March 30, 2011

**SUBMITTED ELECTRONICALLY**

Jennifer J. Johnson, Esq.
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: **Proposed Rule: Definitions of "Predominantly Engaged in Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company Docket No. R–1405 and RIN No. 7100–AD64**

Dear Ms. Johnson:

These comments are submitted by the Private Equity Growth Capital Council (the "PEGCC"), 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 33 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 appreciates the opportunity to comment on the Federal Reserve Board's (the "Board") proposed rule defining "predominantly engaged in financial activities" and "significant" nonbank financial company and bank holding company for purposes of Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The PEGCC believes that the Board's proposed definition of "significant nonbank financial company" should be modified as it applies to private equity firms, as set forth in this letter.

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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.

Proposed Section 225.302(b) defines a "significant nonbank financial company," in relevant part, as any "nonbank financial company that had $50 billion or more in total consolidated assets (as determined in accordance with applicable accounting standards) as of the end of its most recently completed fiscal year." As the Board notes, this definition will be used for two principal purposes. First, systemically important financial institutions ("SIFI") that are designated for enhanced supervision by the Financial Stability Oversight Council ("FSOC") and bank holding companies with more than $50 billion in assets will be required to file reports regarding their credit exposures to significant nonbank financial companies. Second, in deciding whether an entity should be designated as a SIFI, FSOC may consider the interconnectedness and relationships between the entity and significant nonbank financial companies.

The PEGCC believes that the Board needs to modify its definition of "significant nonbank financial company," as applied to private equity firms, so that the $50 billion or more asset test includes only the proprietary assets of a private equity firm, inclusive of the private equity firm's own investments in the funds (and portfolio companies) that the firm manages. Assets that the private equity firm manages for third-party investors (whether pursuant to separate accounts arrangements or through private equity funds managed by the firm) should not be counted. Such third-party managed assets should not be included in a private equity firm's calculations even if current Generally Accepted Accounting Principles ("GAAP") require some of these assets to be consolidated with those of the private equity firm.

Using a private equity firm's total consolidated assets, which in some cases could include third-party managed assets, rather than assets that are owned by the private equity firm, would provide a misleading view of the size and interconnectedness of the private equity firm. Indeed, a private equity firm's ability to acquire, hold and dispose of third-party managed assets is strictly limited by contract, regulation and other legal arrangements. Neither the private equity firm nor any creditor of the firm can use third-party managed assets to gain access to liquidity or to settle a debt of the firm. In addition, because holdings of private equity funds that are sponsored by the same private equity firm are not cross-collateralized or cross-guaranteed, a counterparty or investor's exposure to one private equity fund managed by a particular private equity firm does not lead to exposure to other funds managed by that same firm. (See Annex A hereto, at Section 8.) For these reasons, the PEGCC strongly believes, as it has detailed in prior comment letters to the FSOC, that the proper metric for measuring the size and interconnectedness of a private equity firm is the amount of the firm's own assets that are at-risk.

Conflating assets that are owned by the private equity firm with assets managed by the firm for third parties in defining "significant nonbank financial company" would obfuscate the amount of the true assets of a private equity firm, result in credit exposure and other reports that may be misleading to regulators (and others, including investors) and result in potentially varying treatment for otherwise similarly situated asset managers. The PEGCC respectfully submits that these results are at odds with the Board's goals.

For these reasons, the PEGCC recommends that the Board modify Section 225.302(b)'s concept of "total consolidated assets." The definition should start with the consolidated assets concept, but, as relevant to private equity firms, should allow for any necessary deductions for managed or other non-proprietary assets. This would produce a figure that includes only the consolidated assets of the private equity firm that are at risk regardless of the private equity firm's accounting treatment of managed assets. Taking this approach would produce more accurate pictures of significant nonbank financial companies and the resulting credit and other reports to regulators.

We appreciate the opportunity to comment on the proposed rule and would be pleased to answer any questions you might have regarding these comments, or the private equity industry more generally.

Respectfully submitted,

Douglas Lowenstein
President
Private Equity Growth Capital Council

**ANNEX A**

# Structure and Operations of Private Equity Firms and Funds

This summary was prepared 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. 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.

## 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.[1] 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.[2]

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1 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.

2 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.

### 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.[3]

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.

### 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

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[3] 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.

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."[4]

### 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

[4] 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 equity holders 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.

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.