Case Western Reserve Law Review

Volume 51 | Issue 3 Article 11

2001

Comment: Private Equity, Capitalism, and Efficiency

William H. Coquillette

COMMENT: PRIVATE EQUITY, CAPITALISM, AND EFFICIENCY

William H. Coquillette[†]

On the panels today, Mr. Reffner and I are the token representatives of darkness in that we are practitioners with large law firms. Today I will try to give you a sense that partners in large law firms have feelings, and thus I thought I would talk to you about how I feel sitting here in front of you.

The first feeling I have is the one of humility because I know looking around the audience that there are a number of people in attendance who are experts in the areas that we are discussing. If I really had a serious question about these topics, I would certainly ask them what their thoughts were.

The second thing I feel is that the presentations thus far have been rich in information. The first set of speakers provided much valuable information and insight about the real world of private equity investing. We had wonderful presentations from two authorities in that area. Then we have heard some presentations on the academic side concerning the securities regulation aspects of these activities. Having spent most of my time on the practical side of all this, I have learned a lot from reading these academic papers and digesting their contents.

I also feel that I have had a very rich experience this week, experiencing many different activities characteristic of private equity investing in our time. Right now I am feeling very challenged trying to make sense of it all. Let me share with you what I see as happening in the world around us, how some of the subjects we have been talking about today relate to those things, and perhaps, as a final thought, what securities regulation has to do with all of this.

We are seeing a very interesting economy right now, and I will start by contrasting the economy that we are currently experiencing with the economy that I learned about in college. If you can believe it, I was in college back in the late 1960s and early 1970s. At that

† Partner, Jones, Day, Reavis & Pogue, Cleveland, Ohio.

time, the view of innovation and the economy from the smartest people was basically as follows. The economy was going to be dominated by large corporations, which would get ever larger. Only those large corporations would have the financial resources to engage in true innovation. Innovation at that time was viewed as basic research, which was a very expensive and very long process. It would take years and millions—only companies like IBM could handle it.

In addition, these large corporations, which were destined to dominate the landscape, were not very smart. They were not very fast moving. They would not be effective innovators.

The moral of the discussion was that capitalism was an inferior economic system and would be eventually outpaced by socialist or communist economies, which would be much more effective at innovations, innovative business, innovative manufacturing, science, and so forth.

Now, I can tell you with the hindsight of thirty years that some of the smartest economists that you will ever meet completely missed what was going to happen. What actually emerged was the very robust, dynamic, capitalist, innovative economy which is all around us. Let me tell you about my week.

Tuesday I drove down to Pittsburgh to see an idea factory. It is basically a warehouse where a lot of smart people from Carnegie Mellon University are creating businesses. They think about businesses, and when they think they have something they work on it a little bit. If they think it has merit, they set it up as a separate business. Then they arrange financing and do other things to make it grow. They are in the business of creating businesses.

I spent Wednesday and Thursday talking to people in enormous financial institutions—a couple in Ohio and one in Minnesota—who are in the business of lending money to people like John Nestor and the things that they do. Basically those conversations revolved around how to organize these financial institutions to cover all of the United States (and perhaps other parts of the world) and how to channel their capital to the right parts of the private equity activity.

Last night, I attended a closing dinner with venture capitalists from a number of different cities who had backed a company in Minneapolis that is in the business of using the Internet and computer resources to help businesses train employees. This morning at breakfast I was talking to a man who runs a venture capital firm where all of the venture capital comes from overseas sources, mostly Asia. These funds are housed offshore, somewhere in the Caribbean, and they are invested all over the world with people like the people I visited in Pittsburgh.

What is this? This is robust capitalism in its rawest form. It is innovation being led not by the largest companies, but by small companies that have come together almost on an ad hoc basis; financed not by pools of capital run by sleepy corporate management, but by very supercharged pools of capital collected from all over the world and managed by people like John McIlwraith and John Nestor. These people use this capital to provide enormous value to the economy by financing innovation and by having the ability to finance very large projects. One of the important benefits that the economy gets from these private equity investors (like the two Johns) is not just from their decisions to back certain projects, but also from their decisions not to back certain projects. They are highly selective, ruthless decision-makers in terms of allocating capital. This has the effect of conserving capital for the most promising projects. As we are seeing capitalism in its rawest form, it is very energetic. It is innovative. It is selective and ruthless. It is a little exciting and a little scary.

One can also understand much of what is going on in the world today as an enormous drive for greater efficiency in capital markets. This is one of the things revealed to me by reading Professor Fox's paper. We see, and hear talk of, evidence of business cycles. Of course, venture capital experienced cycles in the 1980s and early 1990s. Similar cycles also happened in the leveraged buyout markets. Such business cycles are in part a reflection of the inefficiency in the underlying capital markets. But that inefficiency is slowly but surely being ground out of the system by a lot of smart people thinking about the regulatory scheme, by the globalization of business taking away inefficiencies that come from geographic barriers, by the ability to handle information more efficiently so that it can be beneficial to businesses and be circulated around the world and different sectors, and by the ruthlessness of the money that will only back the best ideas.

We are developing a very large expertise in private equity investing. Again, John McIlwraith and John Nestor are examples of this expertise. There are over 800 private equity firms where people are learning how to do this very kind of investing activity and becoming smarter at it as time goes by. This creates greater efficiency in the markets. As the financial institutions like these big banks are becoming more adept at running their business, the market is becoming more efficient in financing activity and other kinds of activity.

So the last question I want to ask is: What is the role of securities regulation in promoting this efficiency, and how does that relate to this very robust private equity marketplace that we see?

I am not sure that it does have a role. I think that one of the characteristics of this marketplace in its early stages is to be very non-public—if I understand the use of the word. One of the things that I learned this week reading Professor Fox's paper was that the purpose of securities regulation is to promote efficiency rather than to protect investors. I was just thinking about that at a higher level. When we are talking about a legal system that promotes efficiency, it is almost as though it is protecting and promoting capitalism. So rather than having securities laws to protect the widows and the orphans, the securities laws are protecting our system.

I am not sure that the private equity marketplace, where the flow of funds is from the very smart and ruthless investors, really benefits from securities regulation. When you get into the public market where the connection between the business and the investor is more remote and the balance of power in corporate governance moves from the investor to the hands of the management, then you are in a situation where regulation is required to maintain robust capitalism.

As a practitioner, every time that I run into the securities laws in doing private equity transactions there is big trouble. It usually means that there is a mischaracterization of "accredited investors." In the end, the definition of accredited investors is not a good proxy for what is "non-public" in the private equity area.

So, for example, if you have a fund, sometimes the people that run the big private equity funds have a "side-by-side fund" where they invest their money at a little bit cheaper transaction cost than the people who invest through the main fund. If anybody in that side-by-side fund is not an accredited investor, such as the junior people working as professionals for the fund manager, then that creates a huge problem in the transaction. Too many resources are used up on other circumstances to police the separation from what is public and what is non-public. So we may well see a pushing back of securities regulation from the arena of non-public private equity investments.