SUBMITTED ELECTRONICALLY

February 25, 2011

The Honorable Timothy F. Geithner
Secretary, United States Department of the Treasury
Chairman, Financial Stability Oversight Council
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Financial Stability Oversight Council (the "FSOC") Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the "NPR") – FSOC-2011-0001

Dear Secretary Geithner:

These comments are submitted by the Private Equity Growth Capital Council (the "PEGCC"). The PEGCC is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy. Established in 2007 and formerly known as the Private Equity Council, the PEGCC is based in Washington, D.C. The members of the PEGCC are 33 of the world's leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest.[1]

The PEGCC has supported and continues to support efforts to identify potential systemic risks before they arise and, where appropriate, to require enhanced regulation of systemically significant, nonbank financial companies. On November 5, 2010, the PEGCC submitted comments in response to the FSOC Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of

[1] The members of the PEGCC are: American Securities; Apax Partners; Apollo Global Management LLC; Avista Capital Partners; The Blackstone Group; Brockway Moran & Partners; The Carlyle Group; Crestview Partners; Francisco Partners; Genstar Capital; Global Environment Fund; GTCR; Hellman & Friedman LLC; The Jordan Company; Kelso & Company; Kohlberg Kravis Roberts & Co.; KPS Capital Partners; Levine Leichtman Capital Partners; Madison Dearborn Partners; MidOcean Partners; New Mountain Capital; Permira; Providence Equity Partners; The Riverside Company; Silver Lake; Sterling Partners; Sun Capital Partners; TA Associates; Thoma Bravo; Thomas H. Lee Partners; TPG Capital (formerly Texas Pacific Group); Vector Capital; and Welsh, Carson, Anderson & Stowe.

Certain Nonbank Financial Companies. The PEGCC reviewed each of the statutory factors that the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires the FSOC to consider in determining whether a nonbank financial company should be designated for enhanced supervision (the "statutory considerations"), as such considerations apply to private equity and growth capital firms ("private equity firms") and the private equity and growth capital funds managed by those firms ("private equity funds").[2]

The PEGCC concluded in its November 5 letter that private equity firms and private equity funds, as a class and individually, do not present systemic risk concerns under any or all of the statutory considerations. Federal Reserve Board Chairman Bernanke has expressed his view that no individual hedge fund or private equity fund would become a systemically critical firm:

> [M]y view at this point is that I would not think that any hedge fund or private equity fund would become a systemically critical firm individually. However, it would be important for the systemic risk council to pay attention to the industry as a whole and make sure that it understood what was going on so there wouldn't be kind of a broad-based problem that might cut across a lot of firms. [3]

The PEGCC believes that that the NPR correctly identifies the appropriate criteria for designating nonbank financial firms, and continues to believe that application of those criteria demonstrates that private equity firms and private equity funds, individually or as a class, do not present systemic risk concerns.

The PEGCC appreciates the opportunity to submit these comments, for consideration by you and your fellow FSOC members, concerning (*A*) the structure and operations of private equity firms and funds, (*B)* the application of systemic risk criteria to private equity firms and to private equity funds and (*C*) the notice, information collection and hearings process set forth in the NPR.

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2 For the avoidance of doubt, for purposes of this letter we do not include in the definition of private equity funds the following: private investment funds sponsored by banks or insurance companies, even if some of those funds make private equity-type investments; any private investment fund that is open-ended; funds of funds (funds that invest in private equity funds or other private investment funds); and hedge funds.

3 Testimony of Ben Bernanke, Chairman of the Federal Reserve Board, to the House Committee on Financial Services (October 1, 2009).

A. Structure and Operations of Private Equity Firms and Funds.

To provide important context for the discussion below, here we provide a description of the structure and operations of private equity firms and private equity funds:

1. 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 fund ("GPs"). Private equity firms most frequently 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, or after July 21, 2011 will be required to be, registered as investment advisers under the Investment Advisers Act of 1940.

Private equity firms may have one or several lines of business. Many private equity firms organize and advise a private equity fund to pursue a particular private equity investment strategy and, once that fund is largely invested, the private equity firm will organize a successor fund to continue that investment strategy. Other private equity firms may 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 to invest in different geographies.

In addition, some private equity firms—although primarily in the business of advising private equity funds—also have ancillary (non-private equity) businesses, such as hedge funds or fund of funds businesses, among others. These ancillary businesses are small relative to large asset management businesses and, critically, are not cross-collateralized or otherwise interconnected with the private equity firm or any of the private equity funds advised by the firm. Thus, these diversified private equity firms do not raise systemic risk concerns. To the extent that regulators review these non-private equity businesses for systemic risk purposes, the PEGCC believes that these other ancillary businesses should be assessed separately from a firm's private equity business.

2. Private Equity Funds: Typical Structure.

Private equity funds are closed-end pooled investment vehicles, most frequently organized as limited partnerships, that invest in operating businesses ("portfolio companies"). A private equity fund typically is controlled by its GP, which makes investment decisions for the fund and is affiliated with the private

equity firm that 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 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 who agree to become 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. The LPs are not involved in the management or control of the business of the fund except in very limited circumstances (e.g., to vote on conflicts of interest or to remove the GP). LPs of private equity funds include corporate pension plans, public retirement plans, foundations, endowments, sovereign wealth funds, insurance companies and (historically) banks, and to a lesser extent very high net worth individuals and family offices.

3. Private Equity Funds: Investment Strategies and Diversification.

Private equity funds pursue a variety of investment strategies (*e.g.,* venture capital, growth capital, buyout, real estate, distressed and mezzanine investing) and invest in a broad range of industries and geographies.[4] While an individual private equity fund may hold a limited number of investments, and while some private equity firms and/or private equity funds have a geographic or industry focus, private equity funds in the aggregate are diversified across multiple geographies and industries and thus lack concentrated exposure in any single region or sector.[5]

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[4] Private equity investing can take many forms. For example, a private equity fund may acquire common or preferred stock of a promising start-up or early stage company with the intent of providing its founders with the capital necessary to commercialize the company's product (*i.e.,* a venture capital investment). Or, the fund may inject equity into, or buy debt of, a struggling company in an effort to turn around its operations (*i.e.,* a distressed investment). Or, the fund may invest in a promising or strong company that needs capital to expand into new markets or develop new products (*i.e.,* a growth capital investment). Or, the fund may make equity investments in more mature businesses, where the purchase price is a combination of the fund's equity investment and proceeds from new senior and subordinated debt that is borrowed (and eventually is to be repaid) by the business being acquired (*i.e.,* a buyout transaction). These private equity transactions could involve purchases of: unwanted, non-core (and often undermanaged) divisions of large conglomerates; family businesses where the founders are seeking to transition beyond family ownership; public companies that are taken private in an effort to increase value long-term without the short-term earnings pressures of the public markets; and underperforming businesses where not only capital but also operating and financial expertise can be brought to bear to turn around the business.

[5] From 2000 to 2007, for example, buyout investment in a sector as a percentage of total buyout investment was as follows: for industrial companies, 21.2%; for consumer-related companies, 14.7%; for communications businesses, 12.1%; for computer firms (software and hardware), 9.6%; for health care concerns, 9.5%; for Internet-specific companies, 7.8%; for business and financial consulting and other services firms, 7.3%; and for other types of businesses, 17.9%.

4. Private Equity Funds: Long-Term Funding, Long-Term Illiquid Investments.

As noted above, capital is contributed to a private equity fund by its GP and its LPs over the fund's term as and when needed by the fund to make investments and pay its expenses. The term of a private equity fund is typically 10 years (subject to extension for up to two or three years if needed by the fund to dispose of any investments then remaining in the portfolio). Most often new investments are made by a fund only during the first three to six years of the fund's term. Whatever the investment strategy or focus of a private equity fund, that fund typically invests capital in highly illiquid securities (*i.e.,* securities not tradable on a securities exchange)—common equity and, to a lesser extent, preferred equity or debt securities such as mezzanine debt—of operating businesses. A private equity fund typically holds each of its investments for between three and seven years. In each case the fund works to improve the value of the business in which it has invested so that, eventually, that investment may be sold by the fund at a profit based on the value created during the period that the fund owned a stake in that investment.[6]

When an investment is sold by a fund, the sale proceeds typically are distributed by the fund to its investors so that: first, the investors receive a return of their capital; next, the investors receive a preferred return (typically 8% per annum) on that capital; and then the profits are shared between the LPs and the GP so that over the life of the fund the GP receives, in addition to the return on its capital investment, a share of the profits, typically 20%, referred to as the GP's "carried interest." With very limited exceptions, a private equity fund is not permitted to reinvest (recycle) the proceeds from the sale of a portfolio investment. So, when the fund has invested (or reserved to cover fund expenses or liabilities) all of its capital commitments, the fund can make no further investments; and the private equity firm must raise a new, successor fund to continue that private equity fund's investment strategy.

Source: Robert J. Shapiro and Nam D. Pham, *The Role of Private Equity in U.S. Capital Markets*, supported by the PEGCC (October 2008), at page 14.

6 Regardless of the type of portfolio investment made, the objective of a private equity fund is the same: increase the value of the portfolio company during the time that it is owned by the private equity fund. Private equity funds accomplish this by, for example: strengthening and adding to the management team; assisting the company in achieving an optimal capital structure; requiring the implementation of management and employee equity stock ownership and/or revised performance based bonus plans; professionalizing financial management of the portfolio company; providing operational assistance; sitting on a revitalized board of directors; working with management to develop and implement a new or revised business plan; and/or causing the company, as appropriate, to make capital and R&D expenditures, to cut corporate waste and inefficiencies, to expand into new markets and develop new products, and/or to make strategic acquisitions to create the scale required to compete more effectively and become market leaders.

5. Private Equity Funds: Strictly Limited Hedging and Trading.

As discussed above, the investment strategies of private equity funds are mostly long-term "buy and hold" strategies, not trading strategies. Private equity funds typically purchase highly illiquid securities. Not surprisingly, therefore, private equity funds typically are prohibited by the terms of their partnership agreements or other governing documents from hedging for speculative purposes, from purchasing commodities or derivatives, and from investing in hedge funds or publicly traded securities (except in connection with a going private transaction).

6. Private Equity Funds: Limited Lending, Limited Borrowing.

Most private equity funds purchase equity securities, although a relatively small number of funds purchase privately-issued mezzanine or other debt of operating businesses. Even these debt funds rarely originate debt or otherwise provide credit. Accordingly, private equity funds (including these debt funds) are not a material source of credit to businesses, and they are not a source of credit at all to consumers or governments.

With the exception of certain real estate funds, private equity funds almost never borrow, and frequently they are prohibited by their partnership agreements or other governing documents from borrowing. To our knowledge none are reliant on short-term credit markets or regularly roll-over debt as part of their operations. Private equity funds rarely borrow because of the particular tax concerns of tax-exempt LPs concerning "unrelated business taxable income."[7]

[7] It is true that some private equity funds, such as buyout funds, purchase companies using equity and borrowed money—but the funds themselves do not borrow or guarantee that debt. In a leveraged buyout transaction, a buyout fund may, for example, incorporate an acquisition vehicle and make an equity investment; the acquisition vehicle then uses the capital that the fund invested, together with cash that it borrows from a bank or other lender, to purchase the target company from the seller of that business, with repayment of the debt being secured by a lien on the assets of that company and by a pledge by the fund of its shares in the portfolio company. There are many variations on this simplified buyout structure, but all leveraged acquisitions have this in common: when the acquisition is complete, the fund owns an equity stake in an operating business that, like almost all operating businesses in this country, has some degree of leverage on its books that the company (not the fund) is obligated to repay from its earnings; and if the business fails, the lenders and other creditors of the company will be repaid before the fund or other equityholders are entitled to any additional return on their equity investments. In any event the lenders have no recourse to the assets of the private equity fund (except for any shares of the failed portfolio company that were pledged by the fund to secure the borrowing), of any other portfolio company, or of the private equity firm.

7. **Private Equity Funds: No Redemption, Withdrawal or Unlimited Transfer Rights.**

Because of the long-term, illiquid nature of their investments and because they typically do not borrow, private equity funds do not offer (and are not able to offer) redemption rights to their investors. Indeed, a private investment fund is not considered a private equity fund if its investors are permitted to redeem their interests in the fund. Private equity funds typically do not allow their investors to withdraw from the fund, and in any event the fund is not forced to sell assets to effect such withdrawal. For tax and business reasons, private equity funds do not allow LPs to transfer their interests in the fund without the consent of the GP.

8. **Private Equity Funds: No Cross-Collateralization, No Cross-Guarantees.**

Except perhaps for a pledge by a private equity fund of the shares of a portfolio company that it owns as security for that portfolio company's borrowings, the borrowings or other obligations of that portfolio company are not guaranteed by, or secured by pledges of the assets of, the fund or any other portfolio company. So, the failure of one portfolio company should not impact the fund's other portfolio companies. The fund and its investors may lose their investment in the failed portfolio company, but not in other investments held by the fund.

Similarly, the obligations of a private equity fund are not guaranteed by, or secured by pledges of the assets of, another private equity fund; and no private equity fund advised by a private equity firm guarantees or pledges its assets to secure the obligations of the private equity firm, or vice-versa. So, the failure of one private equity fund advised by a private equity firm should have no impact on the other funds advised by that firm.

If one or more private equity funds advised by a private equity firm fail(s) to generate satisfactory returns for their LPs, it may be difficult if not impossible for the private equity firm to raise new private equity funds. If the private equity firm fails to raise new funds, it will continue to advise its existing funds (which existing funds, in turn, will manage and eventually wind down their portfolios over the terms of those funds), and then the private equity firm will quietly go out of business.

B. The Six-Part Framework Described in the NPR is an Appropriate Framework for Analyzing the Potential for Systemic Risk. Application of this Framework to Private Equity Firms and Private Equity Funds Demonstrates that Such Firms and Funds Do Not Present Systemic Risk Concerns.

In its November 5, 2010 comment letter, the PEGCC discussed the six factors—size, substitutability, interconnectedness, leverage, liquidity risk and existing

regulatory scrutiny—that the NPR describes as making up the framework that the FSOC will use to assess the risk that the material distress of a financial institution would adversely impact the financial stability of the United States or threaten the stability of the United States financial system. The PEGCC agrees that the FSOC should analyze these factors and believes that no private equity firms or funds present systemic risk under the proposed framework. We discuss each of the six factors below.

1. **Size: Private equity firms and funds are too small in size to present systemic risk concerns.**

Private equity firms and private equity funds are quite small in size relative to large banks, insurance companies, broker-dealers and advisers to registered investment companies. To put this discussion in context, the 50 largest U.S. bank holding companies had average total assets of nearly $300 billion, and the six largest U.S. bank holding companies had average total assets of over $1.5 trillion, as of December 31, 2010.[8]

The PEGCC believes that, for purposes of analyzing potential systemic risk, the proper metric for measuring the size of a private equity *firm* is risk assets, which is the total amount that a firm would lose in the extraordinarily unlikely (indeed, unprecedented) event that the firm and all of the funds it advises were to fail. The largest private equity firm known to us has risk assets of less than $6 billion.

The PEGCC believes that the proper metric for measuring the size of a private equity *fund* is its assets available for investment, *i.e.* capital commitments. The largest private equity fund known to us has capital commitments of less than $21 billion, and most private equity funds are significantly smaller.

Although private equity firms are also relatively small when measured by assets under management, the PEGCC does not believe that it is appropriate for systemic risk analysis purposes to calculate the size of a private equity firm based on its assets under management. As discussed at paragraph A.8 above, private equity firms and their sponsored funds are not cross-collateralized and portfolio investments are (indirectly) managed, and not owned, by the private equity firm. The risk of loss of a particular portfolio investment made by a particular private equity fund is a risk borne by that fund and its investors, and not by the private equity firm (except to the extent of its investment through the GP of that fund). The private equity firm cannot use the assets of a private equity fund to gain access to liquidity or to settle its debt.

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[8] Source: National Information Center's list of Top 50 bank holding companies, available at http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx.

Private equity firms and funds are also quite small when measured by liabilities. As compared to other financial system participants, whose liabilities can be enormous, the liabilities of private equity firms and private equity funds barely register because (as discussed below) they do not have significant counterparty exposure and they typically are not leveraged.

Another way to measure size is by measuring transaction volume. Private equity funds generally invest in illiquid securities, and do not actively trade their portfolios. A typical private equity fund will make between two and eight investments each year (perhaps a few more in the case of venture funds). Therefore, as compared to other financial institutions, some of which place hundreds or thousands of trades every day, the amount of trading activity of a private equity firm or fund is insignificant.

Given the material differences between private equity firms and other nonbank financial companies, the PEGCC believes that the FSOC should not take a "one size fits all" approach to designating nonbank financial companies based on size. Size should be considered together with the other factors discussed herein and no arbitrary thresholds should be established based solely on size, given that the failure of even the largest private equity funds would not have a negative impact on the broader financial system in the absence of interconnectedness and substitutability concerns.

2. **Substitutability: Private equity firms and funds do not provide financial products or services that cannot be replaced.**

Substitutability concerns exist when a bank or nonbank financial company provides a product, service or infrastructure that is of critical importance to the functioning of the financial system *and* that product, service or infrastructure cannot be replaced if such bank or nonbank financial company fails. Examples of products, services and infrastructure that might be considered to be of critical importance to the financial system include: (*a*) financial products and services that are critical to consumers (such as savings and checking accounts and consumer credit); (*b*) financial products that are legally required to be purchased by consumers (such as medical, motor vehicle and certain other insurance products); and (*c*) infrastructure that is necessary for the functioning of the financial system (such as clearance and settlement activities). If a provider of such vital products, services or infrastructure fails and cannot be quickly replaced by another provider, material systemic risk concerns are raised.

The PEGCC believes that private equity firms and funds over the years have made, and continue to make, important positive contributions to job growth, innovation, economic growth, and productivity by improving the operations of the businesses in which they invest. Private equity firms and private equity funds

themselves do not present substitutability concerns, however, because such firms and funds do not provide the kinds of products, services or infrastructure (*a*) that are necessary for the functioning of the financial system *and* (*b*) that could not quickly be replaced by other firms. There is intense competition in the marketplace to raise capital from the sophisticated investors that invest in private equity. If a private equity firm decides to not raise or is unable to raise a new fund, there are large numbers of investment professionals and new and existing investment firms ready and able to step in and compete for that capital and the available investment opportunities. Indeed, a number of private equity firms have ceased operations in the past decade (including some of the largest such firms) with no negative impact on the functioning of the U.S. financial system.

We note that private equity firms and private equity funds are not a source of credit to households, governments or (except to a very limited extent) businesses, nor do they act as a material source of liquidity for the financial system. Therefore the failure of such firms and funds would not deprive the financial system, or consumers of credit, of an important source of credit.

3. **Interconnectedness: Private equity firms and funds are not deeply interconnected with other financial institutions.**

Private equity firms and private equity funds are not deeply interconnected with non-affiliated banks or other nonbank financial companies, because typically: (*a*) they do not hold derivatives positions; (*b*) they do not have counterparty exposure arising from swaps or securities lending activities; (*c*) they do not rely on short-term credit for their operations; (*d*) they do not provide liquidity to financial system participants; (*e*) they do not borrow; and (*f*) they neither rely on prime brokers nor, typically, are they otherwise operationally linked to other financial institutions. Their structures and operations are such that their failure could not have "spillover" or "ripple" effects on other financial system participants.

Indeed, even *within a large private equity business*, where the private equity firm manages multiple private equity funds, the firm and the funds that it manages are not interconnected with each other, because such firms and funds neither pledge their assets as security for, nor do they guarantee, each others' obligations. A private equity firm typically does not go out of business because the failure of a portfolio company or fund causes another portfolio company or fund to fail, but because the poor performance 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.

Drilling down even more, even *within a single fund*, the fund's portfolio companies are not interconnected with each other, or with the fund that owns them, because the fund does not pledge the equity of a portfolio company to secure indebtedness or other obligations of another portfolio company, and no portfolio

company pledges assets in favor of, or guarantees the indebtedness or obligations of, another portfolio company or the fund.

Because of this lack of interconnectedness, the material financial distress, or even failure, of a private equity fund or a private equity firm would not create cascading negative effects on the broader financial system. Indeed, the PEGCC is not aware of any failure of a private equity firm or fund that has had a negative impact on the broader U.S. financial system.

4. **Leverage: Private equity firms and funds generally are not leveraged and portfolio company leverage does not present more risk than other operating company leverage.**

Private equity *funds* typically are not leveraged. Indeed, (*a*) many fund partnership agreements or other fund governing documents prohibit the private equity fund from borrowing; (*b*) most private equity funds have little or no current income that would enable them to service debt on a current basis even if they were permitted to borrow; and (*c*) investors in private equity funds generally do not expect or want those funds to borrow, either because (*i*) leverage (if it can be serviced by portfolio company cash flow) is incurred at the portfolio company level, or (*ii*) in the case of U.S. tax-exempt investors, borrowing by the fund would likely generate "unrelated business taxable income," which is taxable to those otherwise tax-exempt investors. The private equity business model simply does not rely on the use of fund-level borrowing to magnify returns or for any other purpose. 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. Therefore, private equity firms and private equity funds generally are not subject to unsustainable debt or creditor margin calls.

It is true, of course, that even though private equity funds typically do not borrow, many of the *portfolio companies* in which private equity funds invest are leveraged—as are other operating businesses. However, given the absence of cross-collateralization among a private equity fund's portfolio companies, which prevents the failure of one portfolio company from affecting the fund's other portfolio companies, the PEGCC submits that portfolio company leverage is not relevant to an assessment of the potential for systemic risk posed by private equity firms and funds. If a portfolio company faces financial distress and is unable to service its debt, there is no risk (beyond the potential loss of that particular investment) to the private fund that invested in the portfolio company.

Turning to the potential systemic risk that portfolio company leverage might pose to banks and other lenders to portfolio companies, the PEGCC wishes to make six points. First, if a portfolio company is neither a bank nor a nonbank financial company, we believe that the FSOC is not charged with assessing the risk that the

material distress of such a company might pose to the U.S. economy or the U.S. financial system. The Dodd-Frank Act, to our knowledge, does not mandate the FSOC to examine the operations of non-financial businesses. The mere fact that a non-financial business is owned (in whole or in part) by a private equity fund rather than a strategic investor or public shareholders should not expand the FSOC's mandate.

Second, if the FSOC nevertheless determines that it is empowered and required to analyze the risk to the U.S. economy and financial system presented by the borrowing practices of non-financial businesses, there is no reason to limit that examination to operating companies owned by private equity firms. If operating company borrowing is risky, it should not make a difference to regulators if the company is owned by a strategic investor or public shareholders or is owned (in whole or in part) by a private equity fund.

Third, if the FSOC determines that it is empowered and required to analyze the risk to the U.S. economy and financial system presented by the amount of leverage at non-financial businesses, the PEGCC submits that a regulatory focus on sound *lending* practices applicable to all such businesses is more likely to uncover systemic risk concerns than a focus on borrowers.

Fourth, if regulators do focus on borrowing by operating companies, the PEGCC submits that there is no evidence that private equity-owned businesses default on debt at a rate greater than other businesses. In fact, there is evidence that the default rate for private equity portfolio companies is lower than the average default rate for all U.S. corporate bond issuers.[9]

Fifth, to the extent that the FSOC believes that leverage at the portfolio companies of private equity funds is relevant to systemic risk analysis, the PEGCC submits that such leverage is modest in comparison to that of large bank holding companies and broker-dealers. The average gross leverage ratio of private equity deals is historically approximately 2.85:1, although some portfolio companies may be

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[9] Source: Kaplan, Steven N. and Per Stromberg. 2009. "Leveraged Buyouts and Private Equity," *Journal of Economic Perspectives*, Volume 23, Number 1 (Winter 2009) (Analyzing data on 17,171 worldwide private equity acquisitions announced between 1970 and 2002 and finding that the annualized default rate as of 2007 for private equity portfolio companies was 1.2%, compared to the average default rate of 1.6% reported by Moody's for all U.S. corporate bond issuers); Thomas, Jason, "The Credit Performance of Private Equity-Backed Companies in the 'Great Recession' of 2008–2009," *Entrepreneurship & Finance*, Vol. 5, No. 30 (April 12, 2010), supported by the PEGCC, available at SSR: http://ssrn.com/abstract=1582666 (Analyzing private equity-backed companies acquired in a buyout or similar transaction between 2000 and 2009 and held through 2008-2009 and finding that private equity-backed businesses defaulted at less than one-half of the rate of comparable companies during 2008-2009).

materially more or less leveraged.[10] By comparison, Lehman Brothers was leveraged at approximately 32:1 at the end of February 2008,[11] a gross leverage ratio relatively common among large broker-dealers at that time.[12]

Finally, the PEGCC agrees that if a portfolio company is itself a bank or nonbank financial company, that portfolio company should be analyzed for systemic risk purposes like any other similarly situated company. The mere fact that it is owned (in whole or in part) by a private equity fund should not change that analysis.

The PEGCC is aware that the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission issued joint proposed rules on January 25, 2011 regarding Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF (the "Proposed Private Fund Reporting Rules"). Although the Proposed Private Fund Reporting Rules concern reporting by private fund advisors, they do suggest two (relatively limited) ways in which private equity transactions could have systemic risk implications. The PEGCC believes that these concerns are misplaced.

First, the Proposed Private Fund Reporting Rules suggest that the bridge financing that is sometimes provided by banks to portfolio companies in connection with their acquisition could have systemic risk implications for the banks that provide such bridge financing:

> Leveraged private equity transactions often rely on banks to provide bridge financing until the permanent debt financing for the transaction is completed, whether through a syndicated bank loan or issuance of high yield bonds by the portfolio company or both. When market conditions suddenly turn, these institutions can be left holding this potentially risky bridge financing (or committed to provide the final bank financing, but no longer able to syndicate or securitize it and thus forced to hold it) at precisely the time when credit market conditions, and therefore the institutions' own general exposure to private equity transactions and other committed financings, have worsened.[13]

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[10] Source: Standard & Poor's Q4 2010 Leveraged Buyout Review.

[11] Source: Lehman Brothers Holdings Inc., Quarterly Report on Form 10-Q, for the quarterly period ended February 29, 2008, at pages 5-6 (available at http://www.sec.gov/Archives/edgar/data/806085/000110465908023292/a08-10156_110q.htm).

[12] Source: Tobias Adrian and Hyun Song Shin, *Liquidity and Leverage*, Journal of Financial Intermediation (2010), at page 433, Figure 16.

[13] Source: Proposed Private Fund Reporting Rules, pp. 24–25.

The Proposed Private Fund Reporting Rules mischaracterize bridge financing as risky short-term financing. Bridge commitments, if they are ever drawn upon and not subsequently refinanced, convert to long-term debt—typically with a seven- to ten-year maturity. Bridge financing is relatively expensive compared to public bonds, so borrowers prefer public bonds, but bridge financing does not present inherently greater systemic risk than any other form of financing. The PEGCC strongly believes that the total outstanding amount of bridge financing at any time is highly unlikely to pose a risk to the financial system. But even assuming that a particular bank were to extend excessive bridge financing, designating a private equity firm or fund as systemically significant would have no impact on such bank. If there is systemic risk involved in bank lending, the regulatory focus should be on sound lending practices.

Second, the Proposed Private Fund Reporting Rules suggest that "if private equity funds conduct a leveraged buyout of an entity that could be systemically important, information about that investment could be important in FSOC monitoring and assessing potential systemic risk." As noted above, the PEGCC believes that any systemic risk that would arise from such an acquisition would be due to the nature of the portfolio company, not due to the identity of its owner. There is no evidence that a systemically important bank or nonbank financial company owned by a private equity fund poses a greater risk than a systemically important company owned by another type of shareholder. If the portfolio company itself meets the criteria for designation, it should be designated as presenting systemic risk without so designating the private equity fund that acquires it.

5. **Liquidity risk: Private equity firms and funds generally have long term assets and liabilities.**

Private equity funds invest in highly illiquid assets and rely on long-term, stable financing in the form of capital commitments from their investors. Once a private equity fund draws and invests all if its capital commitments in portfolio companies, it generally may not make additional investments. Private equity funds do not rely on short-term financing that could dry up (indeed, as discussed above, private equity funds typically do not borrow at all). Rather, long-term capital (in the form of capital commitments that are typically locked-up for 10 years) is used to make long-term investments.

Furthermore, private equity funds do not invest in liquid securities that could be dumped rapidly into the markets if the firm needs capital; and in any event their investors generally 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". Therefore, private equity firms and private equity funds cannot be forced to rapidly unwind their portfolios and dump assets to satisfy investor or other claims.

6. **Existing regulatory scrutiny: Private equity firms are and will be subject to significant SEC scrutiny.**

Subject to limited exceptions (for small firms, certain non-U.S. firms and venture capital firms), private equity firms are registered, or after July 21, 2011 will be required to be registered, with the SEC as investment advisers and thus subject to SEC regulation, reporting and inspection. Regulators also now have the authority to require all private equity firms and private equity funds to provide any additional data needed to assess systemic risk. Furthermore, interests in private equity funds are and always have been offered to sophisticated investors in private placement transactions subject to the antifraud provisions of U.S. federal and state and non-U.S. securities laws.[14] In addition, most private equity funds are organized as limited partnerships, with a general partner that under state law owes common law and statutory duties to the limited partners (investors).

C. The Proposed Notice, Information Collection and Hearings Process Should Allow Nonbank Financial Companies Adequate Time to Respond to Notices and an Opportunity to Present Oral and Written Arguments to the FSOC.

The designation of a nonbank financial company for enhanced supervision and prudential standards under the Dodd-Frank Act could have a material and adverse effect on such company. Companies that in fact are large and interconnected enough to present systemic risk are likely to be highly complex institutions. The PEGCC believes that companies being considered for determination must be given sufficient time to respond to FSOC notices and must have the opportunity to discuss the systemic risk analysis with regulators as early as practicable in the designation process. The PEGCC believes that the notice, information collection and hearing provisions in the Proposed Rule should be revised as follows:

1. **Nonbank financial companies should receive detailed information in initial notices and have the opportunity to meet with FSOC staff.**

Under Section 1310.21(a) of the Proposed Rule, the FSOC must provide a nonbank financial company written notice (a "1310.21(a) Notice") if the FSOC is considering whether to designate such company for supervision by the Board of

[14] In addition to being subject to U.S. federal and state and non-U.S. securities laws, private equity firms and funds are subject to significant contractual restrictions and oversight imposed by the sophisticated investors in those funds. Investors in private equity funds typically are large institutional investors and high net worth individuals, usually represented by counsel, who conduct extensive due diligence and heavily negotiate the terms and conditions, reporting, governance and other duties of the private equity fund and the private equity firm (or general partner) that manages and controls the fund.

Governors of the Federal Reserve System and prudential standards ("1310 Designation"). In order to assure that a nonbank financial company is able to adequately respond to a 1310.21(a) Notice, the PEGCC respectfully requests that Section 1310.21(a) be revised to provide that (*a*) the 1310.21(a) Notice shall include a reasonably detailed statement as to why the FSOC is considering a 1310 Designation with respect to such company, (*b*) the 1310.21(a) Notice shall state that representatives of such company shall have an opportunity to meet with senior staff having responsibility for recommending the 1310 Designation to the full FSOC in order to discuss the FSOC's concerns and the basis for such concerns, and (*c*) the FSOC shall provide for such meetings, within 30 days after the 1310.21(a) Notice is provided to such company.

2. Nonbank financial companies should be allowed sufficient time to prepare written materials for the FSOC.

Under Section 1310.21(a) of the Proposed Rule, the FSOC must fix a time for a nonbank financial company that has received a 1319.21(a) Notice to submit written materials, which date may not be later than 30 days after the 1310.21(a) Notice is provided. Given the complexity and number of factors that are to be considered by the FSOC under the Proposed Rule and the likely complexity of the company that may be proposed for designation, the PEGCC believes that such company will require significant time and resources to prepare written materials in response to a 1310.21(a) Notice. The PEGCC respectfully requests that Section 1310.21(a) be revised to provide that a nonbank financial company shall have *at least* 60 days to submit written materials.

3. Written notice of proposed determination should include the data used by the FSOC.

Under Section 1310.21(b) of the Proposed Rule, if the FSOC makes an initial determination that a nonbank financial company should be subject to a 1310 Designation, the FSOC must provide a written notice of such proposed designation to such company, including an explanation of the basis of the proposed determination (a "1310.21(b) Notice"). In order to ensure that a nonbank financial company is able to respond adequately to a 1310.21(b) Notice, the PEGCC respectfully requests that Section 1301.21(b) be revised to provide that a 1310.21(b) Notice shall include the data used by the FSOC in making the proposed determination (or that such data be made available upon request).

4. Nonbank financial companies being considered for 1310 Designation should have the right to present oral and written arguments.

Under Section 1310.21(c) of the Proposed Rule, a nonbank financial company being considered for a 1310 Designation may request an oral or written hearing

before the FSOC. The FSOC has sole discretion to allow oral testimony or argument. Given the complexity and number of factors to be considered by the FSOC and the likely complexity of the company being considered for designation, the PEGCC believes that all companies that receive a 1310.21(b) Notice should have the opportunity to meet with the FSOC to submit oral and written testimony and argument and to discuss the appropriateness of a 1310 Designation.

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The PEGCC appreciates the FSOC's consideration of this letter and is available to discuss any questions that the FSOC may have concerning the private equity industry.

Respectfully submitted,

Douglas Lowenstein
President
Private Equity Growth Capital Council

cc: Mr. Alastair Fitzpayne
Deputy Chief of Staff and Executive Secretary
United States Department of the Treasury