PRIVATE EQUITY STAKEHOLDER PROJECT

25 April 2022

U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

**Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (File No: S7-03-22)**

Dear Secretary Countryman,

We appreciate this opportunity to express our support for the Securities and Exchange Commission's (SEC) 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. It would also prohibit certain practices and fees levied by investment managers that create misaligned interests with investors.

The Private Equity Stakeholder Project (PESP) is a financial watchdog organization that researches and reports on private equity investments and their impacts on various communities.

We support these proposals as these disclosures will (1) provide investors with a clearer picture on how their investments are being managed (with such investments largely being funded by public sector workers), (2) prevent disparate treatment of investors, and (3) rein in unnecessary fees that are costing investors and portfolio companies millions of dollars annually.

In addition to the other disclosures provided for in this proposal, we encourage the SEC to consider requiring climate-related disclosures for private funds. The SEC has rightly proposed enhanced climate-related disclosures so that investors in publicly listed companies can have "consistent, comparable, and decision-useful information for making their investment decisions."[1] The financial and physical risks from climate change and the energy transition are relevant to investors in private markets just as they are to investors in public markets. In fact, the risks for private market investors may be greater given the illiquid nature of closed-end investment vehicles and the limited visibility investors have into the holdings of private funds. In the absence of disclosures, investors do not have adequate information about the risks and extent of their capital's exposure to fossil fuels and other sectors with significant greenhouse gas emissions.

The proposed investor protections take on greater importance given the growth of private markets, which has reached $18 trillion in gross assets per the SEC.[2] Research by Vanguard also showed that "the asset

[1] SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors, SEC, March, 2022; https://www.sec.gov/news/press-release/2022-46
[2] Statement on Private Fund Advisers Proposal, SEC, February 2022; https://www.sec.gov/news/statement/gensler-statement-private-fund-advisers-proposal-020922

size of the private equity market has been gradually growing on an absolute basis and relative to the public equity market over the last 20 years."[3] Over a corresponding timeframe, the number of companies backed by private equity has grown – McKinsey found that the number of US-private-equity backed companies doubled to 8,000 between 2006 and 2017 – while the number of publicly traded firms dropped to 4,300.[4]

**Greater financial transparency benefits investors and the public.**

Investors are often left in the dark about basic information pertaining to how their investment in any given fund is being managed. This unfairly creates information asymmetry between fund advisors and their investors. Investors are often not provided with information pertaining to (1) what fees they are being charged and how they are being charged, (2) accurate information on returns, (3) if the fund adviser has been engaged in misconduct or (4) whether other fund investors are receiving preferential treatment that puts the investor at a disadvantage.

By requiring fund advisors to provide (1) a table detailing all the different fees and expenses charged (2) a standardized, reliable set of returns for investors to evaluate alongside more detailed assumptions used to calculate returns, and (3) disclosures of special arrangements it may have with certain investors (often known as "side letters") to all investors on a quarterly basis, investors will be better able to monitor and make informed decisions regarding their investments. As many institutional investors in private equity funds are public pension systems,[5] disclosure of the aforementioned information to such investors is in the public interest as well.

Therefore, we strongly support the SEC's proposed disclosure requirements as a welcome change to the existing information and power imbalances between limited partners and fund advisors.

**Prohibiting private funds from charging investors or their portfolio companies' fees related to wrongdoing or for services not provided.**

We strongly support the SEC's proposal that explicitly prohibits charging investors and portfolio companies for (1) accelerated monitoring fees, (2) costs related to governmental or regulatory investigations, (3) compliance expenses and (4) costs related to obtaining external financing. These fees and expenses are not related to services provided to investors but rather as the SEC correctly characterizes them "compensation schemes that are contrary to the public interest and the protection of investors" and should therefore be covered by the fund manager, not the investors.

Importantly, there is precedent for and interest in private fund advisors taking responsibility for the wrongdoing of their portfolio companies. For example, in 2021 H.I.G. Capital, a Miami-based buyout firm,

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[3] Vanguard, "The role of private equity in strategic portfolios," October 2020

[4] McKinsey Global Private Markets Review 2019
https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/private%20markets%20come%20of%20age/private-markets-come-of-age-mckinsey-global-private-markets-review-2019-vf.ashx

[5] Public pension funds, for example, have now allocated about 9% of their portfolios to private equity investments, totaling $480 billion in 2021, compared to $300 billion in 2018.

agreed to pay almost $20 million to settle Massachusetts's allegations that its portfolio company, South Bay Medical Center Inc., billed the state for services provided by unqualified and unsupervised therapists.[6] In other recent cases, Texas-based firm Ancor Holdings LP last year agreed to pay almost $1.8 million for involvement in an alleged kickback scheme with a medical-testing company,[7] and in 2020 the Gores Group agreed to pay $1.5 million to settle allegations that a medical device company it used to own promoted treatments for patients that weren't approved by the federal Food and Drug Administration.[8] As private fund advisers continue to be scrutinized and held liable for the actions of portfolio companies under their control, it is important that indemnification for such wrongdoing not be passed down to a private fund's investors, a practice that this proposal would prevent.

Additionally, accelerated monitoring fees charged to portfolio companies are particularly harmful because they siphon resources from companies without offering anything in return.[9] Rather than using revenue to grow and enhance operations, such portfolio companies may find themselves in positions where they must use that capital to pay accelerated monitoring fees for no discernable benefit.

Therefore, we support this proposal because it would protect portfolio companies from predatory wealth extraction, which also affects such companies' employees and the consumers, clients or patients that they serve.

**Changes to Form ADV.**

We strongly support the SEC's proposal to require the following disclosures on Form ADV:

1. The assumptions and calculations that go into the return figure for private equity funds who would be considered "illiquid funds," which the industry currently shows using an Internal Rate of Return (IRR). Given the historical unreliability of IRR, we also strongly support the SEC's proposal to require that advisers provide investors with return figures that show how many multiples of capital have actually been returned to investors. Currently, investors in illiquid funds have very little insight into how returns from their fund's investments are calculated, which in turn means they have little information about the accuracy of the return figures they are presented with, or about what more accurately or comparably presented returns might be.

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[6] Private Equity Firm and Former Mental Health Center Executives Pay $25 Million Over Alleged False Claims Submitted for Unlicensed and Unsupervised Patient Care, Mass. Attorney General, October 2021; https://www.mass.gov/news/private-equity-firm-and-former-mental-health-center-executives-pay-25-million-over-alleged-false-claims-submitted-for-unlicensed-and-unsupervised-patient-care

[7] EEG Testing and Private Investment Companies Pay $15.3 Million to Resolve Kickback and False Billing Allegations, US Department of Justice, July, 2021; https://www.justice.gov/opa/pr/eeg-testing-and-private-investment-companies-pay-153-million-resolve-kickback-and-false

[8] Former Owners of Therakos, Inc. Pay $11.5 Million to Resolve False Claims Act Allegations of Promotion of Drug-Device System for Unapproved Uses to Pediatric Patients, US Department of Justice, November, 2020; https://www.justice.gov/usao-edpa/pr/former-owners-therakos-inc-pay-115-million-resolve-false-claims-act-allegations

[9] Celariar, Michelle, 'The SEC Unveils Its Plan to Bring Private Funds in Check,' Institutional Investor, February 9, 2022; https://www.institutionalinvestor.com/article/b1wps2drnfbyhm/The-SEC-Unveils-Its-Plan-to-Bring-Private-Funds-in-Check

2. Detailed reporting on a quarterly basis, breaking down all the compensation, fees, and expenses paid to the adviser. At least some fund advisers are not currently providing that baseline level of information and have largely ignored investors' requests to do so.[10] This rule will help ensure that investors know what fees and expenses they are being charged and will be better able to determine whether they are appropriate.

**Annual audits of every private fund should be mandatory.**

We strongly support the SEC'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.

Such independent audits would provide an additional level of scrutiny over whether the fund advisers' estimated valuations on its illiquid investments, that otherwise have few public price points, are consistent with Generally Accepted Accounting Principles.

Given the SEC's findings that 10% of private funds are still not being audited, mandatory audits should be required of all private funds so that investors are provided with the necessary safeguards against inflated fund valuations and other compliance breaches.

**The SEC should collect and share information about fees and returns with researchers, policy makers, and the public.**

While the additional detail surrounding fees, expenses, and returns provided to private fund investors will be useful for investors in private funds, we also urge the SEC to share such information with researchers, policy makers, and the public. This is similar to our March 25th comment letter requesting that the SEC disclose otherwise confidential Form PF information to the public in such a manner.

These public disclosures would add another layer of accountability for all actors in the system and would also provide private fund investors with additional insights into what they are being charged relative to others' and into the performance of PE investments.

**All side letters need to be disclosed to all other investors; side letters that put some investors at a material disadvantage should not be permitted.**

We support the SEC's proposal to require that all special arrangements or terms offered to a certain set of fund investors, often referred to as "side letters," be disclosed to all other investors in the fund to ensure there are no violations of fiduciary duties to other investors.[11] Investors need to be able to see

[10] 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

[11] Dechert LLP. Private fund side letters: common terms, themes, and practical considerations. Oct 28, 2018. https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html

what side agreements funds have with other investors to ensure that they are not being unduly harmed by agreements they have no visibility into. Allowing preferential treatment enables private fund advisers to actively discriminate between different classes of investors.

The side letters with the greatest potential to harm other fund investors are those that include the ability to redeem their holdings first, which leaves remaining investors invested in a materially different portfolio that may be far riskier and/or less liquid.[12] We therefore support the SEC's proposal to prohibit preferential terms regarding redemption to select investors.

**Preferential information sharing that is illegal in the public markets should be prohibited in private markets.**

We support the SEC's proposal to prohibit the selective disclosure of information to certain investors. Under Regulation FD, it is illegal for a publicly listed company to disclose information to a certain set of investors but not others.[13] However, private funds have been allowed to engage in this practice. Such selective disclosures to certain investors may also be a violation of a private fund's fiduciary duty to its other investors who may be negatively harmed as a result.

The SEC should therefore ban any such side arrangements that allow the selective sharing of material, non-public information with some of its investors to the exclusion of others.

**Additional reporting requirements are not an unfair burden on smaller funds.**

Contrary to the arguments that are being made about the additional costs associated with these reporting requirements, it is worth noting that all the information the SEC is requesting is already available to the funds themselves; it is simply not being disclosed. Any properly operated private fund is already tracking all this information pursuant to its ordinary course of business. The SEC is simply proposing to mandate that this information be made available to investors. Therefore, arguments about the potential financial burden borne by smaller funds should be dismissed.

**Climate-Related Disclosures**

We also strongly encourage the SEC to take further action regarding the climate-related risk for private markets investors by enhancing risk disclosures applicable to private fund advisors through Form ADV.

Given the limited transparency for fund holdings in private markets, investors know little in terms of their operations or those of their portfolio companies. Investors in private equity and other private funds have exposure to undisclosed risks due to climate change, greenhouse gas emissions and the energy transition.

[12] Davie, Alexander. Strictly Business. Using Side Letters in Private Funds. Nov 29, 2017. https://www.strictlybusinesslawblog.com/2017/11/29/using-side-letters-in-private-funds/
[13] Regulation FD, https://www.sec.gov/rules/final/33-7881.htm

Pitchbook data show that private equity has invested over $1.1 trillion in energy between 2010 and 2021.[14]

Fund performance analysis and examples of investment losses illustrate the potential risks to investors in energy investments through private funds.

In 2021, the private equity-backed Limetree Bay Refinery in the U.S. Virgin Islands filed for bankruptcy, resulting in hundreds of millions in losses for investors in private equity firm Arclight Capital Partners.[15] The refinery was shuttered by the Environmental Protection Agency just weeks after Arclight resumed operations as part of a revival of the previously mothballed facility.[16]

Investors also lost millions in 2017 when a $2 billion energy-focused private equity fund managed by firm EnerVest collapsed under the weight of its debt, and was reduced to virtually nothing when commodity prices in the oil market plunged.[17]

Price swings in oil markets in 2020 induced by the COVID pandemic sparked a string of bankruptcies in the oil and gas sector, with the majority filed by private-equity backed companies.[18] Notably, 2020 saw an increase in bankruptcies with debt loads greater than $1 billion, with an unusually high number relative to the prior six years. More than two thirds (71%) of 2020's multibillion-dollar bankruptcies were backed by private equity.[19]

Overall, investors that committed to energy funds have experienced disappointing returns. Based on an analysis of Preqin data, *Bloomberg* reported in April 2020 that oil- and gas-focused funds have been among the lowest-yielding asset classes for private capital over the prior 10 years. The median internal rate of return (IRRs) for these funds is about five percentage points lower than those of comparable buyout firms.[20]

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[14] Private Equity Stakeholder Project, "Private Equity Propels the Climate Crisis" October 2021, https://pestakeholder.org/wp-content/uploads/2021/10/PESP_SpecialReport_ClimateCrisis_Oct2021_Final.pdf

[15] Laura Sanicola, Tim Mclaughlin "Private equity bet on troubled Caribbean refinery blows up on retirement funds," Reuters, June 3 2021. https://www.reuters.com/business/energy/exclusive-private-equity-bet-troubled-caribbean-refinery-blows-up-retirement-2021-06-03/

[16] https://www.epa.gov/newsreleases/epa-uses-emergency-powers-protect-st-croix-communities-and-orders-limetree-bay-refinery

[17] Wall Street Journal, "From $2 billion to zero: A private-equity fund goes bust in the oil patch," https://www.wsj.com/articles/from-2-billion-to-zero-a-private-equity-fund-goes-bust-in-the-oil-patch-1500210002

[18] Private Equity Stakeholder Project, "Private Equity-backed companies dominate 2020 oil and gas bankruptcies," https://pestakeholder.org/private-equity-backed-companies-dominate-2020-oil-and-gas-bankruptcies/

[19] Private Equity Stakeholder Project, "Private Equity-backed companies dominate 2020 oil and gas bankruptcies," https://pestakeholder.org/private-equity-backed-companies-dominate-2020-oil-and-gas-bankruptcies/

[20] Rachel Adams-Heard, "Private Equity Can't Escape the Pain of Shale Country's Collapse," Bloomberg, April 1, 2020, https://www.bloomberg.com/news/articles/2020-04-01/private-equity-can-t-escape-the-pain-of-shale-country-s-collapse

According to *Cambridge Associates*, for the 184 mature and maturing private equity energy funds with vintage years between 2004 to 2014, performance on average lagged broader private equity returns by 0.56x on a net multiple on paid-in capital basis (MOIC).[21]

Under Section 203(c)(1) of the Advisers Act of 1940, the SEC has authority to require "information and documents as the [SEC], by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors" including "the nature of the business of such investment adviser" to be disclosed on Form ADV. The SEC currently requires that financial risks be disclosed on Form ADV in order to protect potential investors, a disclosure which touches on the nature of an investment adviser's business.

Investment advisors are already including disclosures related to climate change in Part 2A of Form ADV, the brochure. However, the disclosures are limited, subjective, not quantitative, and difficult to compare between firms – leaving investors without adequate information to assess relative risks within an asset manager's portfolio or among several asset managers.

Therefore, in line with current practice, we recommend clarifying that risk disclosures through Form ADV should include quantitative metrics and qualitative information about climate-related risks for private equity firms overall as well as fund-level details, including exposure to energy and fossil fuels, direct and indirect emissions, and individual portfolio companies' risks, leverage and environmental impacts.[22]

This will help investors in private markets, including public pension systems, assess whether a potential investment may align with their own risk tolerance and internal policies related to climate or energy exposure.

**Conclusion**

Thank you again for the opportunity to comment. PESP strongly supports this proposed rule and believes it will benefit investors and the public alike. We also urge you to consider requiring the same climate disclosures that were proposed for publicly listed companies to apply to private fund advisors through Form ADV. For more information, please contact PESP Policy Coordinator, Chris Noble, at chris.noble@pestakeholder.org.

[21] Cambridge Associates, "Real Asset Dynamics: PE Energy," Cambridge Associates, May 2020, pg. 4 https://www.cambridgeassociates.com/insight/real-asset-dynamics-pe-energy/

[22] 'Comment Letter: Public Input Welcomed on Climate Change Disclosures, Acting Chair Allison Herren Lee, March 15, 2021,' Private Equity Stakeholder Project, July 14, 2021; https://www.sec.gov/comments/climate-disclosure/cll12-8916249-244994.pdf

PRIVATE EQUITY STAKEHOLDER PROJECT

Best,

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