

Sign-on Comment

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,

We, the undersigned organizations, appreciate this opportunity to comment on the Securities and Exchange Commission's ("the Commission") proposed rules that would provide investors with new and necessary information they need in order to make the best decisions possible. We believe these disclosures of fees, expenses, returns, and compliance records of private funds will go a long way in providing investors the insight they deserve.

We believe that denying investors access to this basic information, especially because much of it is already clear to fund advisers, is highly problematic. Without it, investors cannot determine what fees they are being charged, accurate returns information, whether their fund advisor is engaged in misconduct, or whether another investor is receiving preferential treatment.

Given that fund advisers already have access to much of this information, we appreciate that this proposal will correct that problematic imbalance. The proposal would also prohibit certain hidden conflicts and fees that unduly enrich the fund adviser at the expense of investors, while requiring annual independent audits to address the systematic compliance deficiencies and ensure private investments are valued properly.

One of the reasons we support this proposal is because we want to ensure that private fund investors are properly stewarding 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.

**Current rules for private equity are outdated and necessary now as private equity continues to grow**

The growth in private funds has greatly outpaced the rules governing those funds. The outdated rules mean that investors frequently have very little insight into their private fund investments.<sup>1</sup> One reason for the growth in private equity is the uptick in 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>2</sup> Public pension funds have now allocated about 9% of their portfolios to private equity investments, totaling \$480 billion in 2021, compared to \$300 billion in 2018.<sup>3</sup>

These investors 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>4</sup>

### **Investors need detailed accounting of fees as required in SEC proposal**

We strongly support the Commission's proposal requiring private fund managers to provide detailed reporting on a quarterly basis to all their 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 investors cannot tell what additional fees they are being charged on top of their standard 2% management fee and 20% performance fee.<sup>5</sup>

This rule will help ensure that investors know what fees and expenses they are being charged and determine whether they are appropriate.<sup>6</sup> The lack of transparency has even enabled some private fund advisers to pass the costs of private jet flights<sup>7</sup> and personal expenses<sup>8</sup> onto fund investors.<sup>9</sup>

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<sup>1</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>2</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>

<sup>3</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>4</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>5</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>6</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>7</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>8</sup> Indap, Sujeet and Vandeveld, Mark. Financial Times. Apollo rebuked in trial over bogus expenses. Dec 4, 2020. <https://www.ft.com/content/f2b79a28-889c-4ff1-86cf-53dc96454d76>

<sup>9</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>

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

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 accelerated monitoring fees, costs related to governmental or regulatory investigations, compliance expenses, and costs related to obtaining external financing from being passed on to investors.

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.

## **SEC proposal will help investors verify they are getting accurate return information**

We strongly support the Commission's proposal to require private equity funds, which would be considered "illiquid funds," to include the assumptions and calculations that go into their return figures. The industry currently uses an Internal Rate of Return (IRR), but given the historical unreliability of IRR<sup>10</sup>, we also strongly support the Commission's 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 that returns are being calculated accurately. Investors pay performance fees based on returns, and they consider making investments based on prior performance figures.

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

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<sup>10</sup> Albertus, James and Denes, Matthew. Carnegie Mellon Tepper School of Business. Distorting Private Equity Performance: The Rise of Fund Debt. June 2019.

returns as a result of this investment choice.<sup>11</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 on their investors 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>12</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, that 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.

### **The SEC should collect and share appropriately aggregated and anonymized information about fees and returns**

While the additional detail surrounding fees, expenses, and returns provided to private fund investors will be useful for investors in private funds, we also urge the Commission to share information in appropriately aggregated and 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**

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<sup>11</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>12</sup> Robertson, Gary. Callan. Private Equity Performance Measurement Requires Unique Calculations. Oct 22, 2019. <https://www.callan.com/blog-archive/pe-measurement/>

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>13</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>14</sup> We therefore support the Commission’s proposal to prohibit preferential terms regarding redemption to select investors.

### **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>15</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 negatively harmed as a result. The Commission should therefore ban any such 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 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

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<sup>13</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>14</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>15</sup> Morrison & Foster. Frequently Asked Questions About Regulation FD. Oct 2, 2017. <https://media2.mofo.com/documents/faqs-regulation-fd.pdf>

business. The Commission is simply proposing to mandate that this information be made available to investors.

We thank you again for the opportunity to comment.

Signed,

20/20 Vision DC

ACRE

Action Center on Race & the Economy

Alliance of Californians for Community Empowerment (ACCE)

American Economic Liberties Project

American Federation of Labor and Congress of Industrial Organizations

American Federation of State, County and Municipal Employees (AFSCME)

Bargaining for the Common Good (BCG)

CASA

Cincinnati Federation of Teachers/Office Professionals Local 1520-R

Communications Workers of America (CWA)

Consumer Action

Detroit Action

Fight Corporate Monopolies

Good Jobs First

Institute for Agriculture and Trade Policy

Institute for Policy Studies, Global Economy Project

Make the Road Nevada

Make the Road NY

National Employment Law Project

New York Communities for Change

Ohio Organizing Collaborative

RI AFT/R Local 8037r

Service Employees International Union

SOC Investment Group

UA-UNM