Consumer Federation of America

April 25, 2022

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number S7-03-22
Private Fund Advisers; Documentation of Registered Investment Advisers Compliance Reviews

Dear Secretary Countryman,

On behalf of Consumer Federation of America (CFA),[1] we write to express our strong support for the above captioned Private Fund Advisers proposal,[2] which would promote transparency and accountability and reduce harmful conflicts of interest in the private funds market. Among other things, the proposal would require private fund advisers to provide private fund investors with quarterly statements that include information regarding fees, expenses, and performance for any private fund that they advise, obtain an annual audit of the financial statements of the private funds they manage, obtain a fairness opinion from an independent opinion provider in connection with adviser-led secondary transactions, and 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.

In particular, we commend the Commission for its boldness in seeking to root out harmful advisory conflicts of interest that are contrary to the public interest and the protection of investors. We encourage the Commission to use its Dodd-Frank Section 913(g) authority more broadly, especially with regard to sales practices, conflicts of interest, and compensation schemes that harm retail investors.

We urge the Commission to finalize this proposal without undue delay.

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[1] The Consumer Federation of America is a non-profit association more than 250 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.
[2] Proposed Rule, Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews, Release Nos. IA-5955, February 9, 2022, https://bit.ly/3vdlG1B ["Proposing Release"].

I. Private Funds and the Activities of Private Fund Advisers Increasingly Have the Potential to Affect the Investing Outcomes of Retail Investors.

The private funds market has grown dramatically in the last decade, from approximately 4,000 investment advisers' managing nearly 31,000 private funds with total assets of $8 trillion,[3] to over 5,000 investment advisers' managing more than 44,000 private funds with total assets over $18 trillion.[4] With this growth in supply, private funds are no longer being restricted to the wealthiest and most sophisticated investors on Wall Street. Rather, private funds and their advisers are increasingly seeking to tap all available markets, including by gaining access to retail investors' portfolios and by occupying larger allocations of the portfolios of institutional investors, such as public and private pension plans, college and university endowments, and non-profit organizations.[5] As a result, private funds and the activities of the advisers who manage them have the potential to affect the investing outcomes of a wide variety of investors, including retail investors saving for retirement or their children's college education, to a much greater degree than ever before.[6]

Private equity funds in particular are increasingly targeting sales to retail investors. According to a June 2021 *Pitchbook* article, "Over the past few years, private equity firms have pursued the retail market aggressively."[7] Large private equity firms have made no secret of the fact that the retail market is where the money is. For example, in a recent interview with *Pensions & Investments*, Apollo's Chief Client and Product Development Officer Stephanie Drescher stated that historically, Apollo was primarily focused on institutional investors and high net worth investors. The retail investor channel was "not a key piece of our strategy," Drescher said, "but it certainly is now."[8] Similarly, on Blackstone's fourth quarter and full year 2021 investor call, President and Chief Operating Officer John Gray said individual investors are a largely untapped $80 trillion market, and they will bring Blackstone closer to the company's goal of managing $1 trillion.[9] And *Bloomberg* recently reported that Blackstone is considering launching a private fund for millionaires, capturing the money of dentists, surgeons and other

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[3] *See* Carlo V. di Florio, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, Address at the Private Equity International Private Fund Compliance Forum, May 2, 2012, https://bit.ly/3LgX4KK.

[4] *See* Proposing Release at 8, citing Form ADV data current as of November 30, 2021.

[5] *See* Special Report, *Investors rely more and more on higher returns from private market*, ECONOMIST, February 23, 2022, https://econ.st/3rLxcis ("[I]nstitutional investors of all stripes have been gradually raising their allocations to private markets, typically to percentages in the high teens or low 20s. Many plan to go higher: in a survey last year by Preqin, a research firm, around 90% said they expected to commit the same or more to PE funds over the next 12 months.").

[6] *See, e.g.*, Andrew J. Bowden, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, "Spreading Sunshine in Private Equity," May 6, 2014, http://bit.ly/2nzzAL5 ("To the extent private equity advisers are engaged in improper conduct, it adversely affects the retirement savings of teachers, firemen, police officers, and other workers across the U.S.").

[7] Adam Lewis, *Opaque private equity is marketing to retail investors despite pushback*, PITCHBOOK, June 2, 2021, https://bit.ly/3OCvKbQ. *See also*, Steve Brennan, *Buyouts: Hamilton Lane takes aim at retail investors*, HAMILTON LANE, December 6, 2021, https://bit.ly/3rQc36Q ("What used to be elusive to the Main Street investor is now becoming commonplace, as more and more private equity firms are making plays to attract retail investors.").

[8] Arleen Jacobius, *Firms eye the prize: wooing and winning retail investors*, PENSIONS & INVESTMENTS, December 27, 2021, https://bit.ly/3Lgr9KA.

[9] Blackstone Fourth Quarter and Full Year 2021 Investor Call January 27, 2022, https://bit.ly/3Ldk6Cn.

suburban millionaires.[10] Not to be left out of this campaign for retail assets, Scott Nuttall, co-president of KKR & Co., said in a recent investor presentation that in the past several quarters, "about 10% to 20% of the money that we've been raising has been coming from individual investors."[11] Private equity funds have also sought to be included in individual investors' retirement plans, including their 401(k)s.[12] However, serious questions have been raised about whether offering such funds in 401(k)s is consistent with plan fiduciaries' legal obligations.[13]

II. Complexity and Opacity in the Private Funds Market Hinder Investors' Ability to Make Informed Investment Decisions.

The private funds market is complex and private fund adviser reporting practices are often opaque. This can make it difficult for investors to understand the total costs they are paying, the true value and risks of their investments, and how their investments have performed, among other things.[14] The Commission itself has acknowledged that, "private pools have become increasingly complex and involve risks not generally associated with many other issuers of securities. Not only do private pools often use complicated investment strategies, but there is minimal information available about them in the public domain. Accordingly, investors may not have access to the kind of information provided through our system of securities registration and therefore may find it difficult to appreciate the unique risks of these pools, including those with respect to undisclosed conflicts of interest, complex fee structures and the higher risk that may accompany such pools' anticipated returns."[15] As a result, the Commission staff has stated with regard the hedge funds, "We remain concerned that less sophisticated investors, even those meeting the accredited investor standard, may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision."[16] Private equity funds can pose the same problems.

Complexity and opacity in the private funds market also make it difficult for private fund investors to compare their current investments to available alternatives. Without this critical information, investors are unable to make fully informed investment decisions about how to allocate their capital. When investors are unable to make fully informed investment decisions, it

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[10] Dawn Lim, *Blackstone Plans Fund for People With Millions Not Billions*, BLOOMBERG, March 19, 2022 https://bloom.bg/3rPVQ1w.

[11] Benjamin Robertson and Melissa Karsh, *Private Equity Funds Want to Enlist the Millionaires Next Door*, BLOOMBERG, May 14, 2021, https://bloom.bg/3LfKeMW.

[12] *See* Information Letter 06-03-2020, from Louis J. Campagna, Department of Labor, to Jon W. Breyfogle, Groom Law Group, June 3, 2020, https://bit.ly/3LfKgo2.

[13] *See* Letter from organizations that advocate on behalf of consumers, workers, investors, and retirees, to Secretary Scalia, Department of Labor, June 24, 2020, https://bit.ly/3vbPQCc; U.S. Department of Labor Supplement Statement on Private Equity in Defined Contribution Plan Designated Investment Alternatives, December 21, 2021, https://bit.ly/3xQVvzi.

[14] *See* Jessica Hamlin, *Private Equity is Notoriously Opaque. Researchers and Investors Say This is No Longer OK*, INSTITUTIONAL INVESTOR, October 1, 2021, https://bit.ly/3xPCs8A; *See also* Ashby Monk, Sheridan Porter, Rajiv Sharma, *An Economic Case for Transparency in Private Equity: Data Science, Interest Alignment and Organic Finance*, September 27, 2021, https://bit.ly/3vJoYZu.

[15] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, SEC Rel. Nos. 33-8766 and IA-2576, December 27, 2006, http://bit.ly/2lOtYfc.

[16] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (September 2003), at 81, http://bit.ly/2niaIHA.

makes it more likely that they will allocate to investments that are not in their best interests and are not efficient from a capital formation perspective.

A. Fees and expenses

For years, investors large and small have been unable to get the kind of high-quality information they need, and in a format they can use, to make informed decisions in the private funds market. One reason for this is that private fund fee and expense reporting often lacks uniformity and clarity, and in some cases, is missing relevant information. In a landmark speech in May 2014, Former Director of the Office of Compliance, Inspections, and Examinations (OCIE) (currently named the Division of Examinations) Andrew Bowden discussed his observations from the more than 150 exams of private equity advisers that had been conducted to date.[17] He stated:

> By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses. When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time. This is a remarkable statistic...The flipside of expense-shifting is charging hidden fees that are not adequately disclosed to investors.

Unfortunately, the Commission's examinations do not appear to have adequately addressed this problem. A 2015 New York Times investigation of private fund reporting showed inconsistencies between the amount of fees reported to private fund investors and those reported in portfolio company disclosures, suggesting that not all fees and expenses that were levied on investors, directly or indirectly, were accounted for.[18]

That same year, state treasurers and comptrollers sent a letter to then Chair Mary Jo White, highlighting the "culture of opacity" by private equity firms and urging the Commission to require general partners to make better disclosure of private equity expenses to limited partners.[19] "Though private equity firms generally disclose information on all types of fees, it is often reported deep in annual financial statements and is not reported directly to limited partners on a quarterly basis," they stated. "This lack of clear and frequent reporting has resulted in an uneven approach to fee disclosure from private equity general partners to limited partners."[20]

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[17] Andrew J. Bowden, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, "Spreading Sunshine in Private Equity," May 6, 2014, http://bit.ly/2nzzAL5.

[18] Gretchen Morgenson, *Challenging Private Equity Fees Tucked in Footnotes*, NEW YORK TIMES, October 18, 2015, https://nyti.ms/3xRDj8D.

[19] Letter from state treasurers and comptrollers to Mary Jo White, SEC Chair, Re: Standardized Private Equity Fee Disclosure (July 21, 2015), https://on.nyc.gov/38iEkfm. Signatories included District of Columbia Treasurer Jeffrey Barnette; California State Treasurer John Chiang; North Carolina State Treasurer Janet Cowell; New York State Comptroller Thomas P. DiNapoli; Virginia State Treasurer Manju Ganeriwala; Wyoming State Treasurer Mark Gordon; South Carolina State Treasurer Curtis Loftis, Jr.; Rhode Island General Treasurer Seth Magaziner; Vermont State Treasurer Beth Pearce; Nebraska State Treasurer Don Stenberg; New York City Comptroller Scott M. Stringer; Oregon State Treasurer Ted Wheeler; and Missouri State Treasurer Clint Zweifel.

[20] *Id.*

Separately, John Chiang, the former treasurer of California, called for legislation requiring full transparency in the reporting of fees charged by private equity firms.[21]

Despite the fact that certain investors and advisers have adopted a reporting template that is intended to provide more standardized fee and expense information,[22] many advisers do not provide transparent and uniform disclosures and, as a result, many investors continue to struggle to understand this information. According to a 2020 *Wall Street Journal* article, "different private equity firms report fees, returns and asset values in different ways, so it is difficult to make direct comparisons. Firms often use different terms and metrics to report on their performance, with some breaking out fees and expenses investors have paid while others make such information harder to identify."[23] In response, Pennsylvania State Treasurer Joe Torsella stated that, "Standardization would help prevent inflated or overstated successes through metrics that are known to be easily manipulated."[24]

In addition, a recent *Bloomberg* analysis of data collected from more than two dozen U.S. public pension plans shows that most of those investors aren't able to track expenses in their private equity portfolios.[25] "Some say the task is too difficult because fund managers are reporting the costs in vastly different ways or fail to break out expenditures at all," according to the article. Among the practices that contribute to a lack of transparency in this market, advisers often fail to itemize expenses in their disclosures, instead labeling expenses generically as "other" or "other operating expenses," for example. This makes it virtually impossible for investors to understand the purpose of these expenses or exercise meaningful monitoring or oversight of the charging of these expenses.

The lack of high-quality, comprehensive fee and expense information that is provided on a regular basis makes it more likely private fund investors will make allocation decisions that are not in their best interest.

B. Performance

Complexity and opacity in the private funds market also make it more likely that private fund advisers will make claims about their funds that are difficult for private fund investors to verify. For example, private fund advisers often claim that their funds' returns are significantly

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[21] Letter from John Chiang, California Treasurer, to CalPERS and CalSTRS, October 12, 2015, *available at* https://bit.ly/3kcbCQa (urging CalPERS and CalSTRS to help draft legislation to promote "sufficient visibility into the nature and amount of those fees….Because fees paid to private equity general partners reduce returns, trustees should be able to see and understand all of the fees they are charged.").

[22] *See, e.g.,* Institutional Limited Partners Association ("ILPA") Reporting Template, https://bit.ly/3vKNE3w.

[23] Simon Clark, *Investors Urge Private-Equity Industry to Improve Transparency*, WALL STREET JOURNAL, January 7, 2020, https://on.wsj.com/3vcmvaG.

[24] *Id*.

[25] Sabrina Willmer, *Private Equity's Opaque Costs Mystify the Pensions That Pay Them*, BLOOMBERG, March 29, 2022, https://bloom.bg/3K7pKog.

higher than the returns observed in public markets.[26] This is partly because of the fact that there are no standards for reporting returns, which allows private funds to present returns in various ways. Given this flexibility, some do so in misleading and deceptive ways.[27] The Commission has in the past acknowledged this concern, highlighting the fact that, "Based on enforcement and regulatory experience regarding private funds, we believe that the areas identified in Rule 156 as being vulnerable to misleading statements in investment company sales literature are similarly vulnerable with respect to private fund sales literature."[28] Retail investors are particularly vulnerable to being misled by such statements.

Without high-quality information that would allow private fund investors to compare the total costs and net of fee performance of current and prospective investments, private fund investors remain unable to determine whether private fund advisers' performance claims are accurate and reliable. As a result, private fund investors may allocate more than is optimal, and therefore not in their best interest, to certain private funds based on claims that turn out to be inaccurate or unreliable.[29]

C. Valuation

Complexity and opacity in the private funds market also make it more likely that private fund advisers will opportunistically over-value private fund investments, potentially to the

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[26] *See* Ludovic Phalippou, *Why is the Evidence on Private Equity Performance So Confusing?*, June 14, 2011, https://bit.ly/3Kilgeu ("Private equity industry associations announce aggregate performance every quarter. Typically these returns are largely above those of public equity markets over long horizons. These numbers are widely disseminated and commented on by the press and have probably played a role in the strong increase in allocation to private equity over the last decade. In contrast, academic studies find returns that are closer to those of public equity (on aggregate). This paper argues that in theory these two results are not necessarily inconsistent. The methodology used in practice can, hypothetically, generate these large returns while the true underlying return may be close to that of the public equity."). *See also* Brad Case, *Has Private Equity Performed for Investors? An Annotated Bibliography*, The Journal of Investing, December 2020, https://bit.ly/3vEHnXb ("A rich body of empirical research over the past 15 years addresses the basic question of whether investments in private equity generally benefit investors in terms of (1) whether net returns from private equity are generally higher than net returns on comparable public equities, (2) whether private equity investors generally earn a volatility premium or suffer a volatility penalty relative to public equity investors, (3) whether investors generally earn a premium or incur a penalty associated with the extraordinary illiquidity of private equity investments relative to comparable public equities, and (4) therefore, whether private equity investors benefit from the asset category on a risk-adjusted net-of-fees basis. This article reviews the extant research approximately by publication date to highlight changes in the questions addressed, the methodologies employed, and the investment environment that managers faced. The literature is remarkable in its failure to find consistent evidence that private equity investors benefit financially from their exposure to the extraordinary risks and principal-agent problems inherent in the private capital model.").

[27] *See, e.g.,* Mary Childs, *How Private-Equity Funds Can Artificially Boost Their Returns*, BARRON'S, August 22, 2019, https://bit.ly/3xRiES9; Don A. Steinbrugge, Agecroft Partners, *What aren't you telling me? Major discrepancies in hedge fund performance reporting*, HEDGEWEEK, June 27, 2019, http://bit.ly/2mJG7SM.

[28] Proposed Rule, Amendments to Regulation D, Form D and Rule 156, Release No. 33-9416; Release No. 34-69960; Release No. IC-30595, July 10, 2013, http://bit.ly/2mJ8gcE.

[29] According to an article in Harvard Business Review, for example, "Overstated private equity performance may partially explain why investors continue to allocate substantial capital to this asset class, despite our finding (forthcoming in the Review of Financial Studies) that PE funds have historically underperformed broad public market indexes by about 3% per year on average." Oliver F. Gottschalg and Ludovic Phalippou, *The Truth About Private Equity Performance*, HARVARD BUSINESS REVIEW (December 2007), http://bit.ly/2nypUjV; *See also* Martin Sorensen, Neng Wang, and Jinqiang Yang, *Valuing Private Equity*, NBER Working Paper No. 19612 (November 2013), http://bit.ly/2lq7Ho3 ("Conventional interpretations of PE performance measures appear optimistic. On average, LPs may just break even, net of management fees, carry, risk, and costs of illiquidity.").

detriment of private fund investors' allocation decisions.[30] Before a fund is completely liquidated and the cash is returned to investors, a private fund's interim performance depends on the valuation of the portfolio companies. Researchers analyzed whether these valuations are fair and whether they become more or less aggressive during the life of the fund.[31] They found that, while valuations generally tended to be conservative, valuations and reported returns were inflated when follow-on funds were being raised. "This has large effects on reported interim performance measures that appear in fundraising documents," according to the authors. Then, there was a gradual reversal once the follow-on fund had been closed. Thus, there was a "distinctive pattern of abnormal valuations which matches quite closely the period up to the first close of the follow-on fund."[32]

These findings suggest that, in an effort to attract future investments, advisers were becoming more aggressive in how they valued their current investments compared with other periods in the life of the fund. Indeed, "[i]t is hard to rationalize the pattern we observe except as a positive bias in valuation during fundraising," according to the authors.[33] To the extent that prospective investors rely on these more aggressive valuations and performance figures, they may allocate more to follow-on funds than they otherwise would, which may not be in their best interest. These findings also suggest the need for an independent check on adviser valuation practices, including ensuring their data, methodologies, and assumptions are reasonable, consistently applied, and in accordance with U.S. GAAP. Investors appear to share concerns about the fair valuation of private funds. According to a 2018 survey by eVestment, valuations of portfolio companies were a top concern among 60 percent of private equity investors and their consultants.[34]

Commission staff have observed instances when private fund advisers did not value client assets in accordance with their valuation processes or in accordance with disclosures to clients (such as that the assets would be valued in accordance with GAAP).[35] Commission staff also have observed that this failure to value a private fund's holdings in accordance with the disclosed valuation process has led to overcharging management fees and carried interest because such fees were based on inappropriately overvalued holdings. Overcharging of management fees is also inconsistent with advisers' fiduciary duties.

D. Conflicts of interest

The complexity and opacity of the private funds market create an environment that is conducive to using, and makes it more likely that private fund advisers or their related persons will use, a private fund vehicle to enrich themselves at the expense of private funds and their investors. The Commission has also acknowledged that, "Hedge fund advisers often have

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[30] Advisers also have an incentive to over-value assets because the value of fund assets often serves as the basis for the calculation of the adviser's fees.
[31] Tim Jenkinson, Miguel Sousa, Rüdiger Stucke, *How Fair are the Valuations of Private Equity Funds?*, February 27, 2013, https://bit.ly/3rOwHo2.
[32] *Id*.
[33] *Id*.
[34] Evestment, *New Survey Looks at Key Concerns in Private Markets in 2018*, April 25, 2018, https://bit.ly/38krkWq.
[35] OCIE National Examination Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), https://bit.ly/394BvyO.

substantial conflicts of interest, both with the hedge fund and with other non-hedge fund investors."[36] Commission staff have also raised serious concerns about the substantial conflicts of interest in the private equity space that pose a substantial threat of harm to private equity investors. Notably, in his May 2014 speech, Director Andrew Bowden highlighted harmful conflicts of interest that had been uncovered in the examinations process:

> With this control and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend. For example, the private equity adviser can instruct a portfolio company it controls to hire the adviser, or an affiliate, or a preferred third party, to provide certain services and to set the terms of the engagement, including the price to be paid for the services ... or to instruct the company to pay certain of the adviser's bills or to reimburse the adviser for certain expenses incurred in managing its investment in the company ... or to instruct the company to add to its payroll all of the adviser's employees who manage the investment.
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> We have seen that these temptations and conflicts are real and significant.[37]

Since then, harmful conflicts of interest in the private equity market have persisted, to the detriment of private equity investors. For example, a 2020 OCIE Risk Alert highlighted the Commission staff's observation of conflicts related to:

- allocations of investments;
- multiple clients investing in the same portfolio company;
- financial relationships between investors or clients and the adviser;
- preferential liquidity rights;
- private fund adviser interests in recommended investments;
- co-investments;
- service providers;
- fund restructuring; and
- cross-transactions.[38]

In a follow up Risk Alert in January 2022, the Division of Examinations detailed additional observations from examinations of Private Fund Advisers, including:

- failure to act consistently with disclosures;
- use of misleading disclosures regarding performance and marketing;
- due diligence failures relating to investments or service providers; and
- use of potentially misleading "hedge clauses."[39]

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[36] Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission (September 2003), http://bit.ly/2niaIHA.
[37] Andrew J. Bowden, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, "Spreading Sunshine in Private Equity," May 6, 2014, http://bit.ly/2nzzAL5.
[38] OCIE National Examination Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), https://bit.ly/394BvyO.
[39] EXAMS National Examination Program Risk Alert: Observations from Examinations of Private Fund Advisers (Jan. 27, 2022), https://bit.ly/38nTTCn.

While these practices were not explicitly the result of conflicts of interest, it is reasonable to infer that misaligned incentives between private fund advisers and private fund investors contributed to these deficiencies. Furthermore, in a recent comprehensive review of the "rich body of empirical research over the past 15 years," Brad Case found that:

> Ample evidence suggests that the persistent misalignment of interests between private equity investment managers and investors—in various forms, including manipulated asset valuations, distortionary use of credit facilities, pressure to spend committed capital, and opaque or misaligned compensation practices—significantly reduces the net-of-fees returns received by private equity investors, but evidence also indicates that investors may systematically be fooled in this respect.[40]

In short, conflicts of interest in the private fund and particularly the private equity space are pervasive, persistent, and can be very harmful to private fund investors. To date, relying exclusively on disclosure to address conflicts has not been effective at curbing the harms that flow from such conflicts. Accordingly, the Commission must consider stronger safeguards that will effectively curb such harmful practices.

III. Private fund investors may not be able to protect themselves against exploitation by private fund advisers.

Some have asserted that the private funds market is one in which wealthy, sophisticated market participants are effective at protecting their own interests. They further assert that it would be inappropriate for the Commission to interfere with the privately negotiated agreements between these market participants.

In "The Private Equity Negotiation Myth," Professor William W. Clayton of BYU Law School challenges these assertions in the context of the private equity market.[41] First, Clayton assails the myth that all private fund investors are on equal bargaining footing. Larger investors generally have much greater bargaining power with private equity fund managers than smaller investors for several reasons. For example, larger investors' substantial investable assets and the threat of walking away from current and future deals can give them greater bargaining power than smaller investors. In addition, larger investors are more likely to have more resources and access to experts to help negotiate better individualized terms than smaller investors.

Second, Clayton highlights how larger investors in private equity funds commonly use their bargaining power to negotiate for individualized benefits outside of fund agreements (i.e., in side letters or side agreements), where the benefit of the bargain is not shared with other investors in the fund. This bargaining power can actually make large investors less sensitive to the quality of fund agreement terms, which can result in weak fund agreement protections for

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[40] Brad Case, *Has Private Equity Performed for Investors? An Annotated Bibliography*, The Journal of Investing, December 2020, https://bit.ly/3vEHnXb.
[41] William W. Clayton, *The Private Equity Negotiation Myth*, Yale Journal on Regulation Vol. 37:67, 2020, https://bit.ly/3MtEW0x.

those investors who do not have similar bargaining power. In other words, this dynamic makes it more likely that smaller investors will receive worse terms in the fund agreement. Private equity fund advisers would clearly prefer this approach because it results in their making concessions to only a subset of fund investors rather than all investors in their fund. Making matters worse, smaller investors are unlikely to know what kinds of side deals the larger investors have made and are therefore unable to factor those differences into their investment decisions.[42]

Professor Elisabeth de Fontenay of Duke Law School further highlighted how the private markets are two-tiered, separating those few investors who have access to information and bargaining power from those who do not when she testified before the House Financial Services Committee in September 2019. In particular, she focused on how "Retail investors would be highly unlikely to gain access to the same issuers and investments in the private markets as institutional investors. Because private firms today face a seemingly bottomless supply of capital from institutional and high-net-worth investors, the firms that seek out direct investment from small-dollar retail investors are likely to be the firms with the worst prospects."[43]

Far from being a market comprised of sophisticated parties who can negotiate skillfully to protect their own interests, this is far more likely to be a market where many investors are vulnerable to being exploited by private fund advisers. The Commission must rectify this market failure.

IV. The proposal would address many of the concerns discussed above.

As discussed above, complexity and opacity in the private funds market, particularly as they relate to reporting around fees and expenses, performance calculations, valuation, and conflicts of interest, hinder investors' ability to make informed investment decisions. According to the Proposing Release, these dynamics prevent even sophisticated investors from optimally obtaining certain terms of agreement from fund advisers, and this can result in investors' paying excess costs, bearing excess risk, receiving limited and less reliable information about investments, and receiving contractual terms that may reduce their returns relative to what they would obtain otherwise.[44]

These market failures exist in part because current rules under the Advisers Act do not require advisers 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. As a result, many investors do not receive this information and for those that do, the format, scope and reporting intervals of these disclosures can vary across advisers and private funds.[45] Moreover, current rules do not require advisers to provide

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[42] Clayton also argues that some of the largest institutional investors in private equity funds may suffer from internal agency problems that reduce their incentives to demand strong protections, even when doing so would be beneficial for plan beneficiaries.

[43] Written Testimony of Elisabeth de Fontenay, Professor of Law, Duke University, Before the United States House of Representatives Committee on Financial Services Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, "Examining Private Market Exemptions as a Barrier to IPOs and Retail Investment," September 11, 2019, https://bit.ly/3vddn5O.

[44] Proposing Release at 215.

[45] *Id*. at 198.

information about preferential terms that are granted to certain investors outside the scope of the fund agreement. Without this critical information, investors are unable to make fully informed investment decisions about how to allocate their capital and are exposed to a heightened risk of making poor investment decisions that are not in their best interest.

In addition, the Commission and its staff have observed that certain sales practices, conflicts of interest, and compensation schemes are either not transparent to investors or can be harmful and have significant negative effects on private fund returns.[46] Despite the Commission's efforts to date to highlight the risks of such practices,[47] they persist.

The proposed rule would provide a regulatory solution to address these problems and enhance investor protections. First, the proposed rule would require an investment adviser that is registered or required to be registered, and that provides investment advice to a private fund, to provide to each of the private fund investors a quarterly statement containing information regarding fees, expenses, and performance. These periodic statements would help investors better understand all of the direct and indirect fees and expenses they are paying and how these fees and expenses affect the overall performance of their investments. They would also provide greater transparency into how private fund performance is calculated, improving an investor's ability to interpret performance results. These quarterly statements would better enable investors to make more informed investment decisions about how to allocate their capital in their best interest.

Next, the proposed rule would require a registered private fund adviser to obtain an annual financial statement audit of each private fund it advises. These audits would need to be performed by an independent public accountant that meets certain standards of independence and is registered with and subject to regular inspection by the PCAOB, and the statements would need to be prepared in accordance with U.S. GAAP. The audit requirement would provide an important check on the adviser's incentive to over-value investments and more generally would improve the quality of private funds' financial reporting.

In addition, the proposed rule would require advisers to obtain fairness opinions from an independent opinion provider in connection with certain adviser-led secondary transactions with respect to a private fund. Importantly, the proposal would require a summary of any material business relationships the adviser or any of its related persons has, or has had within the past two

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[46] *Id*. at 213. *See also* Julie M Riewe, Division of Enforcement, U.S. Securities and Exchange Commission, "Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View," February 26, 2015, https://bit.ly/3rRAyRb; Marc Wyatt, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, "Private Equity: A Look Back and a Glimpse Ahead," May 13, 2015, https://bit.ly/38fx2ch; Andrew Ceresney, Division of Enforcement, U.S. Securities and Exchange Commission, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement, May 12, 2016, https://bit.ly/38hAoLU; Andrew J. Bowden, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, "Spreading Sunshine in Private Equity," May 6, 2014, http://bit.ly/2nzzAL5; OCIE National Exam Program Risk Alert: Overview of the Most Frequent Advisory Fee and Expense Compliance Issues Identified In Examinations of Investment Advisers, (April 12, 2018), https://bit.ly/3LjxZPq; OCIE National Examination Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), https://bit.ly/394BvyO; EXAMS National Examination Program Risk Alert: Observations from Examinations of Private Fund Advisers (Jan. 27, 2022), https://bit.ly/38llZhV.

[47] *Id*.

years, with the independent opinion provider. As with the audit requirement, the requirement to obtain fairness opinions would provide an important check against an adviser's conflicts of interest in structuring and leading these transactions, the result being a decreased risk to investors of experiencing harm from over-valuation or from other conflicts relating to secondary-led transactions.

One of the most significant aspects of the proposed rule is that it would prohibit a private fund adviser from engaging in certain sales practices, conflicts of interest, and compensation schemes that are contrary to the public interest and the protection of investors. These practices include, for example, private fund advisers' structuring deals to benefit advisers at the expense of the private fund and its investors, charging fees for services the adviser never intends to provide, obtaining reimbursement from clients for expenses that don't directly relate to the activities of the private fund, and attempting to convince investors they have fewer rights and avenues for redress under the law in the event of adviser misconduct.

We agree that such practices unfairly enrich advisers by putting their interests ahead of the fund and its investors, and private fund investors often have little or no meaningful ability to protect themselves against exploitation by private fund advisers. It may be hard even for sophisticated investors with full and fair disclosure, were these conflicts allowed to persist, to understand the future implications of such terms and practices. Further, given how harmful these practices are, we do not believe that any reasonable investor would consent to them if they were given a meaningful choice. Unfortunately, in our current market, many investors are not given a meaningful choice and, as a result, risk being taken advantage of by private fund advisers.

In particular, we strongly support the proposed rule's prohibition of an adviser to a private fund, directly or indirectly, from seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, willful misfeasance, bad faith, negligence, or recklessness in providing services to the private fund. All of these practices effectively operate, to varying degrees, as a waiver of the adviser's fiduciary duty, weakening the standard of conduct owed to the investor and an adviser's incentive to comply with the standard of conduct. Such an erosion of the adviser fiduciary duty is contrary to the public interest and the protection of investors, and accordingly, should be deemed contrary to law.

However, we disagree with the proposed approach to carve out from the proposed prohibited activities provisions registered offshore advisers' private funds organized outside of the United States. The proposed prohibitions are intended to protect U.S. investors from harmful conflicts of interest that are inconsistent with the Advisers Act. Whether those protections apply to U.S. investors should not depend on the domicile of the fund. To the extent this carve out remains, it could create an incentive for advisers to evade the proposed prohibitions by domiciling their funds offshore. This result could leave a significant portion of U.S investors vulnerable to the kinds of harm that the Commission is attempting to eliminate with this proposal.

The proposed rule would also prohibit private fund advisers from providing preferential liquidity terms or information regarding the portfolio holdings or exposures of the fund or in a

substantially similar pool of assets that the adviser reasonably expects to have a material, negative effect on other investors in the private fund or in a substantially similar pool of assets. The proposed rule makes clear that providing preferential liquidity rights can be harmful to the fund and those investors who do not benefit from such preferential liquidity terms in several ways. For example, the fund may be left with a less liquid pool of assets, which can inhibit the fund's ability to carry out its investment strategy or promptly satisfy other investors' redemption requests.[48] It can also dilute remaining investors' interests in the fund.[49] Providing preferential information (i.e. selective disclosure of portfolio holdings or exposures) can unfairly benefit those investors who have access to information, allowing them to reap profits or avoid losses that are effectively extracted from those investors who do not have access to such information.[50]

Finally, the proposed rule would prohibit all other preferential terms provided to a private fund investor unless the adviser provides written disclosures about those terms to prospective and current investors. This requirement would better inform investors regarding the preferential terms other investors are receiving, allow them to compare different terms and their potential impacts on their own investments and on the fund, and arm them with information that may help them shape the terms of their relationship with the adviser of the private fund.[51] This requirement has the potential to be significantly beneficial to smaller investors that may not currently know whether or to what extent they are receiving inferior terms relative to larger investors.

V. The Commission should use its authority under Section 913(g) of Dodd-Frank more broadly, especially with regard to sales practices, conflicts of interest, and compensation schemes that harm retail investors.

We commend the Commission for its boldness in seeking to root out harmful advisory conflicts of interest that are contrary to public interest and the protection of investors. We encourage the Commission to use this authority more broadly, especially with regard to sales practices, conflicts of interest, and compensation schemes that harm retail investors.

The authority on which the Commission relies to 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 stems from Section 913(g) of Dodd-Frank.[52] Specifically, Section 913(g) amended Section 211 of the Advisers Act by adding Section 211(h)(2) and amended Section 15 of the Exchange Act by adding Section 15(l)(2). These companion "Other Matters" provisions make clear that the Commission "shall examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and the protection of investors." Importantly, this authority is mandatory, not permissive ("The Commission shall" not "The

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[48] Proposing Release at 165.
[49] *Id*.
[50] *Id*. at 166.
[51] *Id*. at 169.
[52] Footnote 4 of the proposing release mistakenly states that this authority derives from Section 913(h) of Dodd-Frank. However, the authority that the Commission is using derives from Section 913(g) of Dodd-Frank. Section 913(h) relates to harmonization of enforcement of standards of conduct, which is not relevant here. Elsewhere throughout the release, it correctly cites the Commission's authority to promulgate this rule under Section 211(h)(2).

Commission may")[53] and it is extremely broad. If honored, this authority has the potential to address significant failures in our markets.

To date, however, the Commission has not undertaken a complete examination of *all* broker-dealer and investment adviser sales practices, conflicts of interest, and compensation schemes. Rather, the only times this authority has been used were in the context of Reg BI, when the Commission required broker-dealers to eliminate only a very narrow types of sales contest, quotas, bonuses, and non-cash compensation (only those that are time-limited and product-specific)[54] and in this rulemaking, where the Commission is requiring private fund investment advisers to eliminate a broad range of anti-investor practices.

We urge the Commission to rectify this shortcoming and focus its examination of sales practices, conflicts of interest and compensation schemes that harm retail investors. This authority is potentially very powerful in the retail context, where such practices result in putting a firm's or financial professional's interests ahead of retail investors, where disclosure of such practices is highly unlikely to remediate the harms that retail investors suffer, and where no reasonable investor would consent to such conduct if they fully understood the implications of the conduct and resulting harms. Moreover, to the extent there are voices within the Commission that insist the Commission's authority to address advisory conflicts that harm investors is limited to requiring more conflict disclosures – which ample evidence suggests is unlikely to be ineffective in practice – the bold use of this Section 913(g) authority in this rulemaking proves that the Commission has the tools that it needs, should it choose to use them.

In short, if the Commission feels comfortable relying on Section 913(g) authority to protect investors who, at least in theory, can fend for themselves, there is no excuse not to use this authority where investors clearly cannot. All it takes is the will.

Conclusion

This proposal would promote transparency and accountability and reduce harmful conflicts of interest in the private funds market. For the foregoing reasons, we urge the Commission to finalize this proposal without undue delay.

Respectfully submitted,

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[53] The Reg BI release mistakenly states that, under Section 15(l)(2) of the Exchange Act, the Commission "may" examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for brokers, dealers, and investment advisers that the Commission deems contrary to the public interest and protection of investors. *See* Final Rule, Regulation Best Interest: The Broker-Dealer Standard of Conduct, at 346, Release No. 34-86031, http://bit.ly/2mMO75u.
[54] See *id*.