

# MERGERS *unleashed*

## Keeping an Eye on Capitol Hill

**As Washington grows hungry for regulation, private equity professionals are watching the saga unfold with trepidation.**

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March 16, 2009

Wall Street was the first to get Washington's responsibility manifesto. The areas targeted by legislators, perhaps predictably, have been executive pay, corporate junkets, and transparency – in fact, far more transparency is expected to be the new rule. What that means too is that any politician who wants to get on TV can simply second guess how the banks are using their money. While it hasn't happened yet, many in private equity are anticipating, with growing trepidation, the same kind of attention.

It remains to be seen precisely how the asset class will be affected by Washington's push to apply a stronger regulatory grip, although change is already sweeping through the industry. President Barack Obama's budget, unveiled in February, takes direct aim at PE compensation with tax hikes and a proposal to treat carried interest as regular income. And it's unlikely, in this environment, that investors will be able to pass those costs along to their limiteds.

Also similar to Wall Street, disclosure requirements are expected to present another pitched battle. Henry Kravis sounded the alarm in February when he reportedly told a crowd at the Berlin Super Return conference that “responsibility, transparency and, above all, trust” will be the new tenets the asset class must live by. He warned: “If you don't like change, you're going to like irrelevance even less.”

This is a war private equity firms have battled before. Concessions from the industry have been strong-armed through the use of the Freedom of Information Act, exposing fund level performance data to the masses, while protecting underlying portfolio data. The introduction of FASB's SFAS 157 and mark-to-market accounting was also forced on investors in the name of transparency. Future disclosure requirements could take the form of limited partner information. **BDO Seidman** partner **Mat Wood** notes that these requirements could demand PE shops reveal individual investors, even down to names and addresses.

Other forms of disclosure could compel PE firms to reveal potential conflicts of interest or reveal potential exposures. Part of this drive for disclosure relates to concerns about counter-party risk. Senator Charles Grassley, for instance, has been beating the drum to

bring about more transparency among hedge funds, and he has often lumped private equity into his campaign speeches.

“It’s not about fat-cat investors who can afford to lose. It’s about regular workers and their retirement savings,” the Senator said in a prepared statement in November. These comments coincided with his reintroduction of a bill that would require SEC registration for alternative investment funds.

“Private equity invests in bricks, mortar and people, not financial instruments,” said one lobbying source who spoke anonymously. He added that for this reason the asset class does not pose the “systemic risk” that legislators fear.

However, in Washington this will matter not, so long as bankruptcies of PE-backed companies continue to increase in number. Last year alone, there were close to 50 bankruptcies that came out of private equity portfolios. If that number climbs and includes larger businesses with a greater number of employees, Capitol Hill, right or not, will deem the risk to be systemic.

This could also lead to another demand from legislators. Some have already hypothesized that the biggest buyout shops could face greater difficulty if lawmakers impose caps on leverage multiples. Of course, the market -- on its own -- has already compressed the amount of leverage available. **Tom Bonney, founder of CMF Associates, notes that since the banks have already scaled back, there is less of a need for regulators to further restrict their ability to lend. Bonney adds that restrictions of this sort are “not what this economy needs.”**

Private equity as an industry is expected to fight back. In recent years, the asset class has attempted to increase its presence in Washington lobbying circles. The Private Equity Council was established for this very purpose, with a list of member firms that includes Madison Dearborn, Bain Capital, Apollo Management and Kohlberg Kravis Roberts, among other large-market shops. The National Venture Capital Association also lines up on the side of private equity on many issues. However, the biggest battle these groups have fought to date has been the defense against attacks on carried interest tax treatment. This was a fight, of course, that they lost.

In Europe, the British Private Equity and Venture Capital Association in February suggested a strategy of self regulation. In the US, such a proposal would probably get laughed out of Washington in the current climate. With that said, asset class has stepped up its efforts to burnish its image. In addition to research highlighting the benefits of PE, the Private Equity Council released a set of investment guidelines that jumped from environmental issues to governance to labor and safety and then back to social responsibilities. The aim of the report was transparent, but not in the way that would appease regulators.

**Bonney acknowledged, as other PE pros stated, that there remains a possibility that American private equity shops could seek drastic measures, and possibly shift operations**

out of the US entirely if restrictions become too severe. He said that a rush to create regulatory oversight on American PE shops would place them at a competitive disadvantage to other acquirers.

With that said, many already accept that change is coming. And as Kravis pointed out, adaptation may be the best solution.