



# Americans for Financial Reform Education Fund

April 25, 2022

Vanessa A. Countryman  
Securities and Exchange Commission  
100 F St NE  
Washington, DC 20549

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (File No: S7-03-22)

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 investors with necessary details on the fees, expenses, returns, and compliance records of private funds in which they are invested or are considering investing. We support these proposals which will put investors in a position to make informed decisions.

The fact that this basic information, which is generally already clear to fund advisers, is not disclosed to investors, represents a profound market failure. Currently, even the most sophisticated investors in these funds frequently cannot form a clear picture of:

- what fees they are being charged and how they are being charged
- accurate information on returns
- if the fund adviser has been engaged in misconduct
- whether other fund investors are receiving preferential treatment that puts them at a disadvantage

With this proposal, the Commission addresses the imbalance of power that favors the fund advisers, by requiring the advisers to provide investors on a quarterly basis:

- a table detailing all the different fees and expenses charged
- a standardized, reliable set of returns for investors to evaluate alongside more detailed assumptions used to calculate returns
- disclosures on special arrangements it may have with certain investors, often referred to as "side letters"

The proposal would also prohibit certain hidden conflicts and fees that unduly enrich fund advisers at the expense of investors and would require annual independent audits to address systematic compliance deficiencies and ensure private investments are valued properly.

We strongly support these proposals, which will provide investors in private funds with the information necessary to determine if the fees, returns, and investment terms are suitable and make it easier to make sure their advisers are acting in their best interest.

The proposals will also ensure that private fund investors are properly able to steward the savings of millions of Americans. Investors in these funds include public pension funds responsible for the retirement savings of workers and retirees, along with other important public serving institutions, including universities and foundations. The absence of clear standards for basic information, and of protections against dangerous conflicts of interest, puts both these investors and the integrity of capital markets at serious risk, channeling trillions of dollars of investment in ways that are untethered from accurate reporting of fees and returns.

This lack of transparency, which further erodes accountability, has enabled a transfer of wealth from workers and retirees to Wall Street executives. This dynamic has been described by a leading academic expert as one of the “largest [wealth transfers] in the history of modern finance” from several hundred million retirees to the private equity industry.<sup>1</sup> Further, this lack of transparency and conflicts of interest create misaligned incentives that increase the likelihood of extractive management practices by private equity that benefit executives and at the expense of other stakeholders, including in various ways investors, workers, and consumers/patients.

### **Current rules unfairly benefit private fund advisers at the expense of investors**

The proposed rule is particularly crucial as the size of private funds have grown exponentially. In the last decade, these funds have grown by 383%, from \$3 trillion in 2007 to around \$11.5 trillion at the end of 2021.<sup>2</sup> However, the rules have not kept pace with this growth. The outdated rules mean that investors frequently have very little insight into their private fund investments.<sup>3</sup>

A significant reason for the growth in private funds has been investments from pension funds, non-profit foundations, endowments, and insurance companies driven to seek higher returns than those in the public markets in the context of record low interest rates.<sup>4</sup> These investors

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<sup>1</sup> Flood, Chris. Financial Times. Private equity barons grow rich on \$230bn of performance fees. <https://www.ft.com/content/803cff77-42f7-4859-aff1-afa5c149023c>

<sup>2</sup> Pitchbook. Total private assets. Mar 31, 2021.

<sup>3</sup> Greene, Sophia. Financial Times. Private equity: the definition of an opaque asset class. Jan 24, 2015. <https://www.ft.com/content/7d5fda20-a182-11e4-8d19-00144feab7de>

<sup>4</sup> Jeng, Leslie and Lerner, Josh. American Economic Review. Making Private Data Accessible in an Opaque Industry: The Experience of the Private Capital Research Institute. 2016. <https://www.aeaweb.org/articles?id=10.1257/aer.p20161059>

have increasingly turned to investing in private funds managed by hedge funds or private equity firms to try and meet return targets, but they have faced a lack of transparency and basic accountability that seriously interfere with their ability to accurately determine risks and returns, and to appropriately make critical allocation decisions.<sup>5</sup>

Public pension funds, for example, have now allocated about 9% of their portfolios to private equity investments, totaling \$480 billion in 2021, compared to \$300 billion in 2018.<sup>6</sup>

### **The SEC's proposal to require detailed accounting of fees would greatly benefit fund investors**

We strongly support the Commission's proposal requiring private fund managers to provide detailed reporting on a quarterly basis to investors, breaking down all the compensation, fees, and expenses paid to the adviser. Fund advisers are not currently providing that baseline level of information and have largely ignored investors requests to do so.<sup>7</sup> This rule will help ensure that investors know what fees and expenses they are being charged and determine whether they are appropriate.

There's no question that many private fund investors do not have the information they need to have insight into the additional fees they are being charged on top of their standard 2% management fee and 20% performance fee.<sup>8</sup>

For example, the Commission fined private equity firm Lightyear Capital in 2018 for charging its investors legal, compliance, and consulting expenses without disclosing that funds primarily owned by its own employees in the same investments would not be charged the same expenses. Additionally, because they did not have adequate information about the private funds' expenses, the investors were deprived of the management fee rebates they were eligible for. "The Limited Partners of the Flagship Funds had no way of knowing that the Flagship Funds did not receive the management fee offset," the Commission stated in its cease-and-desist order.<sup>9</sup>

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<sup>5</sup> Sonti, Samir. American Federation of Teachers. Lifting the Curtain on Private Equity: A Guide for Institutional Investors and Policymakers. March 2021. <https://www.aft.org/sites/default/files/private-equity-report-2021.pdf>

<sup>6</sup> Gillers, Heather. Wall Street Journal. Retirement Funds Bet Bigger on Private Equity. Jan 10, 2022.

<https://www.wsj.com/articles/retirement-funds-bet-bigger-on-private-equity-11641810604>

<sup>7</sup> Cumming, Chris. Wall Street Journal. New Rules Aim to Prevent Private-Equity Firms From Passing Legal Costs to Investors. Mar 9, 2022. <https://www.wsj.com/articles/new-rules-aim-to-prevent-private-equity-firms-from-passing-legal-costs-to-investors-11646823601>

<sup>8</sup> Simon, Emma. Morningstar. Why are Fund Fees So Confusing? Mar 17, 2021.

<https://www.morningstar.co.uk/uk/news/210529/why-are-fund-fees-so-confusing.aspx>

<sup>9</sup> Securities and Exchange Commission. Order Instituting Cease-and-Desist Proceedings Pursuant to 203(k) of the Investment Advisers Act of 1940. Dec 26, 2018. <https://www.sec.gov/litigation/admin/2018/ia-5096.pdf>

The lack of transparency has even enabled some private fund advisers to pass the costs of private jet flights<sup>10</sup> and personal expenses<sup>11</sup> onto fund investors.<sup>12</sup>

Even the most diligent investors in private funds find that they cannot figure out where all their expenses are going, even when they demand those additional details from the funds. For example, when the Washington State Investment Board, attempted to determine whether the \$156 million in fees it was charged across legal, travel, and bank fees were appropriate and in line with its limited partnership agreement with fund managers, it found that about 45% of the fees it paid were labeled as “other”.<sup>13</sup>

The opacity that defines the current relationship between trustees managing money on behalf of public employees and inability of the stewards of that capital to properly answer to the suitability of each expense for the funds they invest in led Professor Emil Siriwardane from Harvard Business School to remark recently, “If you are going to spend public money, you should be able to figure out where it went.”<sup>14</sup>

Even when pension fund managers managing public money ask fund managers to fill out templates detailing expenses across different categories, some fund managers simply refuse. When the Teachers Retirement System of Texas, the sixth largest public pension plan in the US, asked 64 of the private fund managers it invests in to fill out the Institutional Limited Partners Association (ILPA) template on fees, the fund managers American Securities, Clearlake Capital Group, and TA associates all declined.<sup>15</sup>

If the sixth largest public pension fund cannot get a basic, understandable breakdown of the fees it pays to private fund managers from every fund it invests in, what about those smaller public pension funds, which are in a weaker negotiating position? This is among the reasons the Commission’s proposal to mandate all private funds provide a detailed breakdown of all fees and expenses to their investors is so important.

### **The SEC proposal protects investors by prohibiting private funds from charging investors or their portfolio companies’ fees related to wrongdoing or for services not provided**

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<sup>10</sup> Flood, Chris. Financial Times. Investors take aim at private equity’s use of private jets. Nov 8, 2021.

<https://www.ft.com/content/1212b266-8760-4766-a03e-9e7db203b5d2>

<sup>11</sup> Indap, Sujeet and Vandavelde, Mark. Financial Times. Apollo rebuked in trial over bogus expenses. Dec 4, 2020.

<https://www.ft.com/content/f2b79a28-889c-4ff1-86cf-53dc96454d76>

<sup>12</sup> Fross, Stuart et al. Foley & Lardner LLP. SESC Enforcement Actions Impacting Private Fund Advisers for Fiscal Year 2020. <https://www.foley.com/en/insights/publications/2020/11/sec-actions-private-fund-advisers-fy-20>

<sup>13</sup> Willmer, Sabrina. Bloomberg News. Private Equity’s Opaque Costs Mystify the Pensions That Pay Them. Mar 29, 2022. <https://www.bloomberg.com/news/articles/2022-03-29/private-equity-firm-fees-create-headache-for-pension-plans>

<sup>14</sup> Id.

<sup>15</sup> Id at 13.

In conjunction with the Commission's proposal to specifically list the various fees and expenses investors are being charged, we strongly support the Commission's new proposed rules to explicitly prohibit the following fees and expenses from being passed on to investors:

- Accelerated monitoring fees
- Costs related to governmental or regulatory investigations
- Compliance expenses
- Borrowing money, securities, or other forms of credit from a private fund client

These fees and expenses are not related to services provided to investors but rather as the Commission correctly characterizes them "compensation schemes that are contrary to the public interest and the protection of investors" and should therefore be covered by the fund, not the investors.

**The proposal to ban accelerated monitoring fees is needed because such fees charged with no services provided are unfair and often not properly disclosed**

We strongly support the Commission's proposal to ban accelerated monitoring fees. Funds often fail to properly disclose that they will charge portfolio companies an upfront collection of future monitoring fees during an Initial Public Offering or sale of a portfolio company, despite the fact that no additional services will be provided. It is for this reason that Oxford Said Business School professor Ludovic Phalippou has called accelerated monitoring fees "money for nothing".<sup>16</sup>

The Commission details how these accelerated payments where no service is provided extract value from the portfolio company, and therefore also reduce the returns to fund investors. Already the Commission has fined private equity funds TPG \$13 million in 2017, Apollo Global Management \$52.8 million in 2016, and Blackstone \$39 million in 2015 related to the improper collection and disclosure of accelerated monitoring fees.<sup>17</sup> In these instances, the Commission found that the private equity firms failed to disclose the fees they were collecting and also that the fees posed conflicts-of-interest and ran contrary to the funds fiduciary duties to the fund investors.

**The Commission's proposal to prohibit funds from charging investors expenses related to governmental or regulatory charges will both protect investors and increase accountability.**

We support the Commission's proposal to restrict private fund advisers from passing on any expenses related to charges or fines related to wrongdoing to investors. Investors should not bear the costs of actions they were not responsible for.

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<sup>16</sup> Phalippou, Ludovic. Oxford Said Business School. Money for Nothing? The Wonderful World of Private Equity. October 2014. <https://www.youtube.com/watch?v=m1paFqPlj6Q>

<sup>17</sup> Kreutzer, Laura. Wall Street Journal. TPG to Pay Nearly \$13 Million Over Accelerated Monitoring Fees. Dec 21, 2017. <https://www.wsj.com/articles/tpg-to-pay-nearly-13-million-over-accelerated-monitoring-fees-1513905032>

Private equity firm the Carlyle Group for example in 2014 passed on to its investors the cost of legal fees associated with a 2007 lawsuit that accused Carlyle and 10 other private equity firms of colluding to limit the costs to acquire companies.<sup>18</sup>

The New York City Retirement System, which manages about \$274 billion in assets, has previously tried to insist in its investment contracts with private funds that the managers pay their own legal fees and penalties through what was known as a “GP Expenses Provision”. However, the fund was eventually pressured to drop the provision because private funds would instead seek out other investors who were not aware of the issue and did not demand such protection.<sup>19</sup>

As the Commission notes in its proposal, regulatory and compliance costs are a cost of being an investment adviser and should not be passed on to private fund investors.

### **The SEC proposal to prohibit clients of private funds from extending loans to the fund will prevent blatant conflicts of interest**

We support the Commission’s proposal to prohibit loans coming directly from existing clients of the fund as such arrangements pose significant conflicts of interest and may involve lending terms that are not fair to other investors in the fund, who have little to no say in the loan’s negotiation.

In addition to the concerns the Commission has highlighted in its proposal over how multiple loans from private fund investors have been unknowingly used with little accountability to pay bribes to foreign officials<sup>20</sup> the practice opens many other potential avenues for abuses and favorable treatment of some investors over others clouded by conflicts-of-interest.

In cases where private funds require additional capital for certain expenses, funds should be provided by an unaffiliated third party and disclosed over Form ADV, similar to the standards now in place when advisers take out loans that have a material effect on their relationships with their clients. Such disclosures were required of financial advisers applying for loans in 2020 under the Paycheck Protection Program for example.<sup>21</sup>

### **Requiring significantly improved performance information is a crucial investor protection**

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<sup>18</sup> Cumming, Chris. Wall Street Journal. New Rules Aim to Prevent Private-Equity Firms from Passing Legal Costs to Investors. Mar 9, 2022. <https://www.wsj.com/articles/new-rules-aim-to-prevent-private-equity-firms-from-passing-legal-costs-to-investors-11646823601>

<sup>19</sup> Id.

<sup>20</sup> FCPA Professor. In Depth Into The Och-Ziff FCPA Enforcement Action. Oct 2, 2016. <https://fcpaproffessor.com/indepthintotheochziffaction/>

<sup>21</sup> JDSupra. SEC Posts Guidance for Investment Advisers on Disclosing Paycheck Protection Program Loans. May 7, 2020. <https://www.jdsupra.com/legalnews/sec-posts-guidance-for-investment-89543/>

We strongly support the Commission’s proposal to require private equity funds that would be considered “illiquid funds” to include the assumptions and calculations that go into their return figures, which the industry currently shows using an Internal Rate of Return (IRR). Given the historical unreliability of IRR, we also strongly support Commissions proposal to require that advisers provide investors with return figures that show how many multiples of capital have actually been returned to investors.

Investors in what the Commission defines as “illiquid funds” currently have very little insight into how returns from their fund’s investments are calculated, which in turn means they have little information about the accuracy of the return figures they are presented with, or about what more accurately or comparably presented returns might be. Since those private investments have no publicly available market price, investors have no independent way to verify those returns are being calculated accurately. Investors pay performance fees based on returns, and they consider making investments based on prior performance figures; this information is crucially important.

One return metric very frequently used by PE firms, the Internal Rate of Return (IRR), has been found repeatedly to be an unreliable measure of performance,<sup>22</sup> especially given that borrowed money can be used to further inflate the IRR.<sup>23</sup>

IRRs from the private equity industry’s titans are heavily distorted by their outsized early returns, as evidenced by how consistent a fund’s since-inception IRR tends to stay over most of the life of a fund.<sup>24</sup> A look into Yale University’s endowment investments into a KKR fund for example shows a since-inception IRR of around 26% in every SEC filing since 2006 while the same goes for its investments in Apollo’s private equity funds where the since-inception IRR stays around 39%.<sup>25</sup>

If those figures were accurate total returns, \$100 million invested in one Apollo fund in 1990 and growing annually at that rate would be worth over \$2.3 trillion today, a mathematical absurdity given that the entire private fund industry is estimated to manage around \$11.5 trillion.

Due to the way the since-inception IRRs are calculated, favoring the larger returns from earlier years, it is next to impossible for those since-inception IRRs to avoid falling meaningfully lower

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<sup>22</sup> Phalippou, Ludovic. Oxford Said Business School. The Hazards of Using IRR to Measure Performance. Sep 29, 2009. <https://ssrn.com/abstract=1111796>

<sup>23</sup> Albertus, James and Denes, Matthew. Carnegie Mellon Tepper School of Business. Distorting Private Equity Performance: The Rise of Fund Debt. June 2019. [https://uncipc.org/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance\\_07192019.pdf](https://uncipc.org/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance_07192019.pdf)

<sup>24</sup> Phalippou, Ludovic. Oxford Said Business School. The Hazards of Using IRR to Measure Performance. Sep 29, 2009. <https://ssrn.com/abstract=1111796>

<sup>25</sup> Phalippou, Ludovic. Oxford Said Business School. An Inconvenient Fact: Private Equity Returns & The Billionaire Factory. December 2020. <https://doi.org/10.3905/joi.2020.1.153>



during a far less competitive investment landscape. KKR for example could lose every penny of a recent \$30 billion private equity fund and its since-inception IRR still would barely change.<sup>26</sup>

Data from investors in more recent private funds show how unreliable the return figures provided are, as returns in those individual funds are often unusually high during the early years of a fund, but unlike the since-inception IRRs, eventually decline over time. Blackstone's Total Alternative Solutions 2020 fund, for example, has only drawn on 14% of its capital and yet has been reporting a 100.5% net IRR. Meanwhile, a slightly older fund from the same series, the Blackstone Total Alternative Solutions V launched in 2019 and calling 51% of its total capital, showed a 42.9% IRR. But the Blackstone Total Alternative Solutions 2014, calling 84% of its total investor capital more recently reported a 7.7% net IRR in March 2021.<sup>27</sup>

The same dynamic of high early returns that later normalize can be seen in funds such as Blackstone's Strategic Partners Secondaries VII Trust launched in 2016. The fund touted to its investors a targeted 17% IRR. After a little more than a year the fund was reporting to its investors a 47% IRR. However, by May 31, 2021, the IRR was down to 8.15% compared to 16.81% return in the S&P 500 that year.<sup>28</sup>

### **Subscription lines are increasingly being utilized; they artificially boost IRR and should be excluded from return calculations**

The Commission should mandate that any IRR performance figures are reported on an unlevered basis, without the boost that loans to a fund, referred to as subscription lines, typically provide. Investment consultant Cambridge Associates has found that subscription lines can have the effect of boosting IRRs by 300 bps or more.<sup>29</sup>

Private funds have increasingly been relying on such loans in a competitive fundraising environment. Before 2010, estimates from private fund data service provider Preqin found that only 13% of private equity funds utilized subscription facilities. However, from 2010-2019, nearly half, or 47% of private equity funds did.<sup>30</sup> As Cambridge Associates' Andrea Auerbach has said "The siren song of easily increasing IRRs by using a currently inexpensive financial solution is just too great for a competitive GP to ignore."<sup>31</sup>

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<sup>26</sup> Ford, Jonathan. Financial Times. The parallel universe of private equity returns. Jul 26, 2020.

<https://www.ft.com/content/33ec23c0-fe95-44ec-a173-bd2fb9b66e63>

<sup>27</sup> Celarier, Michelle. New York Times. Is Private Equity Overrated? Dec 4, 2021.

<https://www.nytimes.com/2021/12/04/business/is-private-equity-overrated.html>

<sup>28</sup> Private Equity Feeder Funds: A Decade in Review. Mar 6, 2021.

[https://docs.google.com/spreadsheets/d/1\\_omKfIZXVb42B7KWYMneWsTOkwVCS4uweteX2LAvZJk/edit#gid=1734374283](https://docs.google.com/spreadsheets/d/1_omKfIZXVb42B7KWYMneWsTOkwVCS4uweteX2LAvZJk/edit#gid=1734374283)

<sup>29</sup> Markham, Isobel. Private Equity International. Cambridge: Sub-lines can boost IRRs by 300bps. Jun 21, 2018.

<https://www.privateequityinternational.com/cambridge-sub-lines-can-boost-irrs-300bps/>

<sup>30</sup> Farr, Jonathan. Callan. GPs Take 'Credit' for Higher IRRs. Jul 29, 2021. <https://www.callan.com/blog-archive/subscription-credit-facilities/>

<sup>31</sup> Id. at 27.



Such usage of borrowed money to boost returns only looks to continue to grow as 17Capital has now raised \$2.9 billion to specifically lend to private equity funds that will pledge a certain percentage of their stakes in their funds to 17Capital in exchange for loans that will boost their returns. 17Capital has lent \$7 billion to 78 funds since its launch in 2009, and that is expected to grow with its new fund. 17Capital's Pierre-Antoine de Selancy explicitly describes such lending arrangements as "a way to bolster investment returns."<sup>32</sup>

Given that such external borrowing is not reflective of the actual returns an investment generates, the Commission should require that any IRR performance figures are reported on an unlevered basis, without the artificial boost such lending provided.

**The Commission should also require returns based on capital returned to investors such as TVPI and PME that are harder to inflate**

We strongly urge the Commission to require alternative and more reliable set of returns to investors that are based on the capital returned to them. Investors currently only have real insight into what their returns actually are after the funds are wound down and they see how much cash is returned to them. It is for this reason that the Commission should require private funds to report return figures such as a Public Market Equivalent (PME) or Total Value Paid In (TVPI) that reflect how much has been paid out to investors compared to how much they have paid in.

In Total Value Paid In return figures, a TVPI ratio of 1.30x would mean that the fund has so far gained 30 cents for every \$1 that has been contributed. Since the calculation is relatively straightforward - being calculated by the total value of the fund divided by the capital that has been paid-in so far - TVPI is difficult to manipulate compared to IRR.<sup>33</sup>

Using TVPI, investors would be better able to evaluate claims of "mid-teens IRR" which many private funds tout during their fund's marketing process.<sup>34</sup>

TVPI also has the added benefit of effectively discounting the effects subscription lines and other borrowing have on boosting returns. Under the TVPI calculation, the interest expenses and fees associated with the subscription lines reduce the capital returned to investors, therefore decreasing TVPI, in contrast to the boost it gives to IRR figures.<sup>35</sup>

Similarly, a Public Market Equivalent (PME) figure such as the Kaplan-Schoar (KS-PME) compares cash flows from private investments against an equivalent public market index and

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<sup>32</sup> Gara, Antoine. Financial Times. Oaktree-backed 17Capital raises almost \$3bn for first credit fund. Apr 20, 2022. <https://www.ft.com/content/db396aea-02df-43b8-8867-c004ef4b5761>

<sup>33</sup> Lee, Ian et al. AngelList Venture. What to Know About TVPI. <https://learn.angellist.com/articles/tvpi>

<sup>34</sup> Robertson, Gary. Callan. Private Equity Performance Measurement Requires Unique Calculations. Oct 22, 2019. <https://www.callan.com/blog-archive/pe-measurement/>

<sup>35</sup> Id. at 28.

gives investors an indication similar to TVPI of how much more than their initial capital has been returned to them. This provides a more accurate gauge of the fund's performance.

As business school professors Morten Sorensen and Ravi Jagannathan concluded in 2015, PME figures are a "valid performance measure" that are "robust to the potential manipulation of the timing of the cash flows" as long as the public market benchmarks used are reasonable.<sup>36</sup>

Workers and retirees are harmed when inflated returns do not come to fruition. A 2013 investigation into six private equity funds the Florida State Board of Administration invested in found that the funds collectively gained \$351.5 million from 1988 to 2011. However, if those same funds had instead been invested in the Russell 3000 index of small cap stocks, those investments would have yielded \$1.38 billion. Florida retirees were deprived of \$1 billion in returns because of this investment choice.<sup>37</sup> Inaccurate return figures guiding investment decisions on a large scale also distort the capital markets.

We therefore strongly support the Commission's proposal to require private fund advisers to disclose the criteria and assumptions used to determine their performance calculations, and to require additional performance figures based on multiples of capital committed to show how much cash has actually been distributed back to investors.<sup>38</sup> Such additions would greatly help investors compare the returns of funds to each other, and to lower-fee alternatives in the public market.

### **Annual audits of every private fund should be mandatory**

We also support the SEC proposal to require that every private fund be audited annually by an independent public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB).

Such independent audits would provide an additional level of scrutiny over whether the fund advisers' estimated valuations on its illiquid investments, which otherwise have few public price points, are consistent with Generally Accepted Accounting Principles (GAAP).

Given the Commission's findings that 10% of private funds are still not being audited, mandatory audits should be required of all private funds so that investors are provided with the necessary safeguards against inflated fund valuations and other compliance breaches.

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<sup>36</sup> Sørensen, Morten and Jagannathan, Ravi, The Public Market Equivalent and Private Equity Performance (March 7, 2014). Financial Analysts Journal, Vol. 71, No. 4, 2015, Netspar Discussion Paper No. 09/2013-039, Available at SSRN: <https://ssrn.com/abstract=2347972>

<sup>37</sup> Edwards, Gina. Watchdog City. Opting for risky and secretive private equity investments cost Florida pension fund an estimated \$1 billion on six deals. Apr 2, 2013. <http://www.watchdogcity.com/storyinfo/216-Opting-for-risky-and-secretive-private-equity-investments-cost-Florida-Pension-fund-an-estimated-1-billion-on-six-deals-.htm>

<sup>38</sup> Robertson, Gary. Callan. Private Equity Performance Measurement Requires Unique Calculations. Oct 22, 2019. <https://www.callan.com/blog-archive/pe-measurement/>

## **The SEC should collect and share appropriately aggregated and anonymized information about fees and returns with researchers, policy makers, and the public**

The additional detail surrounding fees, expenses, and returns provided to private fund investors will be extremely useful for investors in private funds. We also urge the Commission to collect the information and to share it in appropriately anonymized formats with researchers, policy makers, and the public.

These public disclosures would add another layer of accountability for all actors in the system and would also provide private fund investors with additional insights into what they are being charged relative to others' and into the performance of PE investments.

## **All side letters need to be disclosed to all other investors; side letters that put some investors at a material disadvantage should not be permitted**

We support the Commission's proposal to require that all special arrangements or terms offered to a certain set of fund investors, often referred to as "side letters," be disclosed to all other investors in the fund to ensure there are no violations of fiduciary duties to other investors.<sup>39</sup> Investors need to be able to see what side agreements funds have with other investors to ensure that they are not being unduly harmed by agreements they have no visibility into. Allowing preferential treatment enables private fund advisers to actively discriminate between different classes of investors.

The side letters with the greatest potential to harm other fund investors are those that include the ability to redeem their holdings first, which leaves remaining investors invested in a materially different portfolio that may be far riskier and/or less liquid.<sup>40</sup> We therefore support the Commission's proposal to prohibit preferential terms regarding redemption to select investors.

The Commission has fined a number of private fund advisers for willfully violating the Investment Company Act by having side letters in place that contradict their stated disclosures or duties to other clients.<sup>41</sup> In some cases, investors were completely unaware side letters existed allowing the fund adviser to collect fees for placing or maintaining assets with affiliated funds until the SEC's Division of Examinations discovered the side letter and payments in an examination.<sup>42</sup> Such side letters allowing the fund to collect placement fees contradicted

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<sup>39</sup> Dechert LLP. Private fund side letters: common terms, themes, and practical considerations. Oct 28, 2018. <https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html>

<sup>40</sup> Davie, Alexander. Strictly Business. Using Side Letters in Private Funds. Nov 29, 2017. <https://www.strictlybusinesslawblog.com/2017/11/29/using-side-letters-in-private-funds/>

<sup>41</sup> Securities and Exchange Commission. Administrative Proceeding File No. 3-17506, Orinda Asset Management LLC. <https://www.sec.gov/litigation/admin/2016/ia-4513.pdf>

<sup>42</sup> Ayers, Carl. Regulatory Compliance Watch. Undisclosed side letter agreement yields \$500K penalty for IA. Jun 8, 2018. <https://www.regcompliancewatch.com/undisclosed-side-letter-agreement-yields-500k-penalty-for-ia/>

agreements with two clients, one which stated there should be no such commission paid while the second stated such arrangements should be disclosed and refunded back to the client.

One of the major issues the Commission found with charging accelerated monitoring fees, which it is now proposing to ban, is that a majority of investors in private funds were unaware of the fee arrangement as the fee was not explicitly listed in the limited partnership agreements. Private equity firm Thomas H Lee Partners in 2018 paid a \$6.5 million fine because it had only disclosed such an arrangement to some of its investors in a side letter even though all investors in their funds would be affected by the fee arrangement<sup>43</sup>

### **Preferential information sharing that is illegal in the public markets should be prohibited in private markets**

We support the Commission's proposal to prohibit the selective disclosure of information to some investors. In the public markets, under Regulation FD, it is illegal for a public company to disclose information to a certain set of investors, but not others.<sup>44</sup> Yet, private funds have been engaging in the practice of providing only certain investors, often large funds who actively invest with the manager or initial seed investors, with additional details into their portfolio investments.

Such selective disclosures to certain investors may also be a violation of the private funds fiduciary duty to its other investors who may be harmed as a result. The Commission should therefore ban any side arrangements that allow the selective sharing of material, non-public information.

### **Additional reporting requirements are not an unfair burden on smaller funds**

Contrary to the arguments that are being made about the additional costs associated with these reporting requirements, it is worth noting that all the information the Commission is requesting is already available to the funds themselves; it is simply not being disclosed. Any properly operated private fund is already tracking all this information in the ordinary course of its daily business. The Commission is simply proposing to mandate that this information be made available to investors.

### **Investor protections under the Advisers Act should apply to all funds with US investors**

The Commission needs to ensure that the Advisers Act applies to all funds, regardless of where they are domiciled, as long as they have a single US investor, given the popularity of locating private funds in offshore tax havens.

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<sup>43</sup> Diongson, Dominic. Private Funds CFO. The problem with accelerated monitoring fees. Jul 16, 2018. <https://www.privatefundscfo.com/problem-accelerated-monitoring-fees/>

<sup>44</sup> Morrison & Foster. Frequently Asked Questions About Regulation FD. Oct 2, 2017. <https://media2.mofo.com/documents/faqs-regulation-fd.pdf>

Consulting firm Oliver Wyman found that 60% of the 17,700 hedge funds and hedge fund of funds it examined were based in the Cayman Islands while several others were incorporated in the British Virgin Islands.<sup>45</sup>

A number of the 5,500 private equity firms Oliver Wyman analyzed are domiciled in locations such as Guernsey and Luxembourg. In fact, private equity firms account for nearly 75% of all Guernsey domiciled funds.<sup>46</sup>

Given how many private funds are domiciled overseas, for reasons ranging from the avoidance of taxes to friendlier legal jurisdictions, the Commission should ensure that its interpretation of the Advisers Act appropriately applies to any fund, regardless of its domicile, that takes money from a US investor.

## **Conclusion**

We thank the Commission again for the opportunity to comment on these important proposals that will better protect and inform investors in private funds. For more information, please contact Andrew Park at [andrew@ourfinancialsecurity.org](mailto:andrew@ourfinancialsecurity.org).

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<sup>45</sup> Clarkson, David et al. Oliver Wyman. Domiciles of Alternative Investment Funds. Dec 23, 2014. [https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2014/dec/Oliver\\_Wyman\\_Domiciles\\_of\\_Alternative\\_Investment\\_Funds.pdf](https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2014/dec/Oliver_Wyman_Domiciles_of_Alternative_Investment_Funds.pdf)

<sup>46</sup> Id.