

SUBMITTED ELECTRONICALLY

March 25, 2015

Mr. Patrick Pinschmidt
Deputy Assistant Secretary
Executive Director, Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Docket No. FSOC-2014-001

Dear Mr. Pinschmidt:

These comments are submitted by the Private Equity Growth Capital Council (the “PEGCC”). The PEGCC, based in Washington, DC, is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity and growth capital (together, “private equity”) industry and its contributions to the national and global economy. Our members represent a broad cross-section of the private equity industry in the United States and include many of the world’s largest and best known private equity firms, as well as leading small and medium-sized private equity firms. Our members are united by their commitment to growing and strengthening the businesses in which they invest. For further information about the PEGCC and its members, please see our website at www.pegcc.org.

The PEGCC appreciates the opportunity to comment on the Financial Stability Oversight Council’s (the “FSOC”) recently issued notice seeking public comment (the “Notice”) on whether asset management products and activities may pose potential risks to U.S. financial stability.¹ The Notice seeks comment on four broad categories of issues: (1) liquidity and redemption practices; (2) use of leverage; (3) operational functions; and (4) resolution. We first provide background on private equity firms and funds; we then address the major themes and questions proposed in the Notice and explain why private equity firms and funds do not implicate these or other financial stability concerns.

¹ Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77488 (Dec. 24, 2014).

I. Background on Private Equity Firms and Funds

A. Private Equity Firms

Private equity firms sponsor, manage and advise private equity funds (which are described below). Private equity firms, or the owners of private equity firms, typically own and control their funds' general partners (or, in the case of a fund that has a non-partnership structure, the equivalent controlling entity), which make investment decisions for the funds ("GPs"). Private equity firms frequently (but not always) are privately owned and controlled by their senior investment professionals. Subject to limited exceptions (for small firms, certain non-U.S. firms and venture capital firms), private equity firms are required to be registered as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act").

Private equity firms may have one or several lines of business. Many private equity firms organize and advise a single private equity fund that pursues a particular private equity investment strategy and, once that fund is largely invested, will organize a successor fund to continue that investment strategy. Alternatively, private equity firms may choose to pursue two or more distinct private equity investment strategies, organizing a fund (and then successor funds) to pursue each of those strategies. Other private equity firms may organize different private equity funds (and, eventually, successor funds) to invest in different geographies.

B. Private Equity Funds

Private equity funds are closed-end pooled investment vehicles, most frequently organized as limited partnerships, that invest in operating businesses ("portfolio companies"). As described above, a typical private equity fund is sponsored, managed and advised by an affiliated private equity firm.

The fund is controlled by its GP, which makes investment decisions for the fund and, as noted above, typically also is affiliated with the private equity firm that manages and advises the fund. The GP makes a significant capital commitment to the fund, *i.e.*, a contractual agreement to contribute capital from time to time over the term of the fund, generally as and when needed by the fund to make investments and pay expenses.

The private equity fund also obtains capital commitments, at the beginning of its term in private placement transactions, from sophisticated third party investors that agree to become the limited partners (or members or shareholders in a non-partnership structure) of the fund ("LPs"). The LPs, like the GP, contribute capital to the fund over its term, generally as and when needed to make investments and pay expenses. The LPs are not involved in the management or control of the business of the fund except in limited circumstances (*e.g.*, to vote certain on conflicts of interest or to remove the GP). LPs of private equity funds include corporate pension plans, public retirement plans,

foundations, university endowments, sovereign wealth funds, insurance companies and (historically) banks and, to a lesser extent, very high net worth individuals and family offices.

C. Separately Managed Accounts

Separately managed accounts of private equity firms are arrangements negotiated between the private equity firm and a single client, which generally is a very large institutional investor (such as a pension fund or sovereign wealth fund) that makes a very large capital commitment that in return negotiates customized terms and conditions. Separately managed accounts may invest alongside one or more private investment funds or products offered by the same private equity firm and may have some terms that differ from the private equity fund sponsored by the private equity firm, *e.g.* shorter investment periods, customized reporting arrangements and/or have different fee arrangements. But for these customized terms, however, many separate account arrangements are identical in all other respects (and may use partnership agreements cloned from) those of the private equity firm's traditional private equity funds.

A traditional separately managed account is merely a contractual account where the private equity firm manages and advises the client's account; the client retains direct and sole ownership of the assets under management, and those assets are (typically) held at an independent custodian on behalf of the client. Many so-called separately managed accounts managed by private equity firms today, however, are structured as so-called "funds of one," *e.g.*, a limited partnership that is (1) managed and advised by a private equity firm, (2) controlled by a GP that is affiliated with the private equity firm and (3) has a single investor (LP). In this letter, all discussions of private equity funds apply equally to separately managed accounts because, typically, separately managed accounts that are advised by private equity firms have the same basic terms as private equity funds, including provisions concerning (*i.e.*, limiting) redemptions, and use leverage in a manner consistent with private equity funds.

II. Private Equity Firms and Funds Do Not Present Systemic Risk Concerns

As the PEGCC has explained in prior submissions to the FSOC, we believe that the structure of private equity firms and funds and the conduct of their businesses, as a class and individually, do not present systemic risk concerns.² Similarly, private equity

² See PEGCC Letter to the FSOC (Dec. 16, 2011) (commenting on the Second Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies – Docket No. FSOC 2011-0001); *see also* PEGCC Letter to the Federal Reserve Board (March 30, 2011) (commenting on Proposed Rule for Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company – Docket No. R-1405); PEGCC Letter to the FSOC (Feb. 25, 2011) (commenting on the Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain

firms and funds do not engage in activities that implicate the specific issues raised in the Notice. In particular, we highlight the following points discussed in our previous letters:

1. No General Redemption Rights. Investors in private equity firms and funds do not have redemption or withdrawal rights that would enable those investors to force a fire sale of assets were those investors to attempt to make a “run on the bank.” In addition, private equity firms are funded with long-term capital commitments and do not rely on short-term credit. Private equity firms and funds, therefore, do not face liquidity concerns that could result in forced asset sales to meet investor (or other) claims—and which in turn could drive down investment values, thereby adversely affecting other financial system participants.

2. Limited Leverage. Although portfolio companies frequently borrow, there is evidence that the average default rate for private equity portfolio companies is lower than the average default rate for non-portfolio company borrowers.³ In addition, private equity funds (other than certain real estate and debt funds, and other than short-term debt used to bridge capital calls) typically have little to no leverage. Indeed, (1) many fund governing documents limit the amount of borrowing that a fund may incur and (2) most private equity funds have little or no current income to service debt even if they are permitted to borrow. Private equity firms and funds stand in contrast to banks or certain types of investment vehicles, which are (frequently highly) leveraged.⁴

3. No Substitutability Concerns. Private equity firms and funds do not present substitutability concerns because—although they play an important role in our economy and help grow and strengthen the businesses in which they invest—such firms and funds do not provide the kinds of products, services or infrastructure that are necessary for the functioning of the financial system (such as consumer credit, clearance and settlement services, or legally required insurance products) and that other institutions cannot readily provide.

Nonbank Financial Companies – Docket No. FSOC 2011-0001); PEGCC Letter to the FSOC (Nov. 5, 2010) (commenting on the Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies – Docket No. FSOC 2010-0001).

³ Steven Miller, *Romney, Private Equity and Defaults: What the Record Shows*, Forbes, Jan. 23, 2012, <http://www.forbes.com/sites/janetnovack/2012/01/23/romney-private-equity-and-defaults-what-the-record-shows/> (“the average default rate of private-equity-backed loans between 1998 – the beginning of our data series – and 2011 is 3.97% versus 4.62% for non-sponsored deals”).

⁴ In addition, certain U.S. tax-exempt investors in private equity funds are sensitive to the incurrence of “unrelated business taxable income” for U.S. tax purposes, which could arise from the sale of assets acquired using fund-level debt.

4. Limited Financial System Interconnectedness. Private equity firms and funds are not deeply interconnected with banks or with other nonbank financial companies, including by virtue of: limited fund-level leverage (as discussed above); limited or no derivatives positions; limited counterparty exposure relating to, for example, swaps (other than possibly currency and interest rate swaps) or securities lending; and limited or no reliance on short-term credit for their operations or provision of credit to financial system participants. Furthermore, such firms and funds are not interconnected with each other, because they neither pledge their assets as security for, nor do they guarantee, each other's obligations. Therefore, the failure of a private equity firm or fund would not create cascading negative effects on other parts of the financial system. Similarly, the failure of any particular portfolio company will not cause the failure of other portfolio companies in which the same fund invests, the fund itself or the private equity firm that sponsors the fund.

5. Relatively Small Size. Very large financial firms, such as banks or large asset managers, that are interconnected with other financial firms are likely to have larger spillover effects should they fail than would smaller firms. Private equity firms and funds both are not deeply interconnected with banks and other non-bank financial companies, and are relatively small in size compared to large banks, insurance companies, broker-dealers and advisors to registered investment companies.⁵

III. Private Equity Firms and Funds Do Not Implicate Issues Raised in the Notice

Private equity firms and funds do not implicate the issues and concerns raised in the Notice. In particular: the lack of redemption rights means there is no liquidity risk; private equity firms and funds use leverage on a limited basis; private equity firms and funds do not face the same operational risks as large, complex asset managers; and, because private equity firms and funds are not deeply interconnected with other financial institutions, the wind down of a private equity firm or fund would not cascade through the financial system. These issues are described in more detail below.

A. Liquidity and Redemption

The Notice asks about liquidity risk, which it refers to as “the risk that an investor will not be able to buy or sell an asset in a timely manner without significantly affecting the asset's price.” The Notice asks whether liquidity risk issues affect investor

⁵ For example, the largest private equity firm known to us has risk assets (i.e., the total amount that a firm would lose in the unprecedented event that the firm and all of the funds it advises were to fail) of \$9.58 billion. At the fund level, the largest private equity fund known to us has capital commitments of just over \$21 billion, and most private equity funds are significantly smaller.

redemption behavior in a way that could ultimately affect financial stability different from direct investment.⁶

Private equity firms and funds offer no (or extremely limited) redemption rights and therefore do not implicate this concern. Indeed, because of the long-term, illiquid nature of their investments, private equity funds do not offer and are not able to offer redemption rights to their investors. In addition, private equity funds typically do not allow their investors to withdraw from the fund, except in extremely limited circumstances (such as a change in law that makes it illegal for such investor to continue to hold its interest in the fund), and in any event the fund is not forced to sell assets to effect such withdrawal. Furthermore, for tax and business reasons, private equity funds typically do not allow LPs to transfer their interests in the fund without the consent of the GP.

B. Leverage

The Notice inquires about the potential risks posed by leverage. The Notice describes leverage as being created when an investment vehicle enters into transactions resulting in investment exposures that exceed equity capital, notes that leverage can magnify the impact of asset price movements and asks questions regarding the ways in which leverage is used and whether those uses could increase the potential for forced asset sales, other losses or risks and potential impacts on U.S. financial stability.⁷

Private equity *funds* do not implicate these concerns because, although debt may be incurred at the portfolio company level in buyout transactions, most private equity funds themselves engage in limited borrowing. Private equity funds typically are not permitted by their governing documents to borrow, with very limited exceptions, as noted above.

As for private equity *firms*, while they may have revolving lines of credit or other borrowings to fund ordinary business operations, most private equity firms are only modestly leveraged, if at all. So, private equity firms and private equity funds generally are not subject to unsustainable debt or creditor margin calls (and the adverse effects thereof).

Many portfolio companies of funds pursuing a buyout strategy, like most U.S. operating businesses, do employ leverage.⁸ The balance sheet management of underlying

⁶ 79 Fed. Reg. at 77490.

⁷ *Id.* at 77491.

⁸ The average gross leverage ratio for U.S. private equity deals in 2014 was 1.68:1, although some portfolio companies may be materially more or less leveraged. *See* Standard & Poor's Q4 2014 Leveraged Buyout Review. In other words, on average U.S. private equity deals in 2014 were

operating businesses, however, is not an asset management issue; the use of leverage by portfolio companies is a question regarding the broader macroeconomic credit cycle. Further, the portfolio companies of some private equity funds, such as those of buyout funds, may be more (or less) leveraged than other U.S. operating businesses, but the failure of a single portfolio company will not cause the failure of another portfolio company, because the borrowings or other obligations of one portfolio company are not guaranteed by, or secured by pledges of the assets of, the fund or any other portfolio company.

C. Operational Functions

The Notice inquires about risk arising from operational functions, which the Notice describes as the risk arising from inadequate or failed processes or systems, human errors or misconduct or adverse external events, such as business disruptions and failures in systems and processes.⁹ The Notice focuses on risks from two particular areas: (1) transfers of significant levels of client accounts or assets from one asset manager to another; and (2) the reliance by multiple asset managers on one or a limited number of third parties to provide important services, such as asset pricing and valuation or portfolio risk management.

These risks are typically not present in the private equity business. First, private equity firms do not have physical possession of the types of client assets that present these types of risks, such as large positions of publicly traded securities. All large U.S. private equity firms are registered under the Advisers Act and subject to Rule 206(4)-2 under the Advisers Act (the “Custody Rule”). As a result of the Custody Rule, all of the cash and publicly-traded securities held by private equity funds are required to be maintained with a third-party “qualified custodian,” which is typically a bank or broker-dealer. A private equity firm is subject to a strict prohibition on ever having physical possession of such assets. There are limited exceptions from this requirement for certain uncertificated, privately-offered securities and for certain privately-offered stock certificates. However, these exceptions are premised, in part, on the fact that the ownership of these privately-offered securities are recorded on the books of the issuer or its transfer agent and, therefore, if there is a certificate, it can be replaced by the issuer if it is lost or destroyed.¹⁰ Therefore, the holding of these types of privately-offered

financed with 37.31% equity and 62.69% debt. Source: *id.* These private equity purchases on average held a debt/EBITDA ratio of 5.75x. *See id.*

⁹ 79 Fed. Reg. at 77492.

¹⁰ See IM Guidance Update: Privately Offered Securities under the Investment Advisers Act Custody Rule, Division of Investment Management (August 2013)(discussing the exception for privately-offered stock certificates); Custody of Funds or Securities of Clients by Investment Advisers, SEC Release No. IA-2968 (Dec. 30, 2009) at fn. 64 (discussing the exception for privately-offered, uncertificated securities).

securities by private equity firms do not present the operational risks about which the Notice is concerned.

In addition, investors in private equity funds do not hold an interest in the fund's portfolio securities. Rather they acquire limited partnership interests in the fund (either directly or through "feeder" funds in return for making capital commitments to the fund).

Similarly, as noted above, LPs are not permitted to redeem their interest in a private equity fund, and transfers of LP interests generally require GP consent, which places a natural limit on any "mass" transfers by LPs in a fund.

In addition, unlike asset managers that require valuation and other services to manage the liquidity and others risks of portfolios that include a wide variety of asset classes (such as equities, derivatives, fixed-income and other asset classes), private equity funds hold a single asset class – typically illiquid interests in portfolio companies – and therefore private equity firms do not face the same risk management and portfolio management challenges as a large asset manager. As a result, private equity firms do not rely on a limited number of third-party service providers for critical risk and portfolio management needs in the same way as other asset managers.

D. Resolution

The Notice also seeks information on whether there are any financial interconnections, such as transactions, investments, or loans across affiliated investment vehicles, between investment vehicles and an asset manager, or with third parties, that could complicate resolution in the asset management industry, particularly during a period of financial market stress.¹¹

These concerns are not implicated by the private equity industry for a number of reasons. For example, private equity firms and funds are not deeply interconnected with banks or other nonbank financial firms because typically: they do not hold derivatives positions; they do not have counterparty exposure arising from, for example, swaps or securities lending activities; they do not rely on short-term credit for their operations; they do not lend to financial system participants; and they neither rely on prime brokers nor are they otherwise operationally linked to other financial institutions.

Similarly, private equity firms and funds are not interconnected with each other (except, of course, that a private equity fund is operationally linked to the private equity firm that advises and manages such fund) because such firms and funds neither pledge their assets as security for, nor do they guarantee, each other's obligations. A private equity firm typically does not go out of business because the failure of a portfolio

¹¹ *Id.* at 77494.

company or fund causes another portfolio company or fund to fail. Rather, a private equity firm goes out of business because the poor performance (i.e., subpar investment returns) of one or more of the funds advised and managed by the private equity firm makes it impossible for the firm to organize successor funds.

IV. Conclusion

For the reasons outlined above, the PEGCC believes that the activities of private equity firms and funds do not present risks to financial stability. In general, the structure and activities of private equity firms and funds do not implicate the concerns raised in the Notice and do not give rise to systemic risk concerns.

The PEGCC appreciates the FSOC's consideration of our views and is ready and available to respond to any questions that the FSOC may have concerning this letter or that otherwise may develop concerning the private equity industry.

Respectfully submitted,



Steve Judge
President and CEO
Private Equity Growth Capital Council

cc: The Honorable Jacob Lew
Secretary of the Treasury

The Honorable Mary Jo White
Chair, U.S. Securities and Exchange Commission

The Honorable Janet Yellen
Chairman, Board of Governors of the Federal Reserve System

The Honorable Timothy Massad
Chairman, Commodity Futures Trading Commission

The Honorable Martin Gruenberg
Chairman, Federal Deposit Insurance Corporation

The Honorable Melvin Watt
Director, Federal Housing Finance Agency

The Honorable Thomas J. Curry
Comptroller of the Currency

The Honorable S. Roy Woodall, Jr.
Financial Stability Oversight Council

The Honorable Debbie Matz
Chairman, National Credit Union Administration

The Honorable Richard Cordray
Director, Consumer Financial Protection Bureau