November 14, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: November 19, 2019 hearing entitled, "America for Sale? An Examination of the Practices of Private Funds"

On Tuesday, November 19, 2019 at 10:00 a.m., the Committee on Financial Services will hold a hearing in Room 2128, Rayburn House Office Building entitled, "America for Sale? An Examination of the Practices of Private Funds." Witnesses for the hearing are:

- **Eileen Appelbaum,** Co-Director, Center for Economic and Policy Research
- **Wayne Moore**, Trustee, Los Angeles County Employee Retirement Association
- **Giovanna De La Rosa**, United for Respect, former Toys "R" Us Employee
- **Drew Maloney**, President and CEO, American Investment Council

Background

Investment advisers are generally required to register with the Securities and Exchange Commission (SEC).[1] Although previously exempted from registration requirements,[2] the Dodd-Frank Wall Street Reform and Consumer Protection Act created a limited regulatory framework for investment advisers to private funds with $150 million assets or more under management that requires them, among other things, to register with the SEC, maintain records that are subject to audit by the SEC, and file annual disclosures.[3]

A PE adviser, also referred to as a PE firm, pools investments from high worth individuals, institutions, and pension funds into a PE fund, which invests in other companies.[4] In addition to charging investors a management fee, PE firms often charge the companies they invest in quarterly consulting fees, plus a percentage of any corporate transactions the company participates in during the PE fund's ownership, including mergers, acquisitions, and asset sales. PE funds typically sell their ownership of the acquired company within 5 years, limiting the time to create value for investors.[5] These strategies range from cost

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[1] 15 U.S.C. § 80b-3 (1940)
[2] Wesley G. Nissen & Milton K. Buckingham, *New Investment Adviser Requirements of the Dodd-Frank Act: What CPAs Should Know*, Journal of Accountancy (Jan. 1, 2011), https://www.journalofaccountancy.com/issues/2011/jan/20103194.html.
[3] 15 U.S.C. § 80b-3 (1940)
[4] *Private Fund Adviser Overview*, SEC (modified Oct. 21, 2016), https://www.sec.gov/divisions/investment/guidance/private-fund-adviser-resources.htm; Eileen Appelbaum & Rosemary Batt, *A Primer on Private Equity at Work*, Center for Economic and Policy Research (February 2012) at 9, http://cepr.net/documents/publications/private-equity-2012-02.pdf.
[5] Eileen Appelbaum & Rosemary Batt, *Private Equity Pillage: Grocery Stores and Workers At Risk*, The American Prospect (October 26, 2018), https://prospect.org/power/private-equity-pillage-grocery-stores-workers-risk/.

cutting and layoffs to reorganization,[6] and may or may not improve the acquired company's long-term value.

PE funds are playing an increasing role in the U.S. economy. At the end of 2018, PE firms managed between $6 and $7 trillion worth of assets,[7] up from $1 trillion during the 2008 financial crisis.[8] In 2014, the SEC found "violations of law or material weaknesses in controls over 50% of the time" in its examinations of PE firms.[9] PE funds invest in everything from fire departments and retail stores to hospitals and voting machines, so their practices affect both businesses and consumers. A New York Times investigation found that PE ownership can lead to slower reaction times for emergency services, excessive interest rates, aggressive mortgage collection practices, and the sort of foreclosure abuses that preceded the financial crisis.[10]

In the retail industry, 10 of the last 14 companies that filed for bankruptcy were PE-owned,[11] and all of the seven major grocery chains that have filed for bankruptcy since 2015 were owned by PE.[12] While 9% of PE firms are women- or minority-owned,[13] PE job losses disproportionately affect women and people of color.[14] While bankruptcy may not be the intention of PE, the PE fund may not bear the cost of bankruptcy and, can make a substantial profit off the acquired company even if the company enters bankruptcy, creating incentives for PE firms to encumber acquisitions with high amount of debt. If the company goes bankrupt, the costs are borne by the employees, shareholders, and by smaller unsecured creditors including vendors, suppliers, and workers owed back wages and benefits.[15] Even though the economy has added jobs for 108 consecutive months, a recent study shows that employment in the months following a PE acquisition falls 4.4% on average across all sectors.[16]

Investment Practices

PE funds may invest in emerging growth companies or in established, profitable companies looking to expand. Other PE firms may invest in struggling companies using the practice known as leveraged buyout (LBO).[17] In an LBO, a PE fund takes over a company by purchasing the company's existing or newly issued equity shares, worth only a portion of the company (usually less than 40%) and then buying the rest of company with debt backed by the acquired company's assets.[18] The acquired company is

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[6] Davide Scigliuzzo, Kelsey Butler, & Sally Bakewell, *Everything is Private Equity Now*, Bloomberg Businessweek (October 3, 2019), https://www.bloomberg.com/news/features/2019-10-03/how-private-equity-works-and-took-over-everything.

[7] Division of Investment Management, *Private Fund Statistics*, Securities and Exchange Commission (July 23, 2019), https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2018-q4-accessible.pdf.

[8] Jim Baker et al., *Private Equity: How Wall Street Firms are Pillaging American Retail*, at 8, (July 2019).

[9] Andrew Bowden, *Spreading Sunshine in Private Equity*, Private Fund Compliance Forum (May 6, 2014), https://www.sec.gov/news/speech/2014--spch05062014ab.html.

[10] Danielle Ivory, et al., *What Can Go Wrong When Private Equity Takes Over a Public Service*, New York Times (June 25, 2016), https://www.nytimes.com/2016/06/26/business/dealbook/when-you-dial-911-and-wall-street-answers.html; *Bottom Line Nation*, New York Times (2016), https://www.nytimes.com/series/private-equity-bottom-line-nation.

[11] Scigliuzzo, *supra* note 6; Baker, *supra* note 8, at 12

[12] Appelbaum, *supra* note 5.

[13] Josh Lerner, *2018 Diverse Asset Management Firm Assessment*, Knight Foundation (Jan. 20, 2019), https://knight.app.box.com/s/5l2s2pi75b6qoip5uo47zsiawk133vud.

[14] Baker, *supra* note 4, at 17.

[15] Appelbaum, *supra* note 4.

[16] Stephen Davis et at, *The Economic Effects of Private Equity Buyouts*, (October 7, 2019) at 21.

[17] Appelbaum, *supra*, note 4.

[18] Miriam Gottfried & Ryan Tracy, *Risky Deals Return to Leveraged-Buyout Market*, Wall Street Journal (October 24,2018), https://www.wsj.com/articles/risk-returns-to-leveraged-buyout-market-1540373400.

responsible for paying back the debt that often lasts longer than the PE fund's ownership, while the PE fund's liability in the acquired company is limited to its equity investment. Research has shown that companies acquired through LBOs are more likely to depress worker wages and investments and across all industries, "PE-owned companies are twice as likely to go bankrupt as public companies."[19]

When Toys "R" Us was acquired in 2005 by PE funds Bain and KKR, and real estate investment trust, Vornado, through an LBO, its existing $1.86 billion of debt grew to over $5 billion.[20] By 2007, Toys "R" Us was using as much as 97% of its operating profits to service its debt,[21] from $425 to $517 million annually.[22] In 2018, when Toys "R" Us declared bankruptcy, terminated all 30,000 employees, and closed all its remaining US stores, PE owners had collected $470 million since 2005.[23] Toys "R" Us estimated it was only $250 million short to keep its US Toys "R" Us and Babies "R" Us stores open.[24]

PE funds can also use an acquisition to pay investors dividends when the fund is not performing as promised. For example, Southeastern Grocers was acquired by PE firm Lone Star Funds in 2005 and declared bankruptcy in 2009. After Southern Grocers emerged from bankruptcy, Lone Star was unable to sell its acquisition. So, the PE fund executed a "dividend recapitalization," forcing Southeastern Grocers to take on additional loans so it could pay dividends to investors. Between 2011 and 2013, PE firms paid themselves and investors $839 million in dividends, with some loans charging the bankrupt company as much as 40% in interest.[25] By the time Southeastern filed for bankruptcy again, Lone Star partners had paid themselves and their investors a total of $980 million in dividends, while unsecured creditors like suppliers and vendors received nothing, 2,000 workers lost their jobs, and 94 more stores closed.[26]

PE fund may also generate monetary returns quickly at the expense of distressed companies by selling off valuable assets and leasing them back from the buyer. After PE firm Sun Capital Partners took over Shopko Stores Inc, they monetized Shopko's assets by selling off most of its real estate for $815 million, generating liquid revenue but leaving many stores with costly 15- and 20-year leases, though Sun Capital anticipated holding Shopko for 3-5 years.[27] The idea was to "give[] the company the cash to explore expansion and remodels," but much of the cash was used to pay investors and owners dividends, including quarterly consulting fees, and a percentage of each of Shopko's transactions.[28] Eventually, with less than $1 billion in assets and up to $10 billion in liabilities, Shopko filed for bankruptcy.[29] During its ownership, Sun Capital collected over $170 million in dividends and fees and caused Shopko to incur $179.5 million

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[19] Scigliuzzo, *supra* note 6; Baker, *supra* note 8, at 12.
[20] Bryce Covert, *The Demise of Toys R Us Is a Warning*, The Atlantic (July/August 2018), https://www.theatlantic.com/magazine/archive/2018/07/toys-r-us-bankruptcy-private-equity/561758/.
[21] *Id.*
[22] SeekingAlpha, *Private Equity, Not Amazon, Killed Toys R Us*, (Sep. 20, 2017), https://seekingalpha.com/article/4108364-private-equity-amazon-killed-toys-r-us?page=3.
[23] Kate Gibson, *Toys "R" Us employees demand severance for 33,000*, CBS News (May 9, 2018), https://www.cbsnews.com/news/toys-r-us-employees-demand-severance-pay-for-33000/.
[24] Toys R Us, *Form 10-Q*, SEC (October 28, 2017), file:///C:/Users/astudwell/Downloads/ToysRUSInc_10Q_20171219%20(2).pdf.
[25] Appelbaum, *supra* note 5.
[26] *Id.*
[27] *Id.*
[28] Dan Primack, *How workers suffered from Shopko's bankruptcy while Sun Capital made money*, Axios (June 11, 2019), https://www.axios.com/shopko-bankruptcy-sun-capital-547b97ba-901c-4201-92cc-6d3168357fa3.html.
[29] *Shopko files for Bankruptcy protection*, Associated Press (Jan. 16, 2019), https://apnews.com/dd2814f99f644bfdb72fdd5418fbe063/.

in debt to pay dividends to investors.[30] As a result of the bankruptcy, over 360 stores closed and 14,000 employees lost their jobs, many without their promised severance.[31] When it declared bankruptcy, Shopko owed creditors nearly $120 million[32] and over $13.5 million in unpaid taxes and penalties to Wisconsin.[33]

PE has entered the single-family housing market, issuing the first-ever bonds backed by cashflows from single-family rental homes.[34] After the 2008 housing crisis, PE took advantage of low housing prices to purchase hundreds of thousands of foreclosed single-family homes in working-class neighborhoods with high percentages of minority residents and converted them into rental properties.[35] While PE investment into single-family housing can help stabilize neighborhoods, there are concerns that PE firms are unresponsive landlords that have incentives to raise rents to maximize investor returns, resulting in the displacement of lower income residents.[36] In addition, PE firms' presence in the housing market may result in inflated home values and crowd out potential owner-occupants. Many state and local laws limit rent controls to multifamily housing, creating loopholes for single-family rentals from limits on annual rental increases..[37] In 2019, the United Nations sent a letter to Blackstone, the largest PE firm in the US, condemning the PE practices in affordable housing markets, expressing "serious concerns that [their] actions are inconsistent with international human rights law," and calling for regulators to intervene.[38] Similarly, PE investment in manufactured home communities in recent years has raised concerns about rising rents for manufactured homeowners who can be particularly vulnerable to rent increases due to the difficulties associated with moving a home as opposed to merely one's personal belongings.[39]

<u>Concerns for Investors in Private Equity</u>

PE funds are structured as partnerships, with investors as Limited Partners (LPs) and the managers as General Partners (GPs). Traditionally, investors pay according to a "2-and-20" fee structure: PE firms collect a flat 2 percent management fee on all funds committed and 20 percent of all investment profits over a certain amount.[40] Investors and managers sign a partnership agreement that outlines their contractual relationship. Individual investors may also have supplementary agreements established by a "side letter." Large, sophisticated investors can negotiate for alternative fee arrangements, input into investment decisions, additional disclosures, or fiduciary obligations.[41] But smaller LPs, including private

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[30] Tammy Baldwin, *Letter to Sun Capital Partners on Behalf of Wisconsin Workers*, (June 19,2019), https://www.wearegreenbay.com/wp-content/uploads/sites/70/2019/06/Sen.-Baldwin-ShopKo-Letter.pdf.

[31] Shopko Employees, *Letter to Sun Capital on behalf of Shopko Employees*, (Jun 7, 2019), https://drive.google.com/drive/folders/1Br9jwwXblMWM7I2XXFRYlDR4yprqDkWK.

[32] Jeff Bollier, *Shopko creditors: $117 million in dividends paid to owners 'fraudulent,' 'illegal'*, Green Bay Press-Gazette (March 18, 2019), https://www.greenbaypressgazette.com/story/money/2019/03/18/shopko-bankruptcy-creditors-seek-return-117-million-fraudulent-dividends-court-ashwaubenon-retailer/3155744002/.

[33] Baldwin, *supra* note 32.

[34] Invitation Homes Inc., *Amendment No. 1 to Form S-11 For Registration*, SEC (Jan. 23, 2017) at 5, .

[35] Alana Semuels, *When Wall Street Is Your Landlord*, The Atlantic (Feb. 13, 2019), https://www.theatlantic.com/technology/archive/2019/02/single-family-landlords-wall-street/582394/.

[36] See e.g., Sarah Edelman, et al., *When Wall Street Buys Main Street*, Center for American Progress (Feb. 27, 2014), https://www.americanprogress.org/issues/economy/reports/2014/02/27/84750/when-wall-street-buys-main-street-2/.

[37] See e.g., Steven Lopez, *Column: As renters struggle to pay the bills, landlords and speculators cash in*, Los Angeles Times (Nov. 4, 2017), https://www.latimes.com/local/california/la-me-lopez-housing-profiteers-20171104-story.html.

[38] Leilani Farha, *States and real estate private equity firms questions for compliance with human rights*, United Nations Office of the High Commissioner (March 26, 2019), https://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=24404&LangID=E.

[39] Private Equity Stakeholder Project, Private equity giants converge on manufactured homes (Feb. 14, 2019), https://pestakeholder.org/report/private-equity-giants-converge-on-manufactured-homes/

[40] Appelbaum, *supra* note 4, at 14.

[41] Jeffery E. Horvitz, *Fiduciary duty waivers of LPs may expose sponsors*, Pensions & Investments (October 14, 2013), https://www.pionline.com/article/20131014/PRINT/310149994/fiduciary-duty-waivers-of-lps-may-expose-sponsors.

pensions and small endowments, have less leverage to demand favorable terms, resulting in contracts with little or no disclosure of expenses, assurance that reported returns are audited, or access to information about fellow investors.[42] This imbalance is also true for transparency: over 25% of funds are inconsistent in the way they report to LPs.[43] This can hamper investors' ability to manage their portfolios—62% of public pensions say "lack of reporting consistency hinders ability to monitor PE plan costs."[44]

PE investors are increasingly demanding transparency from advisers.[45] The Institutional Limited Partnership Association, representing over 500 PE investors has criticized the SEC for "permit[ing] PE advisers to limit their fiduciary obligations under the Advisers act by permitting vague, all-encompassing disclosure of conflicts of interest to meet the informed consent requirement."[46] Investors asked the SEC to develop meaningful fiduciary protections, strengthen disclosures, and modernize marketing regulations, and have expressed a willingness to shoulder costs associated with regulation.[47]

Increasing concerns regarding PE transparency have led the state legislatures of California, Washington, and Virginia to pass laws requiring public disclosure of information about private fund fees and expenses.[48] In July 2019, this Committee passed bipartisan legislation that would require corporations to disclose the gender, racial and ethnic composition of their boards.

Legislative Proposals

H.R. 3848: The Stop Wall Street Looting Act of 2019 (Pocan/Jayapal): Imposes several new requirements on PE funds, including provisions to: require PE funds and their investors to maintain liability for debts incurred by acquired companies; prohibit capital distributions for two years following as LBO, strengthen fraudulent transfer laws; require the SEC to promulgate public, annual marketing disclosure regulations for PE funds; and limit PE's ability to waive their fiduciary duty and give preferential treatment to certain investors.

H.R.____: Private Fund Board Disclosure Act of 2019: Requires investment advisers to private funds to report to the SEC the race, ethnicity, and gender composition of the board of directors of private funds and for SEC to publicly disclose this information.

H.R.____: Investment Adviser Alignment Act: Defines private equity adviser and requires private investors be provided with SEC filings, quarterly reports of fees and expenses, and all information related to an SEC examination, inquiry, or enforcement action. This bill also imposes a fiduciary duty on PE funds and requires investors be allowed to communicate with one another.

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[42] Institutional Investor, *Private Equity's Other Transparency Problem*, (July 8, 2017), https://www.institutionalinvestor.com/article/b1505pghn17t4s/private-equitys-other-transparency-problem.
[43] Julie Segal, *Why Transparency Literally Pays Off*, Institutional Investor (December 6, 2018), https://www.institutionalinvestor.com/article/b1c4fcyf80rnz1/Why-Transparency-Literally-Pays-Off.
[44] *NCSL: Transparency in Public Pension Plans*, Institutional Limited Partners Association (Aug. 10, 2016), https://comm.ncsl.org/productfiles/83050601/Choi_ILPA_Presentation.pdf.
[45] Neil Weinberg & Darrell Preston, *Look Who's Coming to Private Equity's Defense on Fee Secrecy*, Bloomberg Businessweek (August 25, 2016), https://www.bloomberg.com/news/articles/2016-08-25/look-who-s-coming-to-private-equity-s-defense-on-fee-secrecy.
[46] Institutional Limited Partners Association, *Letter to the SEC on Standard of Conduct for Investment Advisers*, (Feb. 12, 2019), https://ilpa.org/wp-content/uploads/2019/02/2019.2.12-ILPA-Member-Letter-on-Fiduciary-Duty-Submission-Copy.pdf.
[47] *Id*; Institutional Limited Partners Association, *Letter to the SEC on Strengthening the Private Equity Market Through Balanced Oversight*, (April 30, 2018), https://ilpa.org/wp-content/uploads/2018/04/ILPA-Letter-to-Chairman-Clayton-on-PE-Regulation-4.30.18.pdf.
[48] Arleen Jacobius, *California funds feel private equity shock*, Pensions & Investments (May 14, 2018), https://www.pionline.com/article/20180514/PRINT/180519947/california-funds-feel-private-equity-shock.