



April 11, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St. N.E.
Washington, DC 20549

Re: Private Fund Advisers (File No: S7-03-22)

Dear Secretary Countryman:

On behalf of our collective 4.6 million members, we write to express our support for the proposed new rules and amendments under the Investment Advisers Act of 1940 to enhance the regulation of private fund advisers.

Members of our unions serve as trustees for many public pension funds throughout the country, ranging in size from the largest state funds to relatively smaller municipal funds, the majority of which have some portion of their portfolio allocated to private funds. As stewards of the retirement assets of millions of public sector workers, we feel strongly that they deserve transparency and accountability from their private fund managers. We believe the private fund negotiation process¹ has not adequately provided for this, and we appreciate that the Securities and Exchange Commission has proposed rules and amendments intended to place a floor under investor protections.

We strongly support the proposed rules and amendments in their entirety, including requiring private fund managers to provide detailed reporting on a quarterly basis on Form ADV, which will provide investors with baseline information about how fees and expenses are being allocated, helping them determine whether these costs are appropriate and helping them assess the value of private fund investments. We also favor the SEC making this data publicly available, so that stakeholders can have better insight into the costs of private fund investments. And we believe that the proposed rule requiring funds to disclose “side letters”—special terms or arrangements offered to specific investors—to all investors will help ensure that no investor is unduly harmed by agreements they don’t know the substance of.

While we support the full slate of proposed rules and amendments, our comments will focus on fund performance reporting. Standardized quarterly reporting of the internal rate of return (IRR) and the multiple of capital (MoC) invested, both gross and net of fees and considering the use of subscription

¹ We agree with many of the concerns expressed by William W. Clayton, “The Private Equity Negotiation Myth,” *Yale Journal on Regulation* 37 (2020): 67, <https://digitalcommons.law.yale.edu/yjreg/vol37/iss1/2>.



credit lines, would mark a leap forward in transparency. However, we believe that our members serving as trustees would greatly benefit from the addition of a required public market equivalent (PME) metric in assessing the performance of illiquid private funds.

While the IRR and MoC are useful metrics, interpreting their relationship to each other and the relationship of each to a benchmark index may not be straightforward for fiduciaries of pension funds. Additionally, we’ve found that trustees have encountered presentations that use potentially inappropriate composite IRRs and compare IRRs to time-weighted returns (TWRs). Although these metrics often appear in marketing materials and consultant recommendations, we are including examples here to give a broader sense of the range of metrics that trustees encounter when assessing private fund performance.

IRR and MoC may not provide enough clarity

To illustrate this point, the table below has been constructed to contain anonymized data from two fully liquidated 2006 vintage buyout funds² and a theoretical equity fund that remains 100 percent invested and has a compound annual growth rate (CAGR) of 7.9 percent over a 10-year period.

Fund	Called	Net IRR	MoC
Buyout Fund #1	95.2%	7.9%	1.61x
Buyout Fund #2	94.1%	8.4%	1.38x
Fund	Invested	CAGR	MoC
Theoretical equity fund	100.0%	7.9%	2.14x

Looking at the net IRRs of the two buyout funds, the performance of Buyout Fund #2 looks stronger, but the MoCs suggest a different story. Plugging the 7.9 percent IRR and 1.61 MoC into the “time value of money” (TVM) function on a financial calculator and solving for the time period suggests a holding period of 6.2 years for Buyout Fund #1. For Buyout Fund #2, it’s 4 years.³ While Buyout Fund #2 has produced a higher IRR, Buyout Fund #1 appears to have put the capital to work for longer.

Additionally, a net IRR of 7.9 percent is different than the CAGR of 7.9 percent, which produces an MoC of 2.14x in the theoretical equity fund. To quote Howard Marks, “You can’t eat IRR.”⁴

² Preqin data on file with the NEA and the AFT.

³ On a Texas Instruments BA II Plus calculator: For Buyout Fund #1, PV = -1, FV = 1.61, I/Y = 7.9, CPT -> N; For Buyout Fund #2, PV = -1, FV = 1.38, I/Y = 8.4, CPT -> N.

⁴ Howard Marks, “You Can’t Eat IRR,” memo to Oaktree Clients, July 12, 2006,

<https://www.oaktreecapital.com/docs/default-source/memos/2006-07-12-you-cant-eat-irr.pdf>.



Composite IRR calculations—‘no investor received the returns’

In January 2022, a public pension fund was presented with an opportunity to invest in two funds that were in the process of being raised by a software- and technology-oriented private equity fund manager. What follows are anonymized excerpts from a publicly available presentation created by the fund manager for the two funds.⁵

Following the cover slide and a slide titled “Disclaimer,” we have the third slide of the presentation:

[Redacted] at a Glance

- Strong PERFORMANCE**
 - Realized Software track record: 3.6x Gross MoM and 50% Gross IRR¹
- Experienced ORGANIZATION**
 - Focused on Software investing for nearly two decades
 - Managing Partners have been together for 15+ years
 - Responsible for around 350 Software acquisitions since 2003² representing around \$125B³ of Enterprise Value
- Expanding Software MARKET**
 - About \$9.5T software public market capitalization, +846% increase since 2008⁴
 - Most mature software companies are privately owned⁵
 - Market generally lacks operational discipline, allows for [Redacted] value-add advantage
- Differentiated STRATEGY**
 - Strategy centered around accelerating growth through operational excellence
- Repeatable PROCESS**
 - Consistent execution of the strategy enabled by [Redacted] proprietary processes, business metrics and Operating Partners

[Redacted] is an organization with over \$91B under management⁶ and a long history of strong performance in a growing Software market

Past performance is not an indicator of future results and all data is qualified by the Notes to Presentation. The complete investment history of [Redacted] is available upon request. 1) Returns are the result of Realized Investments in Software made by or under the supervision of persons now part of the [Redacted] investment staff while at [Redacted] or its predecessor firm, [Redacted]. Since in some cases the investments constituted only a portion of the funds in which they were made, no fund investor could have made such an investment and no investor received the returns indicated even if an investor invested in all of the funds indicated. Moreover, fees, expenses and other costs have not been factored into the calculation presented. The performance of an investment and the aggregate performance of investments were calculated using actual cash flows and the Value of Remaining Interests in the investments for the period from closing of the first investment in January 2003 through 9/30/21. The aggregate performance calculations were made as if each investment was made by one continuous fund beginning in January 2003. 2) Includes add-on acquisitions. 3) As of 9/30/21. Although [Redacted] typical strategy is to acquire control positions in its Buyout Funds' portfolio companies, number also represents full value of acquisitions when investments were non-control minority investments. 4) Source: S&P Capital IQ. Current market capitalizations are based on the end of the trading day on 12/31/2020; 2008 is as of 12/31/08. See note qq in Notes to Presentation. 5) Source: S&P Capital IQ. See note qq in Notes to Presentation. 6) [Redacted] have \$67.5B, \$12.6B, \$1.3B, \$1.0B, \$5.1B and \$3.9B AUM respectively as of 9/30/21.

3 Sensitive and Not a Public Offering

As seen in the image above, the fund manager touts: “Realized Software track record: 3.6x Gross MoM and 50% Gross IRR.” The net IRR and net MoM are not provided. Additionally, a benchmark return is not provided for context.

⁵ Presentation on file with the NEA and the AFT.



A trustee or investment board member reviewing the slide may reasonably wonder if investors in the prior funds received these returns. Footnote 1 at the bottom of the slide, the text of which has been reproduced below, indicates that the answer is no:

*1) Returns are the result of Realized Investments in Software made by or under the supervision of persons now part of the [REDACTED] staff while at Thoma Bravo or its predecessor firm, [REDACTED]. Since in some cases the investments constituted only a portion of the funds in which they were made, **no fund investor could have made such an investment and no investor received the returns indicated even if an investor invested in all of the funds indicated.** Moreover, fees, expenses and other costs have not been factored into the calculation presented. The performance of an investment and the aggregate performance of investments were calculated using actual cash flows and the Value of Remaining Interests in the investments for the period from closing of the first investment in January 2003 through 9/30/21. The aggregate performance calculations were made as if each investment was made by one continuous fund beginning in January 2003.*

Comparing IRRs to TWRs

The image below contains anonymized text from the publicly available consultant recommendation⁶ for the two software- and technology-oriented private equity funds described above. We have excerpted the two paragraphs related to performance:

Performance: Since 2000, [REDACTED] have generated a net annualized IRR of 29.0% through June 2021 compared to 19.9% for the S&P IT Sector. Nine of eleven of the [REDACTED] mature flagship funds (funds active more than three-years as of June 30, 2021) rank in the first decile or first quartile on a net IRR, net TVPI, and net DPI basis compared to Cambridge Associates benchmarks for buyout funds formed in the same vintage year.

As of September 30, 2021, the [REDACTED] strategy outperformed the Russell 2000 index and S&P 500 IT index by a wide margin. Since inception, the [REDACTED] platform has produced a net IRR of 44.6%, outperforming the Russell 2000 index by 15.7%. The [REDACTED] platform's mature funds ([REDACTED] and [REDACTED]) rank in the first decile on a net IRR and net TVPI basis as of September 30, 2021 compared to Cambridge Associates benchmarks for buyout funds formed in the same vintage year. [REDACTED] is too early in development to benchmark effectively.

The text contains two examples where IRR calculations appear to be directly compared with time-weighted index returns. A trustee reading the recommendation may reasonably wonder if the two metrics are comparable.

⁶ Consultant recommendation on file with the NEA and the AFT.



We noted earlier that the same IRR and TWR can produce very different MoCs when compared over the same time horizon. Because a private equity fund is expected to expand and contract over its life, the MoC is lower than a theoretical equity fund that remains 100 percent invested. The IRR will better reflect the fund manager’s control over the size and timing of cash flows, but the reinvestment assumption embedded in the calculation may be unrealistic. Additionally, an IRR can be boosted by the use of a subscription credit line.⁷ As a result, direct comparisons of IRRs and TWRs may be misleading.

Since-inception IRRs

Sticking with the consultant recommendation discussed above, we note that the second paragraph contains a since-inception IRR statistic for the “platform.” Without making any judgement on the use of the metric here, we’d like to express a general concern that since-inception IRR calculations could obscure more recent performance over long time horizons. In a paper published in 2011, professor Ludovic Phalippou demonstrated how the since-inception IRR calculation for a theoretical investor could do just that.⁸ The culprit? The reinvestment assumption embedded in the IRR calculation.

Why PME’s are important

We believe that the examples provided demonstrate how a trustee may struggle with interpreting IRR and MoC disclosures. PME’s aim to compare private fund returns with the returns that would result from investing the same cash flows in a public market benchmark.

When used correctly, a PME can serve as a single metric to cut through the confusion that may ensue when attempting to interpret IRR and MoC disclosures. The PME calculation method and the use of an appropriate public market benchmark are crucial. Additionally, the calculation should be net of all fees and expenses and consider the use of a subscription credit line.

Since the mid-1990s, several methods have emerged for calculating PME’s. In a brief published in 2014, Landmark Partners argues that three of the methods—index comparison method (ICM), PME+ and

⁷ In 2018, Cambridge Associates estimated that subscription credit line use of six months or longer could boost IRRs by an average of 200 basis points on the front end and 100 or more basis points on the back end. Andrea Auerbach, “Should You Avoid Commitment (Facilities)?” Cambridge Associates, June 21, 2018, <https://www.cambridgeassociates.com/insight/ca-answers-should-you-avoid-commitment-facilities/>.

⁸ Ludovic Phalippou, “Is Yale a Model?” SSRN, September 2011, <https://ssrn.com/abstract=1950257>.



modified PME (mPME)—suffer from significant weaknesses including their reliance on IRR spreads.⁹ We agree with the concerns expressed about these methods and recommend the use of the Kaplan-Schoar (KS-PME) method or the Direct Alpha method created by the authors of the Landmark Partners March 2014 brief.

As noted in the Landmark Partners brief, the KS-PME creates a market-adjusted equivalent to the total value to paid-in (TVPI) ratio. A KS-PME above 1.0 indicates outperformance against the public market benchmark. The Direct Alpha method, on the other hand, creates an annualized return metric that can be directly compared with the IRR of the private fund. We believe that trustees would benefit greatly from the insights provided by these metrics.

With private funds representing a significant and growing proportion of public pension fund assets, increased regulation of private funds is now more critical than ever. The proposed new rules and amendments under the Investment Advisers Act of 1940 will provide institutional investors with increased visibility into the true costs of private fund investment and prohibit certain activities on the part of private funds that are misaligned with the interest of the public and investors. The proposed rulemaking will protect public employee retirement savings from some of the harmful aspects of private fund investing, and we support its implementation.

Sincerely,

Rebecca S. Pringle
President
National Education Association

Randi Weingarten
President
American Federation of Teachers

⁹ Landmark Partners, “An ABC of PME,” private equity brief, March 2014, <https://www.secondariesinvestor.com/wp-content/uploads/sites/3/2014/03/An-ABC-of-PME-Landmark-Partners.pdf>.