Americans for Financial Reform Education Fund

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Re: Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity and Large Liquidity Fund Advisers (File No: S7-01-22)

Secretary Countryman,

The Americans for Financial Reform Education Fund appreciates this opportunity to comment on the Securities and Exchange Commission's ("the Commission") proposed rules that would provide the Commission, and by extension the Financial Stability Oversight Council (FSOC), critical information about the $18 trillion in private funds, enabling insight into an area where regulators currently have very little.

The Dodd-Frank Act's Section 202 amendment of the Investment Advisers Act of 1940 was the first critical step in requiring private funds, such as hedge funds and private equity firms, to start reporting via Form PF the assets they manage (net assets) and those additional assets that include borrowed money (gross assets).

Since the start of this reporting, the Commission has noted that the value of private fund assets on Form PF have more than doubled, from $5 trillion in 2013 to $11 trillion at the end of 2020. In that same period, the number of funds filing a Form PF has increased 70%.

Given this rapid growth of private funds over the past decade, the Commission urgently needs to exercise its authority under section 204(b) of the Advisers Act to expand the scope of information collected through Form PF to monitor the risk that private funds may pose to financial stability. We strongly support the rule proposal, which advances this important goal.

Private funds can be a major driver of financial instability and have required numerous federal backstops

The regulatory regime around private funds is vastly outdated, reflecting a time when both private equity and hedge funds were a small, niche part of the financial system. This is no longer the case and regulation need to better reflect the current reality of the role that private funds play.

Both types of funds rely specifically on exemptions in section 3(c)(7) of the Investment Company Act of 1940, passed by Congress in 1996[1], to avoid being subject to the same reporting requirements that mutual funds and other investment vehicles must abide by. When Congress passed the National Securities Market Improvement Act of 1996, the entire hedge fund industry managed a fraction of what they do today, around $250 billion.[2]

Over time, private funds have abused the lack of required reporting and disclosures to take outsized risks and have increasingly posed dangers to systemically important financial institutions (SIFIs) and therefore to financial stability.

For example, in 1998, the hedge fund Long Term Capital Management (LTCM) managed about $4.7 billion in assets but borrowed 25 times that amount to run a portfolio of $129 billion.[3] Via several undisclosed derivative contracts, the hedge fund had up to $1 trillion in positions with investment banks such as Goldman Sachs, J.P. Morgan, Barclays, Morgan Stanley, UBS, and others.

A 1998 default by Russia on its sovereign bonds coupled with the ensuing volatility across U.S. Treasury bonds, which LTCM was positioned incorrectly against, led to the fund's insolvency. Losses were not limited to the firm but extended to all the SIFI banks from which it had borrowed and with which it also had derivatives positions.

As a result, one Connecticut hedge fund that had never filed any information with any of the regulatory agencies threatened to damage the entire financial system. After a failed deal to bailout LTCM by private investors, including Warren Buffett at Berkshire Hathaway, the Federal Reserve Bank of New York stepped in and organized a $3.625 billion bailout from a consortium of bank lenders to avoid a broader collapse of the financial markets.[4]

This decision created a remarkable and dangerous precedent where private funds are subject to few disclosure requirements - much less supervision - yet still received the benefit of a government backstop.

The Fed once again bailed out private funds in March 2020 when several hedge funds used a significant amount of leverage to try and capture the difference between Treasury bonds and comparable futures contracts.[5] With the onset of significant market volatility from the

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[1] Securities and Exchange Commission. Release No. IC-22597, Privately Offered Investment Companies. Apr 3, 1997. https://www.sec.gov/rules/final/ic-22597.txt

[2] Fichtner, Jan. University of Amsterdam. The Rise of Hedge Funds: A Story of Inequality. Jan 2013. https://www.researchgate.net/publication/259904632_The_Rise_of_Hedge_Funds_A_Story_of_Inequality

[3] Lowenstein, Roger. When Genius Failed: The Rise and Fall of Long Term Capital Management. 2000.

[4] Partnoy, Frank. Infectious Greed: How Deceit and Risk Corrupted the Financial Markets.

[5] Younger, Josh. Council on Foreign Relations. Revisiting the Ides of March: A Thousand Year Flood. Jul 20, 2020. https://www.cfr.org/blog/revisiting-ides-march-part-i-thousand-year-flood

coronavirus pandemic, the Treasury market was suddenly in danger of malfunctioning, and the Federal Reserve again stepped in to support hedge funds[6].

Banks must explicitly pay for or reserve against federal backstops, either in the form of an insurance fee to the Federal Deposit Insurance Corporation (FDIC)[7] or, for the large and interconnected institutions now labeled as Global Systemically Important Banks (G-SIBs), via mandated requirements to hold additional capital buffers, referred to as G-SIB surcharges.[8] It is alarming that policymakers continue to offer federal assistance to lightly regulated private funds, while only requiring extremely limited reporting.

The Commission needs to obtain timely data on hedge funds under Form PF to provide regulators with information needed to monitor dangers to financial stability

We strongly support the Commission's proposal to create a new reporting requirement under section 5 of Form PF for large hedge fund advisers to report the following:

Sudden loss events:

- Extraordinary investment losses representing 20% or more of a fund's net asset value (NAV) over a consecutive 10-day period
- Margin default by one of its counterparties
- Significant increases in borrowing costs, in which a fund sees its margin requirements increase by 20% or more over a consecutive 10-day period
- A termination or other material change in relationship from a fund's prime broker

Sudden degradation of the fund's stability

- Unencumbered cash of a fund declines by 20% or more over a consecutive 10-day period
- Client requests for redemption of assets representing 50% or greater of the fund's most recent Net Asset Value (NAV)

Operational disruptions

- Any significant disruption to a fund's operational capacity (measured by a 20% disruption from normal capacity) stemming from weather, power outages, cybersecurity attacks, etc.
- Removal of a fund's General Partner (GP) or termination of the fund's investment period
- Date and amount of any "clawback" the General Partner must return to the fund related to performance-based compensation

Secondary transactions

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[6] Timiraos, Nick. Wall Street Journal. Covid-19 Fueled a Treasury Market Meltdown in 2020. Report Offers 10 Potential Fixes. Jul 28, 2021. https://www.wsj.com/articles/treasury-market-meltdown-in-2020-shows-need-for-overhaul-report-finds-11627480800

[7] Bell, Claes. Bankrate. Banks pass along 'FDIC fee'. Aug 24, 2012. https://www.bankrate.com/financing/banking/banks-pass-along-fdic-fee

[8] Bank of International Settlements. G-SIB Framework: Cut-off score and bucket thresholds. July 2013. https://www.bis.org/bcbs/gsib/cutoff.htm

● Reporting of any transaction by the private fund manager or affiliated persons where their interests in the fund are sold or converted into holdings of another fund by the manager

The Financial Crisis Inquiry Commission in 2011 cited the lack of transparency into the non-bank sector numerous times as a major contributor to the financial crisis of 2008.[9] "The speculative binge was abetted by a giant 'shadow banking system', the report stated adding "when the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans, and the risky assets all came home to roost."

By some estimates, sudden redemption requests leading up to the financial crisis led a quarter of the hedge fund industry to sell 40% or more of their equity portfolios. The average hedge fund during that time ended up selling about 30% of its equity portfolio.[10]

To prevent additional financial instability stemming from a lack of visibility for regulators into hedge funds holdings, and to enable the FSOC and policy makers to consider appropriate policy responses, the Commission and FSOC both need to have this critical data.

Private equity funds own a significant number of companies and assets critical to Americans and policymakers need insight into the nature and extent of their holdings

The private equity industry, similar to hedge funds, managed less than $200 billion in 1996[11], when section 3(c)7 was included in the Investment Company Act, exempting private equity firms from most reporting requirements. As the Commission has learned under current Form PF reporting, as of the end of 2020, there are 15,584 private equity funds managing $4.7 trillion in gross assets.

Despite the funds being described as private, the implications of private equity funds' investments touch the public in every corner of the economy, ranging from the 8,000 companies owned or financed by the industry[12] and 11.5 million workers who work under a explicitly financially focused owner[13], two private equity backed physician staffing firms

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[9] Chan, Sewell. New York Times. Financial Crisis Was Avoidable Inquiry Finds. Jan 25, 2011. https://www.nytimes.com/2011/01/26/business/economy/26inquiry.html

[10] Khandani, Amir and Lo, Andrew. What Happened to the Quants in August 2007? Nov 4, 2007. https://web.mit.edu/Alo/www/Papers/august07.pdf

[11] Pitchbook. Assets Under Management for U.S. Buyout Industry.

[12] McKinsey & Company. A year of disruption in the private markets. April 2021. https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%20annual%20review/2021/mckinsey-global-private-markets-review-2021-v3.pdf

[13] Appelbaum, Eileen. Center for Economic Research. Testimony Before the Senate Banking Committee. Oct 20, 2021. https://www.banking.senate.gov/imo/media/doc/Appelbaum%20Testimony%2010-20-21.pdf

controlling 30% of that industry or 90,000 healthcare employees[14], and the 350,000 single-family homes purchased en masse[15] to later be rented worth about $60 billion.[16]

The lack of visibility into the private equity industry's investments has enabled several firms to engage in blatant self-dealing, such as the transfer of valuable company assets into offshore entities to the detriment of other stakeholders[17] or relying on questionable justifications to pay themselves dividends from their portfolio companies at the expense of investors and workers.[18] Many investors, surprised by such asset transfers after they already moved out of their reach, have filed litigation alleging fraudulent transfers, and greater visibility into such activity by the Commission may enable it to bring future enforcement actions where there is illegal conduct.[19]

We strongly support the Commission's proposal to require large private equity advisers managing $1.5 billion or more to report the following data to the Commission:

Under section 4
● What portfolio companies they own
● Financing associated with these portfolio companies
● Investments across other parts of the capital structure of companies (debt, preferred shares, warrants)

Under section 6
● Any transaction by the private fund manager or affiliated persons where their interests in the fund are sold or converted into holdings of another fund managed by the manager
● Date and amount of any "clawback" the General Partner must return to the fund related to performance-based compensation
● Removal of a fund's General Partner (GP) or termination of the fund's investment period

Conclusion

[14] Cooper, Zack et al. Yale Institution for Social and Policy Studies. Surprise! Out-of-Network Billing for Emergency Care in the United States. July 2017. https://isps.yale.edu/sites/default/files/publication/2017/07/surpriseoutofnetwrokbilling_isps17-22.pdf
[15] Lopez, Sofia. Action Center on Race & the Economy. Testimony before the Senate Banking Committee. Oct 21, 2021. https://www.banking.senate.gov/imo/media/doc/Lopez%20Testimony%2010-21-21.pdf
[16] Mari, Francesca. New York Times. A $60 Billion Housing Grab by Wall Street. Oct 22, 2021. https://www.nytimes.com/2020/03/04/magazine/wall-street-landlords.html
[17] Appelbaum, Eileen and Park, Andrew and Batt, Rosemary. American Prospect. How Private Equity Firms Will Profit From COVID-19. May 7, 2020. https://prospect.org/coronavirus/private-equity-firms-profit-covid-19-j-crew/
[18] Cumming, Chris. Wall Street Journal. Buyout Firms Set Record for Loading Companies With Debt to Pay Themselves. Oct 25, 2021. https://www.wsj.com/articles/buyout-firms-set-record-for-loading-companies-with-debt-to-pay-themselves-11635156003
[19] Ayotte, Kenneth and Scully, Christina. Yale Law Journal. J. Crew, Nine West, and the Complexities of Financial Distress. Nov 10, 2021. https://www.yalelawjournal.org/forum/j-crew-nine-west-and-the-complexities-of-financial-distress

In addition to collecting this information we urge the SEC (and the FSOC) to make appropriate summary information on the nature of PE and hedge fund holdings available to legislators, cabinet agencies, and the general public.

We appreciate the opportunity to comment on these issues. For additional questions, please reach out to Andrew Park at andrew@ourfinancialsecurity.org.