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 appreciate 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 they are invested in or are considering investing in. We support these proposals as these disclosures provide a significant step towards investors having the insight they need into private funds.

As an advocate for union-sponsored pension funds, we are particularly concerned that, absent the adoption of the proposed measures, the funds we work with will continue to be at a profound disadvantage when investing in the private markets. Unlike public market investments, these pension funds do not enjoy certain access to accurate, reliable, and consistent information concerning key elements of the private investment fund process, including:

- 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

Lacking accurate, timely, and consistent information on either the private funds in which the funds we work with invest or funds they may consider investing in, it is extremely challenging to determine appropriate asset allocations (e.g. are private fund returns superior to public market returns on a risk-adjusted basis?), project future funding needs, or meet important public policy goals such as diversifying investment managers and minimizing fees.

By requiring increased disclosure of fees, returns, and special arrangements with some investors, as well as standardized formats for these disclosures and detains explaining how the disclosed metrics are calculated, the Commission's prosed rule will go a long way toward addressing this information gap and the resulting bargaining disadvantage at which we typically find ourselves.

In the balance of this letter, we will focus on the two matters we believe to be most critical to addressing our bargaining disadvantage: comprehensive and consistent fee disclosure and reliable reporting of investment returns. While we strongly support the proposed rule changes, we believe that the Commission could go even further in prohibiting practices that directly undermine important public policy goals including reducing economic inequality, encouraging greater competition, and ensuring equal economic opportunities.

The SOC Investment Group works with pension funds sponsored by unions affiliated with the Strategic Organizing Center, a coalition of four unions representing more than four million members, to enhance long term shareholder value through active ownership. These funds have over $250 billion in assets under management.

Current Fee Disclosure Rules Unnecessarily Disadvantage Investors

We strongly support the Commission's proposal requiring private fund managers to provide detailed reporting on a quarterly basis on Form ADV, breaking down all the compensation, fees, and expenses paid to the adviser. Currently, fund advisors do not consistently provide such information, and even when some fee details are disclosed to investors, some advisors seek to prohibit investors from publicly disclosing the fees they pay. Clearly, such a requirement thwarts important public policy commitments to transparency and accountability. But absent regulation, it is very difficult for investors – especially smaller pension funds – to successfully bargain for access to, and the ability to publicly report, the fees they are being charged.[1]

The dim prospects the funds we work with face in attempting to bargain for better fee disclosure stems ultimately from the uneven competitive landscape of the private fund investment market, which, as we will argue below, ultimately stems from the continued use of the Internal Rate of Return (IRR) as a performance measure. Because the IRR metric assumes that capital returned to investors is reinvested at the same rate of return for rest of the private fund's lifetime, the measure over weights the oldest returns, creating the false impression that long-established private equity managers have actually outperformed new managers in recent years. If the funds we work with had greater clarity on actual private equity manager performance, we believe they would be better able to drive a bargain with private equity managers that would lead to better fee disclosure as well as reduced fees. with the imprimatur of superior performance.

At the same time, the lack of comprehensive, accurate, and standardized fee reporting complicates the task of performance monitoring and manager selection. While consultants and proprietary data providers assert that the information they present on private fund performance (whether of an individual fund or of private equity or hedge funds in the aggregate) is calculated after deducting fee payments, investors currently have no way of ensuring that this is the case, or that all private fund advisors are calculating and disclosing fees in the same manner. Such discrepancies in fee reporting make it difficult for investors to perform their role in monitoring performance, selecting managers, and allocating assets in a fiduciarily appropriate manner. Put simply, improved fee disclosure and improved performance disclosure complement one and other.

We view the Commission's proposal to prohibit private fund advisors from charging certain fees and expenses to investors – including accelerated monitoring fees, costs related to regulatory investigations, compliance expenses, and costs related to obtaining external financing - to be part and parcel of its laudable effort to address the bargaining disadvantage we currently find ourselves in, and to ensure that advisors not take advantage of smaller investors.

Private Fund Reporting Practices Disadvantage Investors and Undermine Competition and Diversity

We strongly support the Commissions propose to require private equity funds who would be considered "illiquid funds" to include the assumptions and calculations that go into their return figure, which the industry currently shows using an IRR. Given the unreliability of IRR, 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, or how an equivalent investment in public markets would have performed. Moreover, because the IRR methodology weighs early returns so heavily, it creates a significant barrier to entry for new fund advisors, a disproportionate share of whom are women- or minority-led firms. In addition, the standard-setting bodies that maintain the Global Investment Performance Standards (GIPS) have for some time required private fund managers to publish a "since inception" IRR, making regulatory change the most plausible way to change reporting practices. Consequently, we urge the Commission to consider barring private fund advisors from reporting IRRs, or at least placing stricter limits on their use (such as barring "since inception" IRR reporting).

Before further detailing our objections to the use of IRR as a reporting measure, we want to note that while the performance measurement issues at hand are more severe for "illiquid" investments such as private equity funds than for more "liquid" investments such as hedge funds, there are enough similarities in reporting practices to make the application of the new reporting standards to liquid funds appropriate. First, while hedge funds do not require investors to commit capital for 10 years, they do often have provisions and incentives designed to limit withdrawals that make such investments considerable less liquid that publicly traded securities. Second, despite the availability of other performance measures, in our experience hedge funds typically report IRRs, and certainly also report "since inception" IRRs. We therefore believe that the same rules and limitations that govern performance reporting for illiquid funds should also apply to liquid funds.

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[1] 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; 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

The IRR is the most frequently available data point disclosed by private equity funds (and hedge funds), and in our experience consultants, trustees, and members of the public rely often on IRRs to assess fund performance even when alternative measures are available, in part because the IRR superficially resembles the percentage point returns typically reported for public market investments. But in fact, the IRR methodology is substantially different from the seemingly similar public market metrics, and can materially distort performance reporting. For instance, because IRR relies on a form of net present value calculation,[2] the selection of beginning and end points for the performance period can have an outsize effect on the return calculation, as early returns are weighted more heavily than later ones.[3] As a result, many long-standing private equity managers report very high "since inception" IRRs that appear not to change from year to year despite significant market events. Because these "since inception" IRRs are often well over 20%, they imply geometrically increasing fund sizes, to an extent that is clearly inconsistent with the observable assets under management of the industry.[4] Moreover, newly emerging private fund managers have enormous difficulty competing for limited partner investments, not necessarily because their recent performance is inferior, but because their relatively short life span effectively discounts their relative performance when measured by IRR "since inception." In so far as newly emerging managers are more likely than long-standing incumbents to be women- or minority-led, the widespread reliance on IRRs also inhibits greater manager diversity.

While the Commission's proposal to require private fund advisors to both include at least one alternative measure of fund performance (such as the investment return multiple), as well as the details of how returns are calculated, will improve the situation, we are concerned that habit and convenience will result in many investors continuing to rely on IRR as long as it is available, despite its well documented flaws. Therefore, we urge the Commission to consider prohibiting private fund advisors from reporting IRRs to investors or including IRRs in their marketing materials.

Annual audits of every private fund should be mandatory

Before concluding, we want to express support for the Commission's 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). However, we believe that, given the longstanding evidence of significant conflicts of interest and performance failures in the audit industry, additional guardrails should be put in place to ensure that the audit requirement results in improved informational quality for investors, and not the capture of auditors by the entities they are supposed to be overseeing. As the PCAOB's own reports have indicated, when it reviews company audits it finds deficiencies with great frequency.[5] Moreover, in so far as audit firms provide a range of consulting services beyond the regulated audit (including tax planning, due diligence assistance, and corporate governance advising), the potential earnings from such services may induce auditors to defer to corporate management to the detriment of audit quality.[6] Finally, many public companies retain the same audit firm for decades, potentially undermining the independence and rigor of the audit.[7]

While this comment letter is not the appropriate place to advocate for a thorough reform of the audit industry, given that the Commission is initiating mandatory audits for private funds, it should adopt rules for such private fund audits that address the recognized problems in the industry. For instance, we believe that the private fund auditor (and its effective corporate parent, if relevant) should be prohibited from providing non-audit services to funds for which it is providing the mandatory audit. Additionally, we believe that in order to ensure independence and

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[2] Technically, the IRR is defined as the discount rate at which the net present value of cash flows to and from a fund equal zero.

[3] Phalippou, Ludovic. Oxford Said Business School. The Hazards of Using IRR to Measure Performance. Sep 29, 2009. https://ssrn.com/abstract=1111796

[4] For instance, one of the Yale University Endowment's private equity managers, Apollo Global Investments, has reported "since inception" IRRs of about 39% every year since 2006. If IRR reliably tracked investor returns, a $100 million investment in 2006 (a common level of commitment for large pension funds at that time) would have grown to $2.3 trillion today, or fully 20% of the entire private fund industry. Clearly, no limited partner of Apollo has actually enjoyed such a return. 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

[5] https://www.complianceweek.com/accounting-and-auditing/pcaob-2019-inspection-reports-deloitte-still-tops-pwc-deficiency-rate-rises-again/30024.article#:~:text=Significant%20audit%20deficiencies%20(Part%20I.A,internal%20control%20over%20financial%20reporting

[6] https://www.cpajournal.com/2020/12/01/now-is-the-time-to-operationally-split-audit-and-nonaudit-services/

[7] https://www.financierworldwide.com/auditor-independence-mandatory-auditor-rotation-and-the-increased-burden-for-audit-committees#.Yk8Q6fnMKMo

discourage capture, funds should be required to “rotate” their audit firm every 10 years. We also believe that, when a fund has reached the 10 year anniversary of its last auditor rotation, the next auditor for that fund should be selected by a random draw (conducted by the SEC), in order to ensure that neither prior business dealings nor promises of future work affect the audit engagement.

The Time for Action on Private Fund Disclosure Has Come

We applaud the Commission’s timely and important effort to address the informational asymmetries, and resulting bargaining disadvantages, characteristic of private markets investing. By adopting the proposed disclosure and reporting requirements, the Commission will address both its duty to protect investors as well as its role in encouraging capital formation and enhancing financial market competition. We thank the Commission for this opportunity to comment on its proposed changes to private markets regulation. For more information, please contact our Research Director Richard Clayton at [redacted].

Sincerely,

Dieter Waizenegger
Executive Director