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Regulation of Private Equity in the U.S. Reveals Deep Problems for Investors

Probably no one is more shocked than the partners in the 3,300 private equity firms headquartered in the U.S. to learn that the weak oversight of their activities mandated in the wake of the recent financial crisis may have actual consequences for them. About 1,100 partners in these private equity firms serve as the General Partners (GPs) of the PE investment funds their firms sponsor. These GPs are advisors to the PE funds and make all decisions about the funds' investments. Public sector and private pension funds, university endowments, sovereign wealth funds and very wealthy individuals are the Limited Partners (LPs) or investors in the PE funds. They typically commit 98 percent of the capital in a PE fund, with the GPs (i.e. the PE firm partners) contributing the remaining two percent. The LPs pay management fees to the GPs for managing the fund and its investments.

Private equity funds in the U.S. are among the least transparent financial entities. For the first 30 years following the emergence in 1979 of private equity funds as major financial players, the 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 in 2010 with passage of the Wall Street Reform and Consumer Protection Act, sponsored by Chris Dodd and Barney Frank. While all but the smallest private equity (and hedge) funds are now required to register with the SEC and report such things as total assets under management, types of services provided, clients, employees, and potential conflicts of interest, the reports – in contrast to those of other financial reporting – require far less information and are not made public.

The Dodd-Frank Act is weak tea compared with the EU's Alternative Investment Fund Managers Directive (AIFMD), itself criticized by some European observers as not very strong. The AIFMD requires a risk assessment of the use of debt by alternative investment fund managers, who must set maximum leverage limits and carry out related risk and liquidity management activities. The Dodd-Frank Act has no such requirement. The AIFMD also rules out "dividend recapitalizations" in the first two years after a portfolio company is acquired. In a dividend recapitalization, a PE fund requires a portfolio company that it owns to issue junk bonds and add to its already high debt level in order to pay its PE owners a dividend. Dividend recapitalizations that essentially repay the PE fund for its initial investment of equity, leaving it with "no skin in the game", are quite common in the U.S. and are not prohibited by the Dodd-Frank Act.

While the Dodd-Frank Act passed in 2010, the final rules for reporting requirements were not adopted by the SEC until October 31, 2011, and initial reports were not required to be filed by the General Partners in PE funds until August 29, 2012. Not only are the reporting requirements for private equity fund advisors far less stringent than for publicly traded companies, 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 fund was about six percent. No one expected the new regulatory scrutiny of private equity funds to have much of an effect – including, no doubt, the private equity firms that sponsor these funds.

But in late April 2014, the SEC's top regulator, Mary Jo White, gave testimony to Congress in which she pointedly described abuses by private equity firms, including charging improper and false fees, misallocating fees and expenses, and disclosing fee monitoring inadequately. This was followed on May 6 by the "sunshine" speech delivered to PE fund compliance officers by Andrew J. Bowden, the Director of the SEC's Office of Compliance Inspections and Examinations at the Private Equity International Forum in New York City. Commenting on the

Eileen Appelbaum, Center for Economic and Policy Research, Washington, DC, USA.

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, private equity advisors use LP 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 firm at the expense of the pension funds, foundations and endowments that supply most of the capital for the PE funds. Fees collected from portfolio companies are supposed to be shared with investors in PE funds. But the SEC found that vague wording in the limited partnership agreements (LPAs) leaves investors in the dark about whether they are receiving their fair share of these fees. For example, management fees paid by the limited partners are supposed to cover the expenses of the adviser, but the SEC found a trend of advisers shifting their back office expenses onto the LPs during the middle of the fund's life. Essentially, Bowden asserted that more than half of the PE firms examined were either engaged in what amounted to embezzlement of funds that rightfully belonged to their limited partners or were engaged in other serious compliance violations.

It recently 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 – when they are raising new funds from potential investors for a subsequent PE fund. The private equity industry has no standard method for calculating this important indicator of the actual profits received by LPs. Some PE firms, it turns out, use a methodology in their marketing materials that exaggerates the return LPs can expect to receive. The SEC is examining how widespread the practice is.

Indeed, it is not only in fundraising materials that PE funds exaggerate their investment returns. The industry's preferred metric is the internal rate of return. This, however, is a flawed measure of performance. Among other deficiencies, it gives unwarranted weight to the successful sale of a portfolio company early in the life of a PE fund. Finance economists use a far better measure for comparing returns from private equity funds to returns from passive investment in a stock market index fund – the public market equivalent developed ten years ago by Steven Kaplan and Antoinette Schoar. That measure shows far more modest returns to investing in private equity funds compared with investing in far more liquid and less risky public equities. Indeed, according to this measure, the median PE fund has not beaten the market since 2005. While it is true that PE funds in the U.S. have returned record distributions to their investors in the last two years, the U.S. stock market has also been on a roll during that period, with the S&P 500 setting new records. Investments in private equity neither proved to be a hedge against losses during the economic crisis, when the stock market performed poorly, nor did they manage to beat the stock market in the good times on Wall Street that followed.

The lack of transparency and the confidentiality requirements in the LPAs that pension funds and other LPs sign when they invest in a private equity fund means that neither the unions whose members participate in the pension plan nor the retirees that depend on the pension fund for their retirement incomes can know what is in those agreements. They rely on enforcement actions by the SEC to protect their interests and their retirement savings. Sadly, it is here that the SEC appears to be coming up short. Having done a surprisingly good job of publicly identifying the inherent conflicts of interest in the PE business model as well as the fraudulent and inappropriate behavior of PE firms, there have been virtually no enforcement actions taken. The SEC seems to be relying on limited partners to confront the PE firms. But LPs cannot be expected to take on this role when PE firms do not hesitate to threaten them with legal action if they make public the fee and expense structures in their LPAs. As Bowden made clear in his speech to PE fund compliance officers, SEC examinations have found egregious behavior by PE firms in over half the funds examined. This should be a red flag for potential investors who cannot trust what PE firms tell them and may not be able to rely on the SEC to protect their interests.