

# Regulatory harmonization and the development of private equity markets

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## Abstract

This paper introduces a new dataset from 100 Dutch institutional investors' domestic and international asset private equity allocations. The data indicate that the perceived comparative dearth of regulations of private equity funds impedes institutional investor participation in private equity funds, particularly in relation to the lack of transparency. The data further indicate that the perceived importance of regulatory harmonization of institutional investors has increased Dutch institutional investor allocations to domestic and international private equity funds. The Financieel Toetsingskader (regulation of portfolio management standards such as matching of assets and liabilities) has had the most pronounced and robust effect, followed by Basel II (regulation of risk management and disclosure standards) and the International Financial Reporting Standards (regulation of reporting standards and transparency).

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## 1. Introduction

The purpose of this study is to facilitate an understanding of the factors that motivate institutional investors to allocate capital to private equity.<sup>1</sup> Our analyses build on a growing law and economics literature on venture capital and private equity on engineering venture capital markets (Black and Gilson, 1998; Gilson, 2003) and the role of the law in influencing venture capital and private equity investment (e.g., Bigus, 2006; Hege et al., 2003; Kanniainen and Keuschnigg, 2004; Keuschnigg, 2003, 2004; Keuschnigg and Nielsen, 2001, 2003a,b, 2004; Mayer et al., 2005; Schwienbacher, 2002; Lerner and Schoar, 2005; Cumming et al., 2006). We empirically study institutional investors in The Netherlands. The consideration of Dutch institutional investors is particularly timely in that there have been significant changes in the regulation of institutional investors in The Netherlands.

Our particular interest in this paper is in assessing the role of the institutional investors' *perceived* importance of law versus economics in driving institutional investor capital allocation decisions to private equity. First, we study the effect of a comparative dearth of regulations of private equity funds on institutional investor allocations to private equity. The dearth or lack of regulations in private equity to which we refer is related to the fact that investors in private equity funds are institutional investors and high net worth individuals (not the so-called unsophisticated retail investors) and therefore these funds do not receive the same degree of scrutiny as other types of retail based funds, such as mutual funds. Private equity funds regularly justify their opaque or less than transparent disclosure of their activities and returns (particularly unrealized returns on unexited investments not yet sold in an IPO or acquisition<sup>2</sup>) to their institutional investors as necessary in the interest of their private investee companies. The only actual oversight that private equity funds face includes the fact that private equity funds, if structured as a corporate body or limited partnership, are subject to the requirements of all other like institutions, and if registered with a government ministry for tax purposes (tax deductions for subsidizing R&D and the like), also subject to the ministry's requirements. In every practical sense, therefore, the operations of private equity funds are not regulated above and beyond that of any corporate body. This is in sharp contrast to mutual funds, for example.

In the second major component of this empirical study, we consider the extent to which the changes in regulation of institutional investors by regulators seeking to "harmonize" the existing regulations affecting financial institutions are important to institutional investor's decisions to allocate capital to private equity. We examine three primary regulatory changes: the new International Financial Reporting Standards ("IFRS") in 2005, the proposed new Financieel Toetsingskader ("FTK") for 2006, and the new Basel II regulations in 2004. These regulations are explained in Section 2 of this paper. Harmonization of regulations faced directly by institutional investors facilitates investment in private equity

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<sup>1</sup> In this paper for ease of exposition we refer to private equity as a generic term that also includes earlier stage venture capital investments. This paper analyses Dutch institutional investors, and regulations pertaining to such investors do not make material distinctions for venture capital and private equity investments.

<sup>2</sup> Private equity funds invest for reasons of capital gain, and investment duration is typically 3–5 years before an exit event and capital gain is realized. Prior to the exit event, each year private equity funds make disclosures on their anticipated returns for unexited investments to their institutional investors. Cumming and Walz (2004) find evidence that these disclosures on unexited investments tend to be grossly exaggerated. Phalippou and Zollo (2005) confirm this finding.

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