WHY AB 2833 (/)

What is AB 2833?

Assembly Bill ("AB") 2833 would change California law to require greater transparency by private equity ("PE") firms investing on behalf of California public pension funds and the University of California ("public funds"). The bill is sponsored by state treasurer John Chiang.

PE firms often receive multiple fee streams for the investment management services they provide to public funds. Yet one of these fee streams is largely hidden from investors because PE firms receive the fees directly from portfolio companies they own on behalf of their investors. Historically, PE firms have largely refused to provide their investors with information about this form of related-party compensation, which is often referred to as "portfolio company fees."

AB 2833 penalizes PE firms that refuse to disclose to public fund investors the amount of PE firms' portfolio company fee compensation. The penalty would take the form of barring private equity firms from entering into new contracts with California public funds unless those contracts provide for the full disclosure to the public funds of the PE firms' portfolio company fee compensation.

How much money do private equity firms receive in hidden compensation from portfolio company fees?

A well-respected Oxford professor very recently published a study (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2703354) documenting $20 billion in fees paid by U.S. portfolio companies to PE firms between 1995-2014. This $20 billion figure represents only a small subset of the actual total, as it includes only those companies that were required to report the fees in SEC filings. The full amount could easily be ten or more times as great (i.e., $200 billion).

What's a real-world example of these fees?

In 2006, three large private equity firms bought the hospital management company HCA, which owns numerous California hospitals, including Good Samaritan Hospital in San Jose, Los Robles Regional Medical Center, Riverside Community Hospital, Thousand Oaks Surgical Hospital, and West Hills Hospital.

Between the time of the purchase in 2006 and its IPO in 2011, HCA was forced to pay $245 million in portfolio company fees to its PE firm owners. This money might otherwise have been used for patient care or facilities improvements.

What do PE firms do to earn these portfolio company fees?

That's part of the problem. The press has extensively noted (http://on.wsj.com/1bScn4I) that many contracts PE firms strike with portfolio companies superficially look like fee-for-services arrangements, but actually don't require any services to be provided in order to earn the fee. Academics refer to these arrangements as "Money for Nothing (https://www.youtube.com/watch?v=m1paFqPIj6Q)," and, according to scholarly papers (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2433617), these fees-for-no-work amount to an illegal tax scam that defrauds the U.S. Treasury and the State of California of corporate tax revenues.

Some California public funds say that the amounts of these fees aren't important and that they are not interested in tracking them.

Why should they care?

No California public funds currently report, or appear to even track, portfolio company fees, largely because PE firms frequently refuse to provide the information. Nevertheless, the fees do matter greatly, since they are taken from the treasuries of companies those public funds own in conjunction with a relatively small number of other fund investors. In effect, a fee taken from a portfolio company is economically equivalent to taking the same amount from the pockets of investors.

Don't investors have a legal duty to know how much an investment manager is charging for its services?

There is a strong argument that such a legal duty exists. Article XVI, Section 17(b) of the California constitution states:

> The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system.

Legal experts interpret this provision as imposing a fiduciary obligation on public retirement boards in California to incur only "reasonable expenses" in administering retirement systems. It is impossible for retirement boards to conclude that the fees that private equity firms charge them are "reasonable" if the fees are not even disclosed.

What about relying on private equity firms to scrupulously ensure that each investor receives its cut of portfolio company fees?

The SEC recently warned investors that more than half of private equity firms might be cheating them. Historically, private equity was largely unregulated. However, the Dodd Frank Act gave jurisdiction over private equity firms to the SEC, and in mid-2012, the agency initiated regular audits. In a May 2014 speech (https://www.sec.gov/news/speech/2014--spch05062014ab.html), a high-ranking SEC official shared the agency's initial audit findings:

> When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time.
>
> This is a remarkable statistic.

The speech, which was widely viewed as a watershed moment in the private equity industry, went on to chronicle numerous ways in which private equity firms are "charging hidden fees that are not adequately disclosed to investors."

Since the speech, the SEC has taken enforcement action against two of the ten largest U.S. private equity firms (KKR, discussed here (http://www.wsj.com/articles/kkr-settles-with-sec-for-nearly-30-million-1435592880) and Blackstone, discussed here (http://www.nytimes.com/2016/02/28/business/keeping-investors-on-a-need-to-know-basis.html)) for failing to disclose to investors fees they received from portfolio companies. One of the other ten largest U.S. PE firms, Apollo, has disclosed that it expects to settle with the SEC over the same hidden portfolio company fee practices (discussed here (http://www.nytimes.com/2016/02/28/business/keeping-investors-on-a-need-to-know-basis.html)). Most of the California public pension funds invest with at least one of these firms, and at least one, CalPERS, invests with all three.

It is widely expected that the SEC will take enforcement action against many more PE firms for tricky portfolio company fee practices.

Public funds say that they are making progress in achieving portfolio company fee transparency, so why bother with legislation?

California public funds have actively invested in private equity since the late 1980s. They have had almost 30 years to succeed at establishing transparency but have been unable to do so. Legislation will force private equity firms to provide the transparency that investors have been unable to achieve on their own.

This is a complex area. Wouldn't it be best to rely on the expertise of public fund investment staff?

By hiding their portfolio company fee practices, private equity firms have generated great confusion among investors. CalPERS publicly demonstrated its confusion last summer, when its head of private equity investing, Real Desrochers, made a series of inaccurate statements about portfolio company fees at a board meeting streamed on YouTube. According to (http://fortune.com/2015/09/04/calpers-still-cant-get-out-of-its-own-way-on-private-equity/) Fortune Magazine:

> But the real trouble began on August 17, during what should have been a routine CalPERS investment committee meeting. Desrochers had been asked to make a presentation about how private equity funds work, for the benefit of committee members without capital markets backgrounds.

The Fortune article goes on to describe a series of mistakes about portfolio company fees that Desrochers made in response to board member questions, which ultimately CalPERS was forced to recant:

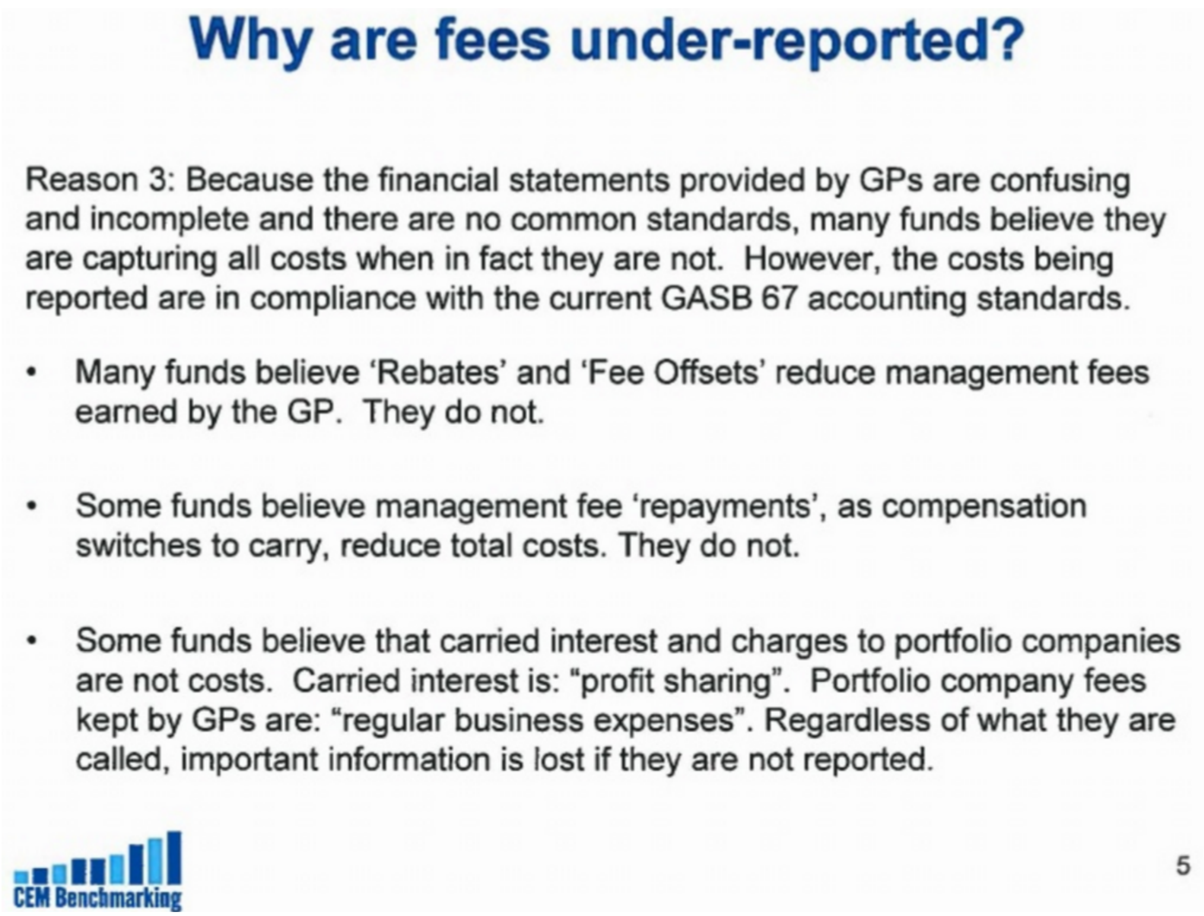
> Last night, a system spokesman acknowledged that Desrochers had made "some regrettable mistakes,"

The ensuing public attention to the video capturing these "regrettable mistakes" included commentary from noted experts expressing alarm about what the commentators saw as CalPERS' seeming lack of expertise. For example, the retired chief investment officer for the North Carolina public pension system wrote a commentary (http://meditationonmoneymanagement.blogspot.com/2015_08_01_archive.html) stating:

> As I watched the [online video of] staff [discussing portfolio company fees] for the better part of two hours, I could only think that CalPERS shouldn't have $30 billion in exposure to private equity and probably upwards of $45 billion in future commitments. The senior staff of the world's largest public fund cannot readily explain the basics of private equity investing and doesn't demonstrate mastery over its investment portfolio.

Here is the video excerpt:

The media firestorm over CalPERS' inaccurate statements was widely viewed as a pivotal development revealing the widespread confusion among investors about portfolio company fees. A few months later, a presentation (https://www.scribd.com/doc/303821849/OpersTotal-PeCostDisclosure) by CalPERS' and CalSTRS' investment cost consultant pointed out that the confusion causes investors to materially under-estimate and under-report their own costs:



Are there any other arguments in favor of AB 2833?

Yes. For example, private equity firms are exploiting the fact that portfolio companies are not publicly traded to refuse disclosure of the fees collected from them. If the portfolio companies were publicly traded, SEC Rule S-K, Section 404 (http://www.ecfr.gov/cgi-bin/text-idx?SID=8e0ed509ccc65e983f9eca72ceb26753&node=17:3.0.1.1.11&rgn=div5#se17.3.229_1404) would require disclosure of the fees. This rule exists because the SEC recognizes that, absent disclosure, large shareholders may be tempted to misuse their power by engaging in abusive fee extraction practices. The same temptation obviously exists with privately held companies.

Who am I?

My name is Michael Flaherman. I am a visiting scholar at the UC Berkeley Goldman School of Public Policy (https://gspp.berkeley.edu/directories/faculty/michael-flaherman). I served on the board of CalPERS for eight years, from 1995-2003. Subsequently, I held senior roles at a large private equity firm for more than a decade.

Please contact me at 415-652-4300 or mflaherman@gmail.com (mailto:mflaherman@gmail.com).