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Private Equity and the SEC after Dodd-Frank

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Overview

Private equity is among the least transparent financial actors in the economy. For the first thirty years following the emergence in 1979 of private equity funds as major financial players, the advisers to these funds were excluded from the requirement that they register with the Securities and Exchange Commission (SEC) and meet the SEC's reporting requirements. This changed with the passage of the Dodd-Frank Financial Reform and Consumer Protection Act in 2010. The law is designed to help avert the loss of jobs and taxpayer bailouts of financial firms that followed in the wake of the financial crisis. Prior to Dodd-Frank, exclusions in the Investment Company Act and in the Investment Advisers Act, both dating back to 1940, enabled most private equity funds and their advisers (the general partners of the funds) to avoid scrutiny by the SEC. This changed with the enactment of financial reform legislation in 2010. Section 404 of the Dodd-Frank Act requires advisers to private equity funds with more than $150 million in assets to register with the SEC and report basic organizational and operational information about the funds. Reporting requirements and frequency of filing reports depend on the size and type of fund. On October 31, 2011, the SEC adopted final rules for reporting requirements; initial forms were required to be filed by August 29, 2012. General partners in most PE funds (who are also partners in the PE firm that sponsored the fund) must now register as private equity fund investment advisers with the SEC and file reports on their operations and finances.

At the time that the Dodd-Frank Act passed, many observers doubted that the reporting requirements for private equity fund advisers would be effective. As Professor Rosemary Batt and I observed at the time, the reporting requirements for private equity fund advisers are thin compared with what publicly traded companies must disclose to the SEC. PE fund advisers are not required to report the incomes of partners and senior managers, which companies their funds own, or financial information about the individual companies in their portfolios. There is no legal requirement to notify employees, unions, vendors, or other stakeholders when private equity takes over the ownership of a company or to publicly disclose the amount of leverage used in the acquisition.[1]

Not only are the reporting requirements for private equity fund advisers far less stringent than for publicly traded companies or for mutual funds and other similar types of investment funds, but the budget deal worked out in the U.S. Congress in January 2014 denied the SEC's request for funds to hire additional inspectors. The probability that an SEC inspector would examine a particular private equity fund adviser appeared slim. No one expected the new regulatory scrutiny of private equity fund advisers to yield information about improper practices or to have much of an effect – including, no doubt, the private equity firms that sponsor these funds.

1 Appelbaum and Batt (2014a).

So it may have been a shock to the 1,100 partners in private equity firms headquartered in the U.S. that serve as the general partners (GPs) of, and advisers to, the PE investment funds their firms sponsor[2] to learn that the weak oversight of their activities mandated by Dodd-Frank in the wake of the recent financial crisis may have actual legal and regulatory consequences for them.

Despite the weak provisions in the law and understaffing at the SEC, the reporting requirements in Dodd-Frank have enabled SEC regulators to identify widespread abuses. Misdeeds by private equity fund advisers include manipulating the value of companies in their fund's portfolio, waiving their fiduciary responsibility to investors (including pension funds), misallocating PE firm expenses and inappropriately charging them to investors, failing to share income from monitoring fees charged to portfolio companies with their limited partners, and acting as broker-dealers and collecting transactions fees from portfolio companies without registering as broker-dealers as required by law. We discuss these problems identified by the SEC in greater detail below. The SEC's revelations have led a few PE firms to voluntarily rein in some of the most egregious practices for their new funds. While changes in behavior that improve the treatment of limited partners and portfolio companies by GPs are a welcome development, the changes to date consist of piece-meal and voluntary agreements by a handful of PE firms to behave better in the future. The majority of PE firms found to have violated securities law have not taken steps to make amends for past misdeeds or to stop such practices.

Still up in the air is the question of whether past bad behavior by PE fund advisors and the PE firms with which they are affiliated will lead to enforcement actions by the SEC. Will those Wall Street firms that have engaged in improper behavior going back many years or even decades that borders on – and sometimes crosses over to – fraud be held accountable? Their misdeeds have resulted in billions of dollars in ill-gotten gains for the PE firms' partners or top executives. Will these firms be required to disgorge the money they and their partners or executives wrongly appropriated? The SEC's enforcement record to date is not encouraging: enforcement actions have been brought in very few cases, most of them small bore and involving relatively unknown private equity firms such as Lincolnshire Management and Clean Energy Capital. Enforcement is a necessity if the bad behavior by so many PE firms that the SEC has identified is to be halted. But these are still early days and if, as some in the finance community expect, the SEC is planning much larger enforcement actions, these may take time to investigate and develop. That is especially true in cases where the PE fund investment adviser acted as an unregistered broker-dealer – a situation rife with conflicts of interest and possibilities for fraud. This is a serious violation of securities law, and one that carries heavy penalties.

2 Melanie (2015).

Wall Street isn't waiting to learn whether enforcement actions will be taken against powerful private equity firms that have flouted their fiduciary responsibility to investors or broken the law. Big banks and investment firms have been lobbying hard for repeal or delay of key provisions of Dodd-Frank.[3] And in the first month of the new Congress, Wall Street has had some victories to show for the tens of millions of dollars it has spent to roll back financial reform. High on Wall Street's wish list is to get an exemption for PE fund advisors from registering as broker-dealers when they play this role in the merger and acquisition activities of their portfolio companies. This, they hope, will set the stage for rolling back the Dodd-Frank provisions that require general partners of larger PE funds to register as investment fund advisers with the SEC and return the industry to the good old days when it could operate out of public sight.

3 Weisman and Lipton (2015).

A Catalogue of Misdeeds

It's no wonder that private equity firms want to be able to make their millions without fear of public scrutiny. We turn now to a discussion of the misdeeds that the SEC examinations of PE fund advisers have revealed.

Valuing Companies in a PE Fund's Portfolio

One concern that the SEC identified early on is how the GP of a fund values companies in its portfolio that have not yet been sold when reporting the fund's performance. Ultimately, we cannot know how a private equity fund has performed until all investments have been sold and investors have received the final payout from the fund. Typically, funds have a 10-year duration, and limited partners (LPs) must commit to a fund for that period of time. In the interim, a fund's reported performance depends on how these unsold portfolio companies are valued. PE firms market subsequent funds based on these interim valuations of their current fund. Since 2008 when accounting standards were changed, GPs have been required to report these interim valuations at 'fair value' – essentially a hypothetical price at which the company could be sold. This is an improvement over the earlier guesstimates by GPs of the value of portfolio companies. However, GPs still have extensive discretion in determining the value of these companies. Some GPs have chosen to value portfolio companies opportunistically – underestimating the value of portfolio companies so that current investors in the PE fund get an upside surprise when distributions are made and overestimating the fund's value when marketing to potential new investors. A major study by three business school professors – well-known experts on private equity – found that valuations and reported returns of PE funds were inflated when their PE firm sponsors were seeking investors for a follow-on fund.[4] They concluded that investors would be ill-advised to base the decision to invest in a new PE fund on the reported returns of the current fund.

In late 2011, the SEC began an informal inquiry into the PE industry. It was particularly concerned about whether PE firms use inflated valuations of portfolio companies in funds they currently sponsor when they seek to attract investors to new funds.[5] Erroneous evaluations can distort measures of a fund's performance. In March 2013, the SEC reached a settlement with the private equity unit of Oppenheimer & Co., which it had accused of inflating the valuation of one of its investments in order to help market a new fund. The settlement required Oppenheimer to be censured, to pay a penalty of $617,579, and to return approximately $2.27 million in capital

4 Jenkinson, Sousa, and Stucke (2013).

5 Peterson (2012).

commitments to investors it had misled.[6] In January 2014 the SEC barred and fined a former fund manager for inflating the fund's value. [7]

Measuring Fund Performance

Most recently it became clear that the SEC is also focusing on how private equity firms report their most important performance measure – the average returns to LP investors net of fees and expenses in earlier funds – when they are raising new funds from potential investors. The PE industry has no standard method for calculating this important indicator of the actual profits LPs in previous funds received. Some PE firms, it turns out, use a methodology in their marketing materials that exaggerates the return LPs can expect to receive. The issue is that the general partner of the PE fund does not pay any management fees. Including the GPs contribution to the fund when calculating average returns net of fees raises the average return. Apollo Global Management makes use of this methodology, for example, while Blackstone Group, Carlyle Group and Bain Capital do not. The SEC is examining how widespread the practice is, and whether information about the methodology used is conveyed to potential investors.[8]

Allocating PE Firm Expenses and Portfolio Company Fee Income

But things really heated up in late April 2014 when the SEC's top regulator, Mary Jo White, pointedly described abuses by private equity firms in her testimony to Congress. Reporting on what SEC investigators had found in their examinations of PE funds and the activities of funds' general partners, White said,[9]

> "Some of the common deficiencies from the examinations of these advisers that the staff has identified included: misallocating fees and expenses; charging improper fees to portfolio companies or the funds they manage; disclosing fee monitoring inadequately; and using bogus service providers to charge false fees in order to kick back part of the fee to the adviser."

White's testimony was followed on May 6 by the "sunshine" speech delivered by Andrew J. Bowden, the Director of the SEC's Office of Compliance Inspections and Examinations to PE fund compliance officers at the Private Equity International Forum in New York City.[10] Commenting on

6 Kiernan (2013).
7 Mason (2014).
8 Roumeliotis (2014).
9 White (2014).
10 Bowden (2014).

the more than 150 examinations conducted by that date, Bowden stunned his listeners when he reported that in over half the cases SEC examiners found violations of law or material weaknesses in controls in the handling of fees and expenses. As he pointed out, PE advisers use limited partner investors' funds to obtain control of non-publicly traded companies. This control combined with a lack of transparency provides numerous opportunities for the PE advisor to enrich his PE firm at the expense of the pension funds, insurance companies, foundations, and endowments that supply most of the capital of PE funds. Fees collected from portfolio companies are supposed to be shared with investors in PE funds. The SEC's examinations focus on process – on whether PE fund advisers' behavior is consistent with the terms of the limited partnership agreements that govern their relationships with their limited partner investors. But many GPs did not even meet this low bar: the SEC found in many cases that the vague wording in the limited partnership agreements left investors in the dark about whether they are receiving their fair share of these fees.

What Bowden described in his speech to PE fund compliance officers was a troubling situation in which more than half the PE firms examined had serious compliance violations or worse and were not sharing funds that rightfully belonged to pension funds and other limited partners.

Several practices related to fees and expenses are especially troubling. On the expense side, management fees paid by the limited partners are supposed to cover the expenses of the general partner. But the SEC found a trend of general partners shifting their back office expenses onto the LPs during the middle of the fund's life. For example, some PE firms reclassify operating partners as consultants rather than employees and charge investors for their services.

Of particular interest to the SEC are fees paid by portfolio companies for monitoring and advisory services provided by the PE firm behind the fund that owns them. During the financial crisis, PE funds were largely unable to deliver on their promise of outsized returns. Limited partners in PE funds began to push back against the 2 percent annual management fee and some were able to negotiate lower fees. PE firms responded to this threat to their profits by charging fees to portfolio companies. Various units of KKR, for example, pulled $117 million in a variety of fees out of First Data, a portfolio company of a KKR fund.[11]

In general fees charged to a portfolio company by the PE firm are supposed to be rebated to the limited partners in its PE fund to offset at least part of the management fees they pay. Vague wording in the limited partner agreements has meant that in many cases these investors have not received the fee income that is owed them; instead, it has been pocketed by the PE firm. The SEC has flagged the practice of some PE firms of using consultants to provide the monitoring services.

11 Chassany and Sender (2014).

Traditionally the executives that provide these services were salaried employees of the PE firm and they were paid by the PE firm. More commonly in the recent period, fees have been charged to portfolio companies for these services – fees that were expected to be shared with PE fund investors. However, PE firms have discovered that they can get around the requirement to share these fees by treating these executives as consultants rather than employees. In this case, the consultants' salaries appear as expenses of the portfolio company. As a result, PE investors do not receive any fee income. Moreover, the profits of the PE firm are increased because the salaries of the executives providing advice have been shifted to the portfolio company.[12] Adding insult to industry, fees paid by portfolio companies to PE firms for monitoring services are tax deductible, so the entire scheme is subsidized by taxpayers.

Money for Doing Nothing

'Accelerated monitoring fees' are a particularly egregious practice that PE firms use to enrich themselves at the expense of both their portfolio companies and their limited partner investors. This is a practice in which a portfolio company is required to enter into a multi-year contract to pay an annual fee for advisory services that extends for as many as 10 years to the PE firm behind the fund that acquired it. If, as is typically the case, the company is sold to a strategic investor or via an initial public offering on the stock market before the end of the contract, payment is triggered and the PE firm gets the payments for the remaining years in one lump sum for services it will never provide. Additionally, because the company is no longer owned by the PE fund, accelerated monitoring fees do not have to be shared with the fund's investors.[13] Moreover, the payment of accelerated monitoring fees is generally taken into account by buyers when the portfolio company is sold and reduces the price at which a PE fund exits the investment, thus reducing the return to investors in the fund.

Critical comments about this practice by a senior SEC official and the resulting negative attention have led Blackstone – a PE firm that has made extensive use of accelerated fee contracts – to do a U-turn. Blackstone Group LP, the world's largest private equity firm, told one of its firm's investors that it would no longer collect extra advisory fees for services no longer needed nor provided once a portfolio company is sold or returned to the public markets through an IPO.[14] Now that the practice has been exposed, PE investors have expressed their dissatisfaction with such payments, which reduce the value of the portfolio company when the investment is exited, reducing their return while unfairly providing a large and undeserved bonanza to the PE firms that make use of this practice. The use of accelerated fees to boost profits appears to be widespread and is used by major players in

12 Morgenson. (2014a).
13 Ibid.
14 Maremont and Spector (2014a).

the industry, as this chart from the Wall Street Journal demonstrates.[15] Whether the approbation of the SEC and Blackstone's example will change norms of behavior and lead other PE firms to cease this particular practice remains to be seen. But it would be a desirable outcome if it occurred.

FIGURE 1
Fee Bonanza

Source: Securities and Exchange Commission filings, from Maremont and Spector, 2014.

Acting As a Broker-Dealer

In April 2013 an SEC commissioner flagged the transaction fees that many PE firms charge portfolio companies in the course of acquiring them in a leveraged buyout as a potential violation of the Securities Exchange Act of 1934. Collecting these fees may make it necessary for the GP of a PE fund (the PE fund's adviser) to register as a broker-dealer. This would generally be the case if the PE fund advisor (the GP), its personnel, or its affiliates receive transaction-based compensation for investment banking or other broker activities in regard to a portfolio company. Such activity is common in the case of leveraged buyouts, and GPs have collected billions of dollars over decades in such deal fees for the PE firms that employ them without being registered to do so.[16] The commissioner noted that the SEC staff[17]

> "has observed that that advisers to some funds — for example, advisers to private equity funds executing a leverage buyout strategy — may also collect many other fees in addition to advisory fees, some of which call into question whether those advisers are engaging in activities that require broker-dealer registration. Examples include fees the manager directs a

15 Ibid.
16 Katz (2014).
17 Blass (2013).

> portfolio company of the fund to pay directly or indirectly to the adviser or one of its affiliates in connection with the acquisition or disposition (including an initial public offering) of a portfolio company or a recapitalization of the portfolio company. The fees are described as compensating the private fund adviser or its affiliates or personnel for "investment banking activity," including negotiating transactions, identifying and soliciting purchasers or sellers of the securities of the company, or structuring transactions."

Transaction-based fees collected by a PE fund's general partner or its affiliates have the potential to create a conflict of interests: the GP may be motivated to carry out a transaction that generates substantial fee income without regard to whether that transaction is in the best interest of the fund's investors. These fees provide an immediate cash windfall to the GP, regardless of how well or poorly the investment performs. Registering as a broker-dealer affords investors protection against such conflicts of interest by providing SEC oversight of such transactions, requiring that the advice that is provided is 'suitable,' and imposing penalties for violating this standard.

Securities laws require anyone engaged in the business of affecting transactions in securities for the account of others, as occurs for example in mergers and acquisitions, to register as a broker and be subject to increased oversight by the SEC to ensure fair behavior. The unlicensed broker-dealer issue arises in those cases where the general partner of a PE fund receives transaction fees from the fund's portfolio companies without registering with the SEC. This is an unambiguous securities law violation for which these GPs face a huge liability. Fines for broker-dealer violations are dollar for dollar of the transaction value.[18]

Most PE firms oppose any requirement that GPs register as broker-dealers, although in recent years many large PE firms including Blackstone Group and TPG Capital have established brokerage units in order to comply with the 1934 law.[19]

Pushback by the PE industry against having to register and, importantly, being legally liable for past violations of the law, is strong. PE firms maintain that they are investment advisers, not broker-dealers, and that the reporting requirements in Dodd-Frank are sufficient to meet the concerns of the SEC. In early 2014, SEC staff began to consider an exemption for PE fund advisers from the registration requirement, which would make it legal for GPs to continue collecting deal fees in the future and unlikely that the SEC would take action against the PE firms for transaction fees improperly collected in the past.[20] The question of whether private equity will get a free pass and be

18 Smith (2015).
19 Katz (2014).
20 Ibid.

exempt from the requirement to register as a broker-dealer is not yet fully resolved.[21] However, legislation passed by the U.S. House of Representatives on January 14, 2015 includes a provision that would exempt many GPs from registering with the SEC as broker-dealers.[22] President Obama has vowed to veto the bill if it reaches his desk.

Appointment of an Independent Monitor

Documents obtained via a Freedom of Information Act (FOIA) request and posted on the web reveal that the SEC's examination of Freeman Spogli & Company clearly established the firm's flagrant disregard for the terms of its limited partnership agreements.[23] The limited partnership agreement provides that only Freeman and Spogli's management company arm or a general partner affiliate

> "should receive transaction fees and director fees, including stock options, and that any such fees received should reduce the management fee due from [investors in] the Funds."

The SEC examination unit found that Freeman and Spogli's

> "failure to reduce its management fees to account for the compensation its Affiliated Executives received in transaction fees and director fees, and to account for the transaction fees it account for the transaction fees it shared with an unaffiliated party, despite the requirement to do so pursuant to the limited partnership agreements, appears inconsistent with its fiduciary duty …
>
> The staff believes that Registrant (Freeman and Spogli) should reimburse Fund V and Fund VI for the amount of the transaction fees and director fees, including the value of any "disposed" stock options, that Registrant failed to offset against the management fees charged to Fund V and Fund VI."

The SEC examination unit also observed that Freeman Spogli apparently acted as a broker-dealer without first registering with the SEC as required by the Securities Exchange Act of 1934. Receipt of transaction based compensation generally indicates that a person is a broker. The examination of Freeman Spogli found that the firm and its Affiliated Executives received transactions based compensation paid by portfolio companies in Fund V and VI upon completion of the deal,

21 Morgenson (2014b).

22 U.S. House. 114th Congress. "H.R.37, Promoting Job Creation and Reducing Small Business Burdens Act." (Version Date: 1/14/15). Text from: https://www.congress.gov/bill/114th-congress/house-bill/37

23 Smith (2015).

> "similar to investment banking fees. Consequently, it appears as though Registrant (Freeman Spogli) and its Affiliated Executives may be and have been acting as unregistered broker-dealers based on the receipt of such compensation."

In addition to making restitution to its earlier funds, Freeman Spogli amended its partnership agreement with its new fund (FS Equity Partners VII) to allow the appointment, should the limited partners in this new fund request it, of a professional adviser that would review the Fund's books and records and advise the limited partners on governance issues and conflicts of interest.[24]

Yves Smith has pointed out that this monitor was not required by the SEC and might or might not be appointed by the limited partners, would be paid by the Fund and not by Freeman Spogli, provides no protections for investors in current funds, and has no greater access to information than the LPs have.[25] Nonetheless, the appointment of a professional adviser to monitor the GP may be a useful precedent. If private equity funds could be required to appoint a monitor as a condition of receiving limited partner investments, it would likely be significant step forward in terms of assuring that limited partners received fee income specified in the LPA.

What More Should the SEC Do?

The SEC has done a surprisingly good job of examining the relationship between private equity fund advisers, the GP of the PE fund, and the limited partners that invest in the funds. The revelations of SEC findings discussed in this issue brief have been eye opening. The lack of transparency surrounding PE firm practices and the confidentiality requirements in the limited partnership agreements (LPAs) that pension funds and other investors sign when they invest in a PE fund shield the behavior of private equity from public scrutiny. Even pension fund participants (and, in the case of public sector pension funds, taxpayers) cannot get this information and assure that their interests are protected. This has made it impossible for outside entities to review what is in these agreements and to determine whether the PE firm is looking out for the interests of its investors or for its own interests.

In the UK, members of the House of Lords have proposed reforms to the regulations that govern pension plans in that country. Their goal is to ban non-disclosure agreements that conceal the management fees paid by pension funds to private equity funds and other asset managers so that current and future retirees can know more about how their retirement savings are being managed.[26]

24 Morgenson (2014c).
25 Smith (2015).
26 Duffell (2015).

The non-disclosure provisions of limited partnership agreements also prevent LPs from sharing information about investments made by the funds in which they have invested and about the funds' performance. Dodd-Frank has provided a partial remedy by requiring most private equity fund advisers to register with the SEC and report basic operational and financial data. However, to really analyze the performance of the private equity industry would require detailed disclosures by PE funds about their investments in portfolio companies. Requiring limited partnership agreements to be made publicly available is an important step toward greater transparency, but it is not sufficient to allow meaningful analysis of PE industry returns.

The public revelations by the SEC of widespread misdeeds and bad behavior among private equity players have had some salutary effects. The Blackstone Group has decided to forego accelerated fees for services it will never provide. Freeman Spogli & Company has agreed to the appointment of an independent monitor, if LPs request it, with the authority to review the firm's financial and other practices and to report information on fee sharing and other aspects of the limited partner agreements to LPs.[27] The appointment of an independent monitor can be a useful precedent. If it becomes widespread – that is, if pension funds and other private equity investors make the appointment of an independent monitor a condition for their investments – we could expect LPs ability to ascertain whether GPs adhered to limited partnership agreements, kept their books honestly, shared fee income properly and so on to be far better than it is at present. Finally, a handful of PE firms have for the first time admitted to improperly charging expenses to investors in their PE funds or to failing to share fee income with them. They have revised the forms filed with the SEC and promised investors that they will be more forthcoming in the future; their hope is that in this way they will escape further regulatory scrutiny or penalties for their past behavior.[28] Without regulatory and legal consequences for misleading investors, however, changes in industry norms that condone bad behavior will be slow to come.

Enforcement

Having done a good job of publicly identifying the inherent conflicts of interest in the PE business model as well as the fraudulent and inappropriate behavior of many PE firms, the SEC has taken virtually no enforcement actions to date, although some in the PE industry think such actions will be forthcoming. For now, the SEC seems to be relying on investors in PE funds to confront the funds' general partners. But LPs cannot be expected to take on this role and deal aggressively with GPs because PE firms do not hesitate to threaten them if they make public the fee and expense structures in their limited partner agreements.[29] PE investors are afraid that they will not be able to invest in future private equity funds if they challenge the practices of PE firms. And they lack the

27 Morgenson (2014c).
28 Maremont and Spector (2014c).
29 Maremont and Spector (2014b).

legal and other resources necessary to challenge fund GPs and go up against the deep pockets of the PE firms in which they are partners even when they are so inclined. Some limited partners in PE funds, mainly large pension funds and endowments, have been able to negotiate lower management fees, but beyond this their accomplishments are limited. The largest LPs do not appear able or willing to challenge the allocation of fees collected from portfolio companies or the use of consultants rather than salaried employees to monitor and advise them despite the fact that this fattens the bottom line of PE firms at the expense of limited partners.

TPG Capital needs to rebuild trust with investors following the disastrous investments by its funds in the now-bankrupt Texas energy company EFH and soon-to-be bankrupt Caesar's Entertainment. It recently agreed to a multi-million dollar settlement with the SEC of charges it conspired with other PE firms to restrict competitive bidding and held down the price paid to acquire portfolio companies.[30] Despite these losses and legal problems, TPG does not seem ready to make things up to investors in its current fund. According to the New York Times, the firm has a 'recovery' team whose job it is to recover monitoring and advisory fees for TPG. Management fees from limited partner investors pay the salary of Kevin R. Burns, a TPG partner. Burns is being paid again through the 'recovery' of part of the fee paid by yogurt maker Chobani for services he is providing to that company – fee income that would otherwise be shared with pension funds for the benefit of current and future retirees and with other limited partners. TPG investors are paying twice for Burns' work on the Chobani deal – once through the management fees they pay and again through fee income they do not receive. As the New York Times article pointed out, this type of double dipping at the expense of limited partner investors appears to be the norm at TPG:

> "Such a payment plan appears to fall within TPG's stated business practices. Members of the firm's operations group may serve in management roles at the firm's portfolio companies, at the expense of clients, according to a regulatory filing by TPG in March."[31]

Informing investors about such business practice may make them legal, but it doesn't make them right. The SEC frowns on such practices. But that may not be sufficient to rein them in.

Even private equity firms that share fee income with investors retain billions for themselves. According to the Wall Street Journal, "The four biggest publicly traded buyout firms—Blackstone, Carlyle, Apollo and KKR—collectively reported $2.1 billion in net transaction and monitoring fees from their private-equity businesses between 2008 and the end of 2013." [32] Fee income retained by all PE firms over this period is substantially higher, although this information is only available for those that are publicly traded.

30 Primack (2014).
31 Alden (2015).
32 Maremont and Spector (2014d).

Limited partners have shown themselves to be quite timid when it comes to demanding better terms from GPs, or enforcing limited partnership agreements, or requiring access to information they are entitled to. Their fear is that they will be blackballed from funds launched by 'top' PE firms. Distributions to limited partners have reached record levels in 2013 and 2014, despite the fact that the median PE fund launched since 2005 did not outperform the S&P 500, which itself hit record levels in each of these years.[33] Flush with these distributions, LPs are fighting to get into coveted follow-on funds.[34] They are not too likely to press for better terms or greater disclosure from GPs. The SEC should not rely on pressure from investors in PE funds as a substitute for enforcement actions to reform the behavior of the GPs in these funds now that the SEC has the authority to regulate them as investment advisers.

The timidity of limited partners in confronting general partners and demanding fair treatment – bizarre as this is – means that current and future pension fund beneficiaries, limited partners, and taxpayers must rely on enforcement actions by the SEC to protect their interests and, in many cases, their retirement savings. Self-dealing appears to be rife in this industry. PE firms can – and often do – include a waiver of the fund advisers' fiduciary responsibility to their investors in the limited partner agreements. Dan Primack, in his December 18 Term Sheet column discussing TPG Capital's newest flagship fund, TPG Partners VII, reprinted the following statements from the fund's Private Placement Memo:

> *"Since the amount of carried interest payable to the General Partner depends on the Partnership's performance, we may have an incentive to approve and cause the Partnership to make more speculative investments than it would otherwise make in the absence of such performance-based compensation. We may also have an incentive to dispose of the Partnership's investments at a time and in a sequence that would generate the most carried interest, even if it would not be in the Partnership's interest to dispose of the investments in that manner."*

And

> *"The General Partner may take its own interests into account in the exercise of such discretion. The exercise of such discretion may negatively impact the Limited Partners generally or may impact some Limited Partners disproportionately."*

Primack characterized these "pieces of boilerplate" as "as fairly egregious, even if they are industry standard," suggesting that the waiver of fiduciary responsibility by PE fund advisers is commonplace.

33 Appelbaum and Batt (2014b).
34 Lim (2014).

This waiver of fiduciary responsibility to the fund's limited partners is especially problematic for pension funds, which by law are required to protect the interests of plan participants, and for life insurance companies that offer annuities to their customers. Limited partners typically commit capital to the private equity fund for a period of 10 years, during which time they have very little control over how the money is invested. Side letters may place some very general restrictions on GPs, but decision making is essentially vested in the general partner. Pension funds and insurance companies that invest in private equity are, thus, largely unable to protect the interests of current and future retirees or annuitants. They must rely of the PE fund adviser – the general partner – to put their interests and those of pension fund participants ahead of its own. But in many cases, it appears, the general partner can take its own interests into account instead.

Apparently no one is exercising the responsibility to protect the interests of current and future pension fund beneficiaries or insurance company annuitants. Their main protection against mismanagement or worse that enriches PE firm partners or executives is the vigilance of the SEC in enforcing the laws that govern the actions of investment advisers vis-a-vis their investors. Sadly, it is here that the SEC may be coming up short. It is not enough to speak loudly about the fraudulent behavior of some GPs. The SEC will need to take strong enforcement action and require PE firms to admit wrongdoing and face the consequences so that investors' interests can be protected.

Relationship with Portfolio Companies

The SEC regulations that implement the Dodd-Frank Act as it affects private equity advisers have focused on GPs treatment of LPs. Little attention by contrast is directed to the relationship between GPs and the individual portfolio companies owned by PE funds. This, in my view, is a troubling omission. The Dodd-Frank Act directs the SEC to collect information that is "necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." The failure to require GPs of private equity funds to report comprehensive information to the SEC about the extent of leverage and the debt structure of each portfolio company makes it difficult to assess the risk to creditors in an economic downturn from overleveraging of portfolio companies. A study of bankruptcy rates among PE-owned companies between 1970 and 2007 (before the financial crisis) found that the rate of bankruptcy or reorganization was twice as high as it was for publicly traded companies. For leveraged buyouts that occurred between 1970 and 2002 the annual default rate was 1.2 percent (7 percent over 6 years) compared with 0.6 percent for publicly traded companies.[35] However, the bankruptcy rate for PE-owned (and other highly leveraged) companies spiked in the first two years of the financial crisis. A study of 2,156 highly leveraged companies in the period 1997 to 2010 found very high default rates

35 Strömberg (2008).

among both PE-owned and non-PE-owned companies. One quarter of the sample had a default between 2007 and 2010.[36]

The covenant-lite loans that banks and other creditors are again making to facilitate the acquisition of portfolio companies by PE funds omit important items from loan agreements that are intended to protect lenders from unnecessary losses. The low interest rate environment and frothy prices to acquire portfolio companies in the last two years have enabled dangerously high leverage levels. According to PitchBook, a major source of data on the private equity and venture capital industries, the median debt used by PE funds to acquire a portfolio company was between 6.9 and 8.2 times earnings (EBITDA) in 2013 and the first half of 2014. Cognizant of the potential systemic risks associated with such high levels of leverage, in 2013 the regulators of the banking system (Federal Reserve System, Office of the Comptroller of the Currency, and FDIC) issued guidelines to banks that propose 6 times earnings as a reasonable limit on debt that can be levered on a company; loans with higher debt multiples may only be appropriate if the bank can provide evidence that they are not excessively risky.[37] Since the guidelines apply to banks and not to companies, private equity has responded by increasing its already considerable reliance on the shadow banking system to finance its leveraged buyouts of portfolio companies. It would be useful for the SEC to examine the level of debt loaded onto individual portfolio companies, debt-to-equity ratios, and the nature of the debt instruments used for this purpose in assessing the exposure of lenders to LBO debt and the potential associated systemic risks.

Conclusion

The SEC's examination unit has shown that it takes its responsibilities seriously. To the chagrin of private equity, its examinations have revealed widespread abuses by PE fund general partners and PE firms of their relationships with their limited partner investors in their management of expenses charged to funds and fee income from companies in which the fund has invested. In particular, the examination unit has rejected the claim by PE firms that general partners, who function as advisers to the fund, can waive their fiduciary responsibility to their investors. It has shamed the PE industry and, importantly, public approbation has led at least some PE firms to moderate their behavior and to eschew questionable or illegal behavior going forward. Voluntary and piece-meal as this is, it

36 Hotchkiss, Smith, and Strömberg (2012).

37 OCC, Department of the Treasury, Board, and FDIC (2013).
The section on underwriting standards (p. 17773) includes the following: "Credit agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed charge coverage), reporting requirements, and compliance monitoring. Generally, a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of 6X Total Debt/EBITDA raises concerns for most industries…"

serves several important purposes. It is useful to have PE firms admit that certain practices are wrong, and possibly illegal. It demonstrates that PE firms can be successful, if not quite so rich, without resorting to unsavory practices. And it suggests new norms of behavior for the industry and, where necessary, the appointment of monitors to assure they are adhered to. This is no substitute, however, for enforcement actions directed against PE firms whose partners flagrantly disregard the law or the interest of their investors.

In addition to exposing bad behavior to the court of public opinion, the examination unit can require that PE firms make restitution to investors in its funds, and it has done this. That's as much as it can do, however. If the examination unit thinks further action is necessary, it must refer the misdeeds it has identified to the SEC's enforcement unit. In cases where large sums of money have been misappropriated or where a pattern of disregard for the law is present, such referrals are warranted. Enforcement actions are a necessity if the worst types of bad behavior are to be deterred.

It would be a costly mistake for Congress to roll back the SEC's ability to examine the behavior of private equity fund advisers, and to require that they live up to the standards of behavior that mutual fund and other advisers must meet – standards that protect the interests of investors in these funds, including pension funds and annuity life insurance companies on which millions of retirees depend. Examinations and enforcement hold the key to whether Dodd-Frank will be successful in doing its job of shoring up the financial system.

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