April 25, 2022

Ms. Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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

Dear Ms. Countryman:

The American Association for Justice (AAJ), formerly known as the Association of Trial Lawyers of America, submits comments regarding the Securities and Exchange Commission's ("SEC" or "Commission") above-referenced proposal ("Proposal"), which would reduce conflicts of interest and promote transparency, efficiency, and accountability, in the market for private funds.

AAJ works to preserve the constitutional right to trial by jury and to make sure people have a fair chance to receive justice through the legal system when they are injured by the negligence or misconduct of others. AAJ advocates for investors and consumers who have been defrauded in capital markers or are the victims of other forms of corporate misconduct. AAJ strongly supports the core elements of the Proposal, and we urge the Commission to adopt it without undue delay.

1. **The Role of Private Funds Has Changed Significantly in Recent Years, and the Size of the Marketplace and Its Reliance on Retail Investor Capital Has Risen Sharply.**

Though investors in hedge funds and private equity funds are often thought of as ultra-high-net-worth individuals who do not need the protection of the SEC, the proliferation of hedge funds and private equity funds means that large numbers of middle-class Americans are impacted by the fees charged and performances of these funds. In recent years, institutional investors, including but not limited to public pension funds and endowments, have significantly increased their allocations to private funds, such as venture capital funds and private equity funds. In fact, over the past decade, the size of the private funds market has grown from an estimated $8 trillion in total assets under management (AUM) to over $18 trillion.[1] For example, CALPERS has announced it will allocate 13 percent of its assets to private equity, totaling $25 billion.[2] Though the fund itself is massive, its beneficiaries are municipal employees, the vast majority being middle class.

As the Commission is aware, major differences exist between the level of investor protections and market safeguards according to investment in public funds versus private funds.[3] While the federal securities laws require public disclosures by registered investment companies, like mutual funds, to

[1] See Release at 8, citing Form ADV data current as of November 30, 2021.
[2] See CalPERS Board Selects New Asset Allocation for Investment Portfolio, Keeps Discount Rate at 6.8%, CalPERS, Nov. 15, 2021, available at https://www.calpers.ca.gov/page/newsroom/calpers-news/2021/calpers-board-new-asset-allocation-keeps-discount-rate-at-six-point-eight-percent.
[3] See Observations from Examinations of Private Fund Advisers, Division on Examinations, SEC, Jan. 27, 2022, available at https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf ("2022 Risk Alert").

make a host of disclosures related to governance, financials, performance, and follow other rules, that is not the case for private funds.[4] Thus, private funds are not subject to most of the disclosure requirements and SEC oversight that exists for registered funds of a similar size and import.

To the extent that private fund advisors make disclosures, moreover, they typically do not do so using traditional metrics to report information about returns, fees, or other factors.[5] As the CFA Institute observed, the type of information disclosed by private fund advisors "work[s] well (at least from a statistical perspective) only for those instruments that are publicly traded and are highly liquid."[6] The absence of comparable information about private fund investments also increases the likelihood advisers will over-value private fund investments, potentially to the detriment investors.

2. **Deficiencies in the Present Regulatory Framework Applicable to Private Funds and Private Fund Advisors are Well Documented and Well Understood.**

For the better part of a decade, SEC examinations of private fund advisors have consistently revealed deeply problematic conduct and business practices. This behavior extends across a host of areas, large and small, including failing to disclose and mitigate conflicts of interests, self-serving or unlawful billing practices, sloppy or nonexistent recordkeeping, and much more.

Indeed, as far back as 2014, the Director of what is now the SEC's Division of Examinations asserted that his office "examined how fees and expenses are handled by advisers to private equity funds, [and] identified what we believe are violations of law or material weaknesses in controls over 50% of the time."[7] More recently, in January of 2022, the Division on Examinations released a Risk Alert that identified an alarming number of significant failures and abuses by advisers to private funds, including fund advisers. The alert identified a host of "deficiencies" with respect to private fund advisor conduct, including with respect to "(A) failure to act consistently with disclosures; (B) use of misleading disclosures regarding performance and marketing; (C) due diligence failures relating to investments or service providers; and (D) use of potentially misleading 'hedge clauses.'"[8]

3. **Deficiencies in the Present Regulatory Framework Perpetuate Greater Costs, Inequity, and Anti-Investor Practices.**

The lack of transparency and accountability that characterizes the SEC's present approach to regulation of private funds serves to perpetuate an array of negative policy outcomes.

For example, this status quo regulatory framework is the reason that investments in private funds are difficult to compare with other investments that are otherwise very similar, and why such investments

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[4] Specifically, the Investment Advisers Act of 1940 and relevant SEC rules do not require advisers to private funds to provide periodic statements detailing fees and expenses to private fund clients or to fund investors, nor do they require advisers to provide investors with periodic statements detailing private fund performance.

[5] Written Testimony of Heather Slavkin Corzo, Senior Fellow, Americans for Financial Reform. Senate Committee on Banking, Housing and Urban Affairs. Hearing on Legislative Proposals on Capital Formation and Corporate Governance. February 28, 2019. P.8. Accessible at https://www.banking.senate.gov/imo/media/doc/Corzo%20Testimony%202-28-19.pdf.

[6] Prasad Ramani, Evaluating Private Equity Performance: PME vs. Direct Alpha, Enterprising Investor, CFA Institute, July 23, 2014. Accessible at http://blogs.cfainstitute.org/investor/2014/07/23/evaluating-private-equity-performance-pme-vs-direct-alpha.

[7] At that time, the SEC's Division of Examination was known as the "Office of Compliance, Inspections, and Examinations," or "OCIE." (See Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Spreading Sunshine in Private Equity. May 6, 2014. https://www.sec.gov/news/speech/2014--spch05062014ab html.)

[8] According to the SEC, the recent examination resulted in "a range of actions, including deficiency letters and, where appropriate, referrals to the Division of Enforcement."

are frequently characterized by high fees that take away from their investors' returns.[9] Furthermore, large investors in private funds routinely use their size and leverage to negotiate benefits that are not shared with other investors in the fund.[10] That, in turn, often leads to weaker protections for investors who do not have similar bargaining power.

Relatedly, because there are presently no federal regulatory requirements for investment advisers offering private funds to provide their investors with periodic statements (which are often monthly or quarterly), such statements may be provided to some investors but not others. In the same vein, information provided in statements made available by private fund advisers to some investors may be excluded from statements made available to the advisor's other investors.

In summary, the SEC's current regulatory framework for investment in private funds is largely optimized to benefit very wealthy, seasoned, and well-connected investors. The SEC's rules interact in a way that usually accords these investors the best prices, the best information, and the best terms. However, as the pool of investors with significant exposure to private funds increases, policymakers should take steps to optimize the rules governing these funds to reflect their present role.

4. **The Proposal Would Increase Transparency and Accountability in the Market for Private Funds.**

Fundamentally, the Proposal aims to ensure that all investors in private funds are afforded basic rights to equitable treatment, transparency, and information about their investments.

Specifically, the Proposal would prohibit the provision of preferential terms to any private fund investor unless the adviser provides written disclosures about those terms to all other prospective and current investors. It would also require that private fund advisors provide all investors with a quarterly statement that includes certain information pertaining to fees, expenses, and performance.[11] The standardization of performance reporting for private equity funds will be very useful to investors such as pension plans, both in managing their existing investments and making new ones. Private equity performance reporting is often confusing, using concepts that may be difficult for trustees to understand, and in some cases outright misleads them. This can make it very difficult to evaluate making new funding commitments, because an institutional investor is being asked to commit more money to a particular firm without having a concrete understanding of how its existing investments are performing. Standardized reporting at fixed intervals will help retirement plans do a better job of understanding their investments, monitoring performance, and making future investments.

The Proposal would also prohibit advisers to a private fund from charging certain fees and expenses to a private fund or portfolio investment, or from shifting fees from one group of investors to another other group of investors. Similarly, it would prohibit private fund advisers from providing preferential liquidity terms or information regarding the portfolio holdings or exposures. The fee disclosures are of critical importance. Private equity funds generally have layers of fees: an annual management fee, "carried interest" (which involves payments where profitability exceeds certain targets), and then

[9] For example, the popular fee structure known as "2 and 20," means that the fund manager gets 2% annually of the total amount of assets under manager plus 20% of the return on any investment.
[10] This common practice is often referred to as a "side letter."
[11] Such statements stand to enable investors to better evaluate the direct and indirect fees and expenses they are paying, and the overall performance of their investments. Such reforms also stand to increase transparency with respect to the ways in which private fund performance is calculated.

transactional fees related to portfolio companies. Funds will often tout their funds having their interests aligned with investors based on the first two categories. But this may not be the case: after a private equity fund buys a company, it usually puts its own people in executive positions and on the board. They then accumulate fees through these tasks, along with consulting fees for advising the companies. These fees are not aligned with investors' interests at all: in fact, they come directly from the profits investors would otherwise make. By knowing how much these fees are and how exactly they are being generated, investors are in a far better position to put pressure on firms to reduce these fees, and the marketplace in general can avoid firms that tend to collect excessive transaction fees. The fee disclosure requirement, which not only requires disclosure of the amount of fees but also details surrounding the source of such fees, will help investors make more informed decisions, will allow institutional investors to put pressure on firms to reduce certain types of fees, which itself will likely lead to lower fees, effectively benefitting all participating investors.

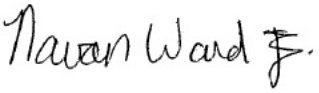
Finally, the Proposal would prohibit private fund advisers from engaging in certain sales practices, conflicts of interest, and compensation schemes that are "contrary to the public interest and the protection of investors." Such practices include, for example, all manner of violations of fiduciary duty, as well as potentially books and records or other compliance requirements. The prohibited activities are in everybody's best interest. Private equity funds should not be bribing foreign governments. Private equity funds should not be loaning money to the firm's employees for personal reasons. And advisers should not be permitted to claw back profits from investors to cover its own tax liability arising from fees that have been paid to the adviser. Prohibition on these practices will help better protect the interests of investors and prevent the shroud of secrecy surrounding private equity fund investments to become a means of engaging in otherwise illegal activity.

5. Conclusion

The Proposal stands to impact not only the ultra-wealthy, but also the security of tens of millions of middle-class Americans who are trying to retire. As previously mentioned, not every person making decisions about investing in hedge funds and private equity funds is sophisticated enough to forego protection from the SEC. Even those who have high levels of sophistication cannot make educated use of that sophistication without transparency into how these private funds are being invested and operated.

For the reasons discussed above, AAJ asserts that the Proposal would improve the marketplace for private funds by increasing transparency and accountability and reducing fees, harmful conflicts of interests, and other anti-investor practices. As such, we urge the Commission to finalize and adopt the proposal without undue delay. If you have any questions or comments, please contact Bonnie Johnston, Senior Federal Relations Counsel at [redacted]

Sincerely,



Navan Ward Jr.
President
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