SUBMITTED ELECTRONICALLY

November 5, 2010

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") Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the "ANPR") – FSOC-2010-0001

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 and resource center 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 32 of the world's best-known and most respected 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 (*i.e.*, those whose material financial distress or failure, or ongoing activities, could pose a threat to the financial

1 The members of the PEGCC are: American Securities; Apax Partners; Apollo Global Management LLC; Avista Capital Partners; Bain Capital Partners; The Blackstone Group; Brockway Moran & Partners; The Carlyle Group; Crestview 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; Thomas H. Lee Partners; TPG Capital (formerly Texas Pacific Group); Vector Capital; and Welsh, Carson, Anderson & Stowe.

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stability of the United States).[2] The FSOC was created to take on this challenge by the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

The PEGCC appreciates the opportunity to submit these comments, for consideration by you and your fellow FSOC members, concerning (*1*) the criteria that should inform the FSOC's possible designation of nonbank financial companies under Section 113 of the Dodd-Frank Act and (*2*) the application of systemic risk criteria to private equity and growth capital firms ("private equity firms") and to the private equity and growth capital funds ("private equity funds") advised by those firms.[3]

Private Equity Firms and Funds Do Not Present Systemic Risk Concerns

The PEGCC believes that private equity firms and private equity funds, as a class and individually, do not present systemic risk concerns under any criteria for assessing such risk of which we are aware.

We discuss systemic risk criteria and their application to private equity firms and funds in detail in our response below to question 2 of the ANPR. However, the most important considerations that lead the PEGCC to this conclusion are the following:

(1) Private equity firms and private equity funds ***are not deeply interconnected*** with banks or with other nonbank financial companies, including by virtue of: derivatives positions; counterparty exposure relating to, for example, swaps or securities lending; reliance on short-term credit for their operations; or the 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 others' obligations. Therefore, the failure of a private equity firm or private equity fund could not create cascading negative effects on other parts of the financial system.

(2) Private equity firms and private equity funds ***do not present substitutability concerns*** because—although they play an important role in our economy and help grow

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[2] See the testimony of Douglas Lowenstein, President of the PEGCC, to the House Financial Services Committee on July 17, 2009 (available at http://www.financialservices.house.gov/Hearings/hearingDetails.aspx?NewsID=1150). See also Mr. Lowenstein's additional testimony to the Committee on October 6, 2009 (available at http://www.financialservices.house.gov/Hearings/hearingDetails.aspx?NewsID=1126).

[3] 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); or hedge funds.

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 provide.

(3) Private equity firms and private equity funds do not rely on short-term financing that could dry up in times of financial stress. In addition, the investors in such 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." Private equity firms and private equity funds, therefore, ***do not face liquidity concerns*** that could result in forced massive asset sales to meet investor (or other) claims—and which in turn could drive down investment values, thereby adversely affecting other financial system participants.

(4) A highly leveraged financial firm, such as a bank, that is interconnected with other financial firms is less likely than an unleveraged firm to be able to absorb spillover effects if another financial system participant fails. However, private equity funds are not interconnected with other financial firms (as mentioned above) and typically ***are not leveraged***. Even the degree of leverage at the portfolio company level is significantly less than that of most large banks and broker-dealers.

(5) Very large financial firms, such as banks, that are interconnected with other financial firms are likely to have larger spillover effects should they fail than would smaller firms. However, private equity firms and private equity funds are not interconnected with other financial firms (as mentioned above) and ***are relatively small in size*** (whether measured by assets available for investment, risk capital, liabilities or transaction volume) compared to large banks, insurance companies, broker-dealers and advisors to registered investment companies.

Structure and Operations of Private Equity Firms and Funds

To provide important context for the more detailed discussion below in our responses to questions posed by the ANPR, here we provide a description of the structure and operations of private equity firms and private equity funds:

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 (and, eventually, successor 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 the regulators review these non-private equity businesses for systemic risk purposes, the PEGCC believes that these other ancillary businesses should be assessed separately from the firm's private equity business. Federal Reserve Board Chairman Bernanke has expressed his view that no individual hedge fund or private equity fund would become a systemically critical firm individually:

> "[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."[4]

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"). As described above, a 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 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 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. The LPs are not involved in the management

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

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.

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.[5] 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.[6]

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

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[5] 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.

[6] 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%. 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.

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.[7] 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 frequently (but not always) 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.

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, virtually all private equity funds 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).

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

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7 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 acquisition to create the scale required to compete and become market leaders.

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." [8]

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, 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. 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.

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

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[8] 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.

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.

Answers to Selected ANPR Questions

1. What metrics should the Council use to measure the factors it is required to consider when making determinations under Section 113 of DFA?

[Text of a. deleted.]

b. Are there some factors that should be weighted more heavily by the Council than other factors in the designation process?

The PEGCC believes that it would be ideal if the FSOC (*1*) could develop objective "screens" that could be used effectively and predictably to eliminate from review nonbank financial companies that clearly do not present systemic risk, and (*2*) then apply additional precise but more subjective criteria to assess the potential for systemic risk presented by the financial firms that remain under review. However, in this letter we limit our comments to the list of factors that are required to be considered by the FSOC and are set forth in Section 113(a)(2) of the Dodd-Frank Act.

Of the Section 113(a)(2) factors, the PEGCC believes that interconnectedness and substitutability considerations, and to a lesser extent liquidity, leverage and size considerations, are among the more important factors that the FSOC should consider when assessing whether (and to what extent) different types of financial system participants are potentially systemically significant.[9] Specifically:

[9] We note that, in discussing systemic risk in his written testimony on financial services reform to the House Financial Services Committee on September 29, 2009, Treasury Secretary Geithner referred to size, leverage and interconnectedness: "Addressing the threats to financial stability posed by large,

(1) ***Interconnectedness*** refers to linkages that exist between and among financial institutions. Examples of these linkages are swaps, securities lending arrangements, derivative positions, and interbank lending and borrowing. Interconnectedness creates the risk of "spillover" or "contagion", *i.e.,* that the failure of one bank or nonbank financial company will have cascading negative effects on other banks or nonbank financial companies. Interconnectedness is a key consideration (perhaps the most important consideration) in assessing systemic risk. If the material financial distress, failure or ongoing operations of a bank or nonbank financial company would not materially impact other banks or nonbank financial companies, then it seems unlikely that such bank or nonbank financial company presents material systemic risk concerns.

(2) ***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: financial products and services that are critical to consumers (such as savings and checking accounts and consumer credit); financial products that are legally required to be purchased by consumers (such as medical, motor vehicle and certain other insurance products); and 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 replaced by another provider, material systemic risk concerns are raised.

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leveraged, and interconnected financial firms is central to the Administration's financial regulatory reforms." *The Administration's Proposals for Financial Regulatory Reform: Hearing Before the Committee On Financial Services*, 111th Congress 54–61 (2009) (written testimony of Treasury Secretary Timothy F. Geithner).

The Financial Stability Board lists interconnectedness, size and substitutability as the key systemic risk factors in its *Report to the G-20 Finance Ministers and Central Bank Governors, Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* (October 2009). The International Monetary Fund discusses interconnectedness in its *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risk* (April 2009).

Publications that contain helpful and accessible discussions of systemic risk include the following: SIFMA and Deloitte, *Systemic Risk Information Study* (June 2010); Robert J. Shapiro and Nam D. Pham, *The Role of Private Equity in U.S. Capital Markets*, supported by the PEGCC (October 2008); Property Casualty Insurers Association of America, *Why "Too Big to Fail" is Too Short-Sighted to Succeed* (January 18, 2010); Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform* (May 2009); and Mary A. Weiss, Center for Insurance Policy and Research, National Association of Insurance Commissioners, *Systemic Risk and the U.S. Insurance Sector* (February 23, 2010).

(3) In times of financial stress, short-term credit could become unavailable, and financial firms that rely on short-term credit for their operations could be forced to sell assets to fund those operations. Similarly, uncertainty in times of financial stress could lead investors to seek to move out of existing debt and equity investments into cash, either by liquidating those investments or, if the investors hold their investments through investment vehicles, by redeeming their interests in such vehicles, which in turn could force those investment vehicles to sell assets to fund those redemption demands. Systemic risk can exist if the ***liquidity concerns*** described above place significant stress on the affected institution and result in forced assets sales that depress investment values, and thereby negatively affect not only the selling institution but also other financial firms.

(4) If a bank or nonbank financial company is deeply interconnected with other financial firms, then ***leverage*** makes that bank or nonbank financial company less likely than an unleveraged company to be able to withstand a financial crisis and absorb spillover effects from one or more other failing financial firms.

(5) If a bank or nonbank financial company is deeply interconnected with other financial firms, then the greater the ***size*** of the bank or nonbank financial company, the more the systemic risk that is made possible by interconnectedness is magnified.

2. What types of nonbank financial companies should the Council review for designation under DFA? Should the analytical framework, considerations, and measures used by the Council vary across industries? Across time? If so, how?

Private equity funds do not present systemic risk concerns under any criteria of which we are aware for assessing systemic risk. The PEGCC believes strongly, therefore, that private equity firms and private equity funds should not, as a class or individually, be required by the FSOC under Section 113 of the Dodd-Frank Act to be designated for supervision and regulation by the Federal Reserve Board,

Specifically, here we review the key systemic risk factors listed in our response above to question 1 of the ANPR and the other factors that the FSOC is required to consider under Section 113(a)(2) of the Dodd-Frank Act, and we apply those factors to private equity firms and private equity funds:

- ***Interconnectedness with other financial companies.*** Private equity firms and private equity 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 the private equity funds that they advise 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 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.)

Because of this lack of interconnectedness, the material financial distress, failure or ongoing operations of private equity firms and private equity funds could not create cascading negative effects on other parts of the financial system.[10]

- ***Substitutability concerns.*** While private equity firms and private equity funds are important to the U.S. economy and help grow and strengthen the businesses in which they invest, they do not provide the kinds of products, services or infrastructure that are of critical importance to the functioning of the financial system, such as (*1*) financial products and services that are vital to consumers (*e.g.,* savings and checking accounts or consumer credit), (*2*) financial products that are legally required to be purchased by consumers (*e.g.,* medical, motor vehicle and certain other insurance products) or (*3*) infrastructure that is necessary for the financial system to operate (*e.g.,* clearance and settlement activities), *and* that could not be replaced by other firms.

- ***Liquidity.*** Private equity funds invest in highly illiquid assets and rely on long-term, stable financing in the form of capital commitments from their investors. They do not incur long-term borrowings to make short-term investments or vice-versa (indeed, as discussed elsewhere in this letter, typically they do not borrow at all). They do not rely on short-term financing that could dry up. Typically they 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

[10] The PEGCC is not aware of any failure of a private equity firm or fund that has had any negative impact on the broader financial system.

other claims, thereby driving down investment values and potentially adversely affecting other financial firms. Private equity firms and private equity funds are structured and operated such that liquidity shortages will not have systemic impacts.[11]

- ***Extent of private equity fund and firm leverage.*** Although debt may be incurred at the portfolio company level in buyout transactions, private equity funds themselves almost never borrow, whether to purchase securities on margin or otherwise. Private equity funds typically do not borrow because of the particular tax concerns of tax-exempt LPs, and frequently are prohibited by the terms of their governing documents from incurring leverage. 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.

- ***Extent of portfolio company leverage.*** Many portfolio companies, like other U.S. operating businesses, are leveraged. 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. The average gross leverage ratio of private equity deals is historically approximately 3:1, although of course some portfolio companies may be materially more or less leveraged.[12] In comparison,

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[11] See, for example, *Globalization of Alternative Investments, Working Papers Volume 3: The Global Economic Impact of Private Equity Report 2010* (World Economic Forum), at page 5: "[T]he structural differences between PE funds and other financial institutions may make them less susceptible to industry shocks. A major source of concern for financial institutions is the so-called 'run on the bank' phenomenon. Runs occur when holders of short-term liabilities, for example, depositors or repo counterparties, simultaneously refuse to provide additional financing and demand their money back. Other versions of this phenomenon arise when companies simultaneously draw down lines of credit, hedge fund investors simultaneously ask for redemptions of their investments, or a freeze in the market for commercial paper prevents structured investment vehicles (SIVs) from rolling over short-term commercial paper. It is unlikely that PE investments create dangers through this mechanism. Private equity funds are typically prevented from borrowing, and the funds' only claimants are their limited partners (LPs), which are typically bound by 10-year lock-up agreements. Hence, the funds have no short-term creditors that can run. By way of contrast, extensive loans are provided to the individual portfolio companies. However, these loans are typically made by a concentrated set of lenders, and are without recourse to other portfolio companies or the fund generally. Hence, an individual creditor's ability to be repaid is largely unaffected by the actions of other creditors, mitigating an incentive to run."

[12] Source: Standard & Poor's Q4 2009 Leveraged Buyout Review, at page 46.

for example, Lehman Brothers was leveraged at approximately 32:1 at the end of February 2008,[13] a gross leverage ratio relatively common among large broker-dealers at that time.[14] The PEGCC does not believe that portfolio company leverage, in the absence of interconnectedness or cross-collateralization concerns (as discussed elsewhere in this letter), is relevant to an assessment of systemic risk; but even if portfolio company leverage is seen as relevant, the PEGCC submits that such leverage is modest in comparison to large bank holding companies and broker-dealers.

- ***Size.*** Private equity firms and private equity funds are important to the U.S. economy and help grow and strengthen the businesses in which they invest. In size terms, however, private equity firms and private equity funds are relatively small participants in the overall U.S. financial system (whether measured by assets available for investment by those firms, or by their risk capital, or by trading volume, or by liabilities), as compared to large banks, insurance companies, broker-dealers and advisors to registered investment companies.

    - To put this discussion in context, please note (for example) that the 50 largest U.S. bank holding companies had average total assets of over $280 billion, and the six largest U.S. bank holding companies had average total assets of over $1.5 trillion, as of June 30, 2010.[15]

    - Individual private equity funds, on the other hand, are quite small relative to the institutions described above. The largest private equity fund known to us has capital commitments from its investors of less than $21 billion, and most private equity funds are significantly smaller. A fund's capital commitments are the total assets that investors are required to contribute to the fund for investment and to pay its expenses, and, therefore, typically are the maximum amount available to be invested by the fund and the maximum amount subject to loss by the fund and its investors.

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[13] 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).

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

[15] Source: National Information Center's list of Top 50 bank holding companies, available at http://www.ffiec.gov/nicpubweb/nicweb/nichome.aspx (as of November 4, 2010).

- Similarly, individual private equity firms are quite small relative to the institutions described above. The largest private equity firm known to us has risk assets of less than $6 billion.

  To the extent that size is relevant,[16] the PEGCC does not believe that it is appropriate for systemic risk analysis purposes to look at the assets of a private equity firm and the private equity funds that it advises on a consolidated basis. Private equity firms and their sponsored funds are not cross-collateralized (as discussed in "Interrelationships with and among a private equity firm, the private equity funds that it advises, and the portfolio companies of such funds" below). Furthermore, portfolio investments are (indirectly) managed, and not owned, by the private equity firm. The $6 billion figure above represents the maximum amount that the private equity firm would lose were it and all the funds that it advises to fail.

- In addition to measuring the size of a private equity firm or fund by reference to its assets, one can also measure size in terms of transaction volume. Private equity firms typically do not invest at all (except in the GPs of their funds). 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). 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 barely registers.

- Another way to measure size is by looking at the liabilities of a financial institution. Again, 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 above, they do not have significant counterparty exposure and they typically do not borrow (in the case of private equity funds) or are only modestly leveraged, if at all (in the case of private equity firms).

- ***Importance as a source of credit.*** Private equity firms and private equity funds are not a source of credit to households, governments or (except to a

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[16] The PEGCC does not believe that size is a good proxy for systemic risk in the absence of interconnectedness. See also Mary A. Weiss, Center for Insurance Policy and Research, National Association of Insurance Commissioners, *Systemic Risk and the U.S. Insurance Sector* (February 23, 2010), at pages 20-21.

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.

- ***Extent to which assets are managed rather than owned.*** From the perspective of a private equity firm, the holdings of a private equity fund are managed, not owned, assets. As discussed elsewhere in this letter, the holdings of private equity funds are not cross-collateralized, and private equity funds and firms do not guarantee each others' obligations. 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). While the failure of a large financial firm that owns significant financial assets might have a systemic impact, the failure of an asset manager such as a private equity firm is much less likely (indeed, is extremely unlikely) to have a systemic impact. The private equity firm's ability to acquire, hold and dispose of a private equity fund's assets is strictly limited by contract, regulation or other legal arrangements. The private equity firm cannot use the assets of a private equity fund to gain access to liquidity or to settle its debt. Moreover, the private equity firm is not directly or implicitly obligated to repay any debt incurred by a private equity fund or its portfolio companies, nor does the firm serve as the guarantor of their debt. This is in stark contrast to consolidated, on-balance sheet assets, which are owned by the private equity firm and can be acquired, sold, otherwise financed or disposed of in any manner the management of the firm sees fit. Conflating these two very different metrics would unduly penalize private equity firms that act as advisors to private equity funds relative to other kinds of financial institutions that actually have large amounts of proprietary capital at risk.

- ***Concentration.*** An individual private equity fund may hold a limited number of investments, and some private equity firms and/or private equity funds have a particular geographic or sector focus. But private equity funds in the aggregate are diversified geographically and across multiple industries, and thus lack concentrated exposure in any single region or sector.[17] If investment in a particular region or industry becomes unattractive or problematic, only a portion of the private equity sector (and certainly not other financial system participants) will be adversely affected, because (*1*) private equity investments are not concentrated in any one region or industry and (*2*) as discussed elsewhere in this letter, private

[17] See the discussion at footnote 5 above.

equity firms and private equity funds are not interconnected either with each other or with other financial system participants.

- ***Degree of regulation.*** 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 Securities and Exchange Commission (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. Interests in private equity funds are 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. The PEGCC believes that, in view of the nature of the private equity industry (and particularly its lack of interconnectedness with other financial system participants and the sophistication of the investors in private equity funds), this degree of regulation is appropriate from a systemic risk perspective, from a safety and soundness perspective, and from an investor protection perspective.

- ***Amount and nature of financial assets.*** Private equity funds generally invest in long-term, highly illiquid assets that most often are significant stakes in operating businesses. As discussed above, private equity funds generally do not invest to any meaningful degree in short-term tradable securities, like derivatives, swaps or publicly-traded equities, and so the volume of trading activity is insignificant and should have little or no market impact. Private equity funds are extremely unlikely to trigger a systemic crisis in the financial system because they invest in individual companies rather than financial instruments.

- ***Reliance on short-term funding.*** Private equity funds do not rely on short-term funding. Rather, private equity funds rely on long-term capital commitments from their LPs, who commit their capital for 10–12 years (or more) with no redemption or withdrawal rights that would force private equity funds to sell assets into down markets to fund payments to investors.

- ***Interrelationships with and among a private equity firm, the private equity funds that it advises, and the portfolio companies of such funds.***

  - Private equity firms do not guarantee the performance or obligations of, or provide credit support to, the private equity funds that they advise.

  - Private equity funds do not guarantee the obligations of, or provide credit support to, their affiliated private equity firms. Typically covenants in a private equity fund's governing document (*e.g.,* its

partnership agreement) and fiduciary duties of the GP would prohibit such an arrangement.

  - Private equity firms and private equity funds are not legally or contractually obligated to "bail out" or otherwise provide credit support to each other.

  - Investors in private equity firms and private equity funds have no expectation that such firms or funds will "bail out" or otherwise provide credit support to each other.

  - A private equity fund's portfolio companies are not cross-collateralized and do not guarantee each others' obligations, nor do they guarantee the obligations of the fund. This means that neither investors in, nor debt holders of, a portfolio company have a claim on, nor can they force the fund to sell, another portfolio company (for example, to repay a debt).

  - For the reasons outlined above, private equity funds and their portfolio investments are, in effect, "firewalled" from one another. Between funds, a nonperforming fund does not negatively affect the performance of another fund. Within any one fund, a nonperforming portfolio investment does not negatively affect the other companies held in the portfolio; should a portfolio company fail, the fund's losses are limited to the value of that investment.

- ***Other risk-related factors.***

  - ***Investment in the firm and its funds.*** Either individual senior investment professionals of a private equity firm, or the private equity firm itself, typically control and make substantial investments in the private equity funds advised by the firm. These substantial investments incentivize such persons not to take inappropriate operational or investment risks that could lead to the failure of the firm or the fund in which they have invested.

  - ***Sophisticated investors.*** The provisions of the Securities Act of 1933 and the Investment Company Act of 1940, and regulations promulgated thereunder, limit the offer and sale of interests in private equity funds to sophisticated investors. The agreements governing private equity funds tend to be heavily negotiated with these investors and their counsel. These investors negotiate forcefully for limits on the GP's discretion, for limits on indebtedness and for other investor protections.

- ***Transparency.*** Private equity funds' ongoing reporting to their investors is extensive and detailed. For many years private equity funds have provided, and been required to provide, to LPs extensive quarterly, annual and other financial, tax and non-financial reporting. When investors lack information in times of financial uncertainty, they may wish to liquidate their investments. While this is not directly relevant to private equity funds because the LPs of those funds do not in any event have redemption or withdrawal rights, transparency is nevertheless a factor that mitigates uncertainty and thus risk.

While the criteria discussed above, as applied to other nonbank financial institutions, may or may not lead the FSOC to conclude that certain of these nonbank financial institutions present systemic risk concerns, the PEGCC believes that an application of those same criteria to private equity firms and private equity funds clearly demonstrates that private equity firms and private equity funds do not present systemic risk concerns.

5. How should the Council measure and assess the scope, size, and scale of nonbank financial companies?

Please see our discussion of size in our response above to question 2 of the ANPR.

[Text of a., b. and c. deleted]

d. During the financial crisis, some firms provided financial support to investment vehicles sponsored or managed by their firm despite having no legal obligation to do so. How should the Council take account of such implicit support?

The PEGCC has seen no evidence of an "implicit" guarantee by any private equity firm or GP to "bail out" or otherwise provide financial support to a failing fund, in the absence of any legal obligation to do so. No such suggestion is contained in any fund marketing materials or fund governing agreements of which we are aware, nor to our knowledge is this a topic of discussion when private equity funds are being organized and negotiated. The PEGCC is not aware of any expectation on the part of the LPs (or any basis for any such expectation on the part of LPs) that a private equity firm or a GP (let alone any government or governmental agency) will provide credit support to a private equity fund beyond the firm's or the GP's capital commitment to the fund. We see no evidence of "moral hazard" in the private equity context.

6. How should the Council measure and assess the nature, concentration, and mix of activities of a nonbank financial firm?

Please see our response above to question 2 of the ANPR.

a. **Section 113 of DFA requires the Council to consider the importance of the company as a source of credit for households, businesses, and State and local governments, and as a source of liquidity for the United States financial system. Given this requirement, are there measures of market concentration that can be used to inform the application of this criterion? How should these markets be defined? What other measures might be used to assess a nonbank financial firm's importance under this criterion?**

b. **Section 113 of DFA requires the Council to consider the importance of the company as a source of credit for low-income, minority, and underserved communities. Given this requirement, are there measures of market concentration that can be used to inform the application of this criterion? How should these markets be defined? What other measures might be used to assess a nonbank financial firm's importance under this criterion?**

Private equity firms and private equity funds are not a source of credit to households or governments or (except to a very limited extent) businesses.

7. How should the Council measure and assess the interconnectedness of a nonbank financial firm?

a. **What measures of exposure should be considered (e.g., counterparty credit exposures, operational linkages, potential future exposures under derivative contracts, concentration in revenues, direct and contingent liquidity or credit lines, cross-holding of debt and equity)? What role should models of interconnectedness (e.g., correlation of returns or equity values across firms, stress tests) play in the Council's determinations?**

b. **Should the Council give special consideration to the relationships (including exposures and dependencies) between a nonbank financial company and other important financial firms or markets? If so, what metrics and thresholds should be used to identify what financial firms or markets should be considered significant for these purposes? What metrics and thresholds should be used in assessing the importance of a nonbank financial company's relationships with these other firms and markets?**

Please see our discussion of interconnectedness in our response above to question 2 of the ANPR.

8. How should the Council measure and assess the leverage of a nonbank financial firm? How should measures of leverage address liabilities, off-balance sheet exposures, and non financial business lines? Should standards for leverage differ by types of financial activities or by industry? Should acceptable leverage standards recognize differences in regulation? Are there existing standards (e.g., the Basel III leverage ratio) for measuring leverage that could be used in assessing the leverage of nonbank financial companies?

Private equity funds generally are not leveraged. Private equity firms have modest leverage in comparison to large banks, insurance companies and broker-dealers. Please see our discussion of leverage in our response above to question 2 of the ANPR.

9. How should the Council measure and assess the amount and types of liabilities, including the degree of reliance on short-term funding of a nonbank financial firm?

Please see our discussion of liquidity, leverage, size (last sub-bullet point) and reliance on short-term funding in our response above to question 2 of the ANPR.

a. What factors should the Council consider in developing thresholds for identifying excessive reliance on short-term funding?

Private equity firms and private equity funds do not rely on short-term financing to any meaningful extent. Private equity funds rely on and provide long-term funding to their portfolio companies that is well matched to the length of portfolio company holding periods.

[Text of b., c. and d. deleted]

12. During the financial crisis, the U.S. Government instituted a variety of programs that served to strengthen the resiliency of the financial system. Nonbank financial companies participated in several of these programs. How should the Council consider the Government's extension of financial assistance to nonbank financial companies in designating companies?

The organization and operations of private equity firms and private equity funds, and the nature and scale of private equity investments, are fundamentally different from the kinds of organizations and investments that produced the current financial crisis and that received financial assistance from the U.S. government.

To our knowledge no private equity firm or private equity fund received or requested, or was even considered as a possible recipient of, TARP funds or other government support during the recent financial crisis. Furthermore, to our knowledge no venture capital or other private equity firm or fund received or requested, or was even

considered as a possible recipient of, government support when the value of many technology investments made by those funds collapsed after the Internet "bubble" burst in 2000.

While history cannot predict the future, these facts strongly suggest that the private equity industry—most likely because it is less interconnected, less vital to the functioning of the financial system, less subject to liquidity crunches, less leveraged, smaller, less important as a source of credit, and less concentrated than other financial institutions—is much less systemically significant (indeed, as discussed above, private equity firms and funds are not systemically significant) than institutions that did receive TARP funds or other government support.

Conclusion

For the reasons outlined above, the PEGCC believes that private equity firms and private equity funds do not present systemic risk. Accordingly, the PEGCC respectfully recommends that private equity firms and private equity funds not be designated by the FSOC under Section 113 of the Dodd-Frank Act for supervision or regulation by the Federal Reserve Board.

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,

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cc: Mr. Alastair Fitzpayne
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