VOLUME 34
NUMBER 3
SUMMER 2022

Journal of APPLIED CORPORATE FINANCE

IN THIS ISSUE:

Corporate Finance and Private Equity

Columbia Business School

Should Private Companies Have the Same SEC Disclosure Requirements as Public Companies? A Debate

Saïd Business School | Oxford University
May 26, 2022

Ludovic Phalippou
Professor of Financial Economics, Saïd Business School, University of Oxford

Gregory Brown
Sarah Graham Kenan Distinguished Professor of Finance at the University of North Carolina-Chapel Hill's Kenan Flagler Business School

Ludovic Phalippou: Good morning, everyone, and welcome to this little debate here at the Saïd Business School about proposals to require and standardize disclosure in the private equity arena. I'm in favor of the proposition. But after I spend the next ten minutes telling you why, I'll turn the floor over to my opponent in this debate, my good friend Greg Brown from UNC-Chapel Hill.

The Case for More Disclosure

To set the stage, let's go back 100 years ago to 1922 in New York City. These were happy times for finance people: Insiders could trade whatever quantity of stocks they wished, whenever they wanted, and without telling anyone what they were doing. And fund managers could do whatever they wanted with their client's money.

Seven years later, the stock market crashed—and stock prices continued to fall pretty much until 1933, the year something called the SEC was created. You may find this hard to believe, but there were many people back then who didn't *want* the SEC. One U.S. senator went so far as to say that the SEC, if created, would not only be the end of the U.S. stock market, but possibly even the end of capitalism!

But, in the grand scheme of things, the creation of the SEC may not have been the most important breakthrough. In the mid-1990s an astonishing thing happened in the U.S. A group of academics put together amazing datasets on mutual funds. The first study to put together a survivorship-bias-free database of mutual funds was published in 1997 by Mark Carhart, following completion of his Ph.D. at the University of Chicago.[1] In that article, Carhart clearly confirmed that actively managed mutual funds are a money-losing proposition, and that there is no persistence among top performers—which means it is useless to invest according to the track record of a fund manager.

Tons of studies using this database and related ones since then have showed how many mutual fund managers have been overcharging their clients in one way or another. And the SEC responded and worked in tandem with the findings; the academics showed that something was wrong, and the SEC closed the gap.

Let me point out three particularly important studies that exemplify this pattern—and keep in mind that these are just three among many.

First, in 2001, Jennifer Conrad, Kevin Johnson, and Sunil Wahal used proprietary trade data to show that mutual fund investors pay additional costs in the form of so-called soft-dollar transactions.[2] In a nutshell, investors buy shares through the mutual fund managers, but the latter do not buy the shares from the cheapest broker—and this more expensive broker then kicks back some of the excess cost to the fund manager. In this way, the fund managers diverted—stole, really—their clients money without the clients seeing it. And these amounts were considerable: the researchers estimated that soft dollars were one third of the trading cost.

1 Carhart, M. M. (1997), "On Persistence in Mutual Fund Performance," *The Journal of Finance*, 52(1), 57-82.

2 Conrad, Jennifer S., Kevin M. Johnson, and Sunil Wahal, "Institutional Trading and Soft Dollars," *The Journal of Finance*, 56.1 (2001): 397-416.

In response to this study, the SEC and other regulators around the world banned soft-dollar commissions. Second, in a 2003 study, Eric Zitzewitz quantified the extent and effects of late trading by mutual fund managers.[3] Basically, some mutual fund managers allowed "special" clients to trade at the cutoff time (4p.m.) prices after 4p.m., thereby favoring some clients at the expense of others. This was another case of robbing some clients and giving money to others potentially in return for some payments in one form or another.

Third, although we have long suspected mutual fund managers of fabricating their track records, we had to wait for confirmation by Richard Evans's 2010 study using specific data to document the extent to which banks are "incubating" mutual funds—that is, literally manufacturing track records and misleading investors.[4] Incubation is a strategy for launching new funds in which several funds are launched privately and, at the end of an evaluation period, some are opened to the public. Of course, the subset that does well in the incubation period and ends up getting presented to the public represents a highly biased sample that is then used to mislead public investors.

Through these stories and financial scandals, we see that access to data is key to detecting fraudulent practices that keep financial markets from working well. The joint work of the academics with the SEC has repeatedly enabled us to get to a better outcome.

3 Eric Zitzewitz (2003), "How Widespread Is Late Trading in Mutual Funds?" Stanford GSB Research Paper No. 1817.

4 Evans, R. B. (2010), "Mutual Fund Incubation," *The Journal of Finance*, 65(4), 1581-1611.

The interests of the LPs and GPs with respect to disclosure are completely aligned. Neither wants to provide more information to the public. —Ludovic Phalippou

Application to PE

Many people are inclined to view all this as evidence of just a mutual fund problem, and assume that private equity fund managers are in a different situation. After all, PE managers are supposed to be closely monitored by powerful investors that keep them on the straight and narrow. Private equity, as we're all assured, is practiced by gentlemen who can be counted on to do the right thing.

But we have already seen at least one exception. The largest fraud in private equity we know of to date is that of Abraaj. I urge you to read the book called *The Keyman*, which provides a superbly documented account of this story.

Who brought down Abraaj? Any of these large and powerful investors monitoring them very closely? No, the man who brought them down is a young employee of the Gates Foundation, whose distinguishing feature was arguably the fact that he did not care about having a career in finance, or in private equity. So it was not one of the big investors who brought Abraaj down. In fact, the largest LP in the world, Hamilton Lane, not only did not seem to monitor Abraaj in the way assumed by academics and others, but it even received an anonymous email in September 2017 informing them that fraud was occurring. And according to documents found by the authors of *The Keyman*, Hamilton Lane did not act on that information. In fact, it seems that Hamilton Lane reacted by informing the fraudster that one of his own employees was sending anonymous emails. So, the above reasoning does not apply here. And much the same was true of other large investors in Abraaj. Many people assume that LPs are sophisticated parties—or at least have sophisticated advisers guiding them— and therefore there's no need to look into what is going on in PE. And for us academics, the message has been that, by looking into these questions, we would be wasting our time and resources.

Now, in fact, most *finance* academics working in PE—and it's almost the opposite situation among scholars from law schools—are *against* the proposition of regulating the disclosure of the private equity industry. Finance academics believe that there is indeed no problem here. Why? I would hypothesize that this is because most think of the PE set-up as a *single-layer* principal-agent problem. In this relation, there is the main principal—say, a pension fund that is large and sophisticated—and a private equity fund manager that is acting as its agent. And I'm inclined to agree that there is no reason to think there would be a big agency conflict in this relationship, since they are two large entities that have access to plenty of information and resources.

But this is *not* the situation in PE. The situation is a *double-layer* agency conflict. The real principal are the retirees themselves, the beneficiaries of the pension fund, which functions as the agent of the beneficiaries—and which is in turned served by *another* agent, the PE fund manager. In such cases, the PE teams working with the pension fund generally do not want things like their own fees to become public information. Nor are they likely to be enthusiastic about receiving documentation of private equity fund managers diverting client money one way or another. Such information is not good for their business! They do not want people to know that they invested in something like Abraaj. PE groups in pension funds just want to expand! They are happy with bogus IRRs that exaggerate performance, and they are happy with bogus fee reports that underreport the fees they paid. In this sense, then, the interests of the LPs and GPs with respect to disclosure are completely aligned. Neither wants to provide more information to the public. Hamilton Lane would lose business if their clients knew that they advise to invest in Abraaj, and this was a fraud. So, their reaction was not to stop the problem but to find a way to sweep it under the rug. The person who went after Abraaj is someone who did not have to worry about his principal or his career in finance. And by the way, this person is no longer working in finance.

In sum, LPs and GPs are both agents—and this is the source and core of the problem. Exactly as in the case of mutual funds, we should try to close all the loopholes, improving the situation for clients by having light shed on the activities. And if there is nothing bad happening, as the industry claims, there is no harm done. Academics will report that it is all very good.

But we need access to data and information to investigate, just as we have done and continue to do in the case of mutual funds. That is why all of the participants in the PE industry need to produce information in a standardized and digestible format that we academics can study. And then *we* can provide the all-clear that PE claims to deserve—or not!

And with that, I will turn things over to my good friend and colleague, Greg Brown, from the Kenan-Flagler School at UNC-Chapel Hill.

The Case Against Mandating Disclosure

Greg Brown: Thanks, Ludo.

Ludo and I are both economists, so if there is one thing we clearly agree on it's that economic decisions are fundamentally about trade-offs. Any real decision is about comparing the benefits and the costs. What Ludo has just done is to try to convince you that the benefits of extensive reporting by private firms are greater than the costs. I am now going to explain why, unequivocally, the costs greatly exceed the benefits.

The argument is in fact quite simple. Any entity that can afford to be an investor in private equity can also afford professional staff or sophisticated fiduciaries who undertake rigorous due diligence. By any standard, the due diligence done on private equity funds by qualified professional investors is intensive and includes access to detailed financial records of the GP and its existing funds. As a consequence, the potential for a net gain to greater mandated disclosure seems highly unlikely.

The root of the information problem the SEC was designed to solve lies in the idea that individual shareholders' stakes in a company are too small for them to bear the costs of optimal monitoring. By definition, this problem does not exist in the case of private equity, where investors take large, often controlling stakes and do tremendous due diligence. The GPs are sophisticated investors or they wouldn't survive in an increasingly competitive PE market. LPs are also either sophisticated themselves or use professional advisors and fiduciaries.

So, where is the benefit from disclosure for private companies controlled by PE funds? Because private companies have to abide by the same labor laws, antitrust laws, tax laws, and so forth as public companies, it's hard to argue that there would be secondary, or indirect beneficiaries from greater disclosure.

But what if we consider a broader set of stakeholders—and let's start with the financial system as a whole, and the question of systemic risk. Perhaps there is a chance of increased systemic risk from PE-backed firms.

The problem with this argument is that, despite initial worries about PE's massive looming "wall of debt," PE's losses during the Global Financial Crisis turned out to be remarkably small, and the PE industry itself proved amazingly resilient. And since the GFC, Dodd-Frank's restrictions on bank loans to highly leveraged PE deals have significantly reduced any risk to the banking system stemming from PE. It's also important to keep in mind that PE, even with its substantial growth over the last decade, still comprises less than 5% of global equity and debt markets.

But what about the risk that PE sponsors can fail in a way that would produce spillovers to the broad economy relative to public company failures? Is that something we need to consider?

Here again, the evidence suggests the contrary. Studies by Josh Lerner and others on PE activities during the GFC tell us that PE firms are more likely to inject *additional* equity during stress times when public companies are pulling in their horns and battening down the hatches. PE effectively became not a contributor to the problem, but a solution, a source of capital for companies trying to keep their employees and maintain their operations as going concerns.

Now, one might make a case that perhaps private *credit* funds should disclose more if only *for the sake of financial regulators*. But, so long as the private credit funds themselves are unleveraged—in contrast to banks—it's not clear how they could significantly contribute to a greater systemic system; there's no clear propagation mechanism in this story.

The owners selling to the PE firms can get intensely granular with company data, in part because they don't have to share their information with the public, including competitors.

—Greg Brown

What about the possible benefits of mandated PE disclosure to individual investors? Such investors almost always use a platform with a professional advisor or an explicit fiduciary. Direct distribution is rare to all but the wealthiest individuals, but even in that case, there may be little to worry about—a point I come back to in a moment.

The Costs

So, with little in the way of expected benefits, let's now think about the *costs* of requiring disclosure by private companies. And let's start with just the direct costs.

According to the SEC's own estimates, the average cost of regulatory disclosure needed to enter the public markets through IPOs is about \$2.5 million. And on an ongoing basis, the annual costs for a typical small-cap company run about \$1.5 million. And since the vast majority of PE portfolio companies would be microcaps if they were publicly listed, the disclosure costs for PE-backed companies would be proportionally higher as a percentage of firm value.

But, again, those are just the direct costs. Are there indirect costs to private companies of disclosing more information publicly that we need to take account of?

To answer this question, it's important to understand that the information asymmetries between managers and owners that are one of the main reasons for mandating disclosure by public companies are in fact significantly lower for private companies. The PE firm typically chooses the managers they want to run their portfolio companies and then directly oversee their operations. And so reducing the information gap is one of the key motives for, and advantages of, the PE model. The owners selling to the PE firms can get intensely granular with company data, in part because they don't have to share their information with the public, including competitors.

As a consequence, PE governance is bound to be better informed and more effective than the control that even the most vigilant public company investors are able to exert over public company managements. Substantial new disclosure requirements could put this PE governance advantage at risk by reducing the kinds and granularity of the information that operating managers and private equity GPs will provide, knowing they will wind up in SEC disclosures. And in so doing, mandating PE disclosure threatens to distort or debase the entire manager-investor dialogue that, again, is widely recognized as one of the main competitive advantages and sources of value in PE.

There are other potential indirect costs as well. For example, requiring PE-owned firms to issue publicly report detailed quarterly financials risks creating myopic decision-making by management. Although market investors generally have shown themselves willing and able to take the long view of corporate prospects and decision-making, there is some evidence suggesting that the public company requirement to disclose quarterly earnings contributes to short-termism by corporate managers that works to reduce investment and distracts companies from pursuing value-creating long-term strategic priorities.

So again, a massive new reporting burden generates indirect costs that threaten to spoil the PE special sauce. In short, GPs are capable of deciding on and obtaining the information they need and no one is forcing LPs to invest if they do not like the information presented to them by GPs.

One Man's Experience

But if the SEC's goal is to protect individual investors, I want to share the experience of one retail investor I know quite well, and that's me. I personally invest in a private credit fund that specializes in mezzanine investments in the lower middle market. These are companies with \$5-10 million in EBITDA and are typically PE-owned when the fund I invest with makes a loan. And this size is typical of a large fraction of PE-owned companies.

According to Ludo and other advocates of the PE disclosure proposal, I should be scared out of my mind as a small unsophisticated retail investor in the corrupt and opaque market for private investments. The practical reality, however, is that I have online access to a platform that lets me look at details of every deal, including a due diligence memo on each investment the fund makes. I know much more about the individual investment decisions made by this fund than those made in my Vanguard corporate bond fund. In addition, I can even call the GP and ask them about anything I want to know—something you certainly can't do as an individual shareholder in public companies and most mutual funds.

So, in preparation for our discussion this morning, I took the step of contacting a partner at my fund and asked him what reporting like a public company would do to a typical portfolio company and his business. His response was simple and unequivocal: Mandating public company-like disclosure levels for his portfolio companies would *put him out of business as a GP*. And it's not hard to see why since the costs of disclosure are of the same order of magnitude as EBITDA for these companies. He also noted that if such a large degree of disclosure was mandated for private companies generally—that is, those not invested in by PE—his guess was that half of those companies would never have made it to the stage of obtaining outside investors.

What this suggests to me, then, is that a large part of the innovation, competition, and growth that we know comes from small private companies would be in danger of vanishing. And these are mostly old-economy companies with relatively predictable cash flow streams. But just imagine what such a disclosure burden would do to the VC industry.

So, in concluding, let me just say that I see very large and clear benefits, and no intractable problems, with the current PE model. Chief among these benefits are the following:

- GPs get unfettered access to portfolio company financials and have been giving ground voluntarily to more transparency and standardized reporting;
- LPs seem increasingly effective at getting the information they want, within reason;
- When we consider other stakeholders, we find little threat of systemic risk, and the existing regulatory framework seems quite capable of dealing with it; and
- Individual investors in PE typically have advisors and fiduciary protections much like those they have in other investments.

In sum, a substantial increase in mandated disclosure—especially disclosure that will in some instances be so punitive as to disrupt capital allocation to small and midsized companies—is a solution in search of a problem. The costs of additional mandated disclosure are substantial, and the benefits negligible.

LUDOVIC PHALIPPOU is Head of the FAME Group at Saïd Business School and specializes in private equity and asset management.

Ludovic is the author of the bestseller *Private Equity Laid Bare*, and professor of Financial Economics at Saïd Business School, University of Oxford. He specializes in private market investments with a focus on fee tracking, interest alignment, and return benchmarking.

GREG BROWN is the Sarah Graham Kenan Distinguished Professor of Finance at UNC Kenan-Flagler Business School and executive director of the Frank Hawkins Kenan Institute of Private Enterprise. He also is the founder and research director of the Institute for Private Capital. Professor Brown's recent research centers on alternative investments, including hedge funds and private equity funds. He previously served as director of research for Amundi Smith Breeden Associates, a global asset management firm specializing in fixed income investments.