Background: How Private Equity Has Violated Broker-Dealer Regulations for Decades

Virtually all private equity ("PE") firms of meaningful size charging "transaction fees" to investors in their funds when the PE firms, as fund managers, buy and sell companies. They also levy transaction fees when these portfolio companies issue debt or equity securities.

These fees are not in lieu of fees paid to investment bankers and brokers; they are ***additional*** charges, on top of both those third party fees and the private equity firm's management fee, the famed "2 and 20" (2% annual management fee, 20% of the gains, although the management fee is lower for very large funds). And these transaction fees are typically comparable in size to the fees paid to investment bankers.

This practice is no secret. The PE industry has charged billions in transaction fees and the financial media has written regularly, usually critically, about it. One of the major concerns is that these fees give PE firms a strong incentive to engage in transactions irrespective of whether they are to the investors' benefit. A related concern is that these fees, which are often paid by the portfolio companies, weaken them and come at the expense of more productive uses of funds, such as internal investment. As Eileen Appelbaum said,

> The purpose of SEC oversight of broker-dealer activities is to rule out a situation in which a PE firm that needs cash can have one of its portfolio companies acquire an add-on business, even when this does not make economic sense for the portfolio company, and charge very high, undisclosed fees for providing this 'service.' The transaction may enrich the PE firm while impairing the value of the portfolio company and reducing the ultimate returns paid to PE fund investors. SEC oversight guards against self-dealing by PE firms, and against PE firms' charging excessively high transaction fees for providing broker-dealer services.
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> Transaction fees related to the acquisition of a portfolio company or to an add-on to an existing company are paid directly to the PE firm. Investors in the portfolio company have no say over the acquisition and receive no information about the size of the transaction fee the PE firm has pocketed. Institutional investors turn a blind eye to this because the PE firm uses these fees to rebate as much as 80 to 100% of the management fee they pay to the PE firm. The LPs then advertise the low management fees they pay to private equity, without counting up all the ways in which this transaction may reduce the fund's earnings and the profit they will ultimately earn from their PE investments.
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> The PE firm, meanwhile, gets to collect and pocket a bonanza in transaction fees.

Under SEC regulations, the entity collecting these transaction fees is required to register as a broker-dealer. The SEC's own summary from its website about BD registration supports the notion that private equity firms are required to register. The SEC lists various activities that could require registration, such as "Finding buyers and sellers of businesses (i.e., activities relating to mergers and acquisitions where securities are involved)." Two of the four further factors that the SEC considers are: (1) "Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction? (2) Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal?"

A Proskauer memo from January 2012 about BD registration discusses the SEC's broad test for who is required to register. "The critical test of whether a person is 'engaged in the business' of securities transactions is whether there is a 'regularity of participation.' *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411 (D. Mass. 1976). The SEC staff (the 'Staff') views this concept of 'effecting transactions' broadly to cover participation 'at the key points in the chain of distribution,' a very flexible test which has been interpreted to include assisting in structuring a transaction, identifying potential purchasers, soliciting transactions (including advertising) and participating in the order taking or order routing process (*MuniAuction, Inc.*, SEC No-Action Letter, 2000 WL 291007 (Mar. 13, 2000). The fact that brokerage activities are only a small part of a person's business does not necessarily mean that registration is not required. *Eastside Church of Christ v. National Plan, Inc.*, 391F.2d 357 (5th Cir. 1968).

Over time, the SEC and the Staff have provided lists of factors that are relevant including actively soliciting investors, advising investors as to the merits of an investment and receiving commissions or other transaction-based compensation (*In re Joseph Kemprowski and the Cambridge Consulting Co.*, Exchange Act Release No. 35058, 1994 WL 684628 (Dec. 8, 1994); see also *SEC v. Margolin* [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) 97,025 at 94,517 (S.D.N.Y. Sept. 30, 1992) and *SEC v. Hansen*, 726 F. Supp. 74 (S.D.N.Y 1989). Through its no-action process, the Staff has also provided guidance on a narrow scope of circumstances under which broker-dealer registration may not be required." Notably, none of the narrow exceptions to registration that the SEC has carved out apply to private equity firms. As a result, there is no justification for the industry's flagrant violation of these clear-cut, long-standing rules. The major PE firms are all advised top securities lawyers; many of them were founded by men who came from Wall Street firms and would therefore have personal knowledge of the registration requirements.

How Private Equity Firms Increase Industry Consolidation

After the 1980s, when leveraged buyout firms could achieve handsome returns purely based on financial engineering, those players, rebranded as "private equity" in the 1990s, no longer found as easy picking in purely finance-based strategies, and looked for additional approaches. One which has become very popular at all levels of the PE industry is the "rollup," or consolidation play. The use of the term "rollup" is meant to convey that it might take a large number of acquisitions to attain the desired outcome.

Bear in mind that these add-on acquisitions may not necessarily target achieving pricing power as a main objective; the goal may be achieving economies of scale or greater operating efficiencies. However, many private equity firms seek to emulate the classic General Electric strategy of achieving the number one or two position in a well-defined niche, with the understanding that that status gave the incumbent market power. Thus these firms can and do create oligopolies at well below the level of firms like Google, health insurers, and cable providers.

A classic book on private equity, Josh Kosman's *The Buyout of America*, devotes an entire chapter to how private equity acquisitions have resulted in the mattress industry being dominated by two companies, allowing them to systematically lowered product quality (for instance, eliminating "flip over" mattresses that are inherently better constructed as well as having longer lives) while greatly increasing prices.

A particularly striking example of how private equity drives consolidation is found in the renal care industry, which provides dialysis services for approximately 500,000 Americans[1] at any given moment. The federal government, through the Centers for Medicare and Medicaid Services ("CMS") spent $11.2 billion in 2014 on outpatient dialysis services[2], which gives taxpayers a direct stake in the competitiveness of the dialysis industry. Two companies dominate the outpatient dialysis market, each with approximately a third of total market share, while the number three company in size is more than ten times smaller than the second largest, and the overall one-third of the market not controlled by the "top-two" oligarchy remains very fragmented.[3] Bear in mind that since these services are delivered in local markets, where the concentration among the top players can be even greater, the nation-wide data almost certainly understates these leaders' ability to set prices in particular cities and states.

Both of the top two dialysis companies were created by multiple mergers over time. If one looks at the genealogy of each, one finds that private equity firms were involved in "rolling up" predecessor entities into the two dominant players. For example, the largest firm, Fresenius, came together, in part, in 2010, when two private equity firms, Bain Capital Ventures and KRG Capital, invested in Liberty Dialysis. In 2011, that firm then acquired Renal Advantage, which was backed by Welsh Carson, another private equity firm and sold the entire combined company to Fresenius.[4] Similarly, DaVita, the number two player several years ago the private equity-backed HealthCare Partners firm as part of

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[1] See http://www.nephrologynews.com/a-quiet-year-for-consolidation-among-largest-dialysis-providers/

[2] See http://www.modernhealthcare.com/article/20160624/NEWS/160629935

[3] See http://www.nephrologynews.com/a-quiet-year-for-consolidation-among-largest-dialysis-providers/

[4] See http://www.thehealthcareinvestor.com/2012/02/articles/healthcare-services-investing/private-equity-investing-in-the-dialysis-sector-part-i/

its industry dominance strategy.[5] The number three dialysis industry player, U.S. Renal, is backed by multiple private equity firms and is pursuing an explicit strategy of rolling up the third of the market that remains unconsolidated into the largest two firms.[6]

This strategy of private equity firms attempting to roll-up major spending nodes in the U.S. healthcare system can be found over and over. For example, the practice is so entrenched in the outpatient surgical center industry that entire newsletters exist simply to track private equity activity in that space.[7]

How Broker-Dealer Registration Would Curb Self-Serving Acquisitions

For the PE industry, having the SEC enforce long-standing broker-dealer regulations would bring the industry more fully under regulatory supervision. The Dodd Frank investment adviser registration has proven to be more powerful than its designers imagined by exposing widespread misconduct in private equity. However, private equity's activities as unlicensed broker-dealers still remains in the dark. Industry complaints indicate the incumbents would very much prefer to keep it that way.

How would registration make a difference?

¶ By exposing the magnitude of these fees. Surprisingly, unlike retail investors, PE investors, who all are accredited investors and presumed to be sophisticated, have no idea of the total amount of fees and expenses they pay when they invest in private equity. Many of the charges, like the majority of transaction fees, are paid directly by portfolio companies to the PE firm, circumventing disclosure to the fund. Oxford professor Ludovic Phalippou estimates the total fees and costs of private equity at 7% per year, and leading private equity investor CalPERS confirmed his estimate as reasonable last year. If the magnitude of these charges were made public and confirmed, there would be considerable pressure on PE firms to cut fees and curtail engaging in self-serving transactions

¶ Broker-dealer regulations require that fees be suitable**.** Clearly, charging what amounts to duplicate fees is not defensible under current SEC rules

The primary effect of enforcing SEC regulations would be to reduce the number of abusive transaction fees and the level of these charges. A secondary effect would be to make consolidation plays and other add-on transactions less attractive. The reason is that

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[5] See http://www.modernhealthcare.com/article/20120526/MAGAZINE/305269878

[6] See http://www.usrenalcare.com/article/us-renal-care-and-dsi-renal-announce-definitive-merger-agreement

[7] http://www.thehealthcareinvestor.com/2012/10/articles/healthcare-services-investing/private-equity-investing-in-ambulatory-surgery-centers-part-i/

despite the considerable profit potential of this approach, its odds of success is much lower due to the many actions that need to be completed. Each one, such as consolidating operations, integrating systems, repeatedly restructuring the management team, streamlining purchasing, and numerous other activities, each represents a potential point of failure. The fact that hefty transaction fees insure that the private equity general partner will profit irrespective of whether the rollup pans out makes them more inclined to pursue this approach than if they were motivated solely by the risk/return of making these investments in isolation.

How the Investor Bulletin Inquiry Puts the SEC on the Spot with Broker-Dealer Registration

On June 1, 2016, the SEC ordered a small private equity firm, Blackstreet Capital Management to pay $3.1 million in fines, which included fines for broker-dealer violations. A reading of the order indicates that the fine for the broker-dealer abuses was on the customary dollar-for-dollar basis, that is, that fine equaled the full amount of transaction fees that Blackstreet charged.

Given the clear-cut nature of the statutory language in combination with the fact that private equity industry firms have long been openly charging transaction fees, it would seem that the SEC would be required to included broker-dealer violations in an investor bulletin. Indeed, these abuses would appear to rise to the level of requiring an investor alert, a more serious warning for "frauds and scams".

The industry is alarmed at the prospect at being required to register, given the magnitude of fees involved. For instance, KKR's most recently quarterly report shows that transaction fees were its second largest source of revenue. Allies of the industry have tried characterizing the SEC's tardy enforcement of long-standing rules as a radical policy change, when there is no regulatory change at issue, or as (remarkably) attempting to present these duplicate fees as a key reason for portfolio companies to select private equity firms (as if acquired companies have agency). A more plausible argument is that smaller private equity firms would find registration burdensome. However, a few top players in the industry, such as Hellman & Friedman and Warburg Pincus, only rarely collect transaction fees, showing that these charges are a luxury, not a necessity. In addition, until recently, merger and acquisition boutiques were also subject to broker-dealer registration, and even small players complied. Since private equity firms have more stable revenues than merger advisors, they should be in a much better position to bear any additional costs.

The July 14, 2016 letter from eight Senators asking for the SEC to issue a private equity investor bulletin or explain its reasons why not, could open up a related line of inquiry, which is whether its policy of selective enforcement is working in private equity. There is considerable evidence that many PE firms are continuing to engage in conduct for which the SEC has fined other firms. The SEC's timidity seems particularly questionable in the area of broker-dealer fines, since these violations are more clear-cut and widespread than other abuses the SEC has sanctioned.[8]

Hopefully, the Senators' letter was intended to prompt a broader discussion of the SEC's posture towards private equity. We would be pleased to provide further information on these issues outlined above to help advance this objective.

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[8] One of the agency's arguments has been that its enforcement actions continue to be at the same level in relationship to referrals from enforcement as it has long been, roughly 10%. This is a questionable metric. First, the SEC has made clear that the misconduct in private equity is more serious and widespread than it has found in other areas, and also uncharacteristically is prevalent at large players seen as reputable. That pattern would point to a need for more vigorous enforcement, and hence a higher ratio of actions to referrals. Second, as a result of Dodd Frank whistleblower provisions, the agency has reported that the number and quality of whistleblower filings has increased dramatically. Better whistleblower leads should lead to a higher percentage of enforcement actions in all areas, including private equity.