The Dubai Initiative
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Policy Brief

Should Private Equity In The Middle East And North Africa Be Regulated? The Case Of Egypt

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SHOULD PRIVATE EQUITY IN THE MIDDLE EAST AND NORTH AFRICA BE REGULATED? THE CASE OF EGYPT

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SUMMARY

Over the five years prior to the financial crisis, global private equity and venture capital investments grew exponentially. Private equity firms and funds are becoming increasingly important actors in emerging markets: they act as a source of financing for new enterprises and as growth capital for existing ones, as owners and managers of portfolio companies[1], and as employers for both management and labor.

The global financial crisis underscored the importance of prudent regulation for financial institutions to avoid systemic risks; however, private equity firms and funds in the Middle East and North Africa (MENA) are typically unregulated, and treated as private transactions. As these firms increase their investments in the MENA region, it is important to consider three policy questions: (1) Should private equity be regulated in the same way as other non-banking financial institutions? (2) Should there be public transparency standards mandated by law? (3) Is a domestic capital gains tax on private equity profits needed?

POLICY RECOMMENDATIONS

- Private equity firms and funds should be included under the regulatory regimes covering non-banking financial institutions (NBFI).
- Regulations should at a minimum focus on establishing transparency standards: disclosing funds, transactions, buyers and sellers, and transaction size.
- A capital gains tax should be considered, covering profits from private equity transactions.

PRIVATE EQUITY FIRMS ARE BECOMING IMPORTANT FINANCIAL ACTORS

Over the five years prior to the financial crisis, global private equity and venture capital investments grew exponentially. The Emerging Markets Private Equity Association (EMPEA) estimates that globally, private equity funds raised $445 billion in 2008, more than three times the 2004 figure of

Private equity firms and funds are increasingly becoming important actors in emerging markets:

$141.7 billion. Gurung and Lerner estimate the global total value of companies acquired by private equity, in leveraged buyout transactions between 2001 and 2007, to be more than $2.7 trillion.[2] In emerging markets, EMPEA (2009) estimates that in 2008 $66.5 billion were raised by more than 210 private equity funds, as compared to $6.5 billion in 2004. In Egypt, total private equity investments over the past five years were estimated at $13.1 billion – an average of $2.6 billion annually, representing 1.6 percent of Egypt's 2008 nominal GDP of $162.3 Billion. Private equity firms and funds are increasingly becoming important actors in emerging markets: they act as a source of finance for new enterprises and growth capital for existing ones, as owners and managers of portfolio companies, and as employers for both management and labor.

The global financial crisis emphasized the importance of prudent regulation for financial institutions to avoid systemic risks. However, private equity firms and funds in MENA are typically unregulated, and treated as private transactions. The US and Europe are facing similar challenges in regulating private equity[3].

KEY POLICY ISSUES

As private equity firms increase their investments in emerging markets, it is important to have a deeper understanding of their business practices and impact on their portfolio companies, as well as their potential to expose the economy to overall systemic risks. This understanding would influence three policy areas:

- **Regulatory regime:** should private equity be regulated in the same way as other non-banking financial institutions?
- **Transparency:** should there be public transparency standards mandated by law?
- **Taxation:** do we need a domestic capital gains tax?

Regulatory Regime

As they stand today, private equity firms are not regulated as financial institutions. They incorporate locally as joint stock companies, or offshore as limited partnerships, and are therefore subject to corporate laws.

Private equity firms argue that there is no need for regulations to protect the investors because private equity investors are large institutional investors or qualified high net worth individual investors who are sophisticated enough to decide, manage, and monitor their investments. However, as they grow larger and control more investments and companies, they should be under regulatory supervision similar to other non-banking financial institutions to provide additional transparency and to limit any unforeseen systemic risks to the entire economy. This issue is especially timely as the Government of Egypt just launched a new regulatory body, the Egyptian Financial Services Authority, to regulate non-banking financial institutions, including insurance, real estate mortgage, consumer credit cards, as well as the capital market authority. Private Equity and other unregulated funds should also be included.

Transparency

The second issue is transparency: how much disclosure should governments require from private equity funds operating in the country, regardless of their origin or domicile[4]? By virtue of being "private," private equity funds are not required to disclose any information to the public, but rather report to their investors. However, if private equity firms own, control, and manage a sizable portion of the economy through their ownership of portfolio companies, there should be a minimum level of public disclosure requirement, such as disclosing transaction size, buyers, and sellers. This issue has been controversial in advanced economies over the past few years (Walker 2007). Transparency should be the top objective for including private equity under a regulatory regime. This would also provide policy makers with information to design smart tax policies that would not drive private equity investors away.

If private equity firms own, control, and manage a sizable portion of the economy, there should be a minimum level of public disclosure requirement,

Taxation

The third issue is taxation: should private equity funds be taxed and, if so, how? At the fund level, private equity firms are often incorporated in offshore tax havens to enable their tax-exempt investors, such as pension funds or citizens of low-tax countries, to benefit from their tax status. Furthermore, many countries, such as Egypt and all GCC countries, have not instituted a capital gains tax which could target profits from private equity transactions (among other capital gains). At the fund partners' level, the

same issue exists. The general partner/limited partner (GP/LP) private equity structure considers partner profits as capital gains rather than regular income, hence they fall under a lower tax bracket (this is the situation in countries that allow the GP/LP structure and that have capital gains tax, such as the US). In the past two years, Egypt considered implementing a capital gains tax on profits from the stock markets, but the government decided against this policy due to concerns it might negatively impact the markets. However, given the current fiscal deficit and the need for growing the tax base, a capital gains tax on financial investments, including stock markets and private equity, should be considered.

Private equity investors, by virtue of investing in illiquid multi-year investments, provide a vote of confidence in the overall economy

One important point to highlight: private equity money is highly illiquid and is tied to long-term investments, unlike "hot money," which focuses on speculations and can cause great macroeconomic problems. Thus, private equity investors, by virtue of investing in illiquid multi-year investments, provide a vote of confidence in the overall economy and its prospects. Their interests are aligned with the overall performance and growth of the economy – they stand to make higher profits if the economy grows faster and if their portfolio companies grow more profitable. Therefore, it is in the interest of government to attract this type of capital.

ENDNOTES

[1] In this paper the term "portfolio companies" is used to refer to companies that receive private equity investments, and are hence part of the *portfolio* of companies owned (fully or partially) by the private equity firm or fund.

[2] Gurung and Lerner, "Globalization of Alternative Investments Working Papers Volume 1: Global Economic Impact of Private Equity 2008" (New York: World Economic Forum, 2008). The total value of a company acquired by private equity, sometimes referred to as the enterprise value.

[3] Walker, David, "Disclosure and Transparency in Private Equity", Consultation Document (2007).

[4] In other words, where they are officially incorporated.

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THE DUBAI INITIATIVE

The Dubai Initiative is a joint venture between the Dubai School of Government (DSG) and the Harvard Kennedy School (HKS), supporting the establishment of DSG as an academic, research, and outreach institution in public policy, administration, and management for the Middle East. The primary objective of the Initiative is to bridge the expertise and resources of HKS with DSG and enable the exchange of students, scholars, knowledge and resources between the two institutions in the areas of governance, political science, economics, energy, security, gender, and foreign relations related to the Middle East.

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The Dubai School of Government (DSG) is a research and teaching institution focusing on public policy in the Arab world. Established in 2005 under the patronage of HH Sheikh Mohammed Bin Rashid Al Maktoum, Vice President and Prime Minister of the United Arab Emirates and Ruler of Dubai, in cooperation with the Harvard Kennedy School, DSG aims to promote good governance through enhancing the region's capacity for effective public policy.

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