-EU AIF (Articles 37, 40 and 42 AIFMD): specific rules regarding third countries are enshrined in Chapter VII of the AIFMD. As in the combination above, a non-EU AIFM may market a non-EU AIF to EU professional investors under EU Member States' private placement regimes, provided it complies with the AIFMD requirements on disclosure and reporting, it meets the requirement for the appropriate cooperation arrangement which must be in place for the purposes of risk oversight between the relevant Member State regulator where the AIF is to be marketed and the relevant third country regulators, and it meets the requirement that the non-EU AIF is not on a FATF blacklist (AIFMD, art 42(1)). Member States may also impose stricter marketing requirements on their territory (AIFMD, art 42(2)).

Article 40 sets out the conditions for the marketing in the EU with a passport of non-EU AIFs managed by a non-EU AIFM. This option will become available when the marketing passport for third country AIFMs becomes activated. When this happens, a non-EU AIFM will be allowed to exercise its passport rights provided it obtains prior authorisation. Authorisation will be granted when the Member State of reference⁵⁸³ is

⁵⁸² A list of high-risk and non-cooperative countries may be found on the website of FATF; *see* [https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/?hf=10&b=0&s=desc\(fatf_releasedate\)](https://www.fatf-gafi.org/publications/high-risk-and-other-monitored-jurisdictions/?hf=10&b=0&s=desc(fatf_releasedate)).

⁵⁸³ A Member State of reference of a non-EU AIFM can be determined in a multitude of ways, depending on the type and number of AIFs, the amount of assets under management or the intended location(s) for the marketing of

indicated by the AIFM, a legal representative established in the Member State of reference has been appointed by the AIFM to perform compliance function for EU marketing activities, appropriate co-operation arrangements are in place, the AIFM fulfils the requirements regarding regulatory cooperation agreements,⁵⁸⁴ FATF blacklist and OECD taxation agreements, and there is no domestic prevention in the third country where the AIFM is established on competent authorities' effective supervision or limitations in the supervisory and investigatory powers of that third country's supervisory authorities (AIFMD, art 37(7)). A duly authorised non-EU AIFM will be then allowed to commence marketing with a passport of non-EU AIFs – this will be subject to full compliance with the AIFMD and fulfilling the requirements regarding regulatory cooperation agreements, FATF blacklist and OECD taxation agreements (AIFMD, art 40(2)). The non-EU AIFM must submit a notification to its Member State of reference in respect of each non-EU AIF that it intends to market in the EU with a passport (AIFMD, art 40(3)).⁵⁸⁵

- iv. Non-EU AIFM and EU AIF (Articles 37, 39 and 42 AIFMD): the requirements for marketing both via national private placement regimes and a passport (when it becomes activated for third country AIFMs) are the same as those for a non-EU AIFM marketing a non-EU AIF above.

The above illustrates that the Directive effectively establishes a dual regime for the marketing of AIFs to investors within the EU, as non-EU AIFMs can market their AIFs in the EU either under the private placement regime in each Member State complying fully with local marketing requirements or under a more formal EU-wide passport regime throughout the whole of the EU (when this option becomes available⁵⁸⁶). Sub-threshold AIFMs cannot avail themselves of a

AIFs (AIFMD, art 37(4)). Based on the criteria prescribed, if more than one Member State of reference is feasible then all regulators of such Member States must be contacted in order for them to jointly decide the Member State of reference for the non-EU AIFM (AIFMD, art 37(4)).

⁵⁸⁴ For the already signed AIFMD cooperation agreements, *see* <https://www.esma.europa.eu/document/aifmd-mous-signed-eu-authorities>. The cooperation agreements facilitate information exchange, cross-border on-site visits and mutual assistance regarding the enforcement of respective supervisory laws. ESMA had negotiated the agreements on behalf of all EU Member State regulators through a common Memorandum of Understanding (MoU), based on IOSCO's Principles Regarding Cross-Border Supervisory Cooperation.

⁵⁸⁵ The notification must comprise the documentation and information outlined in Annex III. The Member State of reference shall inform the AIFM within 20 working days after receipt of a complete notification whether it may start marketing the AIF in its territory (Article 29(3)).

⁵⁸⁶ Initially it was forecast that national placement regimes would be removed at the end of 2018 but this did not happen. Once this happens, however, all non-EU AIFMs wishing to market their AIFs in Europe will need to become authorised as AIFMs and fully comply with the Directive's requirements.

pan-European marketing in relation to the AIFs they manage and do not have the right to market AIFs they manage to investors in other EU states, unless they opt in to the AIFMD regime.

3. The Lamfalussy Process

Following the Lamfalussy Process, there are four levels to the implementation of the new regime, with each level focusing on a different stage of implementation.⁵⁸⁷ The AIFMD (Level 1) is the focus of this thesis; it introduces harmonised minimum requirements for AIFMs and creates high-level general principles. ESMA provides various technical details and the EU Commission publishes delegated acts (DAs) and regulatory and implementing technical standards at Level 2. In the context of AIFMD, Level 2 Regulations furnish considerably more detail and clarity by explaining what AIFMs are expected to do.⁵⁸⁸ This enables the affected stakeholders to move forward and commence to prepare for the AIFMD implementation.⁵⁸⁹ Further, non-binding guidance and clarification on specific key AIFMD concepts (Level 3) is provided by ESMA prior to compliance with and enforcement of the new rules by the European supervisory authorities (Level 4).

4. The AIFMD Review

The Directive is now in force. Pursuant to Article 69(1) AIFMD, the EU Commission is to undertake a review, looking at: analysis of the experience of applying the AIFMD; understanding its impact on investors, AIFs or AIFMs, in the EU and in third countries; and the degree to which the AIFMD's original objectives have been achieved.⁵⁹⁰ In light of this review, and taking into account any developments at international level and discussions with third

⁵⁸⁷ Such regulations supplement the AIFMD in relation to a wide variety of issues and establish a single rule book for all AIFMs with regards to: how AIFMs should calculate the total value of assets under management and leverage; the additional own funds and professional indemnity insurance that AIFMs must hold; operating conditions for AIFMs including various general principles, conflicts of interest, risk management, liquidity management, investment in securitisation positions, organisational requirements, valuation and delegation of AIFM functions; depositaries' tasks and liability; transparency of AIFMs towards investors and supervisory authorities; cooperation arrangements with third countries; and the exchange of information on the potential systemic consequences of activity by AIFMs; see Oliver Glück & Anja Zimmermann, *Secondary Measures of the AIFM Directive* (PLC, Apr. 1, 2013), [https://uk.practicallaw.thomsonreuters.com/2-525-5660?_lrTS=20170208143318948&transitionType=Default&contextData=\(sc.Default\)](https://uk.practicallaw.thomsonreuters.com/2-525-5660?_lrTS=20170208143318948&transitionType=Default&contextData=(sc.Default)).

⁵⁸⁸ Charlotte Hill, *supra* note 415, at 1, 3.

⁵⁸⁹ *AIFM Directive: Crossing the Finish Line* (Deloitte, 2010), http://www.deloitte.co.uk/financialservices/publications/publications_ajax_ecm.htm.

⁵⁹⁰ The review was originally scheduled to take place by 22 July 2017, but it was delayed. A professional services firm KPMG was contracted to produce a report on the practical operation of the AIFMD in October 2017. The final report was published in January 2019; see *Report on the Operation of the Alternative Investment Fund Managers Directive* (AIFMD) (EU Commission, FISMA/2016/105(02)/C, Jan. 10, 2019), https://ec.europa.eu/info/publications/190110-aifmd-operation-report_en.

countries and international organisations, the EU Commission may propose amendments, which will be enshrined in the second iteration of the Directive, the AIFMD II.

5. Conclusion

The broad intent of the AIFMD is to create a harmonised and stringent regime for the regulation of AIFMs in the EU by capturing all unregulated funds and hence filling the European regulatory gap alongside MiFID and UCITS. For the hitherto unregulated or lightly regulated fund managers, this can be seen as a radical reshaping of the regulatory landscape around fund management and marketing across the EU.⁵⁹¹ The entry into force of the AIFMD puts an end to the black and white picture with regulated (harmonised) open-ended public funds on the one hand and mainly unregulated (non-harmonised) closed-ended fund structures on the other hand.

This chapter evidences that the Directive provides for a comprehensive set of rules covering all aspects of AIFMs' activities:⁵⁹² transparency and depositary rules affect risk monitoring; delegation and valuation requirements have an impact on the legal aspects of fund management; business conduct and risk and liquidity management affect AIFMs' processes; and scope and capital requirements as well as third country provisions affect the regulatory sphere. Accordingly, following the Directive's implementation, the AIFMs have had to consider a range of practical implications for their businesses and allocate sufficient resources and time to prepare for the impact of the key provisions. This necessitated, amongst other things, the review of AIFMs' organisational and governance structures, risk management and investment processes, fund documentation, investor relations processes and the renegotiation of arrangements with relevant third-party service providers, such as depositaries and administrators. Whilst some of these new regulatory requirements were relatively innocuous, others may have proven much more burdensome, depending on the domicile of the AIFM. In either case, the AIFMs had to identify key areas of change and design and implement adequate mechanisms to address the key challenges and risks to minimise the impact.

The next chapter looks closely at the implications of private equity-specific provisions, recognising both threats and opportunities presented by the AIFMD.

⁵⁹¹ Ulf Klebeck, *Interplay Between AIFMD and the UCITS*, in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS* 77, 88 (Dirk Zetzsche ed., 2012).

⁵⁹² *AIFMD: Re-Shaping for the Future* 5 (KPMG, 4th ed., Sept. 2013).

Chapter VII

AIFMD: Implications for Private Equity

1. Introduction

The last financial crisis has led to an astonishing volume of national and international regulatory activity. While initial measures were aimed at preventing the collapse of the international financial system, more recent efforts have concentrated more heavily on a long-term and forward-looking improvement of the overall stability of the financial system.⁵⁹³ In Europe, the AIFMD represents a comprehensive overhaul of the regulatory landscape for AIFMs, bringing for the first time all non-UCITS funds, both onshore and offshore, under the EU-wide regulation. This is designed to create a level playing field for AIFMs throughout the EU, including a passport enabling the management and/or distribution of funds on a cross-border basis. The AIFMD was born out of the financial crisis and, despite the fact that private equity had not triggered it, this measure appears to be a legal precaution taken in order to reduce the susceptibility of the European financial markets to systemic failures in the future.

The AIFMD has led to the shakeout within private equity, with significant ramifications for the vast majority of AIFMs⁵⁹⁴ based or operating in Europe.⁵⁹⁵ As one category of AIFM, once authorised, PE fund managers will need to be apprehensive of a whole range of new obligations with far-reaching business consequences. The Directive is likely to affect most AIFMs within its wide ambit⁵⁹⁶ and the grandfathering provisions applied only in very limited circumstances.⁵⁹⁷ Further, AIFMs managing funds that do not exceed the *de minimis* thresholds

⁵⁹³ Rudiger Wilhelmi & Moritz Bassler, *supra* note 563, at 21, 21.

⁵⁹⁴ One should bear in mind that in addition to placing obligations on fund managers, Annex I sets out a number of services and activities, which are directly or indirectly subject to the Directive's requirements. Many of these are performed by third-party service providers to the fund management industry, such as asset custody, record-keeping, fund administration (legal and accounting aspects), valuation, audit, outsourcing services, risk and portfolio management, as well as marketing and distribution.

⁵⁹⁵ Hugh Stevens, *Private Equity Prepares for the Regulatory Reform 5* (BNP Paribas Securities Services, Nov. 2012).

⁵⁹⁶ *Alternative Investment Fund Managers Directive (AIFMD): Private Equity* (PwC, 2012), <http://www.pwc.com/gx/en/asset-management/aifmd/assets/pwc-aifmd-for-private-equity.pdf>.

⁵⁹⁷ According to Articles 61(3)-(4) AIFMD, fund managers of closed-ended AIFs that: (i) did not make any additional investments after 22 July 2013; or (ii) whose subscription period for investors closed before 22 July 2011 and would be liquidated at the latest on 22 July 2016, were not required to seek an AIFM license. Nevertheless, fund managers with such grandfathered funds were obliged to comply with the annual report requirements and, in some cases, the transparency and asset stripping provisions in respect of EU portfolio

are subject to lighter touch regulatory requirements, including registration with regulators, certain investment reporting and periodical notification of investment strategies. This new regulatory regime is expected to bring consistency of standards across Europe.

The Directive bears the hallmark of regulation made in reaction to the financial crisis, designed to establish a harmonised and stringent framework for alternative fund managers. Naturally, it had generated a considerable buzz in the industry since it was first proposed by the EU Commission in 2009, attracting critique due to its original protectionist tone and broad scope best exemplified by the ‘one size fits all’ approach. The final version of the Directive has transpired to be less controversial, although still remains the cause of widespread speculation about the resulting challenges, impacts and complicating factors. For this reason market reaction is mixed. On the one hand, authorisation of managers appears to be a sensible solution, the possibility of cross-border marketing through the EU passport is welcomed and the enhanced transparency should be a utile tool in controlling the build-up of (systemic) risk; on the other hand, some aspects, such as the imposition of one and same piece of legislation on a broad category of fund managers, the discrimination against non-EU fund managers, mandatory depositaries and independent valuers, have raised great controversy.⁵⁹⁸

This chapter provides an early assessment of the Directive’s implications for private equity. Assessing the impact is crucial in view of the benefits flowing from the PE industry and its positive role in the EU economy – as demonstrated previously, private equity provides investment, creates wealth, growth and employment, plays a major role in providing capital to help European companies rebound from the economic crisis and get back on track, as well as contributes heavily in tax revenues to the EU economy, spurs innovation and allows institutional investors to diversify their investment portfolios. In other words, private equity creates value and, if successful, leaves every stakeholder better off, offering benefits for real people in the real economy. Negative implications will be analysed first, followed by the discussion of potential benefits and opportunities and whether they could render the EU a more attractive destination for both private equity and investors in it.

companies. See, e.g., *AIFMD: Re-Shaping for the Future*, *supra* note 592, at 6; *AIFMD Essentials: A Guide to the Alternative Investment Fund Managers Directive* 12 (EVCA, Dec. 3, 2013), https://www.ivca.ie/wp-content/uploads/2020/01/Invest-Europe-AIFMD-Essentials_May-2017.pdf; and Rodrigo Zepeda, *To EU, or Not to EU: That Is AIFMD Question*, 29(2) J.I.B.L.R. 82, 89 (2014).

⁵⁹⁸ *Draft EU Directive on Alternative Investment Funds Managers* 5 (Baker & McKenzie LLP, Client Memorandum, June 2009).

2. Negative Implications and Potential Threats

The rapidly growing profile of the private equity industry and the perceived need to ensure all market participants are submitted to a range of common general principles have motivated the enactment of the AIFMD. The Directive adopts an all-encompassing approach, rather than an asset class by asset class approach which would implement separate measures calibrated specifically to private equity, having the advantage of addressing issues specific to the industry more directly. As a consequence, the ‘hedge fund Directive,’⁵⁹⁹ as it is informally called, creates ambiguities and unnecessary burdens for private equity, especially as problems associated with hedge funds are quite different from those associated with private equity. The AIFMD tries to work for all different types of AIFMs in one fell swoop. This could work for something like UCITS, where there are basic rules what a UCITS can be and what it can do, but this is much harder in the AIF space, where the end result is that many of the new requirements for some AIFMs do not fit comfortably with their businesses.⁶⁰⁰ The EU Commission explained that defining clearly each asset class would be a significant challenge due to definitional obstacles in relation to the fluid business models; not all risks could be covered and some AIFMs would be able to circumvent the rules; and such an approach would not be ‘future-proof,’ requiring new bespoke actions whenever a new relevant asset class would have emerged.⁶⁰¹ Hence the all-encompassing approach, which addresses risks irrespective of where they arise in the alternative funds sector and concentrates on specific behaviours and activities.

There are a number of central areas of the AIFMD that are likely to affect PE managers and funds.⁶⁰² The key implications will principally be in relation to operations⁶⁰³ and will add substantial costs and complexity to the private equity industry, which is already facing a ‘tsunami of regulation.’⁶⁰⁴ The 2013 Multifonds survey analysed the industry thinking on the AIFMD and found that 53 per cent of fund manager respondents cited both depository liability

⁵⁹⁹ Ulrika Lomas, *EU Hedge Fund Directive Approved* (Nov. 15, 2010), http://www.tax-news.com/news/EU_Hedge_Fund_Directive_Approved_46346.html.

⁶⁰⁰ John Adams in *FORUM: Complying with the AIFM Directive* (FINANCIER WORLDWIDE MAG., Sept. 2014), <http://www.financierworldwide.com/forum-complying-with-the-aifm-directive/#.VZLesvIViUI>.

⁶⁰¹ *Impact Assessment*, *supra* note 345, at 34-35.

⁶⁰² Alan Greenough, Jeff Hurlburt & Nicholas Homan, *Reining in Private Equity*, 29 INT’L FIN. L. REV. 48, 48 (2010-2011).

⁶⁰³ In a survey of European industry players on the perceived impacts of AIFMD, 63 per cent of respondents indicated that the largest expected impact will be on operations, including mandatory depository requirements, risk management and independent valuation; Hugh Stevens, *supra* note 595, at 3-4.

⁶⁰⁴ *Part 2: The Impact of AIFMD and Convergence Survey 1* (Multifonds, 2013), http://www.multifonds.com/sites/default/files/Multifondsper_cent20Convergenceper_cent20AIFMDper_cent20Surveyper_cent20Partper_cent202per_cent20Jun13.pdf. The survey represents the views of 64 respondents, such as fund administrators and asset managers who collectively manage \$13trn total AUM.

and operational requirements as the most impactful elements of the Directive; other elements which were deemed significant in terms of their impact included risk and liquidity management, investor disclosure, third country provisions, valuation rules, competent authority reporting and leverage limits. The 2012 Ernst & Young (EY) survey also found that the largest impact of the Directive will be on operations, based on 63 per cent of private equity fund manager responses,⁶⁰⁵ and compliance costs will be felt most acutely by the smaller and mid-sized buyout firms where human and technical resource scarcity is more prevalent. In line with these findings, the 2012 Deloitte survey of UK investment managers revealed that 72 per cent of respondents deemed the AIFMD a business threat, and the aspects of the greatest concern regarded depositary costs (84 per cent), delegation and substance requirements (78 per cent), marketing and the end of national private placement regimes (67 per cent), changes in contractual arrangement and responsibilities (67 per cent), remuneration (67 per cent), third country provisions (66 per cent), initial authorisation process (44 per cent) and professional indemnity insurance cover (34 per cent).⁶⁰⁶ More recently, it was reported that the most significant organisational changes induced by the AIFMD were with regards to authorisation and notification requirements (52 per cent), depositaries (52 per cent) and marketing (48 per cent); moderate changes were required predominantly in response to the rules on transparency and reporting (48 per cent) and portfolio company disclosure (43 per cent).⁶⁰⁷ These various operational and compliance burdens are examined below.

2.1 Transitional Arrangements

The AIFMD came into force on 21 July 2011, followed by a two-year transposition period. Whilst as of April 2017 all 28 Member States had the Directive transposed into their national regulation, some Member States (particularly newer ones) took longer to fully implement the AIFMD. Therefore, it is during this period, when the national transitional arrangements proved to be patchy and inconsistent, and the affected firms were presented with the first challenges.

⁶⁰⁵ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe* 10-11 (Ernst & Young, Mar. 2012). The survey is based on insights and views from 23 private equity and venture capital players (managing partners, CEOs, CFOs, senior relationship managers, financial controllers, in-house lawyers and compliance officers) with operation in Europe. The amount of assets under management by the participants varies between EUR 150m and EUR 20bn.

⁶⁰⁶ *AIFMD Survey: Responding to the New Reality* 6 & 9 (Deloitte, July 2012), https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/FinancialServices/investmentmanagement/2013_aifmd_survey_deloitte_ireland.pdf. The survey was based on UK asset managers from across the hedge fund, private equity and real estate sectors. The respondents collectively managed over £175bn, evenly distributed across these three segments. Twenty-three per cent of respondents belonged to private equity funds.

⁶⁰⁷ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 27.

This was especially problematic for PE AIFMs looking to manage and/or distribute funds in various EU jurisdictions.

The Directive's transposition was delayed in approximately half of the countries in the EU.⁶⁰⁸ Accordingly, before commencing their activities, AIFMs needed to assess the status of implementation in Member States of their interest and verify whether the relevant regime was based on the AIFMD or a national pre-AIFMD regime. The process to obtain information regarding the existence and scope of transitional arrangements had proven challenging, too. Most EU nations had a one-year grace period extending to 22 July 2014 from the AIFMD's application, but this position varied and the AIFMs needed to perform checks carefully in every jurisdiction.⁶⁰⁹ Further, it became evident that the Directive's implementation transpired to be more complex than originally anticipated for the regulatory community,⁶¹⁰ with direct implications for the industry that had to cope with uncertainty over how certain measures were being interpreted and applied.

The scope of grace period was particularly important. In the UK, AIFMs were allowed to market new and existing AIFs provided these had been managed or marketed in the EU immediately before 22 July 2013 (Alternative Investment Fund Managers Regulations 2013, art 72).⁶¹¹ Accordingly, all transitional managers had to guard against complacency, having

⁶⁰⁸ This includes Spain and Italy; *AIFMD Six Months On – Teething Troubles* 1 (Clifford Chance LLP, Briefing Note, Feb. 4, 2014), https://www.cliffordchance.com/briefings/2014/02/aifmd_six_monthsonteethingtroubles0.html.

⁶⁰⁹ See *Alternative Investment Fund Managers Directive (AIFMD): Current Position on Passporting and Private Placement* (Eversheds LLP, Apr. 24, 2014), http://www.eversheds.com/documents/sectors/financial_institutions/Position%20on%20AIFMD%20passporting%20and%20private%20placement.pdf.

⁶¹⁰ Sophia Grene & Chris Newlands, *On the Cusp of a New Gold Standard for Regulated Funds* (FIN. TIMES, July 27, 2014), <http://www.ft.com/cms/s/0/64e6fb1c-1286-11e4-a6d4-00144feabdc0.html#axzz3b9mUpDCD>.

⁶¹¹ Whilst the EU Commission stated that AIFMs still had to use 'best efforts' to comply with the AIFMD, this is not the approach that has been applied in the UK by the FCA or HM Treasury. Instead, Part 9 of the AIFM Regulations specifies details of transitional provisions applicable to the UK; the Alternative Investment Fund Managers Regulations 2013 (SI 2013/1773), available at <http://www.legislation.gov.uk/uksi/2013/1773/contents/made>.

until 22 July 2014 to become duly authorised⁶¹² and comply fully with the new regime.⁶¹³ By contrast, transitional relief was very narrow in Germany and applied only to AIFs which had been marketed by an AIFM into Germany before 22 July 2013.⁶¹⁴ Further, Germany overhauled its entire system of fund management regulation and introduced the Capital Investment Act (Kapitalanlagegesetzbuch, KAGB), which contains some rules unique to Germany and respective new tax provisions in addition to the AIFMD requirements.⁶¹⁵ Thus, AIFs being launched in Germany after the 2013 implementation date had to comply with the KAGB. This demonstrates that approaches to the implementation of the AIFMD and transitional relief was far from uniform across Europe and hence generated additional layer of difficulty for fund managers.

2.2 Authorisation Process

The AIFMD subjects AIFMs to authorisation or registration requirements. However, in the private equity context, the authorisation requirements do not accommodate the nature of private equity (the rules are more aimed at hedge funds) nor the nature of private equity firms, which typically are independent, tightly controlled and owner-managed entities.⁶¹⁶ This illustrates that the Directive has an element of square pegs into round holes because of its attempt to regulate a wide range of fund managers managing a wide range of fund structures.

In general, on an individual country basis, the process to obtain AIFM authorisation may take anything between less than a week to more than a year. According to the report produced by a

⁶¹² Time will be required to process applications for authorisation, and the UK FCA advised AIFMs to apply for authorisation no later than 22 January 2014 as in some cases it may take the FCA full six months to determine the application. AIFMs were able to continue to operate whilst the FCA had been determining their application, save for the AIFMD passporting rights, and had to comply with all the AIFMD requirements from 22 July 2014, even if their application had not yet been determined. See *AIFMD Six Months On – Teething Troubles*, *supra* note 608, at 3; *AIFMD Update* (Eversheds LLP, June 25, 2013), http://www.eversheds.com/documents/sectors/financial_institutions/Financial-Institutions-asset-management-e-briefing-AIFMD-update.pdf; Emma Radmore & Kam Dhillon, *Take Aim For AIFMD Implementation 5* (COMPLIANCE MONITOR, July 3, 2013), <http://www.compliancemonitor.com/international/european-union/directives/take-aim-for-aifmd-implementation-68830.htm>.

⁶¹³ *The EU Alternative Investment Fund Managers Directive: Update on UK Developments 1* (Covington & Burling LLP, Advisory: Funds and Investments, May 1, 2013), <https://www.cov.com/en/news-and-insights/insights/2013/05/the-eu-alternative-investment-fund-managers-directive---update-on-uk-developments>; *AIFM Directive 2013 Update: Marketing by US and Other Non-EU Managers 1* (Sidley Austin LLP, Investment Funds, Advisors and Derivatives Update, Feb. 6, 2013), <https://www.lexology.com/library/detail.aspx?g=0c313b69-c097-429d-92d1-4c7aa8a16e35>.

⁶¹⁴ *AIFMD Six Months On – Teething Troubles*, *supra* note 608, at 1.

⁶¹⁵ *The Alternative Investment Fund Managers Directive – A Guide for US Managers 1* (King & Spalding LLP, Financial Services Regulation Practice Group Client Alert, Feb. 18, 2014), <https://www.lexology.com/library/detail.aspx?g=78d5439f-b394-4f3c-bb3f-2bc747f4f4aa>.

⁶¹⁶ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 28.

consulting firm KPMG for the EU Commission (henceforth referred to as the “KPMG report”),⁶¹⁷ only a minority of respondents got through the process in less than three months, particularly in Germany, the UK and France, where the local regulators have much more experience than others. Whilst only a very small proportion of applications took more than a year and noting that more time is required to analyse the specific requirements throughout the authorisation process whenever new legislation is introduced, it is reasonable to state that the process of more than six months is not business-friendly and may jeopardise investor relationships.

In terms of authorisation costs, the KPMG report found that these vary across the EU. To give a few examples: in the UK the fee for a new authorisation is GBP 5,000 and additional fees are charged for each non-EU AIF marketed into the UK under the NPPR; in Germany the fees range between EUR 10,000 and EUR 40,000; in France, the local regulator does not charge an explicit fee to obtain a licence, but these costs are recouped via an annual fee to the regulator and will be in the region of EUR 2,000 depending on the size of the AIFM and the complexity of strategies; and in Luxembourg the average fee is EUR 10,000.⁶¹⁸

Once authorised, private equity firms need to comply with many regulatory requirements, some of which are not particularly suited to the PE industry, as evidenced further down in this chapter.

2.3 Depositaries

The relationships and processes which exist between the various participants are central to the AIFMD. Most notably, the Directive introduces a pivotal role for the depositary to verify the ownership of assets. This is felt as a new level of intrusion for the private equity industry, which did not commonly use depositaries in the pre-AIFMD world, with the exception of only a limited number of countries, such as France, where this was a pre-existing regulatory requirement. This general position could be explained by the fact that such a requirement was not seen as having value by both the industry and the investors in it – this is because it would be incredibly difficult for private equity assets to disappear or be sold without anyone knowing about it, particularly as fund managers typically complete only a few transactions a year, all of which would be subject to thorough due diligence exercise, capturing the legal documentation in place detailing ownership and transfer of the assets concerned. This would suggest that

⁶¹⁷*Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 69-71.

⁶¹⁸ *Id.* at 143-145.

applying the requirement to AIFMs dealing with real assets is unwarranted.⁶¹⁹ Yet, the requirement has become one of the most important strategic decisions PE fund managers have been tasked with under the Directive, with all relevant in-scope AIFMs, including those from outside the EU if marketing funds under the national private placement regimes into countries, such as Denmark and Germany, having to appoint a depositary for each AIF managed.⁶²⁰

The new requirement is problematic. The process of appointing a depositary may be cumbersome, distractingly complex and bureaucratic; cash monitoring is intrusive and may potentially hinder day-to-day activities, with a depositary's oversight acting as a mini-regulator permanently lurking above the AIFM's shoulder; asset verification may alienate asset holders and delay transactions; and the additional costs associated with the new requirement are even more unwelcome in the subdued post-crash environment (particularly for smaller PE firms). Further, fund managers need to ensure that the depositary has proven capabilities and specialist knowledge and experience in order to be able to perform effectively and efficiently its primary functions of cash flow monitoring, safekeeping and recordkeeping of assets, as well as oversight duties including *ex ante* verification and *ex post* controls. These functions are typically the responsibility of the General Partner, which is why the involvement of the depositary will increase operational costs and a degree of interference in the AIFM's daily activities.⁶²¹ Further, the depositaries themselves have difficulties in interpreting the requirements in place, for example, in relation to cash monitoring as significant cash holdings and cash movements at fund level are relatively rare in the case of PE funds.⁶²² Therefore, the consideration of all cash flows within the AIF at fund level, as well as in the underlying portfolio companies, is not feasible from an operational standpoint. This illustrates that the cash monitoring requirements are not appropriate in the PE context and that the one-size-fits-all approach to depositary rules does not accommodate different asset classes. Last, but not least, whilst one of the objectives of the provision is to reduce investors' exposure to losses as a result of potential fraud on the part of the AIFM, this does not appear to be a real world issue in the PE space. In particular, professional investors conduct thorough due diligence prior to making an investment, change

⁶¹⁹ By contrast, this requirement is sensible for financial players that trade instruments on a daily basis; Simon Burns, *Private Equity's Role in Europe's Brightening Economic Outlook* (FINANCIER WORLDWIDE MAG., Sept. 2014), <http://www.financierworldwide.com/private-equitys-role-in-europes-brightening-economic-outlook/#.VZGsYPIViUI>.

⁶²⁰ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 34.

⁶²¹ Alan Greenough, Jeff Hurlburt & Nicholas Homan, *supra* note 602, at 48, 48.

⁶²² See *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 76; *Effectiveness and Efficiency of AIFMD under Scrutiny* (Bryan Cave Leighton Paisner LLP, Jan. 15, 2019), <https://www.bclplaw.com/en-GB/thought-leadership/effectiveness-and-efficiency-of-aifmd-under-scrutiny.html>.

in ownership is evidenced via extensive legal documentation (e.g. a sale and purchase contract), and the transaction volumes are low (as opposed to a typical hedge fund activity).

The depositary functions are complex, and monitoring and ownership verification will require an extensive overhaul of systems and service agreements by fund managers.⁶²³ Many AIFMs deem the depositary requirement of the AIFMD to constitute the most significant impact in terms of cost.⁶²⁴ Whilst some jurisdictions are already familiar with the depositary concept (Luxembourg and France, for instance), this remains a new constraint for private equity fund managers in other Member States, like the UK and the Netherlands. Therefore, as logic suggests, the impact of the Directive and the controversies surrounding the depositary provisions varies significantly between these two camps of countries, with the latter group naturally attributing more significance to the provisions, perceiving compliance with them as costly, time-consuming and potentially disruptive to their business.⁶²⁵ According to the Deloitte survey, 56 per cent of UK investment managers do not use a single, independent depositary for each AIF they manage.⁶²⁶ This industry practice equally finds support in the EY survey which reported that 74 per cent of respondents do not employ a depositary for their AIFs.⁶²⁷ This shows the sheer scale of necessary adjustments that will have to be made by private equity houses under the AIFMD and the need to become accustomed to the new depositary oversight arrangements. Although the full depositary regime did not apply to offshore AIFs during the transitional period, an EU AIFM marketing a non-EU AIF under a private placement regime of an EU Member State had to make necessary appointments to have depositary duties performed. This illustrates the wholesale shift for the PE industry. According to the 2017 evaluation of the AIFMD by Europe Economics, an independent economics consultancy based in London, above-threshold AIFMs, who were obliged to use depositaries under the AIFMD, stated that the provisions required moderate to significant organisational changes to their businesses (nearly three-quarters) and resulted in substantial overlap between the work performed and investor protection provided by depositaries and that undertaken by auditors.⁶²⁸ It was further reported that despite the obligation not being applicable to sub-threshold AIFMs, some national

⁶²³ Peter McGowan, *A New Level: Depositary Duties under AIFMD Regulations* 27 (Citibank, AIFMD Special: European Fiduciary Services News and Views, 2013).

⁶²⁴ Hugh Stevens, *supra* note 595, at 5.

⁶²⁵ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 22-23.

⁶²⁶ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 21.

⁶²⁷ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 22.

⁶²⁸ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 34.

competent authorities, for example in Germany, used the Directive as an opportunity to include such an obligation in their National Private Placement regimes (NPPRs). Consequently, even small AIFMs need to appoint a depositary in a way similar to the larger AIFMs. This has little added value for investors in private equity as they perform their own due diligence and essentially do not see the scope for fraud by AIFMs as a real-world concern.⁶²⁹

AIFMs will need to liaise with the intended service providers to ensure the counterparty is suitable. According to one survey, 48 per cent of respondents believe that depositaries will not be willing or equipped to perform their role.⁶³⁰ This can be illustrated by the following example. Very often, when AIFMs invest into non-listed companies, these tend to be associated with considerable legal documentation. Private equity firms, which cannot afford to have a separate office in which the documentation (like share registers) is stored, must sometimes resort to using the services of a depositary bank (or a lawyer's office⁶³¹) for safe keeping. A number of fund managers have simply stopped using such depositaries as 'there had been little value for the services they provided and the quality of service offered had been poor.'⁶³² Moreover, depositaries themselves noted that they had little interest in acting for buyout houses because these funds would require a service that does not fit well their business models, which are rather designed to manage millions of transactions in shares or bonds with a large number of inward and outward fund flows and corporate actions.⁶³³ Unsurprisingly, there have been very few large banks in the PE space, which provided appropriate depositary services to their existing clients. These banks, however, have not actively sought new PE clients, since they had much bigger issues within the hedge fund industry. Therefore, diving into a whole new market in private equity would not make sense for them, as private asset verification is completely foreign to what such custodial banks do.⁶³⁴

Further, the depositary will need to show greater transparency in its process of selecting and managing its sub-custodians and it will assume strict liability for potential loss of assets under

⁶²⁹ *Id.* at 36.

⁶³⁰ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 25.

⁶³¹ Claire Cummings, *AIFMD and Private Equity* (Cummings Law, podcast, 2013), <https://www.slideshare.net/ClaireCummings1/aifmd-and-private-equity-cummings-final>.

⁶³² Kyla Malcolm et al., *Impact of the Proposed AIFM Directive Across Europe* 101 (Charles River Associates White Paper for the Financial Services Authority, Oct. 2009), <https://www.crai.com/insights-events/publications/impact-proposed-aifm-directive-across-europe/> (henceforth referred to as "the CRA study").

⁶³³ *Id.* at 102.

⁶³⁴ David R.D. Bailey in *AIFMD for Private Equity Managers: The Roundtable Discussion* (July 29, 2014), <http://cooconnect.com/guide/aifmd/aifmd-for-private-equity-managers-the-roundtable-discussion>.

custody. Shifting the burden of proof onto the depositary exposes them to greater liability, which in turn translates into higher operating expenses.⁶³⁵ Consequently, this increased depositary liability may signify a reduction in the breadth of support for certain asset classes, markets and geographies, forcing depositary costs higher for private equity firms. It was found that the number of suitable depositaries to provide services spelled out under the AIFMD is relatively small and, given that only a few depositaries are prepared to deliver this service, it is likely that some may stop accepting new clients due to their dealings with the ‘AIFMD learning curve.’⁶³⁶ What is worrying is the fact that those private equity firms which will lag behind with their compliance with this specific AIFMD requirement will risk facing operational problems and the potential loss of investors. Naturally, the larger the private equity house, the more pronounced implications the depositary requirement will have – such firms have higher risk profiles and hence might find it more troublesome to find a depositary that is willing to take on a higher level of risk.

2.4 Remuneration

The remuneration requirements are amongst the most disputed and controversial in the Directive.⁶³⁷ They are entirely new for many private equity managers and may lead to restrictions on the functioning of performance-related schemes, including the carried interest structures, for certain categories of staff. In addition, AIFM remuneration disclosure can pose security risks for the individuals involved and be seen as intrusive with limited benefit for fund investors.⁶³⁸ Therefore, the new requirements are likely to present a marked change for senior management and those in control functions or individuals whose activities have a material impact on the risk profile of the managed fund(s). As a general comment, the requirements prescribed by the Directive are based on, but are not identical to, those in CRD and equally ESMA’s remuneration guidelines are closely based on the guidelines produced by the Committee of European Banking Supervisors on the CRD requirements regarding remuneration – this means that the practical impact in this area will differ between those AIFMs who are

⁶³⁵ SunGard, *AIFMD: Private Equity Obstacles and Opportunities* 5 (White Paper, 2013), <http://financialsystems.sungard.com/resources/asset-management/white-papers/am-investran-aifmd-white-paper>.

⁶³⁶ *Last Boarding Call: An Overview of the Alternative Industry’s Preparedness for AIFMD* 7 (KPMG, Dec. 2012), <https://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Marketper cent20Sector/Financialper cent20Services/last-boarding-call-dec2012.pdf>.

⁶³⁷ Charlotte Hill, *supra* note 415, at 1, 10.

⁶³⁸ Glynn Barwick, *Investor Transparency Post AIFMD: What Have We Gained?* (Dechert LLP, September 2014), <https://www.dechert.com/knowledge/onpoint/2014/9/investor-transparency-post-aifmd-what-have-we-gained.html>.

dealing with this type of regulation for the first time and those who only need to identify the differences between CRD and AIFMD in this regard.

Large AIFMs with more than 1bn AUM for non-levered funds need to establish an independent Remuneration committee. Also, the remuneration policy needs to be based on long-term incentives that do not encourage risk-taking inconsistent with the managed funds. This aspect of the Directive in disincentivising fund managers from risky behaviour is surprising from a private equity perspective. Pursuant to the EY survey, 61 per cent of respondents expressed they already have a formal remuneration policy in place, whilst 70 per cent already comply with the spirit and philosophy of the AIFMD's remuneration provisions through the carried interest which effectively dissuades AIFMs from taking unnecessary risks.⁶³⁹ Naturally, the devil is in the detail but, in general, carried interest constitutes a genuine long-term incentive as it is directly linked to the realised performance of the AIF and the investments themselves tend to be closely aligned with investors' interests. This is why private equity is believed to have one of the fairest bases for remuneration across the entire fund management industry, as no money is shared before it is actually made, and no profits are distributed to AIFMs before the investors have their initial capital back, plus the interest.⁶⁴⁰

One practical difficulty in applying the AIFMD remuneration principles lies in the identification of relevant categories of people in the scope of the requirements, so-called 'identified staff,' as risk takers and control functions are both left undefined in the Directive.⁶⁴¹ The former may capture individuals involved in taking AIF-related investment decisions; the latter may include compliance, legal, human resources and risk management staff. Thus, the initial scoping exercise captures the entire AIFM staff population and only then criteria for materiality of influence are applied to determine identified staff – a process that is not always crystal-clear. On top of that, some funds have complex legal structures that do not easily align to the deferral of the variable remuneration component. Unsurprisingly, remuneration may be problematic, and is particularly contentious with many US AIFMs who struggle to reconcile their domestic and new EU obligations.

⁶³⁹ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 14-15.

⁶⁴⁰ David R.D. Bailey in *AIFMD for Private Equity Managers: The Roundtable Discussion*, *supra* note 634.

⁶⁴¹ The ESMA guidelines provide guidance in this regard in section VI.

There is also evidence that the remuneration rules caused only a minor or moderate improvement to investor protection.⁶⁴² The use of carried interest continues to be perceived as a critical element for the alignment of interests between them and AIFMs and to prevent fund managers from taking socially unbeneficial risk at the cost of investors. In general, the requirements have not affected investors' willingness to invest in Europe in any significant way.⁶⁴³

2.5 Risk Management

Exposed by the 2007-2008 financial crisis, risk management has become the regulatory hotspot of EU financial law.⁶⁴⁴ Unsurprisingly, the AIFMD contributes to the larger global regulatory trend towards more robust risk management and risk transparency. Risk management is broad in scope, extending into every facet of an AIFM's operations. This is an issue for private equity as most of its funds have little to no formal risk management in place.⁶⁴⁵ This means that the new requirements may be challenging to meet as they translate into significant operational adjustments, necessitating a permanent functional and hierarchical separation of the risk management and portfolio management functions of the AIFM. This will require adequate risk management systems in order to better identify, measure, manage and monitor all kinds of risk (market, liquidity, counterparty and other risks) to which each AIF and fund investment strategy may be exposed. Theoretically, this should help prevent or minimise risks as well as maximise the risk-return ratio of investments. In practice, however, the separation of risk function is considered to be impracticable in the case of unlisted and illiquid assets as risk management and portfolio management processes are intrinsically linked.⁶⁴⁶

When investing on behalf of the AIF, private equity firms will be required to adopt suitable, documented and regularly updated due diligence process. This signifies that the due diligence policies and procedures which have typically been determined internally by buyout firms in accordance with their professional judgement will have to become more formalised pursuant to the Directive. Also, separating the risk management function from operating units may not be

⁶⁴² *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 43.

⁶⁴³ *Id.* at 44.

⁶⁴⁴ Dirk A. Zetsche & David Eckner, *Risk Management*, in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS* 265, 265 (Dirk Zetsche ed., 2012).

⁶⁴⁵ Samuel K. Won, *AIFMD: A New Regulatory World for Private Equity Firms* (FINANCIER WORLDWIDE MAG., Sept. 2014), <http://www.financierworldwide.com/aifmd-a-new-regulatory-world-for-private-equity-firms/#.VZGIPPIViUI>.

⁶⁴⁶ *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 89, 195; *Effectiveness and Efficiency of AIFMD under Scrutiny*, *supra* note 622.

feasible to be achieved in smaller private equity firms, which may simply lack the relevant resources. By contrast, bigger private equity firms may already have partially embedded the required functional and hierarchical separation of the operating units, and some of the large managers may already have appointed a chief risk officer, or adopted a risk monitoring committee or a formalised risk management system.

According to 57 per cent of EY respondents, they already have a formalised, all-encompassing, independent risk framework and procedures, which adequately safeguard the interests of AIF investors.⁶⁴⁷ The Directive requires AIFMs to adhere to more stringent requirements and this will materially affect the private equity business. The majority of EY respondents noted that the mere concept of risk management is applicable to hedge funds, but the rationale for the provisions in relation to private equity is far from obvious. In private equity, risk management amounts to ensuring that the investments are in line with the fund's investment strategy and that any substantial cash assets are not necessarily with one institution. When the firm is doing only a few transactions a year, the risk management function is not enormous. Yet, because of the AIFMD, the monitoring of activities will need to be evidenced in a more structured, overt way, reaching down into the detail and demonstrating that an investment is in line with policy at the micro-level.⁶⁴⁸ This will make risk managers more dependable on processes, systems and procedures as well as more personnel. The AIFMD has thus changed the very purpose of risk management, requiring it to be embedded in the decision-making processes prior to making investments. This represents a new paradigm for risk management in private equity, necessitating a change in risk managers' culture, philosophy and mindset.⁶⁴⁹

2.6 Transparency and Disclosure

The AIFMD dictates transparency by imposing far-reaching reporting and disclosure requirements in order to monitor, assess, measure and manage potential systemic risk and to increase public accountability of AIFMs for their actions under a harmonised set of rules regarding the format, content and frequency of reporting. Enhanced transparency involves an annual report to investors, disclosure of investment types and concentrations, risk management,

⁶⁴⁷ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 12-13.

⁶⁴⁸ Iain Stokes in *AIFMD for Private Equity Managers: The Roundtable Discussion* (July 29, 2014), *supra* note 634.

⁶⁴⁹ Alan Picone, *AIFMD and the Evolution of Risk management* (Duff & Phelps, 2016), <https://www.duffandphelps.com/insights/publications/compliance-and-regulatory-consulting/aifmd-and-the-evolution-of-risk-management>.

valuation and stress tests, as well as regular reporting to relevant EU regulators. This may represent an overwhelming challenge and an increased cost burden, with no notable positive effect on the ease of cross-border fundraising or usefulness of information provided to investors.

The Directive exponentially multiplies the significance of pro-active regulatory, investor and management reporting. As a corollary, national regulators will be receiving more information than investors, and there is a risk that the numerous reporting requirements will lead to excessive costs and, from a different angle, might overwhelm the regulators by an enormous volume of cross-jurisdictional data provided in relation to almost any aspect of alternative fund managers' activity.⁶⁵⁰ If this would be the case, the very objective of AIFMD to identify systemic risk trends would backfire due to this information overload, rendering the whole reporting requirement futile and unjustifiably expensive. It must be also noted that the private equity industry itself already collects information about its own activities on an aggregate basis – for example, the BVCA in the UK publishes a very detailed and extensive quarterly report that covers, *inter alia*, the size of AUM, types of fund transactions and sources of investor funds. Thus, it should not be surprising that only 23 per cent of respondents in the 2015 Multifonds survey were of the opinion that the Directive will enable regulators to better identify threats to market stability and the build-up of systemic risk in the EU financial system, and 56 per cent of them remained unclear on how the regulators will use and apply the received data.⁶⁵¹ Also, it is important to make a distinction between AIFMD's rules on portfolio company reporting and the provisions focusing specifically on leverage. In the UK, for example, notifications to portfolio companies are covered by the provisions of UK company law and the Walker Guidelines, and the relevant information is also contained in financial statements of the portfolio companies. Therefore, the AIFMD appears to be covering an aspect of national law and requires corporate law disclosures which the financial regulator may not necessarily be interested in.

With regards to leverage specifically, AIFMs are required to set leverage limits in each of the funds they manage and when an AIF is substantially leveraged they must provide additional

⁶⁵⁰ Dirk A. Zetsche & David Eckner, *Investor Information, Disclosure and Transparency*, in THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS 333, 353 (Dirk Zetsche ed., 2012).

⁶⁵¹ Reporting to regulators was cited as the biggest challenge by 81 per cent of respondents; *Part 4: The Impact of AIFMD and Convergence Survey 3 & 6* (Multifonds, 2015), <http://www.multifonds.com/sites/default/files/Multifonds%20Convergence%20AIFMD%20Part%204%20Jun15.pdf>; see also *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 234 (stating that it is not clear how the information is, or can be, used by the national competent authorities in the context of disclosures regarding investment in non-listed companies).

information to the regulator. The key objective of the leverage rules is to discourage over-leveraging and, in turn, prevent the build-up of systemic risk in the financial system. However, with respect to private equity, the use of leverage is relatively rare within AIFs (contrary to hedge funds) and, if present, it is at a relatively low level. Even if bridging or subscription facilities are used these are always against undrawn but committed funds from LPs and, furthermore, they are for a short term only (typically less than one year). Such facilities are not construed as leverage within the meaning intended by the Directive. This indicates that the new requirements are going to have small or non-existent impact as generally they will not be applicable.⁶⁵² This further demonstrates that the AIFMD is not particularly relevant to the PE industry.

Clarity surrounding regulatory reporting is elusive in some respects, such as timing and reporting periods and templates that ultimately depend on national translations of the final ESMA Guidelines on Reporting.⁶⁵³ This shows that the purely procedural reporting obligations are not straightforward. Regional regulators have interpreted the AIFMD's fine print differently and consequently AIFMs that had to file their first transparency report in multiple EU countries by the 31 January 2015 deadline were stuck with an unprecedented and time-consuming burden to figure out the idiosyncratic differences in reporting as each jurisdiction accepted its own version of the Annex IV report. Therefore, it was impossible to simply drop the data from the report to one regulator into the template employed by another. This finding is mirrored in the recent KPMG report which found lack of consistency and coherence with regards to reporting details, duplication of information requested and overlap with other EU regulations (for example, MiFID II), gold-plating and additional requirements imposed by some EU countries, and technological problems resulting from different data standards and reporting formats used.⁶⁵⁴

Technical problems were prevalent when the first report had to be submitted. For instance, in the UK, the first and foremost problem for filers was to obtain access to the FCA's reporting system, Gabriel. Once this obstacle was removed, it transpired that there are discrepancies between what the system accepts and what the technical guidelines provide – a dilemma which

⁶⁵² *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 55 & 41-42.

⁶⁵³ *Guidelines on Reporting Obligations under Articles 3(3)(d) and 24(1), (2) and (4) of AIFMD. Final Report* (ESMA, Nov. 15, 2013), <https://www.esma.europa.eu/document/guidelines-reporting-obligations-under-articles-33d-and-241-2-and-4-aifmd-revised>.

⁶⁵⁴ *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 112.

many AIFMs also faced in other EU jurisdictions.⁶⁵⁵ Thus, the slightly different versions of the report have been adopted by national regulators in the EU, requiring sometimes additional mandatory fields, and therefore resulting in the situation where the requirements for the transparency report remain opaque and far from harmonised. A recent evaluation of the AIFMD supports the view that the supervisory reporting set-up was not straight-forward, characterised by: (i) the ongoing delays in the ability of Member State regulators to accept the reports; (ii) differing interpretation across countries of an ESMA template, with national regulators adding their own tweaks, applying a differing format (i.e. XLS vs XML) or requiring a specific language to be used; and (iii) the requirement to report within 30 days, which is seen by private equity as not well-tailored to the nature and practices of the industry.⁶⁵⁶ The last point is particularly troublesome, as there is no ready-made price nor a standard formula for calculating prices of unquoted companies in which private firms invest; therefore, the requirement is more suitable to hedge funds. Accordingly, the AIFMD requirement has generated unnecessary compliance costs and led to the need of using estimates and/or data previously submitted to the regulator.

The reporting challenge is very acute for the private equity industry which had to undergo in an incredibly short space of time the transition from being relatively unregulated to being highly regulated via the AIFMD. The frequency of reporting is the biggest challenge as PE funds calculate IRR figures on a quarterly basis, but Annex IV requires these to be calculated monthly and to be submitted quarterly.⁶⁵⁷ Putting aside the cultural and logistical aspects of this difficulty, which further demonstrates that PE is worlds apart from hedge funds in terms of its operations, it must be noted that the reason for calculating the figures quarterly is that private companies and real assets are inherently more difficult to value than public ones, and the valuation process itself is more time-consuming.⁶⁵⁸ One of the early uncertainties in this space was the approach of EU regulators and whether they would be demanding exact valuations or whether they would be willing to accept estimates, like the FCA in the UK did.

The recent KPMG report found that the regulatory notifications relating to investment in non-listed entities are not viewed as useful or essential, and they have not improved information

⁶⁵⁵ Bao Chau Nguyen, *When Transparency is Really Opaque* (March 9, 2015), <http://www.confluence.com/blog/transparency-really-opaque-aifmd/>.

⁶⁵⁶ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 38.

⁶⁵⁷ Sarmad Naim, *Private Equity and AIFMD: The Journey Has Only Just Begun* (Regulation Asia, Nov. 11, 2014), <http://www.regulationasia.com/article/private-equity-and-aifmd-journey-has-only-just-begun>.

⁶⁵⁸ *Id.*

provided to portfolio companies or had a positive impact on the relationship between fund managers and the acquired companies.⁶⁵⁹ They primarily increase administrative costs for (smaller) fund managers and, from the capital markets union (CMU) perspective, it could be argued that these costs do not align with the objective to promote ‘financing for innovation, start-ups and non-listed companies.’⁶⁶⁰ In a public M&A context, disclosures regarding employees will be especially acute where the fund manager has an intention to close target premises or make some portion of target workforce redundant following the acquisition. The AIFMD’s specific notification requirements, including disclosures on future intentions and likely repercussions on employment, constitute a concern and also, as stressed by 39 per cent of respondents of the EY survey, lead to the fear of reputational damage resulting from situations when something is said but eventually does not transpire to be true.⁶⁶¹ Further, there is a threat that the disclosure of information concerning the financing of the acquisition to the regulator and the AIF’s investors could result in the commercially sensitive information becoming widely available.⁶⁶² This demonstrates that the new wide-ranging disclosure requirements can potentially threaten the success of the private equity business.

It must be noted that not all transparency requirements are overly burdensome and some of the prescribed pre-investment disclosures were to a large extent already provided to investors, sometimes even in more detail and more extensively than that mandated by the AIFMD. For example, a wide range of items about an AIF and its AIFM is typically provided in an offering memorandum (prospectus) or in a supplement to that document.⁶⁶³ According to the Deloitte survey, 53 per cent of respondents intend to provide investors with more information (for instance in relation to all indirect transaction costs and further risk data) as a result of the new rules,⁶⁶⁴ but they also stressed that certain information, such as leverage figures, might cause a degree of confusion. That said, fund documentation will need to be updated for AIFMD

⁶⁵⁹ *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 98-99 & 116.

⁶⁶⁰ *Id.* at 235; *Capital Markets Union: A Plan to Unlock Funding for Europe’s Growth* (EU Commission, June 2019), https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union_en.

⁶⁶¹ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 28.

⁶⁶² *AIFMD: Key Issues for Private Equity and Infrastructure Fund Managers* 6 (Clifford Chance LLP, Briefing Note, Feb. 2013), https://www.cliffordchance.com/briefings/2013/02/aifmd_key_issuesforprivateequityan.html.

⁶⁶³ A prospectus sets out key items for disclosure to investors, including but not limited to: investment strategy, objectives and policies; investment restrictions; risk management processes; and information relating to the AIFM (e.g. his track record), custodian, fund administration, fees and expenses, subscriptions, anti-money laundering, certain investment risks, conflicts of interest, legal and tax matters, material contracts and documents available for inspection.

⁶⁶⁴ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 24.

requirements so that it contains all the required disclosures; the investment management agreements will also need to be revised as a result of the change of applicable regulation and allocation of responsibility between a fund's governing body and its fund manager. This will be accompanied by additional costs, including the fees of professional service providers engaged in the preparation and distribution of updated AIF documents, and some if not all of these costs are likely to be indirectly borne by end investors.

Further, regarding pre-investment disclosure, any material changes must be made available to investors before they invest. Thus the AIF instruments of incorporation – the offering document or a supplement to it – must be updated to reflect all material changes. However, certain information that needs to be made available in the prospectus may change too frequently or may otherwise be inappropriate or undesirable to be included therein, such as information in respect of preferential treatment (side letter terms regarding reduced fees or redemption periods) or the latest NAV of the fund.⁶⁶⁵ Post-investment, the frequency of reporting and methods of disclosure may be problematic as there is no clear distinguishing factor between “periodic” and “regular.” Also, there is no guidance as to how regular disclosure should be made – as part of periodic reporting provided by the fund, for example in a monthly newsletter or investor conference call, or at a minimum as part of the fund's annual report. In this regard, the 2016 Ernst & Young Private Equity survey finds a spike in the number of specialised reporting requests (e.g. financial reporting inquiries or customised templates); the investors not only require more detailed, customised, higher quality information, but also increasingly turn towards speed.⁶⁶⁶ What follows is that such customised requests and their timely one-to-two day turnaround produce unyielding reporting demands.

Moreover, certain disclosure types are of limited value for investors, and certain disclosure methods are unduly restrictive for fund managers, such as the requirement to apply accounting standards of the AIF's home member state – this limits the EU AIF's flexibility to apply more appropriate accounting standards, for example, US GAAP which could be better suited when targeting US investors.⁶⁶⁷

⁶⁶⁵ Glynn Barwick, *supra* note 638.

⁶⁶⁶ See *Disruption. A Seismic Shift in the Private Equity Industry. 2016 Global Private Equity Fund and Investor Survey 12* (Ernst & Young, 2016), <https://www.slideshare.net/frenchweb/disruption-a-seismic-shift-in-the-private-equity-industry>.

⁶⁶⁷ Glynn Barwick, *supra* note 638.

New reporting requirements represent a significant shift, which will necessitate the review of existing reporting systems and procedures as well as the data strategy in order to ensure a PE firm is capable of handling the complexity of data analysis required in the post-AIFMD regulatory environment. The right strategy is paramount if a firm wants to achieve and maintain a competitive advantage; however, sourcing, managing and processing big data appears to be a formidable operational challenge facing PE funds due to the absence of sufficient technology solutions.⁶⁶⁸ This emphasises the need to synchronise operations with the fast evolving digitisation, thus placing more emphasis on interactive data management systems and reliance on personnel with the right skill sets and/or smart outsourcing, something that can pose a challenge for smaller PE firms that may lack the financial resources larger firms command. This accentuates one of the key facts about the AIFMD, namely, that implementing the new regulatory framework comes at a steep price, posing a threat to the survival of smaller funds.

The AIFMD is primarily promulgated in furtherance of financial stability, but it also advances the interests of investors. Will enhanced investor transparency lead to greater investor protection post-AIFMD? It appears that the new requirements will not necessarily meet investors' needs. This is because investors into alternative investment funds have traditionally been professional investors with the knowledge to evaluate investment risk and financial wherewithal to withstand potential losses. Accordingly, given their investment track record, they are capable of identifying what information they need in relation to investments and may request it from the fund manager if necessary. Finally, the new disclosures will not provide the investors with all the information they will possibly require given their personal circumstances. Thus, enhanced transparency is not going to replace due diligence that prospective investors will have to undertake on their own.

2.7 Acquisition of Control

One of the most controversial aspects of the Directive, although not as onerous as previously feared, pertains to the acquisition of control. Following the 2007-2008 financial crisis, concerns had emerged with respect to the sustainability of debt assumed by the companies subject to LBOs, particularly in the cross-border context, and the treatment, protection and rights of

⁶⁶⁸ See *Disruption. A Seismic Shift in the Private Equity Industry. 2016 Global Private Equity Fund and Investor Survey*, *supra* note 667, at 9.

employees of such companies.⁶⁶⁹ Accordingly, the new rules are intended to improve accountability, stewardship and corporate governance in this area.

Undeniably, the new requirements reflect society's rather than investors' concerns,⁶⁷⁰ and will impact private equity firms, their existing portfolio companies and (future) target companies.⁶⁷¹ General disclosure (i.e. notification) requirements and specific restrictions on asset stripping apply irrespective of whether the AIFM is EU or non-EU domiciled.⁶⁷² Consequently, AIFMs will be required to disclose significant holdings held by their funds and, in the case of acquisition of control in non-listed firms, board-level commercially sensitive information relating, for example, to the financing of the acquisition and the intentions as to the future business of the acquired company. It may be questioned whether all the additional disclosures are necessary, useful or effective. It appears that recent evidence rather suggests that the extent and frequency of the required disclosures points to an excessive administrative burden.⁶⁷³

The anti-stripping rule is interventionist in nature and will apply for two years after the control has been acquired. This may bar AIFMs from carrying out measures that would reduce the company's capital base or exceed distributable profits and reserves. This particular element of the AIFMD is intended to encourage management strategies that create value through growth, innovation and/or efficiency, rather than asset stripping, and is specifically aimed at private equity. However, its presence is surprising as the industry is primarily interested in developing and nurturing growth in companies in the long term – based on evidence, portfolio investment horizons are typically between five to seven years and therefore such “asset-stripping” is generally not a strategic goal envisaged by a private equity firm.

The new anti-stripping rules share the same telos as the UK Stewardship Code of investor long-termism in companies, or what was done heretofore, whether motivated by common sense or

⁶⁶⁹ *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 222.

⁶⁷⁰ Dirk A. Zetsche & David Eckner, *Risk Management*, in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS*, *supra* note 644, at 265, 323.

⁶⁷¹ *Restructuring of Unlisted EU Companies: AIFMD Applies to Non-EU Fund Managers on Acquisitions of Substantial Stakes* (Cadwalader, Wickersham & Taft LLP, Aug. 27, 2014), <http://www.cadwalader.com/resources/clients-friends-memos/restructuring-of-unlisted-eu-companies-aifmd-applies-to-non-eu-fund-managers-on-acquisitions-of-substantial-stakes>.

⁶⁷² *Preparing for AIFMD – Requirements Overview and Implementation Implications*, *supra* note 23, at 18; Christophe Clerc, *The AIFM's Duties upon the Acquisition of Non-Listed Firms*, in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS* 575, 575 (Dirk Zetsche ed., 2012).

⁶⁷³ *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 235.

established market practice. Therefore, the rules, in particular in relation to portfolio company disclosure, may not have much effect on the PE business strategy or lead to increase in pre-acquisition engagement with employees of the target. That said, the AIFMD imposes negative obligations which may sometimes challenge or inhibit post-acquisition reconstruction that would be in the best interest of the acquired company. The provision against asset stripping single out an arbitrary class of investors. Although asset-stripping restrictions may be of little significance during a market downturn, the impact will be far greater in times of rapid economic growth and booming industries, when private equity firms will enjoy less flexibility compared to a competing corporate acquirer. For instance, applying the provisions in a private equity transaction would mean that a leveraged target group could be restricted from making any distributions, such as dividends and interest payments on shares, to shareholders following the acquisition of control. This would restrict activities in which some buyout firms sometimes engage. In particular, the asset-stripping restrictions are very unwelcome to private equity in the context of acquisitions of targets with cash on balance sheet, acquisition-related or other portfolio company re-organisations as well as transactions pertaining to portfolio companies relatively close to an anticipated exit date as the acquisition of control, directly or through a subsidiary, could begin the 24 month timeframe which in turn could complicate an exit.⁶⁷⁴ Thus, fund managers will need to structure their transactions more carefully. There is a risk that the new provisions could mute the market for corporate control, assisting poorly-performing directors or managers of undervalued firms in maintaining their positions. This would in turn reduce private equity's contribution to deepening the takeover market and making it more efficient via buying and selling companies.

Moreover, there is some uncertainty surrounding the provisions themselves. For instance, it is unclear to which company in the corporate chain the asset stripping rules apply. From the policy objective, a logical interpretation would be that the restrictions would apply to the top holding company in the target group (that is, one that is acquired by the private equity fund).⁶⁷⁵ However, given that the requirements interact with local corporate laws, the meaning of 'non-listed company' tends to be interpreted differently. Specifically, contrary to the English and French versions of AIFMD, it is not clear in the German translation of AIFMD if only non-listed entities in the legal form of a capital company are covered by said term, as the term

⁶⁷⁴ *The AIFM Directive: Acquisition of Substantial Stakes in EU Companies* (PLC, 2013), <http://uk.practicallaw.com/4-503-9830>.

⁶⁷⁵ Andrew Henderson, *Asset Stripping under AIFMD*, 28(10) J.I.B.F.L. 644, 644-45 (2013).

‘company’ could be interpreted – according to German legal commentary – in such a way that only entities qualifying as an ‘operating company’ and with working employees are subject to the AIFMD and therefore the mere holding and managing of investments should not be sufficient to qualify the entity as a ‘company’ within the meaning of AIFMD.⁶⁷⁶ This implies uncertainty in the legal and practical application of the AIFMD provisions around Europe.

Further, outside the technical application of the provisions, restrictions on asset stripping are deemed to make it more difficult for the private equity industry to offer an attractive investment opportunity. The reason for this is that the first 24 months following an acquisition is going to impact deal structuring, exit strategies and restructuring operations which will need to be reconsidered and potentially remodelled. AIFMs, in planning for their acquisitions, will need to take into account these restrictions and consider pre- and post-acquisition measures to alleviate their impact on returns. This could translate into additional costs for the fund, as expressed by 70 per cent of EY respondents, who linked those costs to new structuring mechanisms that will be needed to secure returns to investors.⁶⁷⁷ Accordingly, the anti-asset stripping rules could have the potential negative impact on the perception of the industry and private equity ownership.⁶⁷⁸ Adherence to the new requirements will also require upfront legal and compliance costs to comprehend the impact of the AIFMD in this area and an extra item on a deal completion checklist. Whilst this can be considered as annoyance, the new rules will have much more impact in terms of restricting legitimate business practices which traditionally would not amount to “asset-stripping” such as special dividends paid in the first two years following a recapitalisation or equity preference shares taken with the aim to be liquidated within two years of the acquisition. These rules might temporarily constrain the ability of AIFMs to reap the benefits linked to early out-performance.⁶⁷⁹

It is also important to note that the new restrictions only apply to private equity professionals, but not other, similar investors, such as sovereign wealth funds, high net worth individuals or pension funds making direct investment, or other non-AIF providers of capital which fall outside the scope of the AIFMD. According to the recent KPMG report, nearly 70 per cent of respondents stated that there are no similar rules for non-AIFMs in their country in respect of

⁶⁷⁶ *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 116.

⁶⁷⁷ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 30.

⁶⁷⁸ This was highlighted by 67 per cent of EY respondents; *see Id.* at 30-31.

⁶⁷⁹ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 40.

anti-asset stripping and transparency.⁶⁸⁰ Such inconsistency may place the buyout industry at a disadvantage in a competitive auction process⁶⁸¹ and be seen as distorting the level playing field.⁶⁸²

2.8 Valuation

New requirements concerning the independent valuation of assets may affect the way fund managers conduct the business. AIFMs will need to enhance their valuation practices and documentation to ensure they have appropriate asset valuation procedures in place. The AIFMD considers valuation provisions crucial for the protection of interests of investors, although the rules in this area are considered amongst the less impactful overall.⁶⁸³

Industry professionals assert that internal valuation is already the general standard in private equity. According to the EY survey, 92 per cent of respondents apply internal valuation and do not intend to change this practice going forward despite new challenging organisational adjustments that will need to be made with respect to functional separation.⁶⁸⁴ This is because private equity houses have their own valuation or finance departments, which provide primary information and data that is later compared against objective data including multiples of peers or financial statements, and many firms even have valuation committees⁶⁸⁵ or advisory boards with members who are not portfolio managers or do not form part of the front office. Unsurprisingly, the vast majority of EY respondents have expressed their intention to opt for internal valuation, particularly in view of the fact that the significant involvement of own finance departments, investment teams or chief financial executives can fulfil private equity firms' valuation responsibilities.

However, performing the valuation function by the AIFM itself may no longer be an option for firms with smaller headcounts who may struggle to demonstrate the function's functional independence from portfolio management and the AIFM's remuneration policy. This is because

⁶⁸⁰ *Report on the Operation of the Alternative Investment Fund Managers Directive (AIFMD)*, *supra* note 590, at 231.

⁶⁸¹ *Private Equity in 2010 and 2011: The Good, The Bad and The Future* (PLC, Jan. 31, 2011), <http://uk.practicallaw.com/3-504-5756?service=corporate>.

⁶⁸² This idea was recognised early the by UK regulator; see Dan Waters, *The Future of Financial Regulation - Insights from a Regulator* (FSA International Fund Forum, Monaco, June 24, 2009), <https://www.lexology.com/library/detail.aspx?g=10544ef1-64d7-43bd-a20d-3f556896207a>.

⁶⁸³ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 38.

⁶⁸⁴ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 18-19.

⁶⁸⁵ Sixty-five per cent of firms have been found to have a valuation committee that is run as a formal, well-established process, see *Navigating the Headwinds: 2014 Global Private Equity Survey*, *supra* note 18, at 11.

in such firms those who have most knowledge (i.e. individuals involved in portfolio company management or deal execution) are also those typically involved in the valuation process. Therefore, smaller AIFMs will need to review and adjust the apportionment of responsibility,⁶⁸⁶ or use an external valuer, like an accountant. The latter option can be expensive, though, with a valuation of a portfolio by an independent third party potentially costing up to €20,000 per year, per company. This cost would not be an issue for a single company; however, a typical portfolio involves perhaps 10-12 companies,⁶⁸⁷ creating a material cost for a smaller AIFM.

External valuation is not considered an adequate alternative as external valuers are unlikely to be familiar with the underlying business of the portfolio company nor do they have the same access to first-hand information or sector-specific expertise. Traditionally, portfolio valuation has principally been manual, starting with the review of portfolio company data by an associate and then being reviewed for the second time by the managing partner on the transaction.⁶⁸⁸ This blurs significantly the potential added-value of employing services of external valuers, as this could result in a waste of time and a duplication of costs.

The rules require fund managers to undertake an independent assessment of existing valuation policies and procedures in order to benchmark against the requirements of the AIFMD and best practice. Also, valuation policies and procedures need to be drafted for all AIFs and be periodically reviewed to ensure they remain compliant with the Directive. This may be an issue for those AIFMs, which in the pre-AIFMD world did not have appropriately documented valuation policies and procedures or had no such documentation established at all. It may also be the case that the policies and procedures were established but not to the standard required by the AIFMD, meaning that these will need to be uplifted. Finally, some AIFMs may not be familiar with all the potential valuation methodologies available to value all types of assets that its AIFs invest in; and they may tend not to document details of applied models or apply re-workings of the old models that may not have been properly validated by an appropriately competent, experienced and independent person. This will need to change to ensure compliance with the AIFMD and may require the engagement of service providers, such as consulting firms, to carry out an independent validation audit of internally produced models and/or to build valuation models that meet valuation and reporting needs.

⁶⁸⁶ James Greig, *AIFMD: External Valuers and Valuation Requirements (Update)* 31 (Citibank, AIFMD Special: European Fiduciary Services News and Views, 2013).

⁶⁸⁷ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 39.

⁶⁸⁸ *Navigating the Headwinds: 2014 Global Private Equity Survey*, *supra* note 18, at 12.

2.9 Minimum Capital Requirements

The AIFMD imposes increased capital requirements, which can materially affect the business of some private equity firms. The capital requirements are provided to ensure the continuity and regularity of fund management. The requirements are different depending on whether the AIFM is internally or externally managing the AIF. Also, if the capital requirement under the AIFMD is lower than that calculated under the Capital Adequacy Directive (CAD), the capital requirement under the CAD will apply.⁶⁸⁹ From a UK perspective, for most FCA authorised private equity managers, which fall outside the scope of any EU financial services directive, the AIFMD will impose significantly higher costs.⁶⁹⁰ Thus, new requirements may push AIFMs to look at alternatives and restructure their activities in order to reduce the capital burden. This could include, for example, full delegation of discretionary management and marketing activities.

The new AIFMD capital requirements look fairly standardised, yet some AIFMs might find them disproportionate due to the risks involved.⁶⁹¹ According to the EY survey, 30 per cent of respondents indicated that the minimum capital requirements will have an impact on their organisation and that they do not match the risk profiles of buyout firms, especially when compared to other investment categories regulated by the Directive.⁶⁹² This is in agreement with more recent findings, which report that 26 per cent of the above threshold GPs considered this element of the AIFMD to be a significant driver of organisational change, and a further 39 per cent who deemed the required changes to be moderate.⁶⁹³ The impact will be particularly felt by smaller AIFMs in jurisdictions where capital requirements to establish a private limited company are very low (e.g. France) or completely abolished (e.g. the Netherlands or the UK). This could potentially erect an entry barrier for new GPs, or at least create an opportunity cost by diverting a significant proportion of their resources from potentially high-return investments.

⁶⁸⁹ *AIFMD – Impact on Private Equity 2* (PwC, Dec. 2010), <http://www.pwc.com/jg/en/publications/aifmd-impact-on-private-equity-december-2010.jhtml>.

⁶⁹⁰ *The AIFM Directive: Capital Requirements for Managers*, *supra* note 568.

⁶⁹¹ Claire Cummings, *supra* note 631.

⁶⁹² *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 16-17.

⁶⁹³ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 37.

2.10 Delegation

Delegation influences the governance of fund managers, whose key functions are frequently cross-border and certain activities are carried out by third-party service providers as a result.⁶⁹⁴ For instance, portfolio and risk management, marketing and fund distribution, legal, compliance and IT are frequently outsourced and hence the AIFMD delegation principles come into play, together with the increased scrutiny.

What does this mean for private equity and its operational efficiency? This type of AIFM commonly delegates specific tasks related to the acquired assets.⁶⁹⁵ However, the inherent danger of delegation to third-party service providers is that AIFMs to whom investors have entrusted their funds are not directly performing their responsibilities with respect to fund management.⁶⁹⁶ Consequently, important functions end up in the hands of third parties and the fund manager becomes a letter-box entity. To counter this situation, a fund manager must ensure he retains the power and expertise to supervise the delegate and a minimum infrastructure and workforce to monitor the delegated tasks effectively and to manage the associated risks.⁶⁹⁷ Delegation would also result in a letter-box entity if an AIFM would no longer have the power to take decisions in key areas or carry out senior management functions. Moreover, it is forbidden to delegate both portfolio and risk management, and delegation must be based on an objective reason, such as cost saving or expertise, amongst others.

It can be assumed that the new provisions will be prejudicial to private equity firms, which skilfully outsource specialised functions, or parts of these functions, such as technology, valuation, tax compliance, portfolio analysis and fund accounting, as well as those which resort to delegating management functions, particularly when they have a decentralised mode of operation and are spread across the world or a region. An illustrative case would be a Guernsey fund set up with a Guernsey AIFM having a London-based investment adviser.⁶⁹⁸ In this case, the Guernsey AIFM should retain sufficient resources and independence in order not to qualify as a letter-box entity. One further example could include a Dublin company that acts as AIFM

⁶⁹⁴ Thibaut Partsch & Jerome Mullmaier, *Delegation*, in THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS 217, 217 (Dirk Zetsche ed., 2012).

⁶⁹⁵ *Id.*

⁶⁹⁶ Barbara Crutchfield George & Lynn Vivian Dymally, *supra* note 19, at 263.

⁶⁹⁷ Thibaut Partsch & Jerome Mullmaier, *Delegation*, in THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS, *supra* note 694, at 217, 228-229.

⁶⁹⁸ Marc van Dam & Jerome Mullmaier, *Impact of AIFMD on the Private Equity Industry*, in THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS 623, 629 (Dirk Zetsche ed., 2012).

to the AIFs but has no office nor direct employees in Dublin. In this case, the company's board has to adopt a delegation model to carry out its responsibilities effectively and to discharge its obligations under the AIFMD regulations. This will mean leveraging off the skills, experience and knowledge of specialised staff employed by the relevant service provider, for example a UK investment manager, who will perform daily management functions. In addition, the AIFM may delegate administrative functions to the administrator who will be responsible for providing fund accounting and NAV calculations services to the AIFs and for acting as transfer agent and registrar for the AIFs. Compliance with all the AIFMD requirements regarding delegation arrangements must be provided in the Programme of Activity that supports and forms part of the AIFM's application for authorisation in Ireland⁶⁹⁹ – this will contain detailed description of delegate(s), explanation and evidence of objective reasons as well as the type and frequency of monitoring.

Of particular relevance to offshore fund structures will be delegation to a third country fund manager. Such delegate must be authorised or registered according to local criteria and, in addition, there must be a cooperation agreement between his regulator and the regulator of the EU AIFM's home Member State. The latter cooperation requirement of the AIFMD may prove problematic, leading to practical complications, especially for a global firm which has certain activities appurtenant to fund management, risk management and administration located in different parts of the world. Such firms will face the need to re-organise their activities to become compliant with the AIFMD and this might signify increased operational costs associated with restructuring and relocating, duplicating or hiring new personnel with the requisite skills to perform specific activities in Europe.

Interestingly, but somewhat contrary to the above concerns, the majority of respondents (78 per cent) in the EY survey answered that restrictions imposed by the Directive on delegation of management functions, such as portfolio management, risk management, valuation and fund administration, as well as the issue of letter box entity are not problematic and will not impact their operations.⁷⁰⁰ Accordingly, these AIFMs do not feel the need to revise their contractual arrangements with delegates in order to comply with the AIFMD. The divergence in the

⁶⁹⁹ In Ireland, an application for authorisation as an AIFM must be made by completing, *inter alia*, a programme of activity setting out the organisational structure of the AIFM, including information on delegation and sub-delegation arrangements; *AIFM Applications for Authorisation* (Central Bank of Ireland, 2015), <https://www.centralbank.ie/regulation/industry-market-sectors/funds/aifs/guidance/aifm-applications-for-authorisation>.

⁷⁰⁰ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 20-21.

perceived impact of the provisions might result from the location and specificities of the activities of the interviewed private equity firms and service providers.

2.11 Third Country Marketing Rules

Marketing by non-EU AIFMs has gained the biggest prominence in AIFMD news reports and associated legal and regulatory commentary. This is because this area is fraught with particular complexity. Satisfying a range of specific conditions might prove problematic and burdensome, and may cause greater distribution uncertainty and a major administrative effort. This is an important area as according to ESMA, 1,777 non-EU AIFMs marketed their AIFs in the EU under the national private placement regimes (NPPRs), with 1,013 being marketed in the UK alone.⁷⁰¹ According to the FCA, over 500 of these AIFMs were from the US – given a large number of private equity firms in that country, it is clear that this number represents only a small fraction of US AIFMs that have so far marketed their AIFs into the EU under the AIFMD.⁷⁰²

As an illustration of the applicability of third country rules, US managers will have to ensure that their marketing activities comply with the local laws of each relevant Member State. AIFMD authorisation is not feasible at present, thus US AIFMs will not be able to avail themselves of the EU-wide marketing passport until it is activated. Therefore, this is an area that fund managers will need to monitor carefully. The US-based fund managers cannot nominate EU sub-managers or advisers to become authorised under the Directive in order to benefit from the passport. Therefore, if the EU is an important market, US AIFMs will need to consider the commercial value of establishing a new EU-based manager and EU-incorporated funds under a national placement regime. However, some Member States have goldplated above the AIFMD's minimum requirements for non-EU AIFMs, who wish to market non-EU AIFs, in particular in France where non-EU AIF promotion will be very difficult, Germany where the KAGB will require the appointment of a depositary and the national regulator's positive approval, and Austria which has imposed additional tax treaty condition for non-EEA

⁷⁰¹ *ESMA's Opinion to the European Parliament, Council and Commission and Responses to the Call for Evidence on the Functioning of the AIFMD EU Passport and of the National Private Placement Regimes* 13 (ESMA, July 20, 2015), https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1235_opinion_to_ep-council-com_on_aifmd_passport_for_publication.pdf.

⁷⁰² *AIFMD 2015 Update – Implications of ESMA's Opinion and Advice on the AIFMD Passport for Non-EU Managers and Funds* (Sidley Austin LLP, Aug. 3, 2015), <https://www.sidley.com/en/insights/newsupdates/2015/08/aifmd-2015-update-implications-of-esma>.

funds.⁷⁰³ This may be frustrating, especially as some AIFMD provisions do not correspond proportionately to the risks posed by private equity. Another layer of complexity is that some local NPPRs, particularly in France and Southern European countries, are underdeveloped and in some cases, practically closed or do not exist at all (for example, in Italy). This makes fund marketing and distribution even more complicated and affects the fund managers' decision to expand into Europe, as in some cases an EU passport (that does not exist yet) would be the only way to access capital, unless a reverse solicitation would take place, which is very difficult to prove in practice. The effect is that most US AIFMs may decide to concentrate on one or two EU markets only, taking an opportunistic, investor-led approach to investment.

Further example may be furnished by the effect of AIFMD requirements on UK AIFMs who manage funds established, say, in the Cayman Islands and intend to market them in the UK. The Cayman Islands do have an existing cooperation agreement with the UK, are not listed as a non-cooperative country and a taxation agreement between the two countries is in place. Accordingly, UK fund managers can use a private placement mechanism to distribute their funds in the UK, but if they intend to market them in other EU Member States they will have to establish whether the Cayman Islands have a tax agreement in place with each Member State of their interest. Such taxation agreements already exist in a number of countries, such as France, Germany and the Netherlands, but the UK AIFMs will need to monitor status in the other EU countries,⁷⁰⁴ an activity that will be needlessly costly and time-consuming. Interestingly, in light of the UK's vote to leave the EU, the UK will become a third country itself, meaning that UK AIFMs will lose the ability to market AIFs across the EU without barriers and EU investors will be limited in their ability to benefit from accessing UK funds to diversify their holdings and hence minimise the concentration risk in specific asset classes.⁷⁰⁵

Reflecting on the short period of the new AIFMD regime, it is clear that despite years of lobbying there are several technical problems and practical issues, which have emerged and come to light after the July 2013 implementation deadline in relation to marketing by third country managers. The landscape still remains confusing and difficult to navigate, but market

⁷⁰³ *The Alternative Investment Fund Managers Directive – A Guide for US Managers*, *supra* note 616, at 2.

⁷⁰⁴ *AIFM Directive: Crossing the Finish Line*, *supra* note 589, at 3.

⁷⁰⁵ It must be noted, however, that since much of ESMA's analysis on the extension of the third country passport has so far focused on whether the assessment criteria are met by the non-EU country to an equivalent level as achieved under the AIFMD, the UK would be in a prime position to be assessed positively in a post-Brexit scenario, particularly as the country has been operating the AIFMD framework for a number of years.

practices and positions slowly continue to emerge.⁷⁰⁶ Firstly, EU Member States have adopted diverging approaches to defining marketing. The lack of clarity regarding the key marketing concept results not only in diverging national requirements, but also cumbersome compliance processes. Some countries have taken a broader stance than that prescribed in the Directive, like Sweden where marketing covers any form of advertising and sales promotion; other countries have adopted a contrasting position, like the UK and the Netherlands which do not recognise marketing unless documentation is in a sufficiently final form in order to allow an investor to make a subscription in an AIF.⁷⁰⁷ This raises the corollary question of what is exactly the difference between pre-marketing – or “soft marketing” to investors with early stage documents – and actual marketing. Naturally, there is a spread of regulatory views on this. Can “teaser” documents, like a draft private placement memorandum (PPM) and Limited Partnership Agreement (LPA), trigger the AIFMD requirements and constitute marketing?⁷⁰⁸ Or does the sole existence of a PPM/LPA signify marketing is taking place? At the time of writing this thesis, there was no clear guidance on these issues across many EU countries. The position was not ‘completely clear’ in the UK as to when exactly a fund manager would be marketing for AIFMD purposes; and in Germany, marketing is linked to yet another question, that of whether a fund name, structure and investment strategy have been finalised. This EU-wide discrepancy demonstrates that the AIFMD has failed to achieve its objective to create a harmonised and comprehensive regulatory regime for AIFMs in Europe. For instance, regarding Article 42 AIFMD, Greece has not implemented the article at all, the UK and Luxembourg have taken a copy-out approach and Germany and France have goldplated.⁷⁰⁹ This illustrates a differing spectrum of requirements across the EU, which prevents AIFMs from developing a uniform, one-stop compliance policy in respect of EU-wide marketing.

⁷⁰⁶ Glynn Barwick, *The Alternative Investment Fund Managers Directive One Year On – A Guide for Non-EU Managers* (Goodwin Procter LLP, Oct. 29, 2014), http://www.goodwinprocter.com/Publications/Newsletters/Client-Alert/2014/1029_The-Alternative-Investment-Managers-Directive-One-Year-On_A-Guide.aspx?article=1.

⁷⁰⁷ Owen Lysak, *The AIFMD Created a Harmonised Regime for Marketing Funds in Europe. Discuss.*, 4 J.I.B.F.L. 250, 250 (2014).

⁷⁰⁸ Some jurisdictions permit soft marketing provided certain conditions are met, for instance, using general material such as slide presentation or pitch book, not incorporating the fund until the last moment or referring generically to a “new fund” rather than utilising a precise AIF name. That said, soft marketing may make reverse enquiry claims difficult to sustain.

⁷⁰⁹ *AIFMD Marketing for Third Country Managers – Deadlines and Dilemmas* 1 (Clifford Chance LLP, Briefing Note, Mar. 2014), http://www.cliffordchance.com/briefings/2014/03/aifmd_marketing_forthirdcountrymanagers.html#.U0fe56LeioY.

Secondly, non-EU AIFMs will initially need to face notification or fund registration requirements under NPPRs. These are cumbersome, far from straightforward and lacking clarity as EU states have imposed stricter requirements for private placement in addition to those mandated by the Directive. Consequently, formal approval requirements prior to marketing vary across the EU, but complying with the private placement regime of a target Member State is necessary in order to register the fund or to obtain marketing authorisation for an AIF.⁷¹⁰ It was found that post-AIFMD, a fair percentage of large non-EU AIFMs with AUM of \$4bn and above have elected to market their funds under the applicable NPPRs of the relevant EU jurisdictions,⁷¹¹ and those who have decided not to market actively in Europe did that because their funds were closed or soft-closed to new investors, or because they did not have a significant EU investor base, or because they are so well-known that they can rely on reverse solicitation in order to attract EU capital; for the vast majority of smaller non-EU fund managers with AUM below \$1bn the situation is different – they have elected to eschew active marketing in Europe, a decision which stems from poor understanding of individual NPPRs, the perceived costs and complexity, and the desire to avoid AIFMD remuneration disclosure.⁷¹² This confirms that the AIFMD can be seen as a protective measure against offshore AIFMs, prohibiting their access to the EU market.⁷¹³

The notification process in the UK is relatively straightforward and not burdensome, requiring a properly completed notification form submitted to the FCA.⁷¹⁴ A notification to the local

⁷¹⁰ For a summary of the current position on private placement regimes, see *Alternative Investment Fund Managers Directive (AIFMD): Current Position on Passporting and Private Placement*, *supra* note 609. It is recognised that the private placement of funds is currently not possible in Croatia, Greece, Latvia and Poland and it is limited in Austria, Denmark, France, Germany, and Italy where strict local requirements apply.

⁷¹¹ This is under the assumption the relevant cooperation arrangements have been entered into. As at September 2014, Croatia and Slovenia had not entered into any MoU at all, Spain and Italy had not entered into MoUs with popular AIF domiciles like the Cayman Islands or the British Virgin Islands (BVI), and Germany had not entered into an MoU with the BVI, Isle of Man or the Bahamas, but did enter into an MoU with the Cayman Islands. It was also suggested that some non-EU AIFMs, particularly those from the US, have indicated a preference to continue their marketing activities via the NPPRs to avoid being subject to dual regulation – full AIFMD authorisation would be necessary for the passport, the cost of which might not be justified or proportionate to the small size of the potential investor base; see *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 56-57.

⁷¹² *AIFMD 2014 Update – Private Placements: Where Did We End Up, and Where Are We Going?* (Sidley Austin LLP, Sep. 8, 2014), <https://www.sidley.com/en/insights/newsupdates/2014/09/aifmd-2014-update--private-placements-where-did-we-end-up-and-where-are-we-going>.

⁷¹³ Martin Krause in *FORUM: Complying with the AIFM Directive*, *supra* note 600. See also Lizzie Meager, *Fund Managers Celebrate AIFMD Advice* (July 19, 2016), <http://www.iflr.com/Article/3571838/Fund-managers-celebrate-AIFMD-advice.html> (stating that since the AIFMD implementation some fund managers in non-EU countries have criticised the framework for facilitating overly protectionist behaviour from Member States and leaving them to deal with NPPRs that are notoriously divergent and difficult to navigate).

⁷¹⁴ In practice, a fairly simple spreadsheet needs to be emailed to the FCA. Subsequently, the regulator will send an email (typically within 24-48 hours) confirming the notification has been received and providing details on how

regulator must be also provided in Ireland and no formal approval is required prior to marketing. The process, however, is more onerous in other EU jurisdictions,⁷¹⁵ with Germany, Denmark and the Netherlands being notable examples, where it will take longer to obtain the requisite marketing registration before AIF marketing can begin. In Germany, the application form is lengthy, complicated and voluminous, with BaFin, the national regulatory authority, having to grant positive prior approval, stretching to as much as eight months.⁷¹⁶ Fund managers may find this process to be commercially unappealing and causing significant interruptions to business. In Denmark, it might not be feasible to register at all until a fund is set up, whereas the Netherlands has introduced a special condition in the notification form requiring an attestation from the national regulator of the third country AIFM and/or the AIF, confirming it is able to effectively comply with the requisite co-operation agreement with the Dutch regulator in relation to the AIFM and the AIF.⁷¹⁷ Accordingly, non-EU AIFMs will have to plan well in advance in order to obtain the necessary registration and/or formal approval in time prior to the launch date for marketing. This further puts credence to the notion that finding a single marketing strategy across the EU can pose a challenge, deflecting AIFMs away from their primary mandate.

The AIFMD has introduced a passporting regime, meaning that once an AIF is authorised in one EU Member State, it can be distributed in any other EU Member State without the need for any additional authorisation. The EU passport is a novelty for third country AIFMs; however, before it is activated, non-EU AIFMs will have to continue to raise capital from EU investors through NPPRs, which contain rules that are country-specific and constantly evolving. The lack of visibility due to transitory national rules means that any marketing activities under NPPRs will generally incur extensive legal costs for both ongoing and ad-hoc advice. Although market practices are slowly emerging and thus providing some answers, cost and timing implications cause concern and frustration, specifically for smaller or first time AIFMs in the PE space. Of course, a non-EU AIFM may benefit from the AIFMD passport without delay by creating an AIF in Europe and appointing an EU AIFM, hence opting into the current full-fledged AIFMD regime – this would be the cleanest and most durable manner to ensure AIFMD compliance, as well as getting access to all EU countries and enjoying economies of scale, but it would also

the notification fee may be paid. The AIFM does not need to wait for the confirmation email prior to commencing marketing.

⁷¹⁵ Mark Mifsud, Lisa Cawley & Jane Scobie, *United Kingdom*, in *THE PRIVATE EQUITY REVIEW* 172, 181 (Stephen L. Ritchie ed., 4th ed. 2015).

⁷¹⁶ *AIFMD: Private Placement Update* (Eversheds LLP, Apr. 24, 2014).

⁷¹⁷ *AIFMD Marketing for Third Country Managers – Deadlines and Dilemmas*, *supra* note 709, at 2.

mean subjecting oneself to the full rigour of the Directive with its strict and convoluted requirements, especially those impacting fund distribution strategy – something most non-EU AIFMs wish to avoid. Hence, even though a passport would relieve non-EU AIFMs of compliance burdens associated with the patchwork of differing NPPRs and restricted access to EU jurisdictions, non-EU AIFMs keep relying on NPPRs in order to sidestep the Directive’s restrictions. The NPPRs are envisaged to be eventually switched off, leaving authorisation under the Directive as the only route for non-EU AIFMs to market funds to EU investors.⁷¹⁸ In the meantime, the decision to opt in to the AIFMD regime will be predicated on the sufficient number of investors to make it worthwhile.

An infrequent and quite perplexing marketing strategy employed by some non-EU AIFMs which provides a route to circumventing the Directive’s regime is through reliance on the legal no man’s land of reverse solicitation.⁷¹⁹ This is when an investor approaches the fund manager about a fund at its own initiative – in other words, a passive activity on the part of AIFMs reactive to investor inquiries of interest in the AIFM.⁷²⁰ This option is more likely to be available to the established brand names rather than their smaller brethren, as the former will benefit from better reputation and strong track record. Needless to say, reverse solicitation is a nebulous concept without much guidance on its interpretation and so represents a grey area for fund managers, especially as some EU countries are more liberal and accommodating to reverse solicitation (for example, the UK and the Netherlands) than others (for example, France and Italy)⁷²¹ – this further proves that the transposition of AIFMD around the marketing rules has been mired with challenges and regulatory arbitrage.⁷²² The litmus test for reverse solicitation

⁷¹⁸ *ESMA Issues Call for Evidence: Extension of AIFMD to Non-EEA Fund Managers and Non-EEA Funds* (Covington & Burling LLP, Nov. 12, 2014), https://www.cov.com/files/Publication/e4e70623-2d05-4a51-bf8b-011499538ddb/Presentation/PublicationAttachment/68d74dc8-8ed2-4653-b82c-03eaa031ff5a/ESMA_Calls_for_Evidence_Extension_of_AIFMD.pdf.

⁷¹⁹ *Reverse Solicitation Is the Riskiest Option* (COOConnect, Apr. 2015), <http://cooconnect.com/guide/aifmd/reverse-solicitation-is-the-riskiest-option>.

⁷²⁰ Gary S. Kaminsky, *Reverse Solicitation – AIFMD Solution or Regulatory Minefield?* (Aug. 6, 2014), <http://www.indosgroup.com/2014/08/reverse-solicitation-aifmd-solution-or-regulatory-minefield/>.

⁷²¹ In France, the French regulator (Autorité des Marchés Financiers, AMF) has given a restrictive guidance, requiring in effect that a prospective investor must have specifically identified the relevant AIF into which it wishes to invest by making a specific written request that precisely states the name of the new AIF. The UK is not as hostile to the idea of reverse solicitation as France, and the FCA provides formal guidance on the marketing at the initiative of the investor: “A confirmation from the investor that the offering or placement of units of shares of the AIF was made at its initiative, should normally be sufficient to demonstrate that this is the case, provided this is obtained before the offer or placement takes place. However, AIFMs and investment firms should not be able to rely upon such confirmation if this has been obtained to circumvent the requirements of AIFMD” (PERG 8.37.11). Most other EU Member States have not provided any guidance on this issue. *See also* Charles Gubert, *Regulation in 2016: What Private Equity Needs to Know* (KNect365, Jan. 19, 2016).

⁷²² *AIFMD: The Ongoing Challenge with Reverse Solicitation* (INDOS Financial, Apr. 7, 2015), <http://www.indosgroup.com/2015/04/aifmd-nine-months-on-is-marketing-vs-reverse-solicitation-any-clearer/>.

is not clear-cut. Amongst the uncertainties, it is not clear whether a prospective investor's request of offering materials in respect of an AIF managed by the AIFM following an earlier receipt of general information about the AIFM would be considered a reverse solicitation and hence marketing at the initiative of the AIFM. If this was the case, the AIFMD rules would apply. Hence, every communication and its nature as well as all contact with potential EU investors has to be religiously documented in order to have an internal record for the sake of compliance. For instance, some US-based private equity firms require their clients to confirm in side-letters that they are happy to obtain information about next funds.⁷²³ Lawyers routinely advise AIFMs to remove references to fund performance on their websites as they could be accused of direct marketing, like in Germany.⁷²⁴ In the same vein, speaking to the media or even at industry conferences in the EU could lead to issues, especially in those countries with tough private placement criteria. Furthermore, there are also very practical problems relating to being able to continue a relationship with existing investors – for instance, it is unclear to what extent may an AIFM discuss potential investment opportunities for which it is raising capital for a new fund. Thus, reliance on reverse solicitation carries a high level of risk, especially as the regulators in some jurisdictions (predominantly France, Germany and Austria) are very proactive. This may lead to regulatory sanctions that would in turn have to be disclosed to existing and prospective fund investors, prompting redemptions or a reluctance to allocate capital, not to mention reputational damage and brand erosion.

The above provisions evince a particularly complex regulatory regime, which requires careful interpretation and practical application in each EU country PE fund managers intend to market. Non-EU AIFMs will be required to perform extensive due diligence, covering pre- and post-marketing periods and stay vigilant in respect of any goldplating (tightening) of the legacy national private placement regimes which currently are about as far away from being harmonised as can be with regards to timeline, registration process, fees, reporting formats and ongoing compliance obligations.⁷²⁵ Due to uneven AIFMD implementation in the EU, verifying the position in each country will be costly, onerous and may prove uneconomical if a fund manager does not focus its resources on a smaller group of key investor jurisdictions where the

The article confirms that the UK has adopted a pragmatic approach, but some jurisdictions have been less flexible, for example Sweden which deems any contact between the fund manager and the investor as a breach of reverse solicitation. Jurisdictions adopting a tougher stance include France, Germany and Italy. Most of the remaining EU jurisdictions have yet to produce any guidance whatsoever in this regard.

⁷²³ Charles Gubert, *supra* note 721.

⁷²⁴ *Reverse Solicitation Is the Riskiest Option*, *supra* note 719.

⁷²⁵ Marc Schubert, *The Evolution of Marketing Private Funds under AIFMD* (Oct. 25, 2016), <https://www.ipes.com/resources/technical-library/evolution-marketing-private-funds-under-aifmd>.

chance to raise funds is the biggest. The legislative history of the EU passport looks like a power struggle and a patchwork of compromises. Third country PE fund managers, who want to have their funds managed in the EU or who want to market their funds in the EU, are forced into EU law by means of wide-ranging cooperation agreements, many of which are still being put in place.⁷²⁶

The foregoing arguments illustrate that marketing under the AIFMD for third country AIFMs is in a state of flux in a number of EU jurisdictions. The position is still evolving and it seems there is a long way to go before the marketing landscape in the EU fully emerges. For instance, ESMA has adopted a sluggish country-by-country approach to determining whether the AIFMD passport should be extended to non-EU managers.⁷²⁷ The ESMA advice in this area was eagerly anticipated by international AIFMs who hoped that ESMA would provide clear recommendations to European lawmakers as regards the marketing of non-EU AIFs in Europe. However, the ESMA papers failed to give much encouragement to key non-EU fund jurisdictions that the route to marketing to EU professional investors would become any easier.⁷²⁸ The timescale for developments in this area remains unclear and therefore leaves non-EU AIFMs disappointed by the lack of apparent progress. For instance, there is still no indication of when the passport will go live despite the fact that two batches of non-EU fund jurisdictions have been positively assessed by ESMA.⁷²⁹ This frustratingly forces third country managers to simply wait and watch, and prevents them from building their future fundraising plans. Such delays caused by the protracted analysis of which non-EU countries should attain

⁷²⁶ *AIFMD Marketing for Third Country Managers – Deadlines and Dilemmas*, *supra* note 709, at 3.

⁷²⁷ ESMA published its first set of advice on the application of the passport to six non-EU countries (Guernsey, Hong Kong, Jersey, Switzerland, Singapore and the US) in July 2015. The EU Commission subsequently asked ESMA to assess a further six countries. In 2016, ESMA published its second advice, this time in respect of twelve countries: Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Japan, Jersey, Isle of Man, Singapore, Switzerland and the US; see *ESMA's Advice to the European Parliament, the Council and the Commission on the Application of the AIFMD Passport to Non-EU AIFMs and AIFs* (ESMA, July 30, 2015) https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1236_advice_to_ep-council-com_on_aifmd_passport.pdf; and *ESMA's Advice to the European Parliament, the Council and the Commission on the Application of the AIFMD Passport to Non-EU AIFMs and AIFs* (ESMA, Sep. 12, 2016), https://www.esma.europa.eu/sites/default/files/library/2016-1140_aifmd_passport.pdf. The EU Commission indicated in 2015 that it would take a decision as to the activation of the third country passport once 'a sufficient number of countries have been appropriately assessed.' Now that some form of positive assessment has been given in respect of nine states, it remains to be seen whether a Delegated Act to activate the passport for these countries will be issued; *AIFMD 2016 Update – Implications of ESMA's July 2016 Advice on the Third-Country AIFMD Passport for Non-EU Managers and Funds* (Sidley Austin LLP, July 25, 2016), <https://www.sidley.com/en/insights/newsupdates/2016/07/aifmd-2016-update-implications-of-esmas>.

⁷²⁸ Stephen Sims, Patrick Brandt & Greg Norman, *AIFMD Passport: Europe Must Try Harder* 17(2) J. INV. C. 10 (2016).

⁷²⁹ Gregg Beechey & Zac Mellor-Clark, *Update on AIFMD Passport for Non-EU Managers: ESMA Put Back on the Clock* (Fried, Frank, Harris, Shriver & Jacobson LLP, Jan. 20, 2016), <http://www.friedfrank.com/index.cfm?pageID=25&itemID=7400>.

regulatory equivalence will ultimately hurt the smaller AIFMs that are hoping to obtain a foothold amongst investors in Europe. The most popular marketing destinations for non-EU AIFMs (predominantly from the US) are the UK, the Netherlands, Finland and Sweden, which impose only the minimum AIFMD private placement requirements (that is, disclosure to investors,⁷³⁰ regular reporting to regulators and an annual report, as well as certain asset stripping and notification requirements; the same conditions equally apply in Luxembourg, Belgium and Ireland⁷³¹). Other EU jurisdictions which otherwise might have been attractive for capital raising make active marketing very difficult in practice, if not impossible, as noted above because the relevant cooperation agreements are either not in place or the local NPPR would effectively require full AIFMD compliance. Thus, depending on the EU Member State, the consequences of the new rules vary from minimal changes to significant new requirements for offshore fund managers.⁷³² Unsurprisingly, many non-EU AIFMs, such as those based in Asia (for example, Hong Kong and China) and Australia, remain baffled and frustrated by the AIFMD, especially as they have realised that that the EU is not a single bloc, but a population of countries with differing rules.⁷³³ The fragmented implementation process means that the challenges for marketing non-EU funds in Europe have ‘substantially increased,’ causing problems in respect of ‘costs, passporting delays and changing regulatory requirements.’⁷³⁴ Consequently, third country AIFMs are increasingly focusing on marketing efforts elsewhere, omitting Europe for other markets in the world and hence bypassing EU investors by seeking investors in the US, Asia Pacific and the Middle East where there is a growing wealth market.

Once the national private placement regimes no longer exist, non-EU AIFMs will have no choice other than complying with the AIFMD in order to be able to move freely across the EU in the management and marketing of AIFs. This will not come for free, as access to Europe’s single market will be granted only in return for accepting the AIFMD’s heavy regulatory burden and associated compliance costs. Therefore, it is conceivable that “imposing” the passport will have the effect of discouraging a number of non-EU AIFMs from marketing in the EU.

⁷³⁰ Although not particularly complicated or expensive, non-EU fund managers will have to get used to the required investor disclosure standards that may not have previously been the practice for them.

⁷³¹ *AIFMD 2014 Update – Private Placements: Where Did We End Up, and Where Are We Going?*, *supra* note 712.

⁷³² Martin Brockhausen in *FORUM: Complying with the AIFM Directive*, *supra* note 600.

⁷³³ Tamasin Little in *Q&A: Regional View* (Bloomberg Brief: AIFMD Special Report, July 2, 2014), http://www.bloombergbriefs.com/content/uploads/sites/2/2014/07/AIFMD_Special_July_2014_Opt.pdf.

⁷³⁴ Peter Guy, *New AIFMD Rules Pose a Major Problem for Asian Alternative Funds* (Regulation Asia, May 27, 2015), <http://www.regulationasia.com/article/new-aifmd-rules-pose-major-problem-asian-alternative-funds>.

2.12 Compliance Costs

The recurring theme of many AIFMD requirements is increased costs, which in the worst case scenario could be even responsible for driving business away from Europe. Therefore, the extent of compliance costs could be the tipping point for the Directive's ultimate success or failure. The costs can be both one-off costs and ongoing costs. The former capture the costs of authorisation (e.g. application fee to the regulator) and other sunk costs of compliance, such as legal/regulatory advice needed to understand the AIFMD and create/amend relevant documentation, practices, procedures and internal structures; the latter costs include the costs of regulatory compliance with the ongoing requirements (e.g. reporting, depositaries, and external valuers).⁷³⁵

One private equity survey found that the most anticipated effect eventuating from regulatory change will result in increased costs due to the broad impact of AIFMD and the need for greater controls, transparency through enhanced investor and regulatory reporting, and resources that do not add value.⁷³⁶ Seen from an economic perspective, multifaceted costs definitely reduce the AIFMD's benefits and reduce its value. Costs rise with regard to implementing operational changes in order to be able to transmit detailed fund information to competent authorities as well as publishing information about portfolio companies, and these can vary considerably depending on the actual number of companies in which private equity fund has invested. Since the valuation of non-listed companies presents a difficulty and is much more complex than valuing listed securities, it must be expected that independent external valuation will involve significantly higher costs as well – according to one source, valuation would need to be carried out for each portfolio company and the cost would vary between €8,000-22,000 per company.⁷³⁷ These costs would be more significant for smaller buyout houses which will have to pay more per portfolio company as they cannot enjoy the benefits of economies of scale. Further, private equity funds have not previously faced capital requirements. Nevertheless, they have typically held the necessary capital to meet the daily needs of managing their investments, despite a much lesser risk of failure than other types of funds. This is because PE funds are closed-ended,

⁷³⁵ It was reported that the AIFMD provisions driving significant or moderate one-off costs were those with regards to initial authorisation and notification (95 per cent), cross-border marketing (88 per cent) and setting up the depositaries (87 per cent); in terms of ongoing costs, the rules identified as being the key drivers of higher costs were those in relation to depositaries (95 per cent) and transparency and reporting (80 per cent); see *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 58-59.

⁷³⁶ *Navigating the Headwinds: 2014 Global Private Equity Survey*, *supra* note 18, at 7.

⁷³⁷ Kyla Malcolm et al., *supra* note 632, at 99.

redemptions are rare and funds enjoy the stability of their income stream structured as a fixed percentage of initial fund capital.

The Deloitte survey found that depositary requirements will constitute the greatest cost – 45 per cent of those surveyed considered these costs to be ‘considerable,’ whilst over one third regarded depositary fees to be ‘high’ or ‘major.’⁷³⁸ These costs will vary depending on the type of AIFM, the nature of their investments and their risk profile. Non-EU AIFMs will not have to comply with the depositary requirements until national private placement regimes are terminated. Other costs associated with the AIFMD, in descending order of importance, are in relation to authorisation, regulatory reporting, risk management, marketing and distribution, and investor disclosure. Individually, each of these risks constitutes ‘major cost’ only for 6 per cent of respondents; however, taken together, all these costs will add up to considerable expense with respect to ongoing compliance costs and changes regarding operations and firm organisation. Further, according to the survey, AIFMs do not intend to use third party service providers in order to assist in fulfilling the Directive’s requirements – 67 per cent of Deloitte respondents intend to implement operational requirements by using in-house resources, and of those who will seek external support, they will most likely outsource regulatory reporting (reporting requirements are complex, therefore outsourcing is considered to be a more streamlined and cost-effective solution compared to performing this activity in-house).⁷³⁹

In the EY survey, 61 per cent of respondents stressed that the compliance costs will negatively impact the fund’s performance, and they will also put pressure on AIFMs’ remuneration.⁷⁴⁰ The Multifonds survey equally reflected the costs concern, finding that 77 per cent of respondents thought that European funds may choose to domicile offshore in order to avoid the additional regulatory costs.⁷⁴¹ Moreover, the limited access to the passport and the constraints on third country may further contribute to re-domiciliation of fund managers.⁷⁴² This illustrates that in addition to direct compliance costs, there are also some costs that are difficult to quantify, but

⁷³⁸ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 20.

⁷³⁹ *Id.* at 22-23.

⁷⁴⁰ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 33.

⁷⁴¹ *Part 2: The Impact of AIFMD and Convergence Survey*, *supra* note 604, at 7.

⁷⁴² *AIFMD: All You Need to Know in a Nutshell* (BNP Paribas, 2013), https://securities.bnpparibas.com/search.html?src_originSiteKey=web&src_sitesForReferences.values=systemsite&src_terms%5b0%5d.applyFilter=true&src_sites.values=web&src_languages.values=en&src_terms%5b0%5d.fields.tags=true&jcrMethodToCall=get&src_terms%5b0%5d.match=all_words&src_terms%5b0%5d.fields.files=true&src_terms%5b0%5d.term=aifmd&src_terms%5b0%5d.fields.siteContent=true&src_nodeType=bpnt%3aarticle.

they could be substantial, for instance, due to the exodus of private equity firms. These costs can be complemented with opportunity costs, that is, forgone benefits that could have been reaped had the Directive not been adopted. The AIFMD raises barriers to entering the industry and increases the cost of launching new funds by imposing burdensome and costly requirements. The costs can be passed on to investors through lower returns and higher fees and charges, but some degree of lower industry growth due to being a less desirable asset class or delays in launching new funds should be expected owing to the increased initial and ongoing compliance costs.

Quantitative analysis of compliance costs reveals that the average one-off cost estimates provided by above-threshold GPs totalled €738,000 and average annual ongoing costs amounted to €269,000.⁷⁴³ The costs varied by the location of the AIFM, the amount of assets under management and the year of the last fundraising. Further, the reported costs were highest for EU AIFMs managing and/or marketing EU AIFs – in this case, one-off costs were approximately €955,000 and ongoing costs were approximately €367,000. Perhaps unsurprisingly, the costs increase as the size of assets under management (AUM) grows: one-off costs are €114,000 for AUM up to €500 million and €1,138,000 for AUM above €1 billion, with corresponding ongoing costs totalling €95,000 and €426,000, respectively.⁷⁴⁴

2.13 Exodus of Fund Managers from Europe

As early as in 2006, the FSA discussion paper (DP06/6) acknowledged that PE constitutes a ‘compelling business model’ making a ‘positive contribution to capital markets’ and highlighted that ‘too much regulation could...cause the private equity industry to move to more lightly regulated jurisdictions.’⁷⁴⁵ The overall compliance costs with the ever-increasing global regulatory initiatives is a pervasive issue impacting alternative fund managers today. The AIFMD has added substantial costs and burdens which may be seen as nuisance by AIFMs which are suffering from regulatory fatigue that is taking them away from their primary mandate to generate profit for fund investors. Since reliance on reverse solicitation cannot be viewed as panacea to the AIFMD burdens, it could be that the most prudent business decision would be to avoid Europe altogether and focus on other jurisdictions, especially if the capital raised in the EU is minimal and the cost economics of AIFMD compliance makes little sense.

⁷⁴³ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 59-61.

⁷⁴⁴ *Id.* at 60-61.

⁷⁴⁵ *Private Equity: A Discussion of Risk and Regulatory Engagement (DP06/6)*, *supra* note 381, at 5.

In view of certain burdensome requirements one may get the impression that Europe is hostile towards AIFMs. In response, some of them may look for strategies to ensure their business falls outside the purview of the Directive. One extreme solution to sidestep the AIFMD would be to completely withdraw from the EU market, in respect of fundraising, fund marketing and management operations. Whilst such a radical measure could mute financial innovation, it seems highly unlikely given the capital available in the EU. This is also supported by a recent report which did not find any statistically significant indication that the Directive has resulted in a change in the level of fundraising in Europe or in the individual EU Member States tested.⁷⁴⁶ A different study found that only two out of 14 respondents (14 per cent) observed a moderate relocation *out of* Europe.⁷⁴⁷

This darkest scenario exemplifies potentially grave but unintended consequences of the new regulation. Should the worst case scenario come into fruition, we could be witnessing the departure of private equity from Europe, with thousands of jobs and millions of Euros in tax revenues being at stake and less investment taking place in companies across the EU, resulting in Europe that is a less attractive destination for investors and talent from around the world. This in turn could reduce the EU's overall competitiveness,⁷⁴⁸ although the Executive Summary of the EU Commission's *Impact Assessment* observed that '[d]ue to uncertainty about costs, it is not possible to assess or to quantify precisely the impact...on the competitiveness of EU-domiciled AIFM.'⁷⁴⁹

The Deloitte survey found that the Directive would affect the choice of fund domicile for 61 per cent of responding managers; of this percentage, 37 per cent managers intend to continue to establish funds in non-EU locations, 27 per cent intend to move funds outside the EU, whereas 18 per cent plan to re-domicile non-EU funds to the EU.⁷⁵⁰ Moving in or out of the EU or maintaining the *status quo* for as long as possible will ultimately depend on the overall cost-

⁷⁴⁶ GP respondents did not suggest there was a significant change in investor willingness to invest in private equity funds which could be attributed to the AIFMD, and the majority of LPs agreed with this opinion; further, the majority of respondents did not observe any difference in the number or diversity of available EU funds; *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 46 & 50-51.

⁷⁴⁷ *Id.* at 70. The study also found that there has been a moderate relocation of AIFMs and AIFs *within* Europe. This trend was due to differences in AIFMD implementation, seeing relocation preference from Germany, the Nordic states and the Central and Eastern European region into the UK (at least before the Brexit referendum), Ireland and Luxembourg.

⁷⁴⁸ Mats Persson, *The EU's AIFM Directive: Likely Impact and Best Way Forward* 4 (Open Europe, Sept. 2009), <http://www.openeurope.org.uk/Content/documents/pdfs/aifmd.pdf>.

⁷⁴⁹ *Impact Assessment*, *supra* note 345, at 7.

⁷⁵⁰ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 12. According to the 2015 Multifonds survey, 50 per cent of respondents saw evidence of AIFMs setting up offshore structures to avoid the additional costs of AIFMD; *Part 4: The Impact of AIFMD and Convergence Survey*, *supra* note 651, at 2.

benefit analysis, investor requirements and the marketing strategy of each AIFM. Worthy of note is the fact that the adoption of the Directive might reduce the number of non-EU AIFMs operating in the EU for whom investment activities in Europe constitute only a fraction of their overall business and therefore the compliance costs would simply be too high a barrier to entry. Should the number of AIFMs decrease, other managers might wish to exploit this situation by taking advantage of reduced competition – especially the large(r) AIFMs which can absorb the compliance costs more easily and thus find it easier to dominate the more sheltered market. Sixty-eight per cent of Deloitte respondents highlighted that the compliance burden will reduce competitiveness of the alternative funds industry in Europe.⁷⁵¹ If so, the end result could be less choice, lower returns and higher costs for investors due to the creation of a more protective European market (“Fortress Europe”) that is suspicious of global liberalism and sheltered from competition. Thus, the Directive may cost more than it is worth, in particular if the rest of the world does not follow the EU’s lead in the regulation of the alternative investment fund industry.

Discussing a theoretical exit of AIFMs from Europe is important as this could have knock-on effects on the wider economy, such as the loss of tax revenues and thousands of jobs, less capital for underperforming companies, less money to spur innovation and growth and more limited choice for investors if AIFMs decided not to remain or invest in the EU.⁷⁵² Unnecessary restrictions and raising costs could result in less investment in European companies at a time when more investment is desperately needed and diminish Europe’s competitiveness in the global marketplace, as well. The AIFMD and its restrictive tone may bring about competitive disadvantage for EU-based buyout funds, which have to comply with many various requirements whereas other funds, like sovereign wealth funds, family-run funds and non-EU funds, fall outside the scope and do not have to comply. Only the larger buyout houses will be able to easily handle operational challenges and increased costs, most likely by passing these on to the investors in the form of increased charges or lower returns.

It must also be noted that the complex and far-reaching AIFMD is only one of the several regulatory measures that fund managers have to be aware of. Due to the seriousness of the

⁷⁵¹ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 12.

⁷⁵² For instance, the 2016 Private Equity survey may be offering an early indication of the post-AIFMD trends in this area – the percentage of invested capital allocated in Europe has dropped from 23 per cent in 2014 to mere 9 per cent in 2015, whilst investments in North America increased from 40 per cent to 61 per cent during the same time. Although it is not explicitly stated, the decrease in PE investment in Europe may be due to the regulatory impact of AIFMD; *Disruption. A Seismic Shift in the Private Equity Industry. 2016 Global Private Equity Fund and Investor Survey*, *supra* note 667, at 32.

crisis, the density and complexity of the global regulatory agendas has increased, with the AIFMD being only one piece of a global regulatory puzzle. Indeed, the precise nature of the reforms varies substantially region by region. This has an impact on AIFMs' decision as to where to pursue clients and where to set up an operational base. Notably, the varying responses by jurisdictions in North America, Europe and Asia create the potential for regional regulatory arbitrage, whilst differing implementation guidelines by region can lead to temporal arbitrage.⁷⁵³ It is not easy to navigate the headwinds of change which clearly make the private equity business more complex, especially in the short term. In the KPMG survey, one alternative asset manager noted, 'I would rather see one Directive with one set of rules rather than the patchwork of regulation that we have that is just becoming a nightmare. It is just becoming too unwieldy, too complicated, too complex to...work your way through.'⁷⁵⁴ In general, the EU's intensive crisis-era reforms could be vividly likened to 'death by a thousand directives.'⁷⁵⁵ This mountain of new regulations frustrates buyout firms by disrupting their activities, draining their resources and limiting their ability to focus on key priorities, especially if they find themselves engaged in a two front war due to their international operations by means of having bases in both London and New York. A private equity survey by EY found that 45 per cent of Chief Financial Executives view (global) regulation and compliance as their key concern/challenge over the next two years, and 80 per cent of them believe the AIFMD will have a high or medium impact.⁷⁵⁶

3. Positive Implications and Opportunities

Whilst there is no evidence suggesting that private equity actually caused the financial crisis, there is an argument that better regulation was needed in this sector just as in any other area of the financial services industry.⁷⁵⁷ Despite the critique, many of the Directive's principles and rules are sound and broadly consistent with good market practice that has been in operation for years.⁷⁵⁸ As with all challenges and threats, herein lie benefits and opportunities, such as the

⁷⁵³ Benjamin Poor, *Private Equity Update: Regulatory Arbitrage* 4 (Citi Global Transaction Services, 2010), http://www.transactionservices.citigroup.com/transactionservices/home/securities_svcs/docs/RegulatoryArbitrageC.pdf.

⁷⁵⁴ *Last Boarding Call: An Overview of the Alternative Industry's Preparedness for AIFMD*, *supra* note 636, at 8.

⁷⁵⁵ 'Everybody is aware that there is a huge volume of regulatory and legal change which is going to affect financial institutions. Firms are trying to cope with this unprecedented challenge. It can feel like crossing the Pacific Ocean in an open boat with only a compass and a huge pile of documents as navigation aids;' *Sea of Change: Regulatory Reforms to 2012 and Beyond* 1 (Clifford Chance LLP, Briefing Note, Nov. 2010), http://www.cliffordchance.com/content/dam/cliffordchance/PDFs/SOC_Open_Boat_LR.pdf.

⁷⁵⁶ *Navigating the Headwinds: 2014 Global Private Equity Survey*, *supra* note 18, at 5 & 6.

⁷⁵⁷ Mats Persson, *supra* note 748.

⁷⁵⁸ Claire Cummings, *supra* note 631.

EU passport facilitating cross-border investments, greater investor protection and transparency that may increase the scale of investments in PE funds, and the development of the AIFMD label that could come to be seen as a label of quality, similar to UCITS, having a positive impact on perceiving the PE industry.

According to the Deloitte survey, the EU passport offers the greatest opportunities, followed by increased investor confidence, reduced competition due to barriers to entry, creation of the level playing field through a common set of rules, and brand recognition. Since 22 per cent of respondents chose ‘none of these’ (the second most popular answer), evidently there is a degree of concern about the new bloc-wide regime and scepticism regarding these potential opportunities.⁷⁵⁹

3.1 EU Passport

It is conceivable that the possibility to market AIFs more easily throughout the EU should make the region a more attractive jurisdiction and hence a potential avenue for gathering assets in PE funds. Fund distribution across the EU can potentially enhance the Single Market and so the EU-wide marketing passport is an element of AIFMD that is generally welcomed. Given that nowadays capital raising is increasingly global, the marketing passport will grant access to the large prospective investor base in the entire EU market, which may be a key strategic advantage for fund managers. Equally, the EU management passport will enable the management of AIFs located in any Member State, either directly or through a branch.

According to the Multifonds survey, 70 per cent of respondents agreed that the AIFMD will encourage non-EU fund managers to establish operations in Europe in order to benefit from the new regime imposed by the Directive.⁷⁶⁰ This in turn can lead to some degree of regulatory arbitrage as some Member States, which will want to attract more AIFMs, will have their competent authorities perform their task of authorising fund managers speedily and more efficiently. Such authorised AIFMs will be able to market their funds to a wider group of investors in different Member States. The EU passport will help offset some of the compliance and marketing costs as it will enable operations across the EU without the need to establish management companies in multiple jurisdictions. Through the creation of an EU passport, the

⁷⁵⁹ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 10-11.

⁷⁶⁰ *Part 2: The Impact of AIFMD and Convergence Survey*, *supra* note 604, at 7. In the 2015 survey, Multifonds reports that 76 per cent of respondents concur that non-EU AIFMs are coming to Europe and establishing EU operations in order to realise the benefits of AIFMD; *Part 4: The Impact of AIFMD and Convergence Survey*, *supra* note 651, at 2.

AIFMD will aim to achieve a single European market in AIFs, which is one of its objectives. This should also facilitate the expansion of the investment options for investors and result in greater competition and efficiencies in the EU market.

However, the availability of the EU passport is subject to some complexity as the provisions apply depending on the transposition timeline⁷⁶¹ and whether the AIFM and AIF are based inside or outside the EU.⁷⁶² Particularly, the extension of the EU passport to non-EU AIFMs seems unlikely at present, given that the EU is pre-occupied with Brexit and the 2019 elections to the EU parliament. Moreover, it is still uncertain to what extent AIFMs will be willing to take advantage of the new passporting opportunity. It was found that 59 per cent of UK investment managers will not avail of the new EU passport in order to extend distribution as they do not consider distribution benefits sufficient enough to compensate for all the compliance-related costs.⁷⁶³ In the same vein, it was reported that 69 per cent of responding managers are not going to centralise operations across the EU by using the AIFMD management passport as typically AIFMs have a smaller and simpler organisational structure than UCITS-type fund managers.⁷⁶⁴

3.2 Increased Investor Protection and Confidence

The Directive was born out of a need to bolster the protection afforded to investors, as evidenced by measures such as reliable asset valuation, sound remuneration policies, robust governance controls, and minimum capital requirements. Accordingly, professional investors, especially large ones like pension funds who often place their trust in private equity, should be able to take greater comfort from the enhanced regulatory framework for the supervision and prudential oversight of AIFMs in Europe and, consequently, be inclined to invest in private equity funds with greater confidence. Regulated AIFs offer a more secure environment, with better

⁷⁶¹ Marketing and third-country access provisions are highly contested and complex. The AIFMD can be divided into three periods: Period 1 in which the passport is available to EU AIFMs only; Period 2 in which the passport is extended to non-EU AIFMs; and Period 3 which will mark the end of private placement regimes; *Making Sense of AIFMD: Your Guide to the Directive* 7-8 (BNP Paribas, Apr. 2012), http://securities.bnpparibas.com/jahia/webdav/site/portal/shared/documents/Marketper_cent20Insight/AIFM-directive-guide-regulation-AIFMD.pdf.

⁷⁶² This causes further uncertainty as there is a risk that some Members States, following the wave of political support for restrictions on the activities of fund managers, might tighten, or even abolish, their private placement regimes. Accordingly, fund managers will have to be alert to changes to the respective national private placement regimes as they may have to comply with stricter requirements in the short to medium term; *The Alternative Investment Fund Managers Directive* 15 (Jones Day LLP, Jan. 2014), http://www.jonesday.com/Alternative_Investment_Fund_Managers_Directive/?RSS=true.

⁷⁶³ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 16.

⁷⁶⁴ *Id.*

governance, supervision and safeguards to adequate investor confidence.⁷⁶⁵ Mandatory authorisation – the new AIF seal of approval – will be utile to LPs when conducting pre-investment due diligence,⁷⁶⁶ whereas enhanced protection eventuating from reinforced controls on the investments carried out by fund managers will have a positive impact on investor choice, as investors will be able to spread their investments, hold more assets, exploit economies of scale whilst hedging against risks. There are numerous benefits associated with enhanced transparency with regards to information about funds.⁷⁶⁷ This can reduce asymmetric information and thus allow investors to better match their investment objectives with the fund's strategies.⁷⁶⁸ Thus, the real positive impact will potentially be conferred on pension funds which will be able to meet the challenges raised by the ageing population in Europe and the pressure this places on pension schemes.⁷⁶⁹

Nevertheless, the benefits flowing from enhanced transparency might prove to be relatively limited since large professional investors already obtain detailed, sufficient information regarding AIFs, and AIFMs are cooperative in supplying any additional information at request. Thus, transparency, although certainly positive from a policy perspective, may have little additional value from an investor's perspective. Specifically in relation to PE investors, whilst they in general recognised that various AIFMD rules have contributed, at least to some extent, to an improved investor protection, many of them did not think that the Directive has diminished the need for their own due diligence, and the majority of those surveyed did not agree that regulating the PE sector in general had any significant impact on investor protection.⁷⁷⁰

In another survey, it was emphasised that investors are mainly returns-driven as opposed to being regulatory-driven.⁷⁷¹ Therefore, despite embracing the AIFMD, the quality seal does not seem to be likely to attract much more investment as the asset allocation is predominantly commercially-driven and diversification-based, with regulatory compliance being only one

⁷⁶⁵ Sophia Grene & Chris Newlands, *supra* note 610.

⁷⁶⁶ ESMA will keep a register of all authorised fund managers.

⁷⁶⁷ In contrast, it can be argued that since private equity is predominantly a wholesale rather than a retail market, institutional investors can be expected to look after themselves. This means that they can acquire information they need about their investments without regulatory intervention. As a matter of fact, it has been reported that this type of investors actually receive far more detailed, extensive information and disclosures than investors in quoted companies, and reporting arrangements between buyout firms and investors are felt to be satisfactory; see Sir David Walker, *supra* note 469, at 6.

⁷⁶⁸ Kyla Malcolm et al., *supra* note 632, at 42.

⁷⁶⁹ Mats Persson, *supra* note 748, at 11.

⁷⁷⁰ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 65-66.

⁷⁷¹ *Game-Changing Regulation: The Perceived Impact of the AIFM Directive on Private Equity in Europe*, *supra* note 605, at 32-33.

aspect that is considered as part of the whole decision-making process. Seventy-one per cent of respondents agreed with this assumption.⁷⁷² This does not appear to be surprising as institutional investors are accustomed to, and confident about, making investments, across Europe and globally. The AIFMD itself does not explain why professional investors require additional protections, and the accompanying EU Commission *Impact Assessment*, whilst referencing a number of sources on investor protection, has only one of them considering private equity specifically – a 2008 survey conducted by a consulting firm, which identified concerns with regards to the reporting of management fees and the disclosure of conflicts of interest. However, no evidence of actual detriment to investors was provided (it was presumed, not demonstrated).⁷⁷³

The economies of scale in Europe depend on the type of funds under consideration. However, in the case of private equity, the benefits would be limited as AIFMs manage or provide advice to the underlying portfolio companies. Passporting might also be limited due to differences in business cultures and tax regimes in individual Members States. Therefore, some countries are likely to gain, whilst others are likely to lose, in terms of investment volume. The worst scenario embraces a concern that the investment choice opportunities for investors will actually be reduced if fund managers decide to withdraw from the EU and stop serving the EU market altogether. Although not necessarily good for investors, this could be a good outcome for AIFMs remaining active in Europe as they will be able to gain considerably from a greater investment pool.

In addition, some private equity houses might seek to circumvent the new piece of legislation and split into smaller entities, which do not have to comply with the Directive provisions. One study found that 92 per cent of private equity's assets under management will be within the scope of AIFMD.⁷⁷⁴ Should private equity fund managers decide to avoid being regulated by the AIFMD, investors would be forced to consider other options, such as direct investments into underlying companies or direct mandates, which would manage the assets in a manner that mimics the performance of a particular fund. This would constitute a complication for investors, not to mention the uncertainties regarding the success and financial returns of such investments due to not having the skills of the private equity professional. Another possibility is that there would be a shift away from private equity to investing in companies via listed securities. These

⁷⁷² *Id.*

⁷⁷³ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 21-22.

⁷⁷⁴ Kyla Malcolm et al., *supra* note 632, at 50.

investment options have existed for many years, but the potential problem is the limited choice for investors in restricting their access to private equity. This affects negatively their diversification opportunities. In general, diversifying across different asset types necessitates making investments in a number of assets, which are not perfectly correlated with each other, such as private equity and hedge funds. These investments, in tandem with the traditional asset classes, allow a better risk/reward combination. Such an investment strategy fits in the modern portfolio theory created by Markowitz,⁷⁷⁵ which reflects the concept of not putting all eggs in one basket. Thus, including alternative investments, such as private equity, in the portfolio reduces risk for a given level of return or increases returns for a given level of risk. This indicates that access to AIFs can provide the majority of diversification benefits, which would be foregone in the event of an entire asset class being no longer available to investors, especially as private equity has no close substitutes and other alternatives may not necessarily have the same expertise in particular industries or markets. Therefore, there is a risk that investors may lose their ability to design optimal portfolios.⁷⁷⁶

The prospect of an exodus of private equity funds from Europe is extremely unlikely. It was found that the proportion of private equity funds, which would effectively be no longer available to investors as a result of the Proposal Directive, would be 35 per cent.⁷⁷⁷ Given that the final Directive is much more refined and thus less controversial, the percentage of AIFMs honestly contemplating to abandon the EU market must be significantly smaller. It is therefore more likely that, rather than trying to avoid the jurisdiction of the AIFMD, the AIFMs will actually remain in operation in Europe and comply with the new regime.

3.3 AIFMD as a Global Brand

The Directive could potentially enhance the success of the private equity industry as investors will have a larger choice of regulated vehicles when seeking alternative strategies, especially as the EU marketing passport will augment the promotion of PE funds. Broad parallels can be drawn between AIFMD and UCITS as the former was designed to replicate the harmonised framework of the successful UCITS network for traditional funds in Europe.⁷⁷⁸ The original

⁷⁷⁵ Harry Markowitz, *Portfolio Selection*, 7 J. FINANC. 77 (1952).

⁷⁷⁶ Kyla Malcolm et al., *supra* note 632, at 56.

⁷⁷⁷ *Id.* at 61.

⁷⁷⁸ Undertakings for the collective investment in transferable securities (UCITS) are investment funds regulated at EU level. They are open to all investors, including retail investors, and are the most common investment fund type in Europe that accounts for around 75 per cent of assets under management (AuM) in the European fund industry; Ulf Klebeck, *supra* note 591, at 77, 78.

UCITS Directive⁷⁷⁹ was created as a European cross-border mutual fund vehicle which over the past 20 years has gained a reputation as a well-regulated standard for open-ended structures, which invest in transferable securities or other liquid assets. Due to the global distribution, the UCITS structure has successfully been exported across the globe to Asia, Latin America and the Middle East.⁷⁸⁰ It must be noted that UCITS did not gain significant attraction from its inception and early years, but only at a later stage following UCITS III.⁷⁸¹ Thus, the appetite for UCITS did not appear overnight. This long process demonstrates that the AIFMD may also replicate the success of UCITS in the alternative space⁷⁸² and become the gold standard for sophisticated investors. We are at the beginning of the path and therefore it may take a couple of iterations and revisions of the Directive over the following years before it truly gains global momentum by transcending the borders of the EU and developing a good comprehension of this new framework. However, at this stage, early indications, for example from Asia Pacific, do not support the EU Commission's hope that the AIFMD will become a trusted brand with similar cachet to the UCITS stamp of approval.⁷⁸³

Pursuant to one survey, 59 per cent of respondents believed that in the long term the Directive will become an international standard for distributing alternative investment funds globally, alike the UCITS brand.⁷⁸⁴ Accordingly, it is feasible that the AIFMD will become an appealing *de facto* global brand that will attract more investment into private equity, particularly from investors who will want the peace of mind of a regulated industry, characterised by increased risk and liquidity management, independent oversight and better transparency. As with the

⁷⁷⁹ UCITS I (Directive 85/611/EEC) aimed to allow collective investment schemes (open-ended funds investing in transferable securities) to operate freely throughout the EU on the basis of a single authorisation from one Member State.

⁷⁸⁰ Ulf Klebeck, *supra* note 591, at 77, 78.

⁷⁸¹ UCITS III had its roots in the amended UCITS I, which was amended and adjusted over time and notably by a Management Directive and a Product Directive. The Management Directive sought to give management companies a European passport to operate across the EU and widened the activities which they were allowed to undertake. Further, it introduced the concept of a simplified prospectus to provide more accessible and comprehensive information in a simplified format to assist the cross-border marketing of UCITS. The Product Directive aimed to remove barriers to the cross-border marketing of units of collective investment funds by allowing funds to invest in a wider range of financial instruments, such as derivatives, subject to the same regulation in every Member state.

⁷⁸² Yuri Bender, *AIFMD to Add an Alternative String to Luxembourg's Bow* (May 2, 2013), <http://www.pwmnet.com/Regulation/AIFMD-to-add-an-alternative-string-to-Luxembourg-s-bow?ct=true>.

⁷⁸³ Tamasin Little in *Q&A: Regional View*, *supra* note 733.

⁷⁸⁴ *Part 2: The Impact of AIFMD and Convergence Survey*, *supra* note 604, at 8. Two years later, the 2015 survey reported that the overwhelming majority of 87 per cent of respondents believed that the AIFMD would ultimately come to rival UCITS (noting, however, that this would take time – approximately five years, and the extension of the AIFMD passport). This shift in attitude shows the positive impact of time on the industry's perception of the AIFMD following its implementation; *Part 4: The Impact of AIFMD and Convergence Survey*, *supra* note 651, at 3 & 8.

UCITS which has come to represent a stamp of approval for quality and transparency, those private equity houses that will adopt the AIFMD provisions early will be distinguished. They will be able to attract new clients and hence gain a source of competitive advantage over the slower adopters of AIFMD.⁷⁸⁵ This chimes well with the words of Benjamin Franklin who once said, ‘you may delay, but time will not.’⁷⁸⁶ Therefore, acting fast and responding proactively may be the key to success for the affected PE firms. More transparency and disclosure should lead to more trust, which in turn should have several positive side-effects, such as reduced risk of market abuse, improved reputation of the private equity industry, and better comprehension of this asset class and its workings.

4. Conclusion

Several years after the collapse of Lehman Brothers, the regulatory dust from the global financial crisis has started to settle. New policies and regulations have been introduced internationally to address the pathologies of excessive financial liberalisation and risk taking. In Europe, the crisis has reordered the location of regulatory and supervisory control over European financial markets, but the exact implications of this reordering on efficiency and stability are yet unknown and remain to be seen.⁷⁸⁷ The AIFMD is one of the most wide-reaching, ambitious and complex regulatory regimes ever introduced into the alternative investment sector, aiming to protect EU investors, limit systemic risk and ensure proper risk management by fund managers. Unsurprisingly, it has had a significant re-shaping effect on the AIF industry in Europe and beyond. Key provisions relate to authorisation (scope, authorisation and capital requirements), marketing (EU vs non-EU AIFMs), conduct of business (remuneration, rules of conduct, conflict of interest), functions and service providers (valuation, risk and liquidity management, depositary, delegation and sub-delegation), transparency (reporting to regulator, disclosure to investors) and some more specific provisions (leverage, major holdings and acquisition of control). This confirms that the AIFMD will have a significant impact on private equity and its core activities, although it is also observed that the degree of this impact will vary, depending on the AIFM’s size and domicile, as well as the gap that will need to be aligned between the pre- and post-AIFMD regime.

⁷⁸⁵ Thomas M.J. Möllers, Andreas Harrer & Thomas C. Krüger, *supra* note 557, at 87, 88-89.

⁷⁸⁶ Benjamin Franklin (BrainyQuote, 2014), <http://www.brainyquote.com/quotes/quotes/b/benjaminfr101831.html>.

⁷⁸⁷ Niamh Moloney, *Resetting the Location of Regulatory and Supervisory Control Over EU Financial Markets: Lessons From Five Years On*, 62(4) I.C.L.Q. 955, 965 (2013).

The AIFMD potentially offers some benefits, but these may not be available to all AIFMs. It appears that AIFMs who are enthused about the AIFMD and regard the EU passport as an opportunity tend to be larger, managing at least £1bn AUM and having a focus on regulated non-UCITS. By contrast, smaller firms and private equity fund managers in particular take a more negative view of the Directive and consider it a business threat – 72 per cent of Deloitte respondents believe that their ability to take advantage of some of the AIFMD's benefits is limited and they have fewer internal resources to tackle the initial and ongoing compliance costs and responsibilities.⁷⁸⁸ Therefore, this reveals a particular polarisation of opinion amongst AIFMs on the AIFMD, and given the wide scope of the Directive, individual fund managers will have to adopt different approaches and strategies.

The AIFMD has important implications, but not all of them are positive for the affected firms. The business impact on private equity specifically is significant, adding extra costs, often for no apparent benefit. Such approach towards private equity remains odd and perplexing, especially as the EU Commission observed itself that, '[t]he financial resources and the know-how of private equity managers are considered as important factors for a turn-around of the EU economy in the current crisis.'⁷⁸⁹ In general, fund managers seem to be supportive of the idea of introducing the Directive and its underlying goals, but feel the text could have taken a different approach. However, given its current form, it is feasible that the number of non-EU AIFMs operating in the EU may fall, making the EU market for alternative investment funds less competitive. This in turn may lead to reduced investor choice. Moreover, AIFMs are burdened with providing more information about their organisation and activities to regulators and investors, follow acutely detailed disclosure and reporting requirements when acquiring companies and comply with a range of rules setting out how they should operate. Substantial compliance and on-going costs may prove critical in determining whether the Directive is a success. If they transpire to be too significant, fund managers may decide to leave EU investors altogether in their attempt to avoid being in scope of the AIFMD. Job losses may well increase if private equity managers move out from Europe as private-equity backed companies represent an important group of employers.⁷⁹⁰ There is also much uncertainty as to how the EU AIF market will look like when national private placement regimes are terminated. On top of that,

⁷⁸⁸ *AIFMD Survey: Responding to the New Reality*, *supra* note 607, at 4-5 & 7-8.

⁷⁸⁹ *Impact Assessment*, *supra* note 345, at 53.

⁷⁹⁰ For instance, BVCA reported that companies which received PE-funding employ around 3 million people in the UK (equivalent to 21 per cent of UK private sector employees) and private equity contributes to the UK financial sector in the City by employing over 9,000 people of which some 5,000 professionals actively invest in private companies; *The Economic Impact of Private Equity in the UK*, *supra* note 92.

even though the AIFMD could become an international standard for alternative investment funds, crisis-induced regulation in general creates an attitude which is less concentrated on quality and more on political and economic influence.⁷⁹¹ This could weaken the reception of the AIFMD brand and for this reason it could take a number of years and iterations of the Directive before this perception is changed. If all these risks were to materialise, the AIFMD could become a paragon of regulatory failure, although the application of new rules in various Member States will be crucial in determining the Directive's success and, ultimately, the future of the alternative investment funds sector in the EU. Also, as demonstrated in this chapter, establishing harmonisation is a double edged sword – as much as increased harmonisation is welcomed, dealing with different or even contradictory AIFMD transpositions across the EU, as this is currently the case, causes frustrations and delays marketing activities.

Although private equity firms are largely concentrated in the UK, the benefits of the industry and its investment activities are spread across the continent.⁷⁹² Given these cross-border effects and the impact on other financial actors, it appears appropriate that private equity will be monitored in a similar fashion to other financial institutions. Through the requirement of authorisation and supervision the industry gains more credibility as a regulated alternative investment class. This should not only benefit investors and fund managers, but also ensure that private equity is not the root cause of a future financial crisis. Despite a number of concerns, doubtful or unrealised benefits, the investors might paradoxically gain and expand their investment options if the AIFMD brand actually takes off and manages to attract overseas funds to the EU. More private equity funds will in turn have a positive impact on employment, innovation and growth in Europe. However, this opportunity has not yet materialised.

Given the industry's bold and endeavouring attitude, it is not surprising that many fund managers have reacted proactively to the new AIFMD requirements in order to be able to continue generating value for their clients. It has helped that many of the general AIFMD principles are essentially a codification of those principles, which have consistently been applied in the PE industry and routinely reflected in fund documentation (at least in some Member States, like the UK). However, many other elements required considerable amount of consulting time and cost to ensure full compliance with regulatory expectations. Whilst

⁷⁹¹ Dirk A. Zetsche & Daniel Litwin, *AIFMD's Cross-Border Dimension and Third country Rules – A Systematic Perspective*, in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS* 367, 408 (Dirk Zetsche ed., 2012).

⁷⁹² According to the CRA study, UK managed buyout funds invested more than 40 per cent of their investments in European companies; Kyla Malcolm et al., *supra* note 632, at 67.

currently the AIFMD is business as usual, in the early stages the extent and intensity of response ultimately had to be determined individually by each AIFM by reference to its business activities, distribution strategy and investor base. In the context of private equity, however, this chapter has demonstrated that many aspects of AIFMD do not work or are fairly irrelevant.

Chapter VIII

Regulating in the Crisis

1. Introduction

Mark Twain supposedly said, ‘the past does not repeat itself, but it sure does rhyme.’ These words could certainly apply to recent developments in the financial sphere, for the financial crisis which struck during the first decade of the 21st century was not the first one the world has ever endured, nor will it be the last one.⁷⁹³ It is true that financial crises have come and gone,⁷⁹⁴ occurring in different forms and shapes, subsequently leaving the global community scattered by the damaging grip of ensuing recession.⁷⁹⁵ For this reason, the history of financial crises is ‘long and undistinguished.’⁷⁹⁶ But it is now acknowledged that the recent one is the biggest and worst economic crisis of market capitalism since the Great Depression eight decades earlier in 1929.⁷⁹⁷ It engulfed most of the world in just a few months,⁷⁹⁸ exerting an extraordinary impact on every major country and market centre, as well as the lives and fates of people, companies, and whole industries, such as private equity. Although the crisis was global in nature, the main effects were felt in the financial markets of Europe and the US.⁷⁹⁹ Unsurprisingly, the salience of recent events had inspired new ways of thinking about how financial markets and services operate, what policies are needed⁸⁰⁰ and what kind of regulation is possible.⁸⁰¹ The near-consensus on the need to re-regulate finance has led to the outpouring of wide-ranging

⁷⁹³ TONY CIRO, *THE GLOBAL FINANCIAL CRISIS: TRIGGERS, RESPONSES AND AFTERMATH* 1 (2012).

⁷⁹⁴ Steven Kates, *Introduction*, in *THE GLOBAL FINANCIAL CRISIS: WHAT HAVE WE LEARNT?* 1, 1 (Steven Kates ed., 2011).

⁷⁹⁵ John J. Kirton et al., *Introduction and Analysis*, in *GLOBAL FINANCIAL CRISIS: GLOBAL IMPACT AND SOLUTIONS* 3, 3 (Paolo Savona et al. eds., 2011).

⁷⁹⁶ John Authers, *Human Nature Means Financial Crises are the Cost of Progress* (FIN. TIMES, Apr. 27, 2014), <http://www.ft.com/cms/s/0/473a1a4a-cde9-11e3-9dfd-00144feabdc0.html?siteedition=intl#axzz30CW2JTjK>.

⁷⁹⁷ *Globalization of Alternative Investments Working Papers Volume 3: The Global Economic Impact of Private Equity Report 2010*, *supra* note 181, at iii.

⁷⁹⁸ Philip Arestis et al., *Introduction*, in *THE FINANCIAL CRISIS: ORIGINS AND IMPLICATIONS* 1, 1 (Philip Arestis et al. eds., 2011).

⁷⁹⁹ Kevin Davis, *Regulatory Reform Post the Global Financial Crisis: An Overview* 2 (Mar. 2011), <http://www.kevindavis.com.au/secondpages/Miscellaneous/Regulatory%20Reform%20Post%20the%20GFC-%20Overview%20Report.pdf>.

⁸⁰⁰ *GLOBAL ECONOMIC CRISIS: IMPACTS, TRANSMISSION AND RECOVERY* xi (Maurice Obstfeld et al. eds., Edward Elgar 2012).

⁸⁰¹ C.P. Chandrasekhar, *Reregulating Finance after the Crisis*, in *FINANCIAL STABILITY AND GROWTH: PERSPECTIVES ON FINANCIAL REGULATION AND NEW DEVELOPMENTALISM* 143, 143 (Luiz Carlos Bresser-Pereira et al. eds., 2014).

regulatory changes with differing effects across jurisdictions.⁸⁰² This effectively overcame Milton Friedman's 'tyranny of the *status quo*,'⁸⁰³ demonstrating that the crisis is capable of providing space for new ideas to emerge.⁸⁰⁴ This also shows that there are two clear patterns that recur and reverberate across financial bubbles and crashes: regulatory stimulus which spurs investment activity and a substantial legal backlash, and regulatory reaction when the bubble bursts.⁸⁰⁵ The challenge then is to ensure that regulations coming into force off the back of the crisis are sustainable, balanced and contain proportionate rules that are predicated on sound, methodological analysis, rather than knee-jerk assessment.⁸⁰⁶ Otherwise, there is a risk that the creativity, innovation and competition of the affected industries will be crowded out.

In the world of financial regulation, since the time of the South Sea Bubble⁸⁰⁷ in the early 1700s, experience has repeatedly illustrated that only after a catastrophic market collapse regulators and legislators can surmount the resistance of the financial community and are able to implement new comprehensive reforms.⁸⁰⁸ Accordingly, each crisis may be a game-changer⁸⁰⁹ and there may be a positive side to it – notably, it may furnish the *modus operandi* to implement major reforms, making it feasible to align interests of multiple constituencies with the purpose to achieve a greater good. Unsurprisingly, the recent unique crisis environment engendered a blizzard of reform proposals, which eventually transformed into laws having real and wide-ranging ramifications. Nevertheless, this crisis-induced process can be uncertain when the old is dying and the new is born, potentially bringing about unintended consequences resulting from

⁸⁰² Jennifer G. Hill, *Why Did Australia Fare So Well in the Global Financial Crisis?*, in *THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS* 203, 300 (Eilís Ferran, Niamh Moloney, Jennifer G. Hill & John C. Coffee Jr eds., 2012).

⁸⁰³ 'There is enormous inertia – a tyranny of the status quo – in private and especially governmental arrangements. Only a crisis – actual or perceived – produces real change;' MILTON FRIEDMAN, *CAPITALISM AND FREEDOM* ix (40th anniversary ed., 2002).

⁸⁰⁴ Walter Mattli & Ngaire Woods, *In Whose Benefit? Explaining Regulatory Change in global Politics*, in *THE POLITICS OF GLOBAL REGULATION* 1, 37 (Walter Mattli & Ngaire Woods eds., 2009).

⁸⁰⁵ ERIK F. GERDING, *LAW, BUBBLES, AND FINANCIAL REGULATION* 63 (2014).

⁸⁰⁶ Simon Burns, *supra* note 619.

⁸⁰⁷ For the historical account of the South Sea Bubble and its causes and consequences, see CHARLES MACKAY, *EXTRAORDINARY POPULAR DELUSIONS AND THE MADNESS OF CROWDS* 46-88 (L.C. Page & Co. 1932) (1852); WALTER BAGEHOT, *LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET* 127-29 (1892); STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690-1860*, at 41-87 (1998); RON HARRIS, *INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844*, at 60-81 (2000); Henry N. Butler, *General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes*, 6 INT'L REV. L. & ECON. 169, 171-73 (1986).

⁸⁰⁸ John C. Coffee, *The Political Economy of Dodd-Frank: Why Financial Reform Tends To Be Frustrated and Systemic Risk Perpetuated*, in *THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS* 301, 301 (Eilís Ferran, Niamh Moloney, Jennifer G. Hill & John C. Coffee Jr eds., 2012).

⁸⁰⁹ Eilís Ferran, *Crisis-Driven Regulatory Reform: Where in the World is the EU Going?*, in *THE REGULATORY AFTERMATH OF THE GLOBAL FINANCIAL CRISIS* 1, 1 (Eilís Ferran, Niamh Moloney, Jennifer G. Hill & John C. Coffee Jr eds., 2012).

unreasoned emotional response, especially when the underlying causes of the financial crisis are multi-faceted, complex and not yet fully comprehended. Thus, amongst many positive, rational changes that arise from each crisis, there will inevitably be some that do not have the intended impact and the expected benefits of the regulatory intervention will not be realised.

A well-known dictum attributed to the French politician Emile de Girardin (1806-1881), ‘Gouverner, c’est prévoir’ (to govern is to foresee), means that prediction is required for rational policymaking;⁸¹⁰ this dictum continues to hold in the 21st century. Due to the financial markets globalisation and internationalisation as well as their subsequent unprecedented upheaval, business and financial activity are being accompanied by fundamental reforms characterised by a natural expansion of supervision, oversight and regulation across national borders. The scope and complexity of regulation in the financial industry has increased palpably and this desire for more control and investor protection may seem understandable. Nevertheless, influencing the complex financial system may be challenging, creating some undesirable effects. In this context, looking ahead requires a careful, prudent analysis that takes into account a forecast of the effects of the policymaker’s measures. These requirements for good or optimal policymaking have not changed, nor become easier, since the time of Emile de Girardin. Therefore, given the fact that the AIFMD was passed amidst a crisis atmosphere, the challenges and threats associated with such crisis-induced regulatory rulemaking, which could affect the private equity industry for many years to come, warrant detailed analysis.

2. Regulation of Finance and Financial Investments

The term ‘regulation’ is not a term of art. It has acquired a bewildering variety of meanings,⁸¹¹ sometimes indicating different forms of behavioural control or, in the political context, the stifling effect on an industry. The legal concept of ‘regulation’ is often perceived as control or constraint. *Black’s Law Dictionary* defines ‘regulation’ as ‘the act or process of controlling by rule or restriction’⁸¹² and, somewhat similarly, *The Oxford English Dictionary* defines the term as ‘the action or fact of regulating,’ and ‘to regulate’ as ‘to control, govern, or direct.’⁸¹³ Perhaps unsurprisingly, seen from this angle, ‘control’ connotes commonly restrictions to many people,

⁸¹⁰ Marcel Lotscher & Patrick Bont, *Challenges from the Supervisor’s Perspective*, in THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS 71, 71 (Dirk Zetzsche ed., 2012).

⁸¹¹ BARRY M. MITNICK, THE POLITICAL ECONOMY OF REGULATION: CREATING, DESIGNING, AND REMOVING REGULATORY FORMS 1-20 (1980).

⁸¹² *Black’s Law Dictionary* 1311 (9th ed. 2009).

⁸¹³ *The Oxford English Dictionary* 524 (2d ed. 1989).

although regulation often enables, facilitates, or adjusts activities without imposing burdensome restrictions.⁸¹⁴ The central meaning of regulation, as described by one American social scientist, is a ‘sustained and focused control exercised by a public agency over activities that are valued by a community.’⁸¹⁵ Therefore, broadly defined, regulation organises and controls economic, political and social activities by making, implementing, monitoring and enforcing rules; and it has recently become increasingly global as regulation has migrated to international actors in areas such as finance.⁸¹⁶

The issue of whether or not to regulate financial markets and services is a heavily contested intellectual territory. Naturally, there are arguments for and against regulation, and these arguments vary depending on the timing and the broader environment surrounding the regulation itself as well as the industry to be affected. The basic economic rationale is based on the externalities, which are generated by financial activities but are not easily able to be addressed by private sector actors. It is not surprising that the definition of externalities and the nature and intensity of intervention are highly debatable and hence this leads to many differences of opinion on the extent of the regulatory rulemaking. There is always a risk that an overhaul of financial regulation will be deemed to have gone too far, to be too detailed and intrusive, with damaging consequences for a country’s economy; thus, it will have to be reined back at some point in the future.

Regulatory activity involves the creation of mandatory rules that must be observed and cannot be excluded by agreement between individuals. Thus, the operation of private ordering through contract is limited and the parties cannot avoid regulatory rules by contracting around them.⁸¹⁷ The rationale for statutory regulation in the sphere of financial investment is that commercial and contract law, which principally determine the rights of investors, do not provide an appropriate basis for the operation of investment markets due to information asymmetry and systemic risk. Therefore, statutory regulation is now broadly accepted, being directed at improving the operation of financial markets by establishing rules and procedures aimed at limiting the above shortcomings. Ironically, the recent financial crisis manifested itself acutely amongst highly regulated entities such as banks – thus, a sceptic might conclude that there is

⁸¹⁴ Barak Orbach, *What is Regulation?* (Yale Journal on Regulation, Mar. 11, 2013), <http://jreg.common.yale.edu/what-is-regulation>.

⁸¹⁵ P. Selznick, *Focusing Organisational Research on Regulation*, in *REGULATORY POLICY AND THE SOCIAL SCIENCES* 363 (Roger G. Noll ed., 1985).

⁸¹⁶ Walter Mattli & Ngaire Woods, *supra* note 804, at 1, 1.

⁸¹⁷ IAIN G. MACNEIL, *supra* note 334, at 19-20.

positive correlation between regulation and financial crisis, and a cynic might even see causation therein.⁸¹⁸

Each regulatory system must reflect the rationale for its creation.⁸¹⁹ No regulation at all might not be the right solution, even in countries where the essential elements of the legal framework, such as property and contract law that define ownership interests and rights in financial investments and their mode of transfer, are very well developed. The operation of an unregulated market may ultimately demonstrate that some form of regulation is necessary as unrestricted market entry may have damaging effects when dishonest individuals and/or entities are allowed to participate. Moreover, no regulation causes problems with regard to punishing fraudulent activity as criminal law might be less successful and appropriate to deal with conduct that is not expressly criminal, yet still damaging to the operation of financial markets. Another reason justifying regulation, or some form of it, refers to systemic risk, which connotes the risk of institutional failure that has a domino effect – a collapse of one financial institution leads to the collapse of other institutions, threatening the whole financial system. As noted by MacNeil (2012), this type of risk justifies only a ‘limited form’ of financial regulation, which concerns the financial resources of market participants.⁸²⁰ This is dealt with through prudential supervision that controls the insolvency and liquidity of participants in financial markets, such as private equity, by prescribing capital adequacy rules requiring sufficient regulatory capital to cover the risks arising from investment activities.

Regulatory systems differ around the world. There is a great regulatory biodiversity and the international regulatory system seems extremely complex and cumbersome, including ‘structures intersecting at many levels and locations.’⁸²¹ However, once the need for financial regulation is established, it is necessary to decide upon the form of regulation,⁸²² whether it be statutory regulation passed by government, one supplied by the market itself (self-regulation), or a hybrid of both. The first model is controlled by a regulator and provides a clear legal framework for the exercise of its powers. The choice can be between a single or multiple regulators. Self-regulation allies the debate regarding the mechanisms to be relied upon as an alternative to statutory regulation of financial services and markets. Self-regulation is argued

⁸¹⁸ Angus Duncan, Edmond Curtin & Marco Crosignani, *Alternative Regulation: Directive on Alternative Investment Fund Managers*, 6 C.M.L.J. 326, 329 (2011).

⁸¹⁹ ANTHONY I. OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY 1-12 (2004).

⁸²⁰ IAIN G. MACNEIL, *supra* note 334, at 30-31.

⁸²¹ HOWARD DAVIES & DAVID GREEN, *supra* note 409, at 214.

⁸²² ALAN C. PAGE & R.B. FERGUSON, INVESTOR PROTECTION 78-105 (1992).

by its proponents to be more flexible and market sensitive, easier to update as and when needed, less burdensome, and typically designed by individuals more familiar with the industry and market practices. There are, however, sceptics who invoke chequered experience with self-regulation in various countries, the risk that the system might evolve in a way to favour the narrow interests of market participants, and complexities in ensuring comprehensive coverage of regimes based on self-regulation. Moreover, self-regulation means different things in different countries and therefore takes different forms.⁸²³

Financial markets change rapidly and, as the recent crisis has shown, systems based on either self-regulation or statutory regulation have not proved nimble enough to respond quickly to changing, proliferating types of financial entities (hedge funds, private equity and other alternative forms of investment) and resulting financial activity. Unsurprisingly, a range of new phenomena require novel regulatory responses in view of the dramatic shift regarding the character and location of financial transactions. Although regulators seem to struggle to keep up, they should aim not to lag far behind and, being typically conservative, they should abandon the tendency to cling to outdated methods of working. The recent financial crisis has presented a new chance to challenge previous assumptions, ask questions regarding the role the financial system plays in the economy, consider a wide range of policy options,⁸²⁴ and eye industries that have previously enjoyed light touch regulation. Therefore, a good crisis should never go to waste and should be used to improve the operation of the financial markets.

2.1 Post-Crisis Reforms

Public opinion fluctuates in cycles and only some damaging incident or malfunction triggers public demands for tighter regulation and political imperative for reform, which is often not supported by genuine economic assessment. Perhaps unsurprisingly, following every financial crisis there are calls to ratchet up regulation and the pendulum is swinging violently, expanding the regulatory scale and scope with an intention to prevent as much as possible the recurrence of a previous financial crisis. The ebb and flow of this debate is evident, with more tightly regulated firms or industries thinking they are over-controlled, whilst politicians and policymakers thinking there is too much regulation avoidance, investor detriment and

⁸²³ We can distinguish pure self-regulation, self-regulatory organisations, self-regulation which is above a statutory regime and practitioner involvement in the development and creation of statutory regimes (for example, via consultation); HOWARD DAVIES & DAVID GREEN, *supra* note 409, at 211-212.

⁸²⁴ *Examining the Causes of the Financial Crisis* (Norton Rose Fulbright, Oct. 29, 2009), <https://www.lexology.com/library/detail.aspx?g=77f5ea81-bfd0-4d38-85cf-552a9d2cd925>.

unjustified personal enrichment of financial sector professionals. There is always a risk that post-crisis reforms, which stem from the interplay of legislators, policy advisers and also a degree of lobbying,⁸²⁵ will be far from ideal and have the potential to exacerbate the post-crisis situation.

Banner (1998)⁸²⁶ and Romano (2005)⁸²⁷ argued that the most significant financial regulation is adopted as a response to financial crises. These authors suggest that regulation moves to the top of the legislative and political agenda fuelled by a media clamour and shifts in national mood where the public expects government action to redress a particular problem.⁸²⁸ It is not surprising that politicians, who desire to be re-elected, will respond hastily without taking appropriate measures to ascertain whether the demands are really necessary and would actually resolve the problem. There is a theoretical and empirical political science literature buttressing the proposition that crisis-induced regulation is motivated by a political need to ‘do something’ in order to quash popular grievances, rather than addressing genuine risks in a proportionate manner.⁸²⁹ This illustrates a close connection between election outcome, an issue’s salience in the media and policy design and implementation. In the world of politics, action is always better than inaction, with the latter being positively reported in the media. Politicians act fast when greater deliberateness is called for and the media frenzy propels legislators to respond quickly to resolve problems, imagined or real,⁸³⁰ without being aware of the best solution in the given circumstances, without deep understanding of the causes of the crisis and with the paucity of information preventing the production of high-quality decisions. Consequently, new regulation may be off the mark, arbitrary and capricious. Politicians may also follow their own personal agenda, rather than making unbiased choices that would be in the interest of those affected and the public.

John C. Coffee (2012)⁸³¹ correctly observed that regulatory intensity never remains constant. According to him, a ‘regulatory sine curve’ governs the intensity of the oversight exercised by

⁸²⁵ Abel M. Mateus, *After the Crisis: Reforming Financial Regulation* (Nov. 12, 2009), <http://ssrn.com/abstract=1504895>.

⁸²⁶ STUART BANNER, *supra* note 807, at 257.

⁸²⁷ Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1591-94 (2005).

⁸²⁸ JOHN W. KINGDON, *AGENDA, ALTERNATIVES, AND PUBLIC POLICIES* 19-20 (updated 2d ed. 2011).

⁸²⁹ Ian Clarke, *supra* note 164; Roberta Romano, *Does the Sarbanes-Oxley Act Have a Future?*, 26 YALE J. on REG. 229, 255-57 (2009).

⁸³⁰ Roberta Romano, *Regulating in the Dark* 5 (Yale Law & Economics Research Paper No. 442, March 30, 2012), <http://ssrn.com/abstract=1974148>.

⁸³¹ John C. Coffee, *supra* note 808, at 301, 312.

financial regulators, which increases after a market crash and decreases as the crisis subsides and the market and society return to normalcy, given their leaky and selective memory. Therefore, the window of opportunity to effect regulatory changes quickly closes given a collective social amnesia and the public's short-lived passion for reform as soon as the crisis fades from headlines and memories. This is particularly so in relation to the financial regulation that is an intricate, opaque area. The public simply lacks the 'same visceral identification with the key values in play,' which explicates why the majority of people are less passionate and concerned about systemic risk – which is complex, impersonal and abstract – than civil rights or the environment.⁸³²

New, stricter regulation will not be the right solution, particularly if the reform is rushed before fully understanding the dynamics of turmoil.⁸³³ Paces (2010) posits that contrary to the widespread perception, regulation can also contribute to financial instability. He argues that post-crisis reforms are inspired by a common purpose, that is, an endeavour to fix the failures and shortcomings of financial regulation in the recent past, 'implicitly assuming that prohibiting or restricting those practices that led to the financial crisis will suffice to avoid the next one.'⁸³⁴ Political expediency dictates this particular approach, for it would be almost impossible to resist public pressure for a more vigorous, tighter and stricter regulation. The crisis-induced overhaul of financial regulation typically aims at closing regulatory lacunas highlighted by the crisis. However, as observed by Paces (2010), this looks like 'closing the barn after the horses have escaped.'⁸³⁵ With the lapse of time, as the crisis commences to recede and is *en route* to recovery, political pressure for regulatory reform begins to let down, loses its urgency and is replaced by new pressure to accommodate regulations to the needs of financial innovation.

In a similar fashion, Ferran (2012) argues that crisis situations can propel far-reaching changes, which may in turn have unintended adverse long-term consequences for the regulated parties and areas that could suffer spillover effects.⁸³⁶ Acting too quickly can lead lawmakers into error as the circumstances are characterised by uncertainty. The final outcome of a knee-jerk over-reaction may be a 'misplaced crude simplification of complex issues and faulty policy choices

⁸³² John C. Coffee, *supra* note 808, at 301, 312.

⁸³³ RICHARD H. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 117-47 & 252-58 (2009).

⁸³⁴ Alessio M. Paces, *Consequences of Uncertainty for Regulation: Law and Economics of the Financial Crisis* 2 (European Company and Financial Law Review, Oct. 31, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1700666.

⁸³⁵ *Id.*

⁸³⁶ Eilís Ferran, *supra* note 809, at 1, 2.

designed to pander populist sentiments.’⁸³⁷ Post-crisis environment is not conducive to reflective and careful considerations, but the general mood and hysteria enable popular, nevertheless flawed, ideas to take hold. In good times, such ideas would be screened out. Accordingly, the renowned scholar concludes that the chances for successful crisis-driven regulation are low and very slim indeed with regard to financial reform, mainly due to its complexity.

Speculative bubbles that precede market economic turmoil and market crashes take place for many reasons, such as irrational exuberance⁸³⁸ or excesses in monetary policies,⁸³⁹ and not all of them can be controlled via regulation. As interestingly suggested by Andrew W. Lo (2009), financial manias and panics cannot be legislated or regulated away, and may form an unfortunate but normal, unavoidable aspect of modern capitalism – a result of the interactions between hardwired human behaviour (such as greed, which inflates bubbles to unsustainable levels and fear, which inevitably causes the bubble to burst) and the unfettered ability to innovate, compete and evolve.⁸⁴⁰ In this sense, financial crises are the cost of progress brought about by human nature and the desire to innovate.

Indeed, many of the past financial crises reveal one common theme, that is, a prolonged period of financial liberalisation and prosperity before the crisis and a systematic under-estimation of the risk of loss and lower risk aversion caused by increasing wealth. In boom times, economic conditions produce optimism, which outstrips reality and subsequently causes bubbles. Then, market participants are ready to accept certain frauds that previously would have seemed implausible.⁸⁴¹ As noted by Walter Bagehot, ‘...people are most credulous when they are most happy; and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity.’⁸⁴² Professor Galbraith similarly observed that a feeling of trust is necessary for a boom. This is why embezzlement typically increases in good times when people are relaxed, confident, optimistic, and money is plentiful.⁸⁴³ This makes it hard to distinguish between the credible and the fraudulent. Moreover, individuals are susceptible to overconfidence, especially

⁸³⁷ *Id.* at 1, 3-4.

⁸³⁸ R.J. SHILLER, *THE SUBPRIME SOLUTION: HOW TODAY’S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT* (2008).

⁸³⁹ J.B. Taylor, *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong* (National Bureau of Economic Research Working Paper 14631, Jan. 2009), <http://www.nber.org/papers/w14631>.

⁸⁴⁰ Andrew W. Lo, *Regulatory Reform in the Wake of the Financial Crisis of 2007-2008*, 1 J.F.E.P. 4, 5 (2009).

⁸⁴¹ Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 80 (2003).

⁸⁴² WALTER BAGEHOT, *supra* note 807, at 158.

⁸⁴³ JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929* 133 & 169-70 (50th anniversary ed., 1979).

the successful ones,⁸⁴⁴ and the great commercial prosperity tends to be accompanied by over-speculation.⁸⁴⁵ This human behaviour, based on emotion rather than logic and rationality, finds support in compelling experimental evidence from cognitive neuroscientists that demonstrate that financial gains affect the same ‘pleasure centres’ of the brain, which are activated by some narcotics.⁸⁴⁶ This suggests that extended periods of economic growth and prosperity can ‘induce a collective sense of euphoria and complacency among investors that is not unlike the drug-induced stupor of a cocaine addict.’⁸⁴⁷ This human behaviour parallels, or maybe even offers a simpler explanation for, the boom/bust pattern, which may be a natural consequence of investor evolution and adaptation to a dynamic and complex economy.

This new perspective presents a new rationale for regulatory activity. Under normal market conditions, market forces yield economically efficient results and so regulatory intervention is unnecessary and frequently counter-productive. By contrast, prolonged periods of prosperity create atypical market conditions and market forces cannot be trusted in their ability to yield most desirable market outcomes – this motivates the need for regulatory reform. Tighter regulation commonly ensuing after the bust occurs when the forces which drove the boom and bubble shift into reverse and scepticism replaces optimism. However, the danger is that a crash-induced regulation will be ineffective, correcting the past bubble, whilst doing very little to preclude future threats and challenges, in particular as there is a large possibility that the frauds and causes of the next boom are unlikely to resemble those of the previous one.

Furthermore, it is conceivable that even the most insightful regulatory reforms of today will have shortcomings that will play an important part in a future crisis. This is buttressed by historical evidence on financial crises,⁸⁴⁸ demonstrating that it would be naive to imagine a regulatory change with a rock-solid effect extending far into the future. Reinhart and Rogoff (2009) highlighted the dangers of assuming omniscience and unmistakable regulatory foresight:

⁸⁴⁴ Donald C. Langevoort, *The Organisational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968, 974 (2002).

⁸⁴⁵ CHARLES MACKAY, *supra* note 807, at 88.

⁸⁴⁶ M. Delgado et al., *Tracking the Hemodynamic Response to Reward and Punishment in the Striatum*, 84 J. NEUROPHYSIOL. 3072 (2000); H. Breiter et al., *Functional Imaging of Neural Responses to Expectancy and Experience of Monetary Gains and Losses*, 30 NEURON 619 (2001); R. Montague & G. Berns, *Neural Economics and the Biological Substrates of Valuation*, 36 NEURON 265 (2002); W. Schultz, *Getting Formal with Dopamine and Reward*, 36 NEURON 241 (2002); and B. Knutson & R. Peterson, *Neurally Reconstructing Expected Utility*, 52 GAME. ECON. BEHAV. 305 (2005).

⁸⁴⁷ Andrew W. Lo, *supra* note 840, at 4, 20-21.

⁸⁴⁸ See CARMEN M. REINHART & KENNETH S. ROGOFF, *THIS TIME IS DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY* (2009); CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, *MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES* (6th ed., Palgrave Macmillan 2011); and BOB SWARUP, *MONEY MANIA: BOOMS, PANICS, AND BUSTS FROM ANCIENT ROME TO THE GREAT MELTDOWN* (2014).

‘one would be wise not to push too far the conceit that we are smarter than our predecessors. A few years back many people would have said that improvements in financial engineering had done much to tame the business cycle and limit the risk of financial contagion.’⁸⁴⁹ This appears to suggest that regulation is an evolving exercise that requires an element of trial and error. Therefore, post-crisis changes should not make matters worse but, based on current technical, specialist knowledge, try to minimise the risk of a new crisis occurring and to anticipate how to reduce the consequences of potential future failures, so that economically worthwhile industries, such as private equity, are not handicapped with unnecessary burdens and costs.

2.2 Bubble Laws: SOX and Dodd-Frank

Both the EU and the US have recently undergone a fundamental regulatory overhaul in response to the 2007 financial crisis. In Europe, the EU Commission has taken the initiative, whilst across the Atlantic it has been Congress that has been tackling vernacular shortcomings emphasised by the crisis.⁸⁵⁰ Crises exemplify a boom-bubble-bust-regulate cycle and so past experience can provide fertile grounds for further analysis. The distinctive regulatory pattern reveals the nature and adequacy of laws produced in a crisis environment. In particular, parallels can be drawn with the legislative activity in the US in the early 2000s in relation to spectacular crashes and frauds regarding once highly regarded companies. This propelled Congress to hastily enact the Public Company Accounting Reform and Investor Protection Act 2002⁸⁵¹ (popularly known as the Sarbanes-Oxley Act, SOX) in order to address corporate malfeasance.

SOX engendered an immediate cascade of criticism.⁸⁵² It was adopted amidst a tanking stock market, less than one year after the Enron corporate accounting scandal. It was subsequently criticised, in the most outspoken and doctrinaire fashion, by famous Professor Roberta Romano (2005)⁸⁵³ who argued that SOX was ill-conceived and adopted without recourse to existing empirical studies and therefore represented an inefficient tool to calm the media frenzy. It imposed significant compliance costs, especially for smaller firms, and more than doubled the cost of being public. The new costs were deemed to be considerable and had a deleterious effect

⁸⁴⁹ C.M. Reinhart & K.S. Rogoff, *The Aftermath of Financial Crises*, 99 AM. ECON. REV. 466, 472 (2009).

⁸⁵⁰ Karel Lannoo, *Comparing EU and US Responses to the Financial Crisis* (ECMI Policy Brief No. 14, Jan. 7, 2010), <https://www.ceps.eu/ceps-publications/comparing-eu-and-us-responses-financial-crisis/>.

⁸⁵¹ The Public Company Accounting Reform and Investor Protection Act 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28, 29 U.S.C.).

⁸⁵² J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes Oxley and Quack Corporate Governance*, 90(2) MARQ. L. REV. 309, 310 (2006).

⁸⁵³ Roberta Romano, *supra* note 827.

on the economy and the capital markets. Specifically, the going private movement was increasing,⁸⁵⁴ very few start-ups were deciding to go public and foreign firms were discouraged from listing in the US.⁸⁵⁵ Professor Romano argued that the substantial harm and hardship caused was due to legislating in haste in a post-crash frantic political environment. The scholar's critique enjoyed substantial company including professors Clark (2005),⁸⁵⁶ Ribstein (2004; 2005),⁸⁵⁷ Butler (2006)⁸⁵⁸ and Bainbridge (2006),⁸⁵⁹ amongst others, to the extent that '[t]he voices of those that persist[ed] in the opinion that SOX [was] beneficial to the U.S. market [were] few and far between.'⁸⁶⁰

SOX was adopted in a rush, in a messy political process. The critique of the legislative process revolving around SOX can be compared to what Otto von Bismarck supposedly once said, namely, '[i]f you like law and sausages, you should never watch either one being made.'⁸⁶¹ Ideally, all legislation would invariably be passed after careful consultation and study of academic/empirical literature, avoiding media influences and business lobbyists; unfortunately, reality is different.⁸⁶² Whilst speed caused problems regarding SOX, it must be noted that emergency situations require emergency legislation.⁸⁶³ This confirms that any crisis-induced reform should be subject to later review and fine-tuning.⁸⁶⁴

⁸⁵⁴ For instance, see Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCOUNT. ECON. 181 (2008); Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCOUNT. ECON. 116 (2007); and Stanley B. Block, *The Latest Movement To Going Private: An Empirical Study*, 14 J. APPL. FIN. 36 (2004).

⁸⁵⁵ Roberta Romano, *supra* note 829, at 229, 253-54.

⁸⁵⁶ Robert C. Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too* 2 (Harvard Law and Economics Discussion Paper No. 525, Dec. 5, 2005), <http://ssrn.com/abstract=808244>.

⁸⁵⁷ Larry E. Ribstein, *Sarbox: The Road to Nirvana*, 2004 MICH. ST. L. REV. 279, 293 (2004); Larry Ribstein, *Sarbanes-Oxley After Three Years* (Illinois Law and Economics Working Paper No. LE05-016, June 20, 2005), <http://ssrn.com/abstract=746884>.

⁸⁵⁸ HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT* (2006).

⁸⁵⁹ Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure* (UCLA School of Law, Law-Econ Research Paper No. 06-14, 2006), <http://ssrn.com/abstract=899593> (concluding that the Act 'sacrificed the American economy at the altar of short-term political gain').

⁸⁶⁰ Gregory Carl Leon, *Stigmata: The Stain of Sarbanes-Oxley on U.S. Capital Markets* (GWU Law School Public Law Research Paper No. 224, Nov. 8, 2006), <http://ssrn.com/abstract=921394>.

⁸⁶¹ RESPECTFULLY QUOTED: A DICTIONARY OF QUOTATIONS 190 (Suzy Platt ed., 1992).

⁸⁶² Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?* 62 (Georgetown Law Journal, 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=945796.

⁸⁶³ *Id.*

⁸⁶⁴ See ALAN GREENSPAN, *THE AGE OF TURBULENCE* (2007).

SOX created novel federal monitoring devices and penalties⁸⁶⁵ in order to ensure that similar corporate frauds and scandals would not happen again.⁸⁶⁶ Whether regulation created in a periodic emergency situation influenced by media frenzy, investor outcry and political pressure can prevent such things from recurring is a moot point. Ribstein (2003)⁸⁶⁷ argued that the scandals represent the latest turn in a ‘centuries-old boom-bubble-bust-regulate cycle of financial market regulation.’ This means that the unwarranted trust in markets during a boom leads to the speculative frenzy of a bubble, followed by the unavoidable bust which in turn leads to the disclosure of corporate fraud and a regulatory frenzy motivated by panic and populist antipathy to entrepreneurs and the envy of the rich.⁸⁶⁸ This context prevents a careful balancing of the costs and benefits of regulation, with policymakers reacting to past mistakes, rather than trying to prevent future ones. In the worst case scenario, such post-bust regulation may even impede risk-taking, market flexibility and innovation that could otherwise bring the next boom.⁸⁶⁹ From a normative point of view, crisis-induced regulation is likely to be flawed as the crash environment prevents both careful discovery of causes and cures as well as a full and conscientious evaluation of costs and benefits of regulation. Further, more attention tends to be placed on punishing the guilty, rather than preventing future crises.

Whilst SOX was famously described by Yale law professor Roberta Romano as ‘quack corporate governance,’⁸⁷⁰ a few years later Stephen Bainbridge⁸⁷¹ argued that the same sobriquet should equally apply to the corporate governance provisions found in the Dodd-Frank Act 2010⁸⁷² – a mammoth piece of legislation formulated in response to the 2007 financial crisis in order to reform Wall Street, reinvigorate financial regulation and reduce systemic risk. The scholar posited that the quack (corporate governance) regulation was a result of a number of attributes: it was a bubble act enacted in response to a major negative economic event; it was passed in a crisis environment; it responded to a populist backlash against big companies and/or

⁸⁶⁵ Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1 (2002).

⁸⁶⁶ Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 Hous. L. Rev. 1 (2003).

⁸⁶⁷ Larry E. Ribstein, *supra* note 841, at 77, 80.

⁸⁶⁸ HELMUT SCHOECK: A THEORY OF SOCIAL BEHAVIOUR (Michael Glenney & Betty Ross trans., 1969); Mark J. Roe, *Backlash*, 98 COLUM. L. REV. 217 (1998).

⁸⁶⁹ Larry E. Ribstein, *supra* note 841, at 77, 78.

⁸⁷⁰ Roberta Romano, *supra* note 827.

⁸⁷¹ Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II* (UCLA School of Law, Law-Econ Research Paper No. 10-12, Sept. 7, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1673575.

⁸⁷² The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 401-419, 124 Stat. 1376, 1570-80 (2010) (codified in scattered sections of the U.S.C.).

markets; and it was based on mixed empirical evidence to support its benefits.⁸⁷³ This appears to confirm that SOX was not a one-off event, but rather a fairly standard outcome of the aforesaid boom-bubble-bust-regulate cycle. This is a recurring phenomenon and the pattern can be traced back at least to the late 1600s England where new regulation tended to crystallise immediately after market turmoil.⁸⁷⁴ Therefore unsurprisingly, the recent economic reversal led to populist outrage which in turn propelled the enactment of the Dodd-Frank Act. New regulation was unavoidable given an upswing in public anger and deep-seated suspicion of speculation and markets as well as intense public pressure for action, leaving little room for reflective deliberation in the regulatory expansion process. Therefore, Dodd-Frank is merely the latest iteration of the rushed regulatory process, involving bubble laws adopted in a crisis environment that have real consequences on economy, capital markets and industries.

2.3 Lessons from the Past

Foundational financial legislation tends to be created and adopted in a crisis environment, hugely increasing the regulatory scope and scale for the affected firms and financial institutions. This begs the question whether we should really regulate during the financial crisis. This dilemma is not readily answerable because the issues implicated are quite complex, if not intractable, and whilst regulators are trying to prepare for future challenges, they inevitably fight the previous disaster.

In her recent paper, Roberta Romano (2012),⁸⁷⁵ in line with other scholars, posited that regulation is more challenging amidst a crisis atmosphere and crisis responses are often misguided and more prone to legislative failure as evidenced by her review of SOX, Dodd-Frank and Basel capital accords. According to the scholar, the essence of the crisis-induced regulatory dilemma stems from a few factors: (i) policymakers may lack the requisite expertise to comprehend technically complicated financial markets and products; (ii) there is dearth of information regarding the causes of the crisis; and (iii) financial markets operate in a very dynamic, fluid, fast-paced and complex environment, which is awash with ‘unknowns and unknowables’ and where standard knowledge quickly becomes obsolete. Accordingly, regulators operate under substantial uncertainty and even the most researched and informed regulatory response is likely to be prone to error, thereby producing backward-looking

⁸⁷³ Stephen M. Bainbridge, *supra* note 871.

⁸⁷⁴ STUART BANNER, *supra* note 807, at 9.

⁸⁷⁵ Roberta Romano, *supra* note 830.

regulatory rules that take ‘aim at yesterday’s perceived problem, rather than tomorrow’s.’⁸⁷⁶ Therefore, it is crucially important for the legislators to act with their best intentions so they do not make matters worse in a crisis, especially in view of the fragility of financial markets and financial institutions and their centrality to the economic growth and societal well-being.

Romano invoked SOX as a paradigm of legislative failure, profoundly mistaken and imposing considerable costs on firms,⁸⁷⁷ which after the recent financial crisis, looks like a museum piece. Why does crisis-based financial regulation appear not to work? Romano tried to answer this by referring to a function of dynamic uncertainty in financial markets. The term ‘dynamic uncertainty’ is used in the literature on terrorism⁸⁷⁸ to distinguish between terrorist risk and natural disasters. In both cases, the crystallisation of risk is highly uncertain; however, terrorists adapt their behaviour and strategy as a function of their own resources and knowledge of the target’s vulnerability. The likelihood and success of terrorist acts will depend on a mix of strategies and counterstrategies adopted by a number of stakeholders. This reveals the constantly evolving nature of the risk – it changes over time, and hence leads to dynamic uncertainty.⁸⁷⁹ Accordingly, in the context of financial markets, the ‘action of the regulated in response to regulation alters risk in unanticipated ways that evolve nonlinearly, rendering it extremely difficult to predict the impact of regulation over time.’⁸⁸⁰ Therefore, it is highly improbable to prescribe rules to reduce systemic risk or predict what category of firms or activities might generate this type of risk in the future. The reason is that once regulatory rules are created, even if they seem adequate when initiated, they can quickly become inadequate or even irrelevant as business, legal and technological conditions of a financial system change.

According to Romano, sunseting could improve the quality of crisis-induced financial regulation and mitigate the effect of regulatory failure. Specifically, a sunset clause stipulates that regulation expires on a specified date unless it is reviewed and reconsidered within a fixed period after coming into effect. It is a time-honoured legislative tool in the US, which is well

⁸⁷⁶ *Id.*

⁸⁷⁷ Anwer S. Ahmed et al., *How Costly is the Sarbanes-Oxley Act? Evidence on the Effects of the Act on Corporate Profitability*, 16 J. CORP. FINANCE 352 (2010); Leonce Bargerion et al., *Sarbanes-Oxley and Corporate Risk-Taking*, 49 J. ACCOUNT. ECON. 34 (2009); Roberta Romano, *supra* note 829, at 229, 253-54.

⁸⁷⁸ Erwann Michel-Kerjan, *Report No. 3: Financial Protection of Critical Infrastructure – Uncertainty, Insurability and Terrorism Risk* (June 2005), <http://www.institut.veolia.org/en/cahiers/protection-insurability-terrorism/terrorism-insurability/terrorism-uncertainty.aspx>; Erwann Michel-Kerjan, *Terrorisme A Grande Echelle: Partage de Risque et Politiques Publiques* (113 Revue d’Economie Politique 625, May 2004) (Fr.), <http://hal.archives-ouvertes.fr/docs/00/24/29/18/PDF/2004-11-29-175.pdf>.

⁸⁷⁹ OECD, *TERRORISM RISK INSURANCE IN OECD COUNTRIES* 120 (2005).

⁸⁸⁰ Roberta Romano, *supra* note 830, at 11.

suited to crisis-driven regulatory changes, for it alleviates the predicament of imposing new rules at short notice, with minimal information and without detailed analysis. As a consequence, by the time of a regulation's sunset review, regulators are forced to look afresh at the need for the particular regulation and make appropriate changes, having a much more comprehensive understanding of the financial crisis that the regulatory change initially sought to address. This will include knowledge of the regulation's consequences, both those intended and unintended ones, which is indispensable for getting financial regulation right. Thus, with the benefit of hindsight, sunseting permits a more clear-eyed assessment of the crisis-induced regulation, taking into account any legal, economic and technological changes that may have occurred in the interim. This procedural mechanism is believed to better calibrate the regulatory apparatus, thereby mitigating the unintended errors that typically accompany crisis-induced financial rulemaking, since a rolling review encourages the weeding-out of regulatory provisions that are no longer justified.

3. Systemic Risk and the Impact of Private Equity on Financial Stability

In view of the prominent rise of private equity in Europe, it is important to examine whether the industry, despite a very successful track record, could possibly threaten the stability of the European financial markets and have a negative or even destructive effect on the economy as a whole. The recent global financial crisis has put the spotlight on systemic risk, resulting in widespread political support for its regulation. Systemic risk created by hedge funds was central to the proposal for the AIFMD⁸⁸¹ but it is not entirely clear how private equity may have contributed to the origination, amplification or spread of systemic risk.

The term 'systemic risk' has come into common usage, although it is still an amorphous concept that has successfully resisted formal, objective, universal and widely accepted definition and quantification.⁸⁸² Yet, despite the lack of consensus definition, systemic risk captures the risk to the stability of the financial system *as a whole*, as opposed to individual financial institutions, and this typically involves a broad-based breakdown caused by a single event with extreme and often catastrophic impact. This localised adverse shock can be of very low probability, rare but

⁸⁸¹ '...the abrupt unwinding of large, leveraged positions by hedge funds in response to tightening credit conditions and investor redemption requests has had a procyclical impact on declining markets and may have impaired market liquidity;' *Executive Summary of Impact Assessment 3* (EU Commission Staff Working Document, Apr. 30, 2009), <https://www.kpmgregulatorylibrary.lu/Regulation?gridDocument-sort=Name-asc>.

⁸⁸² Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008); Andrew W. Lo, *supra* note 840, at 4, 9; Lorian Pelizzon, *Global Financial Turmoil: Does Connectedness Matter?* (SAFE NEWSLETTER, Quarter 1, 2014), at 6.

nevertheless retrospectively predictable,⁸⁸³ managing to produce systemic consequences throughout the financial system. Therefore, the instability or failure of one financial institution, referred to as being too big or interconnected to fail, has the potential to disrupt the entire financial system, as the solvency of a financial institution may be threatened by the collapse of another financial entity to which it is linked.⁸⁸⁴ In this context, systemic risk is amplified by interlinkages and interdependencies in a system where the failure of a single entity can cause cascading failures.⁸⁸⁵ There are several factors that trigger systemic risk. They include but are not limited to: (i) the impact an entity's failure would have on the financial system and economy; (ii) the entity's size, leverage and reliance on short-term funding; and (iii) the entity's criticality as a source of credit.⁸⁸⁶

In the PE sector, funds have the potential to gain systemic importance by means of their size, interconnectedness and non-substitutability. However, private equity appears to be unlikely to pose a systemic risk. In relation to scale, even the largest firms in a given segment do not account for a dominant part of the market, indicating that a failure of the most significant GP would not materially impact the real economy – for instance, the largest PE firms manage as much as \$100 billion in private equity assets (The Blackstone Group, the Carlyle Group, KKR); by comparison, the largest asset managers of open-ended funds – regulated by MiFID (now MiFID II), can have €2-4 trillion in AUM.⁸⁸⁷

There are also other arguments indicating that there are no links between private equity and systemic risk.⁸⁸⁸ (i) whilst PE AIFs are typically not leveraged, leverage is indeed used at portfolio company level to fund a change in ownership, however this debt reduces over time and has a disciplining effect on management who adopt a hand-on approach to repay it; (ii) the purpose of most buyout funds is to commit capital for a number of years in order to create value; (iii) there are no significant financial links between PE fund managers (except for co-investments in portfolio companies) – investments are made across the country(-ies) and are

⁸⁸³ So-called “grey swans” as contrasted with “black swans” that are unforeseeable and cannot be identified *ex ante*; NASSIM NICHOLAS TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* 37 (2007). See also Peter Guy, *Trying to Regulate ‘Black Swan’ Events* (Regulation Asia, Oct. 5, 2015), <http://www.regulationasia.com/article/trying-regulate-black-swan-events>.

⁸⁸⁴ IAIN G. MACNEIL, *supra* note 334, at 20.

⁸⁸⁵ UK PARLIAMENT: HOUSE OF LORDS: EUROPEAN UNION COMMITTEE, *DIRECTIVE ON ALTERNATIVE INVESTMENT FUND MANAGERS VOLUME I REPORT*, *supra* note 541, at 18.

⁸⁸⁶ For more details, see, e.g., Darryll Hendricks et al., *Systemic Risk and the Financial System: Background Paper* (NAS-FRBNY Conference on New Directions, May 2006), <https://www.newyorkfed.org/medialibrary/media/newsevents/events/research/2006/0518-background.pdf>.

⁸⁸⁷ *Evaluation of the Alternative Investment Fund Managers Directive*, *supra* note 3, at 67.

⁸⁸⁸ *Id.* at 67-69 & 84; *Systemic Risk*, *supra* note 886.

not intertwined with other financial market participants via counterparty exposures, prime broker relations or derivatives positions; (iv) fund investments are not cross-collateralised and are typically diversified across numerous industries (that is, due to lacking concentrated exposure to any single sector, PE investments are protected one from another, and a single poorly performing investment is very unlikely to have knock-on effects on the fund or other portfolio companies); and (v) investors are tied into long-term commitments, which prevents the bank-run scenario.

There are dissenting views, as well. For example, Acharya, Franks and Servaes (2007) argued that due to the nature of LBO debt financing, even a small shock to the solvency of firms that underwent an LBO can lead to a systematic liquidity crisis. The authors claimed that a large portion of debt – which is principally covenant light – is syndicated and sold off to other banks and financial institutions, such as hedge funds, through structured products (such as collateralised loan obligations), which enable to parcel debt for risk-transfer purposes. This brings about a number of dangers and worrisome consequences. First, syndicated lenders have weaker incentive to properly monitor the borrowers and they are more interested in lending in order to generate greater fee income. The second problem relates to transparency as debt is freely traded and no one can know who has the exposure and therefore who will ultimately bear potential losses. Third, when a financial entity invests its assets in securities that give exposure to extremely high risks of defaults in exchange for extremely high yields, a small fraction of large LBO defaults could result in substantial losses and thus imperil the financial entity. Accordingly, a shock, even a small one, to the LBO market could potentially cause repercussions in global financial markets. Moreover, EU Commission's *Impact Assessment* (2009) observed that adverse market conditions severely affect the sector, providing evidence that AIFMs exacerbate market dynamics. This is due to pro-cyclical behaviour which can undermine financial stability and even contribute to the deepening of the crisis (macro-prudential risk) and failings in risk management and due diligence across the financial system (micro-prudential risks).⁸⁸⁹ What needs to be stressed, however, is that these risks apply particularly to hedge funds, not private equity, although private equity's returns might backfire due to tightened credit conditions and the deteriorating health of portfolio companies, leading to detrimental effects in the real economy.

⁸⁸⁹ *Impact Assessment*, *supra* note 345, at 8-9.

The foregoing arguments touch upon another issue, namely, the high level of leverage commonly employed on buyouts, which could increase the occurrence of defaults, restructurings and formal bankruptcies, especially in time of economic recession. The use of leverage at portfolio company level is a defining feature of PE, and the level of debt tends to be high due to the need to fund a change in ownership. The use of debt at the portfolio company level, its amount and maturity profile, might have implications for the fragility of the corporate sector and thus the resilience of the entire financial system. However, there is evidence that default rates are lower in PE-backed companies relative to non-PE-backed firms.⁸⁹⁰ A recent study by Borell and Tykvova (2012)⁸⁹¹ analysed, amongst other things, whether European buyout companies go bankrupt more frequently than comparable non-buyout companies. The authors found that the former do not trigger excessive financial distress or suffer from higher mortality/bankruptcy rates, unless they are backed by inexperienced buyout funds or involve smaller firms. In the same vein, David Gregory reported in the 2013 *Bank of England Quarterly Bulletin* that there is no clear evidence of a higher default rate amongst companies owned by private equity firms in the UK.⁸⁹²

Therefore, it is doubtful whether private equity was a culpable actor in the crisis. The industry's ascent has been argued as having significant systemic effects on the financial system, but evidence does not appear to corroborate this claim. For instance, Mckinsey Global Institute argued that the high level of leverage in the economy was effectively a result of government, households and commercial real estate borrowing, and was not materially exacerbated by the activities of private equity firms.⁸⁹³ It is also important to note that LBO exposure represents less than 1 per cent of the total size of the balance sheet of two-thirds of EU banks surveyed by the ECB. This shows no support for the argument that exposure to LBO lending could pose risk to the European banking or financial system.⁸⁹⁴ Thus, despite exponential increases in leverage levels along with the volume and size of large and mega buyouts, the leverage in the private equity sector has not reached the size nor the characteristics, which could potentially lead to a

⁸⁹⁰ Jason Thomas, *The Credit Performance of Private Equity-Backed Companies in the 'Great Recession' of 2008–2009* (George Washington University – Department of Finance, March 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1582666.

⁸⁹¹ M. Borell & T. Tykvova, *Do Private Equity Investors Trigger Financial Distress in Their Portfolio Companies?*, 18(1) J. CORP. FINANCE 138 (2012). The study examined all buyout transactions from 15 countries in the period 2000–2008.

⁸⁹² David Gregory, *supra* note 374, at 46.

⁸⁹³ Reported in Lawale Nicholas Ladapo, *Private Equity in a Deleveraged Economy: Lessons from the Financial Crisis* 12 (Harvard Law School Working Papers Series, May 18, 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1610087.

⁸⁹⁴ *Monthly Bulletin* 08/2007 93 (ECB, Aug. 2007), <http://www.ecb.europa.eu/pub/pdf/mobu/mb200708en.pdf>.

negative spillover to the financial system and economy in Europe. Even if an LBO fails, fund investors incur lower returns on their overall investment and fund managers can lose some of their own money. It is the portfolio company that suffers the largest consequences, but there was no major default from any PE-backed company in the period leading up to the crisis. Moreover, in view of the diverse nature of PE investments in various sectors, there are no systemic consequences for the economy since it is highly unlikely that a string of company defaults and bankruptcies would occur at the same time. Further, Limited Partners are locked in for a long time with no redemption opportunities, which means that they are prevented from something analogous to a bank run on the private equity fund. Thus, the systemic failure risk in the industry is basically non-existent. Private equity could not have direct culpability in the cause of the 2007 financial crisis⁸⁹⁵ and is quite unlikely to be a cause of the future one.

Gottschalg's 2007 study⁸⁹⁶ examined the impact of private equity on financial stability through analysing five historic financial crises⁸⁹⁷ with consequences for the worldwide economy and trying to find a link between the activities of private equity and changes in key economic indicators across 12 countries.⁸⁹⁸ The author did not find any evidence to support the hypothesis that PE activity influences the sensitivity of local stock market valuations to international crisis situations in any statistically significant fashion as measured by the bivariate correlation analyses between percentage of PE activity and the change in interest rates, GDP growth and unemployment one year before and after the crisis event. Thus, risks related to the industry's activities are quite unlikely to trigger a major shock to the financial system as PE activity is too low to exert a substantial impact on economic stability.

Therefore, rather than regulating the private equity business, one could argue that regulating the banking sector (the sell side of PE transactions) and its lending strategies and incentives could be a better solution. Change could include imposing controls on the banks' incentives to offer leverage in ways that foster unstable liquidity, banning covenant-lite lending, tightening

⁸⁹⁵ Somewhat controversially, Kosman (2010) argued that the industry has the potential to cause the next credit crisis. The author based his proposition on the 2008 BCG report which suggested that 50 per cent of PE-owned companies could possibly default on their debt by the end of 2011 (this did not happen); see JOSH KOSMAN, *THE BUYOUT OF AMERICA: HOW PRIVATE EQUITY IS DESTROYING JOBS AND KILLING THE AMERICAN ECONOMY* (2010). See also *Get Ready for the Private Equity Shakeout: Will This be the Next Shock to the Global Economy?* 3-4 (BCG Consulting Group, Dec. 2008), <https://media.iese.edu/research/pdfs/ESTUDIO-91.pdf>.

⁸⁹⁶ Oliver Gottschalg, *supra* note 54, at 41-42.

⁸⁹⁷ Junk Bond Market of 1989, Mexican Crisis of 1994, Asian Crisis of 1997, Russian Crisis of 1998 and 9/11 of 2001.

⁸⁹⁸ Australia, Canada, Finland, France, Germany, Hong Kong, Mexico, Netherlands, Singapore, Spain, UK and US.

the regulation of securitisation and originate and distribute strategies, creating regulation that would decouple bonuses of the bankers from the volume of lending they undertake, and increasing transparency as to who actually holds the debt.⁸⁹⁹

Private equity professionals unsurprisingly assert that buyouts do not create systemic risk.⁹⁰⁰ Both in the EU and US managers of private equity firms have now to register with their respective regulators, subjecting themselves to a bevy of new standards. This causes consternation amongst PE professionals as they invest in companies, not exotic securities, and their investments are for a long term. The debt incurred in LBOs is too insignificant to present a systemic risk – it was the leverage and rapid-trading strategies primarily housed in hedge funds that have been a significant part of the problem. Moreover, it would be neither feasible nor desirable to attempt to eliminate all risk which is an unavoidable by-product of financial innovation – an inherent aspect of financing in buyouts. This illustrates that the EU Commission did not have a clear comprehension of the true causes of the 2007 crisis at the time of crafting new regulations and hence incorrectly wrapped everyone into the same regulatory net. Further, one must remember that financial markets are integrated on a global scale and so it is impossible to insulate the EU from externalities deriving from the refusal of other jurisdictions, such as the US which is home to the largest and most influential segment of the AIF industry, to adopt equivalent restrictions, for instance, leverage constraints. Risk contagion is not impeded by geopolitical boundaries and so the EU bears all of the costs of attempting to address systemic risks without the cooperation of other jurisdictions.

Eichengreen and Bordo (2002)⁹⁰¹ argued that compared to pre-1914 era of financial globalisation crises are twice as prevalent today. This indicates that the incidence of financial crises has been increasing as financial markets have become more liberalised and international. This has led to the traditional argument regarding systemic risk, justifying regulation which aims at maintaining or promoting financial stability and market discipline, as financial market

⁸⁹⁹ After originating much of the debt, banks often sell significant portions of it to other, often unregulated, institutions. This demonstrates the transparency deficit; see Ulf Axelson et al., *Leverage and Pricing in Buyouts: An Empirical Analysis* (Swedish Institute for Financial Research Conference on the Economics of the Private Equity Market, Aug. 2007), <http://ssrn.com/abstract=1027127>. See also Anil Shivdasani & Yihui Wang, *Did Structured Credit Fuel the LBO Boom?*, 66 J. FINANCE 1291-1328 (2011) (explaining that structured credit markets altered banks' access to capital which in turn affected their lending policies and at least partially fuelled the recent LBO boom).

⁹⁰⁰ Doug Halonen, *Systemic Risk? Not Us, Say Private Equity Firms* (PENSIONS & INVESTMENTS, Apr. 6, 2009), <http://www.pionline.com/article/20090406/PRINT/304069980>.

⁹⁰¹ Barry Eichengreen & Michael Bordo, *Crises Now and Then: What Lessons from the Last Era of Financial Globalization?* (National Bureau of Economic Research Working Paper No. 8716, Jan. 2002), <http://www.nber.org/papers/w8716>.

participants themselves have repeatedly shown their inability or unwillingness to safeguard the stability of the financial system. Thus, regulation has an important role to play in managing systemic risk. However, for it to work effectively, it must be designed in the context of systemic risk transmission and other factors that justify intervention.⁹⁰²

4. Conclusion

From a global historical perspective, the 2007 crisis is not unique or unprecedented as crises occur with some regularity. The past 40 years witnessed several financial crises, such as the Latin American debt crisis of the early 1980s, the Nordic banking crisis of the early 1990s and the Asian crisis of 1997-8.⁹⁰³ The 2007 crisis was on a different, much larger scale, though. It was a worldwide systemic crisis that threatened the existence of some of the largest financial entities and did devastating damage to much of the global economy, leaving deep scars behind. However, its magnitude should not be unexpected and surprising given the great financial liberalisation of the past decade. It goes without doubt that the crisis has dealt a blow to Anglo-American capitalism, which traditionally has featured highly deregulated markets.⁹⁰⁴ The UK approach of light touch regulation has been discredited, thereby paving the way for a more stability-orientated, and unsurprisingly less market-friendly, approach reflecting a more intrusive regulatory style preferred by Italy, France and, to some extent, Germany in Europe.⁹⁰⁵

Financial reform is characterised by a recurring debate between its proponents, who believe tighter regulation is necessary to restrain systemic risk and its opponents, who distrust regulation and the legislative process which is costly and leads to economic stagnation. Professor Romano falls within the latter category, believing that markets need little regulation – accordingly, regulatory interventions should be short-lived, ‘disappearing like snowflakes in the sun.’⁹⁰⁶ By contrast, it could be argued that the costs associated with market bubbles and crashes that follow them dwarf those of regulation. Even if regulation transpires to be foolish

⁹⁰² Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework* 4 (UCLA School of Law, Law-Econ Research Paper No. 11-01, Oct. 21, 2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1735025.

⁹⁰³ WILLIAM A. ALLEN, *INTERNATIONAL LIQUIDITY AND THE FINANCIAL CRISIS* 1 (2013).

⁹⁰⁴ Eilis Ferran, *supra* note 809, at 1, 29.

⁹⁰⁵ Lucia Quaglia, *The ‘Old’ and ‘New’ Politics of Financial Services Regulation in the EU*, 17(4) N. POL. ECON. 515 (2012); J. Schild, *Mission Impossible? The Potential for Franco-German Leadership in the Enlarged EU*, 48 J.C.M.S. 1367, 1381-82 (2010).

⁹⁰⁶ John C. Coffee, *supra* note 808, at 301, 304-7.

and overboard, it can be changed at a later date. Therefore, the argument goes that it would be more disadvantageous to allow the forces of inertia to block or veto all regulatory change.⁹⁰⁷

However, as evidenced in this chapter, the crisis atmosphere might not be most appropriate for thoughtful policymaking, as the high salience of events forestalls an impartial, careful and balanced consideration of the most relevant issues, potentially leading to panic regulation that has a bigger chance of stifling entrepreneurial activity by imposing burdens on the most innovative firms rather than deterring future fraud and speculation. Therefore, regulatory surge in the midst or aftermath of a crisis may not be the best solution. Regulators should resist the temptation to react to market events in a manner that is too hasty and devoid of conscientious and thorough deliberations, whilst crafting foundational regulations for the financial system in the 21st century. It can be argued that financial markets do not need more regulation, but regulation that is smarter, more effective and adaptive.

This chapter demonstrates that regulating financial institutions effectively is challenging, in both good and bad times, and even seemingly optimal regulatory policies might become mistakes as new, unpredictable risks materialise. Given that financial entities operate in a dynamic, changing environment awash with considerable uncertainty, even legislation adopted under the best circumstances may have perverse unintended consequences. The regulators play a game of cat and mouse with financial firms and, whilst it may appear that a pre-emptive catch-all regulation may aid them in this chase, it may also result in the inefficiency of the regime that is established.⁹⁰⁸ Therefore, there is a risk that crisis-induced responses, like the AIFMD, may result in either bubble laws that crudely overregulate or new regulatory rules which quickly become inappropriate or irrelevant.

⁹⁰⁷ *Id.* at 301, 307.

⁹⁰⁸ Ian Clarke, *The Regulation of Private Equity and the Alternative Investment Fund Managers Directive – Part III* (INT’L CORP. RESCUE, 2013), <http://www.chasecambria.com/site/journal/article.php?id=752>.

Chapter IX

Conclusion

Private equity is an important part of the economy, providing finance and good corporate governance for the efficient revitalisation of underperforming companies. The industry also represents a vibrant component of the market for corporate control, essential to the efficient operation of public companies.⁹⁰⁹ In the 1980s, it helped break up badly run conglomerates in the US by taking neglected non-core businesses off their hands, improving their deficiencies and loss-making segments, and then selling them off to more suitable owners. As put forward by Jensen (2006), ‘...the structure and conventions of private equity have provided US capital markets with a way to recreate old-fashioned active investing...In the process, private equity firms have invented – or perhaps ‘rediscovered’... – a better way to run a group of different businesses...The result has been enormous increases in corporate efficiency and value.’⁹¹⁰ This model was successfully replicated in Europe where inefficient conglomerates and public companies were rife, facilitating the industry’s ascent from the outer fringe to the centre of the capitalist system.

Although private equity had rarely sought the limelight, its sheer clout attracted attention, if not controversy, as many commentators and critics concentrated far more on the ‘private’ than the ‘equity’ side of the industry. The general absence of *bone fide* regulatory oversight and growing regulatory concerns domestically and internationally over the increasing complexity of systemic risk only accelerated the inevitability of regulatory change agenda in the AIF space. The overall frustration with pre-crisis regulatory frameworks and the economic consequences following the 2007 heart attack of the international financial system had led many to hope that there is a unique opportunity for more radical demands and policies.⁹¹¹ Indeed, when the financial crisis came upon Europe with all its force, the pro-market attitude and light-touch regulation defended by private equity managers ran counter to the political interests, which

⁹⁰⁹ Richard A. Epstein & M. Todd Henderson, *The Going-private Phenomenon: Causes and Implications*, 76 U. CHI. L. REV. 1, 6 (2009).

⁹¹⁰ JAMIE MORGAN, *supra* note 48, at 168 (quoting Michael Jensen in his contribution to a symposium on private equity finance in 2006).

⁹¹¹ Dieter Pesendorfer, *Goodbye Neo-Liberalism? Contested Policy Responses to Uncertain Consequences of the 2007-09 Financial Crisis*, in RESEARCH HANDBOOK ON INTERNATIONAL FINANCIAL REGULATION 414, 430 (Kern Alexander & Rahul Dhumale eds., Edward Elgar 2012).

favoured a more stringent regulatory oversight. Furthermore, at the same time when the AIFMD was taking shape in Europe, other jurisdictions were developing their own frameworks in this space, such as the Dodd-Frank Act in the US and its novel regulation of private fund managers. Therefore, this thesis has argued that the crisis opened up a policy window for far-reaching reforms, and since deregulation with its repeal or substantive dilution of financial rules was seen as a factor that influenced the crisis, re-regulation somewhat became the automatic postulate in the post-crisis world.⁹¹²

The global financial crisis formed the background to the AIFMD. A political view was formed that the PE industry, along with other non-UCITS type of collective investment vehicles, needed regulation. Although PE firms were subject to the general provisions of company and financial law that applied to all financial services firms (for example, anti-money laundering regulation, MiFID in respect of marketing and selling, and country specific AIFM or AIF regulations), which were further supported by a long-standing push towards self-regulation, including the industry's Professional Standards Handbook, codes of conduct, best practice lists, and various guidelines, there was no over-arching EU-level regulation of AIFMs. Whilst some Member States required fund managers to register, subjecting them to some form of supervisory oversight, the nature of this control (light regulation) has traditionally varied across the EU, having implications for private equity firms, PE investors and EU supervisors. The patchwork of national regulatory arrangements created regulatory arbitrage between EU jurisdictions, which in turn led to uncertainty for active institutional investors and disallowed comprehensive, effective monitoring of PE fund managers by the relevant authorities. The geographically heterogeneous approach to regulatory supervision appeared to not only prevent buyout firms from taking full advantage of the economies of scale and investors from diversifying their portfolios optimally, but also complicated the sheer task of assessing private equity's impact on the financial system and other market participants. It was felt that the incomplete and nationally fragmented regulatory and supervisory framework for the alternative fund industry was not a solid basis for building the EU financial system. Consequently, it was concluded that more consistency, coherence and harmonisation is needed to put an end to the patchy regulatory frameworks characterised by rules specific to national contexts. In 2013, the European regulatory response to the crisis had finally transitioned from policy debate and negotiation to actual implementation, with the AIFMD representing the vanguard of a wave of EU financial

⁹¹² Dieter Pesendorfer, *supra* note 911, at 414, 420; Trevor Evans, *Die gegenwärtige Finanzkrise und die Grenzen der US-amerikanischen Geldpolitik*, 153 PROKLA 513 (2008).

services regulation.⁹¹³ The Directive builds strongly on the concepts contained in UCITS for retail investment funds and MiFID for investment managers. These three elements of the investment management industry could be graphically visualised as an investment triangle,⁹¹⁴ with the fund itself figuring in the centre thereof.⁹¹⁵ Thus, the AIFMD complements the other EU directives in the area of financial investment law.⁹¹⁶

It may be uneasy to cut through the rhetoric and demagoguery surrounding the debate over the regulation of private equity. Regulators are compelled to act irrespective of the uncertain informational fundamentals. Given the PE industry's impressive growth, it appears it was no longer possible, realistic or justifiable for the EU Commission to ignore PE's existence and its potential impact on the European markets. This thesis explored whether the AIFMD was the right response and what impact it has had. Despite the new regime's operation for a number of years, it is still too early at this stage to assess its full impact with satisfying accuracy (the third country regime is still evolving, for example). However, it is not too early to form early considerations, as encompassed in this thesis. This is important as new regulations commonly impose higher compliance costs and rules that often seem excessively bureaucratic, and may in turn damage the functioning of the affected entities and diminish their economic utility and business efficiency. Given that private equity plays a significant and beneficial role in the EU economy, there is a risk that the introduction of (excessive) barriers to its natural development could have negative consequences not only for the PE industry but also the level of innovation and competitiveness of the EU vis-à-vis the rest of the world.

Created in the aftermath of the financial crisis, the AIFMD is indubitably a crisis-induced regulatory measure. As such, it exhibits a number of crisis-related features,⁹¹⁷ such as strong focus on systemic risk, increased regulatory oversight, disincentives regarding excessive risk taking, greater scrutiny of the use of leverage, and enhanced investor protection. Many of the AIFMD provisions are not entirely novel as they already existed in some form and shape before,

⁹¹³ Helen Marshall et al., *Annual Review 2012*, 102(Jan) C.O.B. 1, 2 (2013).

⁹¹⁴ Any investment activity can be legally characterised as a triangle. This structure has been altered only in some minor ways over the centuries, being able to be traced back to the first Dutch investment funds of the 18th century; Dirk A. Zetsche, *Investment Law as Financial Law: From Fund Governance over Market Governance to Stakeholder Governance?*, in *THE EUROPEAN FINANCIAL MARKET IN TRANSITION* 339, 342-343 (Hanne S. Birkmose, Mette Neville & Karsten Engsig Sørensen eds., 2012).

⁹¹⁵ Dirk A. Zetsche, *Introduction: Overview, Regulatory History and Technique, Transition*, in *THE ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE: EUROPEAN REGULATION OF ALTERNATIVE INVESTMENT FUNDS* 1, 13-14 (Dirk Zetsche ed., 2012).

⁹¹⁶ *Id.* at 1, 16.

⁹¹⁷ *Id.*

as evidenced for example by voluntary, *albeit* widely accepted, corporate governance standards in private equity. It is plausible to claim that the increased costs associated with compliance could be justified in view of the detrimental effects that a potential market disorder could entail, especially as the large volume of the AIFMD rules is of an informative nature. In this sense, the AIFMD could be defended as a reasonable step forward in order to mitigate systemic risk and improve the stability and soundness of the financial system as a crucial element of the EU economy. From an archaeological perspective, the AIFMD certainly forms the first strata of regulation in the alternative investment space, which will serve in the future as a fossil record to trace back the co-evolution of alternative investment activity and corresponding regulatory responses.

The AIFMD aims to improve financial stability and therefore contains provisions that explicitly address systemic risk. This marks a certain shift in the objectives of EU investment law to market governance. The relevant provisions should facilitate the detection, assessment and monitoring of systemic risks through mandatory authorisation and enhanced transparency and disclosure. Theoretically, this should allow EU regulators to intervene faster and more efficiently and effectively if need be. Special legal restrictions, such as those on the use of leverage, capital and risk management, misconduct and engagement in inadequately risky behaviour, should help increase the resilience of the affected financial entities to market distress. Although special provisions regarding the acquisition of non-listed companies do not directly address systemic risk they are meant to protect the perceived investment risk. The particular emphasis placed on systemic risk finds provenance in the understanding that macro-prudential supervision suffered seriously from the undersupply of relevant information before the crisis,⁹¹⁸ hence the perception that more information could help better assess possible systemic risks in funds and curtail investment recklessness and abusive practices. However, based on evidence, this thesis has demonstrated that there is no clear connection between private equity and (higher) systemic risk; there was also no widespread failure of PE-backed companies recorded before or during the global financial crisis. Accordingly, this thesis has found that some of the AIFMD provisions, including the prudential elements, are not particularly relevant in the private equity context.

Increased transparency can reduce asymmetric information, enhance investor protection and confidence, as well as facilitate competition between funds. In particular, from a systemic risk

⁹¹⁸ Rudiger Wilhelmi & Moritz Bassler, *supra* note 563, at 21, 33.

and social welfare perspective, it would be hard to justify any regulatory change that would aim to reduce transparency. However, this thesis has shown that the extent and frequency of disclosures, including notifications relating to investment in non-listed companies, are onerous and costly, especially for smaller PE fund managers for whom the administrative burdens appear to be disproportionately greater. Evidence suggests that EU regulators are misaligned in terms of what exactly needs to be reported and in what format, and that the required data is duplicative in nature and overlaps with reporting obligations stemming from other EU legislation (for example, MiFID II). It is also unclear what use EU regulators can actually make of the additional information, specifically in the context of the last financial crisis when extensive data were collected from fund managers and yet this did not improve EU regulators' alertness to the problems. Whilst there is evidence that most of the reported data is monitored and analysed, the findings are not generally made publicly available. Although it is doubtful whether this would actually benefit sophisticated investors in a meaningful way, this could still allow a better assessment of the AIF market, if required. From a private equity angle, there is a risk that by disclosing more details about the performance of individual portfolio companies PE firms will be fast subjected to the same kind of damaging short-term pressures as those faced by listed companies, which may disadvantage both the portfolio companies and PE fund investors. Therefore, the adoption of the Directive based on the above premises does not appear to represent a strong basis for regulating private equity.

Given that the pre-AIFMD regulatory landscape across Europe was heterogeneous across most aspects covering alternative fund investments, the AIFMD aimed to offer the advantage of more legal certainty (at the management company level) by introducing minimum harmonised EU level requirements and standards. A more complete and consistent supervisory oversight should be able to provide a more solid basis for further development of the internal market. Looking at the macroeconomic impact, from the standpoint of the AIFMD's architects, the Directive ought to open up new cross-border opportunities for growth for PE fund managers. However, this overarching objective of the AIFMD has only been partially achieved, as the Directive is not applied consistently between Member States. The particularised differences exacerbate costs and undermine some of the key potential benefits of the AIFMD, including the creation of a Single Market in AIFs.

The inconsistent implementation of the AIFMD is one of the key findings of this thesis. Specifically, the Directive has facilitated diverse regulatory and supervisory interpretations across the EU as regards certain key terms (for example, marketing) and created differences in

relation to the accessibility and attractiveness of NPPRs and Annex IV reporting. There are also differences in relation to the implementation positions adopted by local regulators (as evidenced via gold-plating) and their responsiveness and experience (for example, the UK's FCA brings superior responsiveness and much more experience than others). On top of that, there are differences at the local level in respect of areas not governed by the AIFMD (for example, rules around alternative investment funds and selling). All this has led to inefficiencies caused by the need to analyse the relevant requirements on a country-by-country basis and conduct a regular monitoring exercise to identify any changes. Unsurprisingly, this is a significant driver of additional costs, particularly as local law firms or regulatory consulting advisers need to be engaged in each jurisdiction to ensure compliance with the local rules – the costs are naturally more burdensome for smaller, less established fund managers who do not have in-house legal and/or compliance teams. The area that best illustrates the issue is marketing, which is considered to be one of the most organisationally burdensome aspects of the Directive. Due to the national differences and the evolving third country regime, the marketing process has been rendered more challenging, time consuming and expensive, if not discouraging from operating on a pan-European scale in some circumstances; this has also restricted the investable universe of non-EU funds. Moreover, the differences in the availability of the marketing passport between EU and non-EU fund managers have led to a different experience and perspective regarding the impact of the AIFMD (more negative in the case of the latter) and disrupted the flow of capital between EU and non-EU countries. Since the third country marketing passport is not available yet, the affected non-AIFMs have been forced to grapple with divergent NPPRs, which may reflect protectionist behaviour, and reverse solicitation does not appear to be a sustainable marketing strategy as it entails a regulatory risk in light of its varied interpretation across the EU. Consequently, the newly introduced concept of the marketing passport for AIFMs, the AIFMD's main value, has not yet reached its potential.

The AIFMD is one of the most rigorously debated pieces of financial regulation to ever emerge from the EU.⁹¹⁹ Although the original intention was to regulate the hedge fund sector only, ultimately the Directive created a single rulebook for all types of non-UCITS fund managers managing different categories of funds. Based on evidence, however, this thesis has demonstrated that the Directive seems to be lacking strong empirical and theoretical justification for the regulation of private equity. It reflects the notion that the activities of AIFMs, whilst largely beneficial, may spread or amplify risk, but there is no compelling

⁹¹⁹ Jennifer Payne, *supra* note 381, at 559, 576.

evidence for this to be the case in relation to private equity – even the EU Commission itself noted that macro-prudential (systemic) risk is associated primarily with hedge funds.⁹²⁰ Given that the business model of private equity and other asset classes, such as hedge funds, is quite distinct, the Directive’s wide-ranging remit is surprising. Consequently, certain requirements (for example, reporting deadlines for liquid assets) are more tailored or adequate for one asset class (such as, hedge funds) than another (such as, private equity). Failure to recognise the specificities of private equity’s business model does not appear to be an appropriate foundation for a comprehensive legislation capturing the PE industry, and rather tends to accord with a view that the AIFMD is an expression of political desire to demonstrate the EU’s ambition to lead the world in controlling the regulation of the alternative investment funds industry. Nevertheless, given the divergent national transposition and the absence of regulatory cooperation in this space at global level, this ambition remains largely illusory.

This thesis has found that whilst the AIFMD clearly marks a transition from a light/non-existent regulation to a much heavier regulatory framework for private equity, the dynamics of regulatory change and associated implications vary from one country to another. For instance, in the UK PE fund managers will be familiar with many of the Directive’s requirements as they already had to comply with many similar FSA (now FCA) rules and, for example in respect of transparency, the UK requirements are stronger under Walker than the AIFMD.⁹²¹ In other EU countries, buyout firms may experience bigger challenges and therefore the AIFMD will have a greater potential to impact buyout activity. Further, the AIFMD’s impact will also depend on the nature and sophistication of PE fund managers. Scale will be a clear advantage for larger PE firms, which will be better suited to absorb additional costs and implement operational realignment. By contrast, this will be a much more daunting task for smaller AIFMs. Therefore, there is a risk that in order to avoid ill-adapted regulatory provisions, the industry might split into buyout managers from large private equity firms and those from the rest of the industry which would prefer to remain within a low regulatory environment. This might accelerate the polarisation of the industry into a leading group of large firms whose core business will be buyouts and smaller players who will have to find niches in specialist markets and industries.⁹²²

⁹²⁰ *Impact Assessment*, *supra* note 345, at 19.

⁹²¹ *Towards Transparency* (BVCA, Aug. 19, 2013), http://www.bvca.co.uk/Portals/0/library/Files/Weekly%20Brief/2013/WB_19Aug13.pdf.

⁹²² *Unlocking Global Value. Future Trends in Private Equity Investment Worldwide*, *supra* note 1, at 5.

Undoubtedly, the AIFMD is a force that has a re-shaping effect on the alternative investment fund management landscape in Europe and outside of it for years to come, and its implications will go beyond the initial regulatory compliance, various operational conditions and obligations affecting AIFMs' business strategy, distribution and market composition. How private equity managers will respond to this new regulatory challenge will define their market positioning in the new era, but at the moment it is unfeasible to predict with utmost confidence how the industry will look like when national placement regimes will be switched off completely and full AIFMD compliance will be required in the matrix of all possible scenarios involving EU and non-EU AIFMs managing and/or marketing EU and non-EU AIFs. Therefore, even if some AIFMs consider moving their funds or operations offshore, this might be only a temporary reprieve from the Directive if they wish to continue to market their funds to European investors. It is plausible that some fund managers will find compliance with the new requirements too onerous and the cost burden too high relative to their interests in the EU market, leading them to terminate their EU operations and exit Europe altogether, particularly as other regions (such as, the US and Asia) have not gone as far as the EU in the regulatory overhaul of the alternative investment fund industry. Ultimately, whether the AIFMD-compliant funds will become a force to be reckoned with will eventually depend on investors who will decide the Directive's fate and its success as a global brand. Therefore, the new regulatory landscape might eventually prove unlikely to deter some fund managers from marketing in Europe if the region continues to provide an attractive and willing PE investor base. Even if some requirements, like reporting, are more demanding and will increase costs and compliance effort, PE fund managers might still prefer not to switch to less regulated jurisdictions.⁹²³

As far as investors in private equity are concerned, based on evidence presented in this thesis, it appears that they do not have any particular views as to the Directive's impact, either positive or negative. This can be explicated by the fact that they are not directly affected by the AIFMD rules and the management fees have remained about the same under the new regime. However, it appears that the AIFMD has had only a mildly beneficial impact on increasing investor protection and confidence by means of requirements around depositaries, transparency and remuneration. This indicates that some of the AIFMD rules are ill-suited or even unnecessary in the PE context.

⁹²³ Roxy Nadershahi & Andrew Lowin, *Fund Managers Face Up to AIFMD* (COMPLIANCE MONITOR, Feb. 5, 2013), <http://www.compliancemonitor.com/international/european-union/directives/fund-managers-face-up-to-the-aifmd-62144.htm>.

In addition to the above AIFMD-specific findings, the current thesis has also arrived at a number of more general conclusions. First, PE firms are a product of their time and play an important role at the current juncture by way of promoting economic recovery through restructuring struggling or underperforming companies. Unlike hedge funds who trade debt, derivatives and other structured, synthetic products, buyout firms invest in physical companies that produce things and provide services and will make profit only if they improve the value of the investee companies. Sometimes the improvement may be more cosmetic than real, but historically private equity firms have in principle had a powerful incentive to make companies perform better. Academic literature suggests that claims against PE firms, often portrayed as ‘primitive asset strippers’ or ‘creative destructors,’ are for the most part undeserved, obscuring the positive economic contribution made by the industry. Some restructuring activities may seem painful for some stakeholders, but the whole process could be compared to a visit at a dentist: one goes there and experiences some pain, but leaves in better shape than without the treatment. There is wide evidence that the majority of portfolio companies are transformed into competitive businesses that perform better in terms of profitability and growth indicators than before the buyout or relative to their industry peers. Naturally some private equity transactions will transpire to be failures and may pave the way to, if not even end up in, bankruptcy. However, these are outliers, not the norm.

Second, the crisis has set a new era of global regulatory compliance for the PE industry that has grown phenomenally in a traditionally lightly regulated environment. Although this thesis has found that most aspects of the private equity business were widely covered by a range of legal measures, the AIFMD can be viewed as a step towards a long-awaited, fully integrated and regulated market for investment funds in Europe. However, the accuracy of this stance will depend on the point of view adopted.⁹²⁴ From a regulator’s perspective, the Directive forms part of a legislative agenda to extend regulation and supervision to all financial entities and activities which embed significant risks. From a fund manager’s or investor’s perspective, the European fund market is far from being fully integrated, mainly due to inconsistent harmonisation bringing in another dimension of legal and operating uncertainty and lack of pan-European tax harmonisation for investment funds.

Third, the introduction of AIFMD has raised concerns about the future of the European PE market, especially as the Directive has induced relatively insignificant benefits on private equity

⁹²⁴ Ulf Klebeck, *supra* note 591, at 77, 96.

for a relatively high cost. The response across the Atlantic has not been that restrictive and invasive as Dodd-Frank's ambit is much wider and has adopted a more lenient approach towards regulating private equity. In view of the wider socio-economic benefits of private equity, the AIFMD would be expected to be the product of mature reflection, as otherwise it could damage the sector's success and growth prospects, subsequently depriving the EU of its competitiveness, investors of profitable investment opportunities, and Europeans of employment. Regardless of the urgency created by the 2007 global financial crisis, regulation should be evidence-based. However, this thesis has shown that the AIFMD is not.

Fourth, some of the most profound regulations tend to emerge from the political change in order to address highly particularised symptoms specific to the crisis period. Post-crisis atmosphere expedited the regulation which engulfed private equity even though the industry bore little connection to the causes and effects of the 2007 financial upheaval. Resistance to greater or stricter regulation is not surprising. It may take a simplistic form, which emphasises efficiency contradiction as regulation is a permanent solution to a temporary problem, or a more sophisticated form, which is based on clear historical resonance and thus posits that regulation is invariably constrained to be retrospective whilst problems are prospective. This implies the recognition of the fact that the future has unknowns and any regulatory action will have unintended ramifications. This raises the corollary issue of the degree of regulation and its appropriateness. The AIFMD can be perceived as a Big Bang of law, an all pervasive solution to the whole alternative investment fund industry and the specific triggers and underlying conditions that could provoke another crisis. However, based on evidence presented in this thesis, private equity was not a *causa proxima* of the financial crisis; it played a constitutive role as a *causa remota* at best. Therefore, the case for significantly increasing regulation of private equity in Europe appears to be rather weak, especially as no incontestable evidence has ever been presented in respect of the industry's detrimental nature, its crisis amplifying activities, or its potential to cause a future one. Based on evidence, the AIFMD is heavily suffused with political interference, and the crisis-induced sense of urgency, which surrounded its adoption, was not conducive to thorough deliberations and the development of carefully-crafted regulatory measures addressing PE-related problems. Consequently, the AIFMD is a politically-driven reforming legislation that unnecessarily complicates the industry's operations.

To conclude, this thesis, and the extensive body of research on which it relies, has evidenced that the AIFMD is a unique, unprecedented piece of EU regulation that has a re-shaping effect

on private equity. Several years into the era of this Directive, the new standards and conditions are starting to stabilise and be regarded as business as usual; however, the impact has been material, requiring substantial work to comply with (or adapt to) the new rules, which in some cases are a bit misguided, discouraging, or even irrelevant. The matters covered by the AIFMD range from anything between relatively innocuous to extensively burdensome; some are controversial, some not; some descend to considerable detail, whilst others only take a very broad brush approach. There is also a conflict between the likely opportunities and threats. There will be no stark triumph of one position over another in the assessment of the AIFMD's impact on private equity until all of its elements are fully implemented. However, even at this stage, it can be argued with confidence that the AIFMD inevitably marks the end of the light-touch regulation of private equity in the EU.

The industry has come a long way in the past 30 years and in view of the pace of its development and financial creativity, it seems quite difficult to predict all the ways in which it could grow, develop and change as a result of the AIFMD. Each regulatory reform can either support or hamper the growth of the affected industry. This thesis has clearly illustrated that PE firms will have to adapt in order to realise their full potential and avoid the threat of further direct regulation. Whether they will survive the regulatory upheaval brought about by the AIFMD depends on their flexibility, ability to innovate and willingness to be more open and transparent about their activities. Navigating the new regulatory climate will consume time, energy and resources, and the winning private equity firms will be those which are prepared to evolve, challenge their *status quo* and begin to think differently about their organisations during these transformative times in order to minimise the impact of the new rules. This thesis has made a contribution to the study of AIFMD and its implications for private equity. However, to better understand the full effect on the industry, future research in this area is desired, particularly when all provisions of the AIFMD are fully implemented, or when the AIFMD II is introduced, with a suite of new changes to the existing regulatory framework.

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