

CHANGE CAPITAL REGULATION:

A Blow to Public Investment?

By

Jay Young, Esquire

**Jay Young, Esquire
Principal
TGV, LLC
Jeffrey.Youngesq@mac.com
202-460-0488**

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Introduction

Private Equity funds have taken on a titan like status in the current economy, as private fund managers have raised in excess of \$400 billion through the capital markets to deploy on business operations in the United States and in other economies (e.g. Europe and China). Traditional private equity funds have long been focused on mid-market firms, in traditional industries, family owned companies, and other stable core manufactured products. More recently, private equity's more risk centered sibling, hedge funds, have been developing at an accelerating rate, accumulating ever larger pools of investment capital and moving beyond exotic hybrid financial instruments into all kinds of investment.

The combination of these forces has created a juggernaut of financial muscle that is asserting itself in every major global market. The private equity and hedge fund capability is even thought to extend to potentially correct the disinvestments imbalance in Africa and to spur the development of transparent, fully functional private companies¹. As a result, private equity and hedge fund capital is seen as **"change capital"**. Change capital is also starting to be deployed in support of public asset sales, public investment, and in lieu of tax increases for public services such as education, business expansion, and healthcare.² The support of public investment requirements by change capital is critical to current needs and comes at a time when the escalating requirements of citizens far outstrips the financial capability and political will necessary to raise taxes to rebuild critical infrastructure and to supply needed services. As a result, change capital has started to flow into a number of vertical market segments which have not been supplied by the financial markets through other investment strategies. The net effect of this use of change capital has been that private equity and hedge funds have expanded into new territories, started to purchase well known corporate properties like Sallie Mae, TXU, and Chrysler from the public markets and remake them back into private companies. Several of the funds themselves are looking to access the public markets for their own benefit.

The Blackstone Group for one recently filed to access the public markets. "The filing makes it crystal clear. It's a bull market for private equity, Blackstone's good at timing, and it would rather use public investor's money to pay down its debt (\$340 million at the year end), expand and allow some of its partners to cash out³". The move toward accessing the public markets by change capital may not in and of itself be a net negative to the financial markets, but it has created a treasure trove of suspicion. The suspicion comes from a lack of familiarity with who manages change capital, how they do it, what it benefits, and how the enormous wealth gets distributed. The suspicion also comes from the radical change in perspective that change capital has had toward the public market;

historically change capital always believed in the benefits of private operation over public operation. Now that time tested approach is being jettisoned in favor of public market liquidity. Additionally, the suspicion is fueled by a lack of regulation of change capital by the SEC and other financial regulatory bodies. This paper looks at the regulatory scheme associated with change capital and seeks to link the developing issues of public investment with potential changes in the regulatory and tax environment applied to change capital.

Change Capital Regulatory Scheme

The SEC's Division of Investment Management has some regulatory oversight of fund managers pursuant to the Investment Act of 1940. This Division works to improve disclosure and identify risk for very high net worth investors without causing a regulatory burden to funds. They review filings made by advisers, enforcement matters, and make sure that the regulatory scheme stays updated with a dramatically changing market⁴. Primarily the Investment Act requires funds to disclose their objectives, financial condition and investment policies to investors when holdings change. The SEC does not review investment decisions or the underlying merits of the funds activities. However, the SEC has brought enforcement actions against dozens of advisers for fraudulent activities, late trading, and other rogue actions⁵. There are no specific pricing rules applicable to change capital and investors may have difficulty estimating the value of their holdings at any specific point in time.

Investors in Change Capital

According to the Investment Company Institute many change capital funds require a minimum investment of \$1 million or more⁶. "Under the National Securities Markets Improvement Act of 1996, certain hedge funds can accept investments from any individual who holds at least \$5 million in investments. This measure is intended to help limit participation in hedge funds and other types of unregulated pools to highly sophisticated individuals"⁷. As such these change capital funds are not intended for average or casual investors, nor are they intended to be used by sophisticated investors with a low risk threshold or immediate need to access invested funds.

Performance of Change Capital

Making sense of change capital returns is not an easy thing to do. Academics have spent significant resources studying, analyzing, and calculating such return scenarios. In general change capital provides risk and return characteristics not easily duplicated from other kinds of investment strategies. "[R]esearch on hedge funds has shown that many hedge fund strategies provide diversification benefits relative to traditional stock and bond investments and, in addition, have shown to outperform passive indices⁸". However, returns within a specific investment strategy are closely tied to market factors such as interest rate spreads, market volatility, and the risk specific to that strategy. "One can therefore think of hedge fund returns as a combination of manager skill in processing information and the underlying return from passive investment in the strategy itself"⁹.

The research also demonstrates that for hedge funds a better proxy of results is volatility (market risk) and not returns. Therefore a simple comparison of return rates does not deliver a true picture. It is also difficult to rebalance change capital portfolios, adjust for lockup requirements, and certain kinds of reinvestment options. “Because portfolios cannot be efficiently rebalanced on a monthly basis, performance studies may require a longer ex post holding period than used in studies of traditional stock and bond markets¹⁰”. The combination of these factors have made relative fund comparisons difficult and even comparisons based on sub-indexed funds of a similar nature are subject to diversification, adjustment, and volatility concerns. For these reasons the sophistication of the investor in change capital is paramount and offers the best checks and balance to some of these evaluation concerns.

Tax Treatment of Change Capital Investments

Funds are established using a variety of principles, structures, and capital flows. Many are funded by pension funds and other forms of institutional capital. Funds may charge a few points to the investors to manage the money, supply reports, and deal with the tax, legal, and financial complexities of their transactions. As previously indicated the funds may require lengthy notice to remove funds from the risk pools, and may even prevent withdrawals to specific discreet intervals. Also, the fund managers may be entitled to a preferential return on the profits (earnings after capital replacement) of varying amounts (e.g. 20%) based upon their execution savvy and money managing ability. Because of the uncertainty of these payment streams, the length of time used to earn them, and a preference for these kinds of risk actions in the tax code, fund managers are typically given capital gains tax treatment on these profits (known as the carry) and are not taxed at the ordinary income rate. The difference in tax treatment is monumental and means the difference between paying taxes at 15% and 35%, or a 20% spread. Given the size of the underlying transactions and size of the carried funds the tax differential represents a princely sum and is a net driver to the risk managed by the change capital funds.

Recently, legislation has been offered on Capital Hill that is designed to buttress hedge fund disclosures, provide more oversight, and change the tax treatment of carried interest to ordinary income treatment. “In March, Sen. Charles E. Grassley (Iowa), the ranking Republican on the Senate Finance Committee, proposed legislation that would require hedge funds to register with the Securities Exchange Commission. A similar rule adopted earlier by the SEC was tossed out by a federal appeals court¹¹”. At this time it is not clear where this legislation is headed, but change capital appears to have a growing political perception problem around the world and particularly within the G7 nations. European regulators are looking at the issue and so are parts of Asia. Many of these regulators perceive change capital to be greed capital and working against other public interests like employment, pension guarantees, and the like. A change in this perception is required if the change capital industry is going to be able to aggressively deploy the capital in its coffers over the next several years.

Obviously, the deployment by change capital managers to investment in public assets can help with their perception problem. Public asset investment offers funds, managers, and investors an opportunity to solve problems, make economic returns, and address their perception problems in the same transactions. “An estimate developed by Booz Allen Hamilton suggests the magnitude of the problem. Over the next 25 years, modernizing and expanding the water, electricity, and transportation systems of the cities of the world will require approximately \$40 trillion...a figure roughly equivalent to the 2006 market capitalization of all shares held in all stock markets in the world¹²”. The costs of not meeting this challenge in the face of attacks, pandemics, and other factors are thought to be even greater. Governments are not prepared to meet these escalating requirements and the future demand for resources. Therefore, there is a viable opportunity for change capital to make a significant difference in this area if investment scenarios and incentives are properly aligned. Allocating risks, selecting projects, and moving capital to the highest points of return are areas in which private firms clearly outperform governments. Private firms can also find significant value in the transactions. “Booze Allen estimates suggest that in 2006, five year returns included 11 to 13 percent for airports, 10 to 13 percent for toll roads, 8 to 10 percent for rail passenger lines, and 10 to 14 percent for wastewater plants¹³”. Recent activity in the market suggests that institutional investors are also interested in lottery operations in the U.S. and may be able to generate similar if not better returns. This activity suggests that public assets are valuable to investors and may include classes of assets previously not subject to securitization and syndication. If so, the financial engineering related to public assets should be nearing an aggressive growth phase.

Given these needs and the importance of the risk scenarios attached to public investment, it is a poorly timed approach to begin adjusting the compliance requirements and the tax treatment of change capital investments. These changes may in fact work to undermine the kinds of things regulators might really prefer happen. Namely that change capital becomes a constructive force rather than a destructive force in the marketplace. Changing the tax treatment on carried interest may make these public oriented investments uneconomical and not viable on a risk adjusted basis. This in turn could cause funds to flow to riskier and higher return scenarios. This is what spurred the development of hedge funds and some private equity in the first place. However, a return to this investment philosophy would represent a roll back from the current expansion that is taking place and it would leave a vacuum for deploying capital in way that can both benefit investors and the public good. This would not be in anyone’s best interest and might prevent critical public needs from being met.

Better Remedies

Rather than adopting the rather draconian remedies being discussed by regulators in Europe and the U.S. regarding change capital as an asset class, the landscape seems to mandate a few clear improvements between funds, investors, and regulators. One is that the change capital industry has to eliminate the Wizard of Oz effect of closely holding information and limiting the disclosure of the practices and procedures that take place in the industry in generating outsized returns. Rather than holding conversations only

between themselves, change capital experts have to start informing the general investing public about their intentions, activities, and outlooks. “We needed to address our message to the wider investment community, and we failed. The current unflattering press coverage of private equity in Europe is a direct consequence of this failure, particularly as it was well signaled in advance”¹⁴. This is surely one of the reasons that change capital firms are susceptible to allegations of asset stripping, anti-unionism, and financial piracy¹⁵.

On the regulatory front rather than adopting explicit oversight and control of change capital, regulators should continue to push for a higher level of transparency of funds and their operation. As discussed above while it may be difficult to produce an apples to apples comparison on fund returns, it is not difficult to clarify the asset concentrations and classes that funds hold, average time horizon, or largest returns per transaction on a rolling scale. The same would add intelligence to the investment decisions made by institutional investors and could add information to the public discourse.

Sophisticated investors are not clamoring for massive changes in the regulatory landscape. While that is no reason to wait until there are a series of related change capital meltdowns, it does argue for a measured and staged approach to regulatory oversight. A greater focus, for example, could be put on the training and development of change capital fund managers. Looking at issues related to certification, lessons learned, and troubled practices on a regular basis could avoid reoccurring detrimental activities from becoming standard industry practice. Tracking complaints and any previous history of fraudulent activities or investigations could help in this regard as well. Since a large portion of institutional capital from pension funds is being used by change capital funds (estimated to be between 5 and 15% of managed funds), other remedies might include criminal penalties for intentionally fraudulent activities, and civil penalties for losses sustained through reckless management practices. While this would be difficult to gauge, measure, or mandate, it does represent an opportunity for benchmarks and for the industry to further police itself.

Change capital is an inexact science so you cannot prevent poor results. What you can prevent is bad actors being able to have more than one bite at the change capital apple. The market is already an efficient regulator of investment and change capital activities. Any additional regulatory activities should work in unison with market conditions and capital flows. They should also continue to encourage funds to flow into public investment vehicles and to support public infrastructure improvements. This is a critical time and the right time to encourage public investment.

Conclusion

Private equity and hedge fund investment are change capital. Change capital is in a different asset class from equity in every sense of the word. As such change capital has been treated differently by investors, regulators, and the financial markets. Change capital has been associated with business risk not covered by other investment vehicles and used as a weapon against changes in underlying market conditions. Once limited in scale and scope, change capital has broken out of its narrow range and started to be used in multiple market segments. These segments now include public asset acquisition.

There is a critical need for public investment, particularly in infrastructure, and change capital can play an important role in this market. Because the focus has dramatically changed, change capital has a perception problem in the marketplace and is not well understood by the general investment public. As a result, regulators are taking a close look at change capital across the globe. As they do, regulators should be mindful of the steps undertaken to preserve change capital's interest and involvement in public investment. A measured approach should be used to improve perceptions, avoid harm, and maintain change capital's desire to make public investments. Ultimately the market forces efficient capital distribution and any regulatory scheme should support this paradigm and not undermine it.

* Jay Young served as COO of a state lottery and has over 20 years experience as a corporate attorney, management expert, and advisor of capital investments. He holds a AB in Economics from Princeton University; a JD from the UCLA School of Law, and a MS International Management from the University of Maryland (University College). The views expressed are those of the author and should not be otherwise attributed. Author may be contacted at Jeffrey.Youngesq@mac.com.

¹ Gibian, Tom, "Private equity the catalyst for Africa". BusinessDay: <http://www.businessday.co.za/articles/topstories.aspx?ID=BD4A253539>. August 22, 2006.

² Young, Jay, "Public Asset Sales: How the Public Wins". American Society for Public Administration: [LA Times](http://www.aspa.org/la-times), March 2007, pp.4-5.

³ Sloan, Allan, "Glimpses Into Blackstone's Magic". Washingtonpost.com: <http://www.washingtonpost.com/wp-dyn/conetn/article/2007/03/26/AR2007032601732.ht>. March 27, 2007.

⁴ Yale School of Management, Presentation on Hedge Fund Regulation.

⁵ Yale School of Management indicates that over \$1.1 billion of such actions.

⁶ Investment Company Institute. Mutual Funds: Investing In America's Future. http://www.ici.org/funds/abt/faqs_hedge.html. P.2.

⁷ Investment Company Institute P. 2.

⁸ Schneeweis, Thomas, Kazemi, Hossein, and Martin, George. "Understanding Hedge Fund Performance: Research Results and Rules of Thumb for the Institutional Investor". Lehman Brothers Capital Group. New York. November 2001, at p. 8.

⁹ Schneeweis, Kazemi at p. 5.

¹⁰ Schneeweis, Kazemi at p.11.

¹¹ Morse, Andrew. Japanese Regulator Seeks Data From Hedge Funds. Washington Post. May 2, 2007 at P. D8.

¹² Doshi, Viren, Schulman, Gary, and Gabaldon, Daniel. “Lights!Water! Motion! Resilience Report”. Strategy +Business, April 17, 2007, at p.3.

¹³ Doshi, Viren, p. 14.

¹⁴ Sampson-Fraser, Guy. “The Open Book on Private Equity”. The Street.com: <http://www.thestreet.com/funds/openbook/10349996.html>. April, 13, 2007.

¹⁵ See for example “Global watchdogs to study private equity sector”. Reuters: <http://today.reuters.com/news/articelinvesting.aspx?type=bondsNews&storyID=2007-04-1..>