3732 Sacramento Street
San Francisco CA, 94118

June 26, 2016

The Honorable Richard Pan
Chair
Senate Committee on Public Employment and Retirement
State Capitol, Room 4070
Sacramento, California 95814

RE: OPPOSE UNLESS AMENDED for AB 2833

Dear Dr. Pan:

I am writing in opposition to AB 2833 which will be heard in your committee on Monday, June 27th. I was initially highly supportive of the bill, and even went so far as to create a website advocating for it.[1] However, the latest round of amendments has fatally weakened the bill by removing the requirement for full disclosure of related party transactions. As a result, I believe that it would set back the cause of private equity transparency for the bill to be enacted as currently written.

I would like to have been present to offer testimony in support, but a death in my family requires me to be out of town that day.

I served on the CalPERS board for eight years, from the beginning of 1995 to the beginning of 2003. For my last three years, I served as chair of the board's investment committee. I then worked at a large alternative investment management firm in senior roles from 2003 through 2014.

Currently, I am a visiting scholar at the UC Berkeley Goldman School of Public Policy, where I conduct research into bad practices of investment managers that negatively impact public pension funds. I believe that my professional background offers me unique insight into why AB 2833 should not become law as currently drafted.

I am also a CalPERS beneficiary. I strongly believe that enactment of the bill as currently drafted will cost CalPERS significant sums over time, and so I have a direct financial interest in seeing the bill further amended to fix its flaws, as does my wife, who is a member of the University of California Retirement System as a result of her position as a professor of pediatrics at UCSF.

[1] www.whyab2833.com

The Problem AB 2833 Set Out to Address

Approximately a year ago, 11 state treasurers and the city comptroller of New York wrote to SEC chairwoman Mary Jo White complaining that investors receive inadequate transparency from private equity funds.[2] Their letter noted several areas of weak disclosure but called special attention to the opaque nature of related party transactions that private equity firms execute with fund portfolio companies.[3] In their letter, the treasurers pointed out that public funds generally do not receive sufficient information to verify that they, the investors, receive the full, contractually required benefit of fees earned by private equity managers (a.k.a., "general partners") from these related party transactions:

> Limited partners, such as state pension portfolios, are typically eligible for an allocation of fees that private equity managers collect from their portfolio companies. However, this limited partner share is usually not transferred to the limited partner, and instead it is maintained by the manager and used as an offset against payment of management fees. The calculation behind this offset is often opaque to the limited partner, making consistent disclosure of private equity expenses to the public extremely challenging.

In the last year, the treasurers' concerns about undisclosed fees have been ratified by three SEC enforcement actions against private equity firms in which California public pension funds had invested.[4] In each of the three cases[5] the SEC found that that the private equity firm was not adequately disclosing fees it collected from related party transactions with portfolio companies

The SEC has also warned investors to expect more enforcement actions over undisclosed related party transaction fees, and large private equity firms, such as Apollo Global Management, which counts numerous California public funds as investors, have publicly stated that they expect to be the subject of enforcement action for such undisclosed fees.

Against this backdrop, California Treasurer John Chiang, AB 2833's sponsor, last October wrote a letter to CalPERS and CalSTRS proposing legislation to force transparency of fees charged to portfolio companies by private equity firms.[6] In a key passage of the letter, he described his proposed features of the legislation as

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[2] Letter found at http://www.nakedcapitalism.com/wp-content/uploads/2015/07/PE-disclosure-letter-to-SEC.pdf

[3] "One tangible example of inadequate expense reporting relates to portfolio company monitoring fees."

[4] CalPERS, in particular, had invested in funds sponsored by all three firms.

[5] SEC Administrative Proceeding File No. 3-16656 *In the Matter of Kohlberg Kravis Roberts & Co. L.P., Respondent*. SEC Administrative Proceeding File No. 3-16887 *In the Matter of Blackstone Management Partners L.L.C., Blackstone Management Partners III L.L.C., and Blackstone Management Partners IV L.L.C., Respondents*. SEC Administrative Proceeding File No. 3-16938 *In the Matter of Fenway Partners, LLC, Peter Lamm, William Gregory Smart, Timothy Mayhew, Jr., and Walter Wiacek, CPA, Respondents*.

[6] Found at https://www.scribd.com/doc/316660336/2015-10-12-Letter-to-Henry-Jones-Sharon-Hendricks

follows, "Disclosure requirements [in the bill] would include, but not be limited to, gross management fees, management fee offsets, fund expenses, carried interest and all other fees as well as related party transactions."

It is notable that Chiang's letter emphasized the importance of related party transaction disclosure. In the analogous context of publicly traded companies, which most private equity portfolio companies are not, it is a bedrock principle of U.S. securities law[7] that there must be disclosure of transactions between a company and persons ("related parties") who have power to force such transactions to occur (such transactions being "related party transactions"). This disclosure[8] is required because related party transactions impose costs on shareholders in two distinct fashions.

First, each shareholder suffers a direct economic cost of a related party transaction equal to the total cost to the company of the transaction multiplied by each shareholder's fractional ownership interest in the company. So, if a company engages in a five million dollar related party transaction, and a particular investor owns ten percent of the company shares, that investor's pro rata share of the direct cost is $500,000. The June 21 version of AB 2833 limits private equity firms to disclosing to each California public fund investor only this cost, the investor's direct, pro rata share of related party transaction costs.

However, there is a second, very important but more subtle cost to related party transactions. It occurs when a company is forced to allocate capital to abusive transactions with related parties that offer little or no benefit or may even harm the company.

For example, imagine that a CEO decided to re-allocate a company's entire advertising budget to his aspiring adman brother, while giving his brother contract terms that explicitly allowed him to do no work whatsoever and still earn the entire ongoing payment for a minimum of ten years. The cost to each shareholder in this scenario would go well beyond that shareholder's pro rata share of the payments to the brother. Many businesses would go bankrupt if they ceased advertising, so the worst-case cost to shareholders would be loss of their entire investment in the company. Other, less dire consequences would include sub-optimal profitability relative to the alternative where the advertising budget was more effectively allocated.

Because it is impossible to estimate this second cost, where capital is sub-optimally allocated to abusive related party transactions, securities regulators around the world recognize that the cost should not be expressed on a per-share, pro rata basis but instead simply disclosed in aggregate so that investors can assess the impact for themselves. Unfortunately, the June 21 version of AB 2833 strips out the prior language that required disclosure of the full cost of related party transactions.

[7] SEC Regulation S-K Item 404.

[8] In the public company context, related party transaction disclosure occurs in 10-K, 10-Q, and annual proxy statement filings with the SEC.

Private Equity Firms Engage Extensively in Abusive Related Party Transactions with Portfolio Companies

In early 2014, a law professor published a scholarly article[9] documenting what many people had long suspected. Namely, the article revealed that a large portion of related party transactions between private equity firms and their fund portfolio companies have striking similarities to the hypothetical no-work, no-fire deal in the good-for-nothing brother example. The professor's assessment was based on obscure filings where the actual contracts for purported services between portfolio companies and private equity owners were filed with the SEC, hence publicly available.

In the article, the professor described ten of the ten largest private equity deals in recent history, focusing on the actual contract language for purported services that private equity owners imposed on each portfolio company after acquiring it. In each case, the contract required the portfolio company to pay millions of dollars annually to private equity firm owners.

For example, just one firm, HCA Holdings, a hospital management company, was required to pay a minimum of $15 million annually for ten years to its private equity firm owners. What services did the private equity firms that owned HCA provide in consideration of these payments? According to the contract, the private equity firms were required to provide absolutely no services:

> Each of the Managers [private equity firms] shall devote such time and efforts to the performance of services contemplated hereby as such Manager deems reasonably necessary or appropriate; provided, **however, that no minimum number of hours is required to be devoted by Bain, KKR, ML, or each Frist [private equity firms] on a weekly, monthly, annual or other basis.**[10]

Similarly, the article pointed out:

> HCA's management agreement allowed the managers to unilaterally terminate the agreement at any time and for any reason yet still receive the present value of the future monitoring fees (discounted using the risk-free yield on U.S. treasuries) that they would have received for the full 10-year term of the management agreement.

This scenario came to pass in 2011, when the private equity firms effectively fired their "client" portfolio company and billed it for five years of future services that they would never perform, a sum well in excess of $100 million.

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[9] "The Untold Story of Sun Capital: Disguised Dividends" by Gregg D. Polsky. *Tax Notes*, February 4, 2014. Found at https://www.scribd.com/doc/316664152/SunCap

[10] Contract available on the SEC website at http://tinyurl.com/hca-inc

The scholarly article found these same abusive terms (no work required, ability to fire the "client" portfolio company at any point and still receive up ten years of payments for services never to be performed) in all ten of the related party transaction arrangements the article analyzed. [11]

These findings received extensive attention and were the subject of a large Wall Street Journal article that raised questions about the legality of the related party transaction fee arrangements with respect to these ten transactions.[12]. Later that year, professor Ludovic Phalippou at Oxford University, one of the most respected economic researchers studying private equity, gave a lecture about the practice, which he entitled "Money for Nothing" and in which he argued that the pursuit of abusive related party transactions is a key driver of private equity strategy.[13]

As is already the case with publicly traded companies, one of the most effective curbs on abusive private equity related party transactions, like HCA, is disclosure of the entire transaction to investors. Unfortunately, the most recent amendments to AB 2833 strip out this requirement.

The Pro Rata Disclosure Limitation Will Misleadingly Understate Total Related Party Transactions

A key question for the Legislature in assessing AB 2833 is whether California public funds can adequately assess the scope of related party transactions if, as the current language provides, private equity firms must only disclose each "public investment fund's pro rata share of aggregate fees and expenses." In other words, does knowing an investor's pro rata share provide the investor with insight into the total scale of a related party transaction? Without knowing the total, can one judge whether a transaction rises to the level of abusiveness in terms of cost to the company relative to services received from the private equity firm?

Because of how private equity firms operate, it is clear that one cannot conclude anything about the scale of a related party transaction with a portfolio company from simply knowing one's pro rata share of the transaction cost. Clearly, that is the private equity industry's goal in amending AB 2833 in this fashion, to keep investors in the dark about the full scope of their related party transactions with portfolio companies and the profits they derive from them.

There is a basic reason why it is impossible to infer the total cost of a related party transaction based on one's pro rata share. Namely, a fund investor generally does not know its pro rata interest in a portfolio company's equity relative to the totality of equity held by all of the private equity firm's different investment vehicles. In

[11] Either CalPERS or CalSTRS, or in most cases, both pension funds were investors in each of the 10 abusive transactions analyzed.
[12] "Private-Equity Firms' Fees Get a Closer Look" by Mark Maremont. *The Wall Street Journal*, February 2, 2014. Found at http://www.wsj.com/articles/SB10001424052702303743604579354870579
[13] Found at https://www.youtube.com/watch?v=m1paFqPIj6Q

other words, an investor typically doe not know whether it owns two percent or ten percent of a portfolio company. As a result, when informed about its pro rata share of a related party transaction cost with the portfolio company, the investor cannot know whether, in order to derive the total transaction value, to multiply that pro rata share by 50 (if the ownership were two percent) or ten (if the ownership percentage is ten percent).

California public funds may inform you that they receive precise detail in fund financial statements disclosing their pro rata ownership of each portfolio company relative to other investors in the fund vehicle in which they are investors. What they may not have explained, and perhaps may not understand, is that, most of the time, a private equity firm purchases a portfolio company with capital from multiple vehicles, only one of which is the capital from the private equity vehicle in which a California pension system is an investor.

In other words, to take a hypothetical example, CalPERS may own a five percent interest in a "KKR 2006 Fund" vehicle, which, along with other KKR investment vehicles, owned 100 percent of the Internet service provider GoDaddy. However, the 2006 Fund's interest in GoDaddy may have only been 65 percent, with the other 35 percent having come from the other KKR vehicles.

KKR very clearly states in its annual Form ADV investment adviser disclosure statement filed with the SEC that its investors receive only partial information about the cost of related party transactions with portfolio companies, which is the pro rata portion of fees attributable to the fund in which they have invested:

> KKR periodically discloses to investors in specific KKR Funds the amount of monitoring fees, transaction fees, and breakup fees allocated to KKR Funds in which they have invested.[14]

So KKR is on the record as stating that it does not disclose to investors the pro rata portion of fees attributable to vehicles other than the one to which a particular investor has allocated capital.

Numerous other major private equity firms also acknowledge in their SEC disclosure filings that investors are not provided with information about all of the fees they collect (CalPERS has invested with all these firms). From the filings:

- Hellman & Friedman- H&F determines the amount of these fees for Related Services [related party transactions] and reimbursements in its own discretion, subject to agreements with sellers, buyers, and management teams, the board of directors of or lenders to portfolio companies, and/or third party co-investors in its transactions, and **the amount of such fees and reimbursements may not (except in connection with the reductions**

[14] Kohlberg Kravis Roberts & Co. L.P. Form ADV Part 2. Filed with the SEC March 30, 2016. Found at: http://1.usa.gov/28YyTDl

described below) be disclosed to investors in the Funds [emphasis added].[15]

- Silver Lake Technology Management L.L.C.- The 9 Adviser determines the amount of these [related party transaction] fees for the services provided and reimbursements in its own discretion (and not necessarily on an arms-length basis), subject to agreements with sellers, buyers, and management teams, the board of directors of, or lenders to, portfolio companies, and/or third party co-investors in the transactions**. The amount of such fees and reimbursements will not necessarily (except in connection with the reductions described above) be disclosed to investors in the Funds.** [emphasis added][16]

- Freeman Spogli Management Co., L.P.- The Firm determines the amount of these Transaction and Monitoring [related party transaction] Fees and reimbursements in its own discretion, subject to agreements with sellers, buyers, and management teams, the board of directors of or lenders to portfolio companies, and/or third party co-investors in its transactions, and **the amount of such fees and reimbursements often will not (except in connection with the reductions described in Item 5 above) be disclosed to investors in the Funds.** [emphasis added][17]

- J.C. Flowers & Co. LLC- This creates a conflict of interest between JCF&Co and its affiliates and the Funds and their investors because the amounts of these fees and reimbursements may be substantial and the Funds and their investors generally do not have an interest in these fees and reimbursements. JCF&Co determines the amount of these fees and reimbursements in its own discretion, subject to agreements with sellers, buyers, and management teams, the board of directors of or lenders to portfolio companies, and/or third party co-investors in its transactions, and **the amount of such fees and reimbursements may not (except in connection with the reductions described below) be disclosed to investors in the Funds.** [emphasis added][18]

Almost certainly, the existence of multiple fund vehicles with fees attributed to each explains why investors do not receive full disclosure of related party transactions. AB 2833 will do nothing to change this reality. The pro rata cost to each California public fund will be disclosed if the bill becomes law, but investors will remain in the dark about the full scope of the hypothetical example offered, where the CEO pays his brother millions of dollars for little or no value received. Some, perhaps even most, of that cost would allocated pro rata to investors in the other vehicles, and so remain hidden, even though all of the payments would materially impact the health

[15] Hellman & Friedman Form ADV Part 2. Filed with the SEC August 1, 2013.
[16] Silver Lake Technology Management Form ADV Part 2. Filed with the SEC March 30, 2016.
[17] Freeman Spogli Management Co., L.P. Form ADV Part 2. Filed with the SEC March 2016.
[18] J.C. Flowers & Co. LLC Form ADV Part 2. Filed with the SEC May 15, 2014.

and profitability of the company in a way that affects all shareholders. The related party transaction costs disclosed pursuant to AB 2833 would therefore inherently understate, in many cases by a large margin, the true economic impact to investors of the related party transactions.

The Legislature has a clear alternative available to deal with this problem of inadequate disclosure of related party transaction costs, which is to restore the language from the prior version of AB 2833, which required disclosure of all related party transaction costs.

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Conclusion

The private equity industry clearly intends to fool the Legislature and the public with the most recent amendments to AB 2833. The industry is pretending that no material difference exists between disclosure of a related party transaction's entire cost compared to disclosure of just an investor's pro rata share of the cost. It is quite unfortunate that many California public pension funds now pretend that pro rata disclosure is substantially equivalent to full disclosure. It is not, and I fear that the pension funds support weak disclosure in order to avoid the Legislature or the public recognizing the full cost of private equity investments, because awareness would result in pressure on the pension funds to reduce those costs.

I urge the Legislature to amend the bill to provide for full related party transaction disclosure or, absent the ability to do that, to reject the bill.

Respectfully submitted,

Michael Flaherman