Americans for Financial Reform Education Fund

July 6, 2021

Chairman Gary Gensler
Securities and Exchange Commission
Washington, DC 20002

Dear Chairman Gensler,

We write on behalf of the 15 undersigned organizations and individuals to urge the Securities and Exchange Commission (the Commission) to strengthen oversight and enforcement of rules related to private funds.

Since the SEC began overseeing private funds, under authority granted by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, it has made multiple public pronouncements about the abusive practices identified by the Commission in its examinations of private funds.[1] Most recently, the SEC issued a Risk Alert last summer warning investors and the public about concerns it identified while conducting examinations of private equity and hedge funds. The problems the SEC identified include fund managers' failure to make full and fair disclosure of conflicts of interest, charging improper fees, and failure to implement policies to prevent staff from trading on material nonpublic information. In other words, the SEC's examinations have shown that many private equity and hedge fund managers are engaged in self-dealing and overcharging investors, including pension funds that provide for the retirement security of millions of Americans.

The period in which the SEC has identified these concerns coincides with a period of rapid growth in the industry - since 2008 private equity assets under management have more than doubled, from $1.6 trillion to $4.6 trillion at the end of 2020.[2] Given the size of the market and the problematic practices identified by the agency, we urge the SEC to strengthen enforcement of existing regulations, including with regard to the recommendation of private fund investments, clarify rules to ensure private funds managers owe investors fiduciary obligations, and improve transparency for investors in private funds.

Step up enforcement against private funds that violate existing rules

Following the warnings from the Commission, referenced above, of improper practices by private fund managers, the investor community expected to see major enforcement actions and

[1] Bowden, Andrew J. Securities and Exchange Commission. Spreading Sunshine in Private Equity. May 6, 2014. https://www.sec.gov/news/speech/2014--spch05062014ab.html.
[2] Fumai, Frank et al. Deloitte & Touche LLP. "The growing private equity market". Nov 5, 2020. https://www2.deloitte.com/us/en/insights/industry/financial-services/private-equity-industry-forecast.html.

pressure for private funds to change their behavior. Seven years after the SEC's first public warnings, however, the absence of significant enforcement action has left investors and pension beneficiaries concerned that their interests are not being adequately protected by the Commission.

The Commission should pursue broad and sustained examination and enforcement initiatives to address the issues noted by SEC staff--which have not abated--including with respect to:

- How adviser's collect and allocate fees and expenses;
- Backdoor fees charged by advisers to funds, which often differentially impact certain limited partners, including fees paid to affiliates of the adviser;
- Undisclosed adviser conflicts of interest;
- Undisclosed deal preferences offered to certain limited partners of a fund at the expense of others;
- Improper disclosures to prospective limited partners with respect to valuation, including:
    - Undisclosed changes in valuation methodologies to inflate returns; and
    - Add-backs to the all-important EBITDA metric; and
- Improper disclosure with respect to fund performance and management teams.

Failure to act has severe consequences for investors. Ludovic Phalippou, Professor of Financial Economics at the University of Oxford's Said Business School, called private equity's abusive fee practices "one of the largest [wealth transfers in] the history of modern finance" taking the savings of hundreds of millions of pensioners into the pockets of those working in private equity.[3]

We urge the SEC to swiftly bring enforcement cases against private fund managers who charge improper fees, fail to disclose clear conflicts to their investors, and trade on Material Nonpublic Information (MNPI) to fulfill its mission of protecting investors. These enforcement actions do not require new rules. Rather, the Commission needs merely to exercise existing legal authority under the Advisers Act and enforce current rules.

Ensure that private fund managers are required to act in the best interest of the investors

It has become increasingly common in recent years for private fund general partners to take advantage of opportunities to limit their obligations to investors and preserve their rights to take investment actions that advance their personal financial interests at the expense of investors. "Hedge clauses," permitted by the SEC in its 2007 Heitman Capital Management no-action letter, allow private fund managers to require investors to indemnify them against any obligations that might arise for the firm and its staff as a result of legal breaches unless the behavior is grossly negligent, intentional, or illegal. Private fund general partners, many of which are organized under Delaware law, are also increasingly availing themselves of the ability in Delaware to seek to have investors waive the traditional fiduciary obligations owed by the general partner.

[3] Flood, Chris. Financial Times. Private equity barons grow rich on $230bn of performance fees. Jun 14, 2020. https://www.ft.com/content/803cff77-42f7-4859-aff1-afa5c149023c.

We urge the Commission to rescind the Heitman Capital Management no-action letter and clarify that fiduciary waivers are impermissible under the Advisers Act.[4]

Review Form ADV disclosures and consider updates to ensure investors receive consistent, accurate information about returns, fees and expenses

In order to address the ongoing problems identified by the SEC related to private funds' improper disclosures of fees and expenses, the Commission should update Form ADV to establish standardized disclosures of returns (which are typically the basis for a portion of the fees that funds charge), fees and expenses. Bringing these disclosures in line with other standardized disclosures investors receive about their investments will also help investors make informed investment decisions about asset allocation and the risk-return profile of their investments in private funds.

Investors in private funds rely on the accurate disclosures of returns, fees and expenses in making investment decisions but, increasingly, experts have been raising questions about whether the information disclosed to investors provides a realistic view of investors' true economic returns and risks.

Recent research has called into question whether investors can in fact expect outsized returns from private equity when compared to similarly-timed investments in the public market.[5]

For example, the Internal Rate of Return (IRR) figures can be deceptively used to show high returns because IRRs are heavily influenced by strong early performance and therefore stay close to those levels despite poor performance in later years.[6] Several IRR figures are also patently absurd. One of the largest private equity firms has stated in marketing materials for its funds that it has generated gross IRRs of 39% since inception. Taken literally, $1 billion earning 39% over 30 years would now be $20 trillion, or the same as the GDP of the United States. This points not only to a need for clear, standardized, and understandable disclosure rules for IRR, but also underscores the need to enforce existing Commission rules prohibiting materially misleading and deceptive statements.

Harvard Business School's Josh Lerner has also shown that when private equity returns were benchmarked against very similar investments in the public markets, the average North American private equity fund from 2000 to 2017 only outperformed public market equivalent

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[4] Securities and Exchange Commission. Interpretation Regarding Standard of Conduct for Investment Advisers. July 12, 2019. https://www.sec.gov/rules/interp/2019/ia-5248.pdf.
[5] CapitalDynamics. Public benchmarking of private equity. July 2015. https://www.capdyn.com/news/white-paper-public-benchmarking-of-private-equity-quantifying-the-shortness-iss/.
[6] Phalippou, Ludovic. University of Oxford Said Business School. "An Inconvenient Fact: Private Equity Returns & The Billionaire Factory". Jul 15, 2020, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3623820.

(PME) Russell 3000 investments by 1.05x to 1.23x despite fees running many multiples higher.[7] Another study from last year suggests that public pension plans in alternative investments underperformed passive investments by 1% a year, while educational foundations underperformed by about 1.6% a year.[8]

The SEC's Form ADV should be amended to require a standardized set of return figures. The Form ADV should also clearly list the different fees and expenses that are being charged so that investors have access to standardized, reliable, and understandable disclosures of returns and fees so that they can make truly informed decisions about how to invest their money. This additional level of information will also help the Commission's Enforcement Division in pursuing cases against firms that are found to overcharge or misallocate fees and report misleading return figures.

Only armed with accurate, clear, understandable and comparable disclosure on returns and fees can pension fund managers be assured that they are satisfying their fiduciary duties.

Review practices of investment professionals who recommend investing in private funds to ensure that they act in customers' best interests and make no misleading statements.

Proper reporting of returns and fees are especially important as the private fund industry seeks to expand into the retail market. We are already concerned that even the wealthy and relatively sophisticated individuals targeted for such investments do not see through misleading performance claims that are all too common or understand the devastating impact that fees are likely to have on their returns.[9] After all, investors buy these investments based on assurances that they are likely to deliver out-sized returns, relative to investments in securities, such as mutual funds and ETFs, that trade in the public market. But the lack of transparency around private fund performance makes it difficult to assess such claims.

Evidence suggests that misleading claims about fund performance are made, not just by the funds themselves, but also by the investment professionals who earn hefty compensation selling these investments. For example, when brokers discuss the "J curve" with customers – the idea that performance of the fund is likely to take a temporary hit as a result of front-loaded fees only to soar later – do they also discuss the potential for the opposite to occur, *i.e.*, when one of deals that makes up the fund, even a relatively small deal, is sold quickly at a profit, causing an artificial and unsustainable pop in the IRR? In addition to looking more generally at whether private funds are being sold based on misleading performance claims, we encourage

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[7] Lerner, Josh. Harvard Business School. "Remarks to the SEC Asset Management Advisory Committee". Sep 16, 2020. https://www.sec.gov/files/prof-lerner-remarks-09162020.pdf.

[8] Ennis, Richard. Journal of Portfolio Management. Institutional Investor Strategy and Manager Choice: A Critique. Feb 2020. https://jpm.pm-research.com/content/early/2020/02/28/jpm.2020.1.141.abstract.

[9] These are spelled out in a series of spreadsheets and discussions available on pefeederfund.com, a website compiled by a former industry insider. See, in particular, https://www.pefeederfund.com/copy-of-willy-wonka-legal-issue; https://www.pefeederfund.com/copy-of-overview-1; https://docs.google.com/spreadsheets/d/139sKc8F_VCvRahyQHo67rzIvFaIn88X0FXMNCI_ho8E/edit#gid=70661035.

the SEC to examine whether firms are providing a balanced discussion of potential risks and rewards when recommending these clients to customers. The agency should follow up with enforcement actions where they find violations.

Even more fundamentally, Regulation Best Interest and the Investment Advisers Act fiduciary standard both require investment professionals to act in the best interests of their customers and prohibit them from placing their own interests or the interests of their firm ahead of the customer's interests. In examining for compliance with Reg. BI and the Advisers Act fiduciary standard, we urge the SEC to look closely at the recommendations brokers and advisers make with regard to private funds to ensure that they meet this standard. Given the high fees investment professionals can earn for recommending these investments, and the differential in compensation depending on which product and which share class is recommended, the conflicts are severe and the mitigation of conflicts needs to counteract those harmful incentives. Disclosure alone is not sufficient to address these conflicts.

In addition to the larger question of whether the investments are in customers' best interests, we encourage the SEC to examine whether dually registered firms, which have the option of recommending either brokerage or advisory share classes, are appropriately managing that conflict. Are they in fact choosing the option that's best for the customer rather than the option that's best for the firm? Given the dramatic difference in costs, and by extension performance, between the two types of shares, this consideration should be at the heart of their best interest assessment. Where dually registered firms could but don't make both types of share classes available, the Commission should require an explanation and consider whether a decision to make only the more costly option available would violate the first prong of the Reg. BI best interest standard – that the investment must be in the best interests of at least some investors.

Update Form PF disclosure requirements so that private fund advisers are required to provide more comprehensive information about their holdings, sources of credit and other key business practices

"Recent market disruptions have underscored the need for enhanced disclosure about the sources of credit and investment positions of private funds. The trading of Archegos Capital Management caused billions of dollars in losses for prime brokers and disruptions in share prices. This episode provides an example of how opaque private funds can exert huge negative impacts on regulated broker-dealers as well as on "fair, orderly, and efficient markets."

This episode also exploded a myth that the network of market intermediaries and actors commonly referred to as "the shadow banking system" is separate and sealed off from the regulated financial sectors. Prime brokerage services to private funds represents just one potential transmission channel for contagion between losses by private funds and regulated financial intermediaries and public markets. Moreover, in a period of low interest rates and rising speculation in securities markets, Archegos may prove to be a foreshock of more severe disruptions.

Neither investors nor regulators can adequately assess the risks posed by private funds to regulated financial intermediaries and the functioning of markets without enhanced disclosure. Only enhanced disclosure can help investors and regulators assess whether losses to private funds, either individually or in a correlated manner, would threaten regulated financial intermediaries and markets. Only disclosure could allow a clear analysis of:

- The exposure of broker-dealers and other regulated financial intermediaries to private funds;
- The potential disruptions to securities markets from private fund activities; and
- The extent to which private funds provide credit and engage in credit and liquidity transformation.

We urge the SEC both to respond swiftly to demands for expanded disclosure by private funds on Form PF and to include a review and update of private equity fund disclosures. Specifically, we urge the SEC to require private fund advisers to disclose individual positions and their sources of credit instead of the limited aggregate data currently provided.

This broader, more granular scope of collection will also lay the foundation for the Commission to share more insightful data on the activities of hedge funds and private equity firms with the Financial Stability Oversight Council (FSOC). Enhanced disclosure is needed to ensure that the risks of market disruptions and financial crises do not metastasize in the gaps in federal regulatory architecture, including gaps where private and public markets intersect and perceived gaps separating different federal regulators.

Require private funds to disclose material ESG factors

The Commission must also require private funds to use a standardized reporting protocol to disclose material Environmental, Social, and Governance (ESG) risks that may negatively affect investors. These disclosures become crucial given the interests of both institutional investors, including pension funds, and their ultimate retail investors in measuring the environmental, social, and governance impacts of their investments.

The investor community is increasingly recognizing that the lack of ESG reporting has made them vulnerable to sudden, unexpected losses. Within the last three years, two companies – PG&E and Brazos Electric Power – have filed for bankruptcy due to climate events despite having investment grade credit ratings right before the events that led to their failure.[10]

International regulatory bodies have already recognized the need for mandatory ESG disclosure requirements. The first phase of the European Commission's Sustainable Finance Disclosure Regulation (SFDR) has just become effective for fund managers, providing a framework to which their financial products can be classified as sustainable investments. Under SFDR, asset

[10] McNeely, Allison and Pitcher, Jack. Bloomberg News. Brazos Becomes Rare 'Failing Angel' After Texas Storm Bankruptcy. Mar 1, 2021. https://www.bloomberg.com/news/articles/2021-03-01/brazos-becomes-rare-failing-angel-after-texas-storm-bankruptcy.

managers will need to take into account ESG considerations in both their organizations and operations.[11]

The SEC similarly needs to adopt its own mandatory ESG reporting requirements for private funds, who provide a significant source of financing but are subject to far less extensive disclosure requirements. Greater transparency puts a spotlight on the activity of private fund managers while also helping to standardize the criteria behind ESG, especially to stamp out the practice of "greenwashing".

Ensure greater transparency in private funds using portfolio company debt to fund dividends and other capital distributions

In the wake of the federal government's massive 2020 interventions to support capital markets, investors and the broader public need greater transparency about the extent to which private funds are causing portfolio companies to increase borrowings to fund dividends and other capital distributions. This practice:

¶ Renders portfolio companies more susceptible to future shocks even after the federal government pumped trillions of dollars to support financial markets; and
¶ May selectively enrich fund managers and certain limited partners and investors at the expense of others.

Greater transparency about the uses of portfolio leverage to fund capital distributions would be valuable to a range of parties, including:

¶ limited partners of funds (and their investors) who are concerned about differential capital distributions and the risks of increased leverage and legal tunneling;
¶ investors with concerns about the ESG impacts of increased leverage combined with capital distributions;
¶ investors in public markets who may invest in highly leveraged companies via new issuances; and
¶ taxpayers and the broader public with concerns with what government interventions have supported, the susceptibility of companies and financial markets to future shocks, and the potential need for future government bailouts.

Greater disclosures around capital distributions to private fund managers and investors would:

¶ protect investors;
¶ increase visibility on the extent to which investor capital and past extraordinary government interventions supporting capital markets actually flow to the real economy;
¶ safeguard fair, orderly, and efficient markets that are resilient to economic shocks and do not require massive government support;
¶ help investors assess the ESG impacts of actions by fund managers; and
¶ promote the legitimacy of capital markets after two massive government bailouts in twelve years.

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[11] Maelva-Otto, Anna and Wright, Joshua. Schulte Roth & Zabel. New ESG Disclosure Obligations. Mar 24, 2020. https://corpgov.law.harvard.edu/2020/03/24/new-esg-disclosure-obligations/.

Broader need for transparency in private markets and private funds

The shift in capital towards private markets includes private equity funds, but also many other elements of the market, and some needed responses touch, but also go beyond, private equity. Capital flowing to opaque private markets provides investors with less disclosure and weaker price discovery and leaves them more susceptible to higher fees, conflicts of interest, and even fraud and manipulation.

Solutions to these problems, including those affecting investors in funds, should start with transaction and resale exemptions. The SEC could address some of the damage by limiting the size of companies that can rely on Regulation D and Rule 144A, which provide transaction and resale exemptions from registration under Section 5 of the Securities Act. Currently, nearly 60% of corporate debt issued now relies on Rule 144A exemptions.[12] Larger issuers can easily access registered capital markets and should not be able to avoid providing the valuable investor disclosures required under Regulations S-K and S-X. Requiring more offerings to be registered with the SEC would provide much greater transparency into the $7.4 trillion corporate debt market in the United States.[13]

These changes would complement the additional position-level data that would be available to the Commission under an expansion of the reporting requirements under Form PF and would mean that new Commission rules on climate change and ESG disclosures would have a wider impact and cover more of the capital markets.

Press for Greater Accountability in Bankruptcy for Private Equity Looting

Bankruptcy is frequently the denouement of the private equity business model. Private equity acquisitions are generally conducted through leveraged buyouts, and the acquired firms ("target firms") are often unable to support the debt they are shouldered with to finance their own acquisition. The end result is often bankruptcy, which one study found happens at ten times the rate of non-private equity owned companies.[14]

Historically, the SEC had a major statutory role in bankruptcy, and the multi-volume study produced by the SEC in the 1930s on bondholder protective committees played a key role in shaping both the Chandler Act of 1938 (the precursor to modern chapter 11) and the Trust Indenture Act of 1939. The SEC's mandatory role in bankruptcy ended in 1978, but the SEC retains a right to appear and be heard in all chapter 11 bankruptcy cases.[15] The SEC, however, rarely utilizes this right other than in cases involving a parallel SIPC proceeding.

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[12] DDJ Capital Management Blog. 144A Bonds and Why We Buy Them. Sep 24, 2020. https://insights.ddjcap.com/blog/144a-bonds-and-why-we-buy-them

[13] Federal Reserve Bank of St. Louis FRED. Nonfinancial Corporate Business Debt Securities. Jun 10, 2021. https://fred.stlouisfed.org/series/NCBDBIQ027S

[14] Ayash, Brian and Mahdi, Rastad. Leveraged Buyouts and Financial Distress. Jul 20, 2019. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3423290

[15] 11 U.S.C. § 1109(a).

The SEC should use its right to appear and be heard in the bankruptcy cases of private equity target firms to oppose “no-look” pre-packaged bankruptcies and to urge the appointment of examiners to investigate concerns about looting of target firms by their private equity owners.

Private equity owned target firms frequently seek to ram through quick pre-packaged bankruptcy cases where a reorganization plan is confirmed before an official committee of unsecured creditors can be formed.[16] As a result, creditors—including the holders of debt securities—are unable to organize and collectively push for the investigation of potential looting of the target firm, such as through alleged fraudulent transfers seen in J. Crew, Neiman Marcus, PetSmart, Caesar’s Entertainment[17], and Nine West.[18] Additionally, even when an official committee of unsecured creditors exists, there is often a reluctance on the part of repeat players to push for the appointment of an examiner to investigate potential looting.

Having the SEC appear and advocate for the process interests of securities holders in target firm bankruptcies would help ensure that bankruptcy is not used to whitewash private equity misdeeds that come at the expense of securities investors and other stakeholders.

Conclusion

The Commission plays a vital role in protecting American investors. More work needs to be done to improve transparency and accountability in the rapidly growing private fund industry. We, therefore, urge the SEC to strengthen enforcement of existing regulations, clarify rules to ensure private funds managers owe investors fiduciary obligations, and improve transparency and sales practice protections for investors in private funds.

Please contact Andrew Park at <andrew@ourfinancialsecurity.org> or Erik Gerding at <erik@ourfinancialsecurity.org> if you have any questions or would like to discuss these topics.

Sincerely,

Americans for Financial Reform Education Fund

AFL-CIO

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

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[16] Gill, Daniel. Bloomberg Law. Federal Watchdog Wants to Put Brakes on High-Speed Bankruptcies. Apr 5, 2021. https://news.bloomberglaw.com/bankruptcy-law/federal-watchdog-wants-to-put-brakes-on-high-speed-bankruptcies
[17] Indap, Sujeet and Frumes, Max. The Caesars Palace Coup: How a Billionaire Brawl Over the Famous Casino Exposed the Power and Greed of Wall Street. 2021.
[18] Batt, Rosemary, Park, Andrew, Appelbaum, Eileen. The American Prospect. How Private Equity Firms Will Profit From COVID-19. May 7, 2020.

Anti-Corruption Data Collective

Better Markets

Center for Economic and Policy Research

Communications Workers of America

Consumer Action

Consumer Federation of America

Laura Katz Olson, Professor, Lehigh University

Public Citizen

Revolving Door Project

Rosemary Batt, Professor, Cornell University

Service Employees International Union (SEIU)

SOC Investment Group