William W. Clayton
Associate Professor of Law
J. REUBEN CLARK LAW SCHOOL
BRIGHAM YOUNG UNIVERSITY
486 JRCB
PROVO, UTAH 84602

December 22, 2022

Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F St NE Washington DC 20549-1090

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

Dear Secretary Countryman:

This letter supplements my comment letter dated April 21, 2022 (my "April Letter") regarding "Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews," published in Release No. IA-5955, File No. S7-03-22.[1] In this letter, I have attached as Exhibit A an unpublished draft of an academic paper that builds on my April Letter and provides a more detailed discussion of how I think policymakers should proceed in both the short-term and long-term future. I presented many of the ideas set forth in this paper during a meeting with the staff on August 18, 2022, and the attached paper reflects additional detail on my views. I have not been compensated or commissioned in preparing my April Letter or in writing the attached academic paper.

I am grateful to the staff for its consideration.

Sincerely,

William W. Clayton
Associate Professor of Law
BYU Law School

[1] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 5955, 87 Fed. Reg. 16,886 (Mar. 24, 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf.

EXHIBIT A

HIGH-END SECURITIES REGULATION

William W. Clayton*

Current Draft: Dec. 22, 2022

The SEC has long taken a hands-off approach to private markets. Instead of direct regulation, the SEC has used investor access restrictions to create high-end contracting environments where investors (in theory) have the resources needed to fend for themselves. But in 2022, this hands-off philosophy was turned on its head. In response to booming growth and concerns about harms to public pension plans and other institutional investors, the SEC proposed a sweeping set of regulatory interventions in the $18 trillion private fund industry, a vast and important part of the private market ecosystem.

In this Article, I argue that any efforts to intervene in private securities markets should revolve around a basic question: What are the causes of bargaining failure? What, in other words, is stopping well-resourced industry participants from structuring their affairs effectively? Unfortunately, this question was not a central focus of the SEC's 2022 private fund proposal or the comment period that followed. To help fill this void in the policy dialogue, this Article presents the first empirical study asking institutional investors to identify the issues that they think cause bargaining outcomes in private equity funds to fall short of optimality and discusses the implications.

Looking to the future, I predict that the debate over high-end securities regulation in private markets has only just begun, and I call on the SEC, industry participants, and scholars to work together more deliberately to study the causes of bargaining failure in private funds and private markets more broadly. I also introduce a novel framework to help policymakers and courts determine when the SEC has (and has not) sufficiently verified the causes of bargaining failure before intervening in private markets, and I show how the optimal selection of policy interventions depends on these underlying causes. As the private marketplace continues its meteoric growth, these principles provide an essential foundation to guide the future of securities law policy in private funds and across the spectrum of private markets.

* Associate Professor, BYU Law School.

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INTRODUCTION

Many scholars have criticized the bargaining outcomes in private equity funds.[1] Over the years, academic critics have referred to private equity funds as an "incubator for agency costs,"[2] a setting with "unnecessarily complex" contracts,[3] and a structure that creates "pernicious misalignments" between the interests of managers and investors,[4] among other things. Yet, notwithstanding these critiques, and notwithstanding the massive size and influence of private funds,[5] surprisingly little attention has been paid to the question of what securities regulators should do in response to these concerns.[6] Scholars have not, by and large, proposed serious alternatives to the SEC's traditional hands-off approach to private funds.[7]

Over the past year, however, these issues have quickly taken on a sense of urgency. In February 2022, the SEC released a proposed rule (the "Private Fund Proposal") that would impose unprecedented regulatory interventions on the $18 trillion private fund industry.[8] Pointing to many of the same issues that have been identified in the academic critiques referenced above, the SEC argued that an extensive set of reporting obligations, mandatory rules, and prohibitions is needed to protect investors and increase efficiency in the private fund market. Traditionally, the SEC has focused its resources on protecting retail investors in public markets and left private market investors to protect their own interests in this

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[1] *See, e.g.*, William W. Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703 (2022) [hereinafter Clayton, *High-End Bargaining Problems*]; William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847 (2018); James C. Spindler, *How Private is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 309 (2009); Paul Gompers and Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J. L. & ECON. 463 (1996); Peter Morris and Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. CORP. L. STDS. 59 (2012); William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. ON REGUL. 67 (2020) [hereinafter Clayton, *Negotiation Myth*]; Lee Harris, *A Critical Theory of Private Equity*, 35 DEL. J. CORP. L. 259 (2010); Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACAD. MGMT. PERSPECTIVES 45 (2021).

[2] Spindler, *supra* note 1 at 333 ("One could view the typical private-equity setup as creating almost an incubator for agency costs, an incredibly hospitable environment for opportunistic managerial behavior.").

[3] Morris & Phalippou, *supra* note 1 at 61 ("Contracts between manager and investor appear excessively and unnecessarily complex. Some of their terms seem less than optimal.").

[4] Magnuson, *supra* note 1 at 1903 ("The governance structure of private equity creates a number of pernicious misalignments between the interests of private equity firms and their investors.").

[5] *See infra* note 12.

[6] Compared to private funds, the topic of SEC regulation in the realm of private operating companies has received more scholarly attention. *See, e.g.*, Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179 (2012); Jennifer Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583 (2016); Elizabeth Pollman, *Private Company Lies*, 109 GEO. L.J. 353 (2020); Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151 (2013); Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. 1203 (2022); Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867 (2019).

[7] *See infra* Section III.C.

[8] *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 5955, 87 Fed. Reg. 16,886 (Mar. 24, 2022), https://www.govinfo.gov/content/pkg/FR-2022-03-24/pdf/2022-03212.pdf [hereinafter "Private Fund Proposal"].

"high-end" space where investors must satisfy substantial minimum asset requirements.[9] But the Private Fund Proposal—which has appropriately been called a "sea change" in the SEC's dealings with private markets[10]—would bring an abrupt end to that approach.[11]

This issue is enormously consequential. Once a relatively minor corner of the marketplace, today over 35% of registered advisers are private fund managers,[12] and the largest investors in this industry are public pension plans that invest on behalf of teachers, fire fighters, and other public employees.[13] Accordingly, any benefits or harms caused by SEC interventions in this $18 trillion industry will be felt by a large cross-section of society.[14] Moreover, if and when these kinds of interventions are adopted in private funds, it would be a short step for the SEC to follow suit in the market for private operating companies,[15] a market that accounts for roughly half the total sales and pretax profits in the United States.[16]

The SEC's Private Fund Proposal lays out a long list of industry practices that the SEC finds troubling, including a chronic lack of transparency relating to fees and expenses and widespread conflicts of interest that provide managers with incentives to take actions against the interests of investors.[17] In effect, the Private

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[9] *See infra* Section I.A.

[10] *See* Hester M. Peirce, Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking, U.S. SEC. & EXCH. COMM'N (Feb. 9, 2022), https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922 (referring to the Private Fund Proposal as a "sea change" for private market securities regulation).

[11] Note that the SEC's express purpose here is to promote investor protection and efficiency in the private funds market, not to address negative externalities generated by private fund contracting. This initiative should thus be distinguished from the SEC's recent efforts to promote ESG goals in recent years.

[12] *See* Div. of Examinations, *Risk Alert: Observations from Examinations of Private Fund Advisers*, U.S. SEC. & EXCH. COMM'N (Jan. 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf. ("More than 5,000 SEC-registered investment advisers, approximately 35% of all SEC-registered advisers, manage approximately $18 trillion in private fund assets. In the past five years alone, we have observed substantial growth in reported private fund assets, which have increased by 70% in that period.").

[13] *See* Preqin, 2020 Preqin Global Private Equity and Venture Capital Report 40 (2020) (showing that public pension plans are the largest investors in private equity funds, representing 35% of all capital in the asset class).

[14] The growth in private investment funds is an important part of the larger macroeconomic shift toward private markets over the past two decades. Remarkably, the value of private market assets has grown by fourteen times since 2000, compared to only four-fold growth in public company assets over the same period. *See* MCKINSEY GLOBAL PRIVATE MARKETS REVIEW (Mar. 2022), *Private Markets Rally to New Heights*, at 22, https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%2 annual%20review/2022/mckinseys-private-markets-annual-review-private-markets-rally-to-new-heights-vf.pdf.

[15] *See* Paul Kiernan, *SEC Pushes for More Transparency from Private Companies*, WALL ST. J. (Jan. 10, 2022).

[16] *See* Elisabeth de Fontenay & Gabriel Rauterberg, *The New Public/Private Equilibrium and the Regulation of Public Companies*, 2021 COL. BUS. L. REV. 1199, 1201 (2021).

[17] These complaints echo similar statements that have been made by institutional investors over the years. *See, e.g.*, Letter from Institutional Ltd. Partners Ass'n to Brent Fields, U.S. Sec. & Exch. Comm'n Sec'y, Proposed Commission Interpretation Regarding Standard of Conduct for

Fund Proposal argues that the contracts used in this industry are inadequate because they demand too little disclosure from managers and permit managers to take on too many conflicts of interest.[18] However, the Private Fund Proposal spends less time discussing *why* private fund contracts—and the sophisticated investors that negotiate them—have fallen short in these significant ways.

In this Article, I argue that in order to craft effective regulation in high-end, private market settings, it is essential to address the question "why?". Why are sophisticated investors signing contracts with terms that are, in the words of the Private Fund Proposal, "contrary to the public interest and the protection of investors"?[19] In other words, what are the *underlying causes of bargaining failure* that prevent sophisticated investors from engaging in effective private ordering?

Paying attention to these underlying causes is particularly important in private markets for a few reasons.[20] First, because private market investors must satisfy minimum asset requirements, there is naturally a greater need to verify the existence of bargaining failure to legitimize intervening. If no collective action problems, principal-agent problems, market power problems, or other underlying issues are causing bargaining outcomes to fall short, the parties in private markets should be unusually well-positioned to use private ordering to find effective solutions to their problems. Second, because investors are required to have significant resources at their disposal, it also creates pressure to apply any interventions narrowly and calibrate them thoughtfully so they address these underlying causes without impinging more than is necessary on freedom of contract. Thus, having a robust theory of the underlying causes of bargaining failure for private funds is unusually important—both to establish legitimacy and to craft effective, appropriately tailored rules.

This need to invest time and attention on underlying causes is magnified by another characteristic of private markets: the lack of publicly available information about how private markets operate. Because private funds are not subject to the public disclosure requirements of the federal securities laws, it is much more difficult to demonstrate basic facts about how bargaining works in this space and cultivate thoughtful policy dialogues. This means that to satisfy the elevated burdens described in the paragraph above, it requires a more determined approach to studying the underlying causes of bargaining failure, along with a willingness to be creative and look beyond the conventional methods of traditional securities law research and policy.

Investment Advisers; Request for Comment on Enhancing Investment Adviser Regulation – File No. S7-09-18, at 9 (Aug. 6, 2018), https://ilpa.org/wp-content/uploads/2018/08/ILPA-Comment-Letter-on-SEC-Proposed-Fiduciary-Duty-Interpretation-August-6-2018.pdf ("[A]s the market has rebounded [from the Great Recession], the legal terms have becom[e] immensely more challenging. This has been exacerbated by the current fundraising environment, which is characterized by unprecedented fund raising levels and speed, where GPs have significant leverage in negotiations, and many LPs, particularly public pensions, are forced to deploy capital under disadvantaged terms . . . .").

[18] Many of these criticisms mirror those made by scholars over the years. *See supra* note 1.

[19] *See* Private Fund Proposal, *supra* note 8 at 16,887-16,890.

[20] *See infra* Section II.B.

Unfortunately, notwithstanding the factors described above, the Private Fund Proposal does not seek to provide a very robust accounting of the underlying causes that lead to poor outcomes in private funds.[21] Moreover, even though 270 comment letters were submitted during the primary comment period (which ran from February 9 until June 13, including two extensions[22]), very few of the commenters discussed the underlying causes of bargaining failure in private funds. Instead of asking for input on this conceptual question, the 900+ questions in the Private Fund Proposal generally asked commenters to focus on practical issues of implementation instead of whether the rule is addressing the right underlying causes in the first place.[23]

This is a remarkable moment for securities regulation policy. The basic structure of the securities regulation regime as we have always known it—one that divides the world between public, regulated spaces and private, unregulated spaces[24]—is on the brink of being fundamentally changed in an $18 trillion market, and the implications for private markets more broadly are huge.[25] Yet some of the most important questions to inform how this new form of securities regulation should be crafted have received relatively little attention.

To help fill this void in the policy dialogue, this Article presents the full results of the first empirical study asking institutional investors to identify the causes of bargaining failure in private equity funds.[26] Institutional investors—including public pension plans, endowments, and private pension plans—have substantial experience navigating the bargaining process in private funds. Many of them are serial players in these investments, with in-house legal personnel focused on making investments in a range of private funds that are managed by a range of advisers. When asked what causes them to agree to problematic terms in private

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[21] *See infra* Section II.E.

[22] The SEC re-opened the comment period for 12 proposed rules, including the Private Fund Proposal, on October 7. However, since this was prompted by a technical glitch in the platform for receiving comments and was intended to solicit the re-submission of letters that had not been successful processed, I do not consider this extension part of the primary comment period for the Private Fund Proposal.

[23] The questions posed in the Private Fund Proposal largely take for granted the existence of bargaining failures in private funds.

[24] A series of important articles have called attention to the shifting lines dividing public and private markets in recent years. *See, e.g.*, Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337 (2013); Hillary A. Sale & Robert B. Thompson, *Market Intermediation, Publicness, and Securities Class Actions*, 93 WASH. U. L. REV. 487 (2015); Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013); Onnig H. Dombalagian, *Principles for Publicness*, 67 FLA. L. REV. 649 (2016); de Fontenay & Rauterberg, *supra* note 16; Edward F. Greene, *The Need for a Comprehensive Approach to Capital Markets Regulation*, 2021 COLUM. BUS. L. REV. 714. To this point, the debate over the public-private divide has primarily focused on the exemptions to public securities registration and the disclosure requirements imposed on public companies. By seeking to impose public-company style regulation on private funds, the SEC has added a profoundly important new dimension to this debate.

[25] *See supra* notes 15 and 16 and accompanying text.

[26] *See infra* Part IV for a detailed description of the data set and the study. A condensed discussion of these results was set forth in the comment letter that I filed with the SEC in April 2022. William Clayton, SEC Comment Letter (Apr. 21, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20125350-284820.pdf.

fund contracts, these results show that the most common explanation given by respondents (by far) pointed to a coordination problem contributing to weak investor bargaining power, with investors expressing concern that they will lose access to fund managers or be allocated a smaller share of the fund if they push back against bad terms.[27] Other explanations similarly pointed to a sense of a lack of bargaining power vis-à-vis many of the managers they invest with. Interestingly, however, when asked whether they would like to see regulatory interventions in response to these issues, investor responses tended to be more mixed. A detailed discussion of these results—and the implications and limitations of the study—can be found below.[28]

Importantly, one of the things that makes this polling data particularly interesting is the fact that the academic literature currently lacks any definitive theory of the causes of bargaining failure in private funds. The absence of a definitive scholarly theory is not for lack of trying. As noted above, private funds have attracted the attention of many securities law and corporate finance scholars in response to the industry's rapid growth over the years.[29] Many of these scholars have shared the concerns voiced by the SEC about questionable practices in the industry and concluded that these practices are signs that things are not functioning optimally.[30] But the hardest question for scholars to answer has been *why* these problematic practices have taken hold in such a sophisticated bargaining environment. Over time, scholars have offered various theories of the causes of bargaining failure in private funds to explain these bargaining outcomes.[31] However, without publicly available information, these are very difficult to test. Accordingly, no specific theories are commonly accepted as definitive or authoritative. Likely because of these limitations, the policy recommendations in these studies have tended to be relatively cautious in their scope and substance.[32]

The polling data provides a starting point for understanding where (from the investors' perspective) the most problematic causes of bargaining failure exist in private funds. While this data should not be interpreted as a source of definitive answers,[33] my hope is that it will contribute to a more productive policy dialogue. One interesting takeaway from the polling results is that, if the responses are an accurate reflection of reality, they encourage the SEC to think twice before imposing an overly prescriptive set of interventions.[34] Because the polling results

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[27] *See infra* Figure A.
[28] *See infra* Part IV.
[29] *See infra* Section III.A.
[30] *See id.*
[31] *See id.*
[32] *See, e.g.*, Clayton, *High-End Bargaining Problems*, *supra* note 1 at 713 ("[I]t cannot simply be assumed that every intervention will be beneficial. As the SEC enters this uncharted territory, its regulatory activity should be calibrated to respond to the impediments to effective bargaining in private equity. Doing this requires a robust theory for what those impediments are and how they impair bargaining outcomes in private equity funds, and academic analysis of such issues has historically been quite limited."); Magnuson, *supra* note 1 at 1910 (describing the policy suggestions set forth in the article as "merely a starting point of a longer conversation").
[33] For a discussion of some of the limits of polling and survey data for purposes of informing private fund policy, including potential respondent bias, see *infra* Section V.B.
[34] *See infra* Section V.A.

describe a structural coordination problem, the best response might be to enact regulations that seek to fix the investor coordination problem rather than impose substantive bargaining outcomes on the parties.[35] Moreover, if unequal bargaining power really is a dominant cause of bargaining failure, it raises questions about how many of these problems might be ameliorated with a shift in market conditions. Private equity fund flows are known for being highly cyclical.[36] Over the past decade, market conditions—particularly in the financing markets—have heavily favored private equity fund managers and contributed to investor demand. But it cannot be assumed that manager bargaining power is a permanent characteristic of the market, and recent signs suggest that we may be entering a period of reduced demand for private equity investment.[37] If that turns out to be true, market forces might plausibly help to diminish some of the problems that the SEC has identified.[38]

This Article offers several proposals to make high-end securities regulation in private markets work better. To guide the future decisions of the SEC, courts, and Congress, I set forth a general framework for thinking about the relationship between private market interventions and the SEC's understanding of the causes of bargaining failure.[39] In short, I argue that the importance of verifying and understanding the relevant causes of bargaining failure in private funds (and private markets more broadly) increases as the aggressiveness of any proposed intervention increases.[40] In the immediate future, this provides the SEC with a useful framework as it considers whether to enact any of the mandatory disclosure requirements or prohibited activity rules set forth in the Private Fund Proposal.[41] In the medium-term future, if the SEC ultimately decides to proceed with any interventions, this framework will also provide courts with a useful tool for evaluating whether the SEC has been guilty of overreaching.[42]

Looking to the longer-term future, regardless of what the SEC and courts decide to do about the Private Fund Proposal in coming months, this issue is not going anywhere. The expansion of private funds and private markets continues apace,[43] which means that there will only be increasing pressure and scrutiny on private market securities law policy—both at the level of the SEC and in

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[35] *See infra* Section III.B for a discussion of how the optimal selection of interventions depends on the underlying cause.

[36] *See* Axelson, Jenkinson, Stromberg and Weisbach, *Borrow Cheap, Buy High? The Determinants of Leverage and Pricing in Buyouts*, 68 J. FIN. 2223 (2022).

[37] *See* Maria Armental, *Earnings Season Shows Private-Equity Firms Bracing for Slower Fundraising*, WALL ST. J. (Aug. 12, 2022); Cameron Joyce & Angela Lai, *Macro Conditions to Weigh on Performance and Industry Growth*, PREQIN SPECIAL REPORT: THE FUTURE OF ALTERNATIVES IN 2027 (Oct. 5, 2022) ("As a result of slowing performance and downside risks emerging within private equity, we expect the pace of fundraising to slow considerably.").

[38] In fact, as will be discussed in detail below, one of the seminal studies on the venture capital industry found that private equity covenants tend to loosen in times of high economic demand and tighten in times of low demand. *See infra* Section III.A.2.a.

[39] *See infra* Section VI.A.

[40] *See infra* Figure G.

[41] *See infra* Section I.A.

[42] *See infra* note 205 and accompanying text.

[43] *See supra* notes 12 and 14 and accompanying text.

Congress—in coming years. Yet, for the reasons noted above, private market regulation presents unusual challenges due to the absence of information in these markets.

I have three suggestions for cultivating a more effective policy dialogue in this new era for private securities regulation.[44] First, I call for the SEC to take a more deliberate approach to studying the conceptual issue of why bargaining outcomes fall short in private markets. As discussed below, this includes more efforts to invite public comment on conceptual questions relating to bargaining in private funds,[45] to perform more agency-commissioned studies on private fund bargaining,[46] and to release more information about private fund bargaining to scholars and the public.[47] Second, I argue that industry participants also have significant potential for improving the policy dialogue in private markets—not just by participating in SEC calls for comments but also by making themselves available for academic interviews and surveys and providing anonymized private fund documents to scholars for research purposes. A handful of scholars has recently tapped into these sources for private funds research,[48] adding valuable insights to the literature on private funds, but these efforts have just scratched the surface of what is possible. Better-informed policy should be more palatable to industry participants on both sides of the aisle than policy created in the dark. Lastly, I call on more corporate and securities law scholars to find thoughtful ways to make contributions to private market securities research. There is enormous potential for high-quality scholarship to lead to better policy in private funds in coming years.

To help accomplish each of the priorities called out above, I also encourage the SEC to do more to utilize the private fund examination program for data collection purposes. As policymakers become more engaged in studying the causes of private market bargaining failure, some forms of evidence will be more compelling than others. When gathering data about private fund bargaining, the more sizable and unbiased the data sources are, the more useful they will be in demonstrating causes of bargaining failure and informing how policymakers should respond. The SEC's examination program offers a valuable opportunity to produce this kind of data about private investment funds, but unfortunately its potential for supporting the SEC's policymaking efforts has largely gone unrealized. By introducing some simple changes to the existing program, the exam program could play an important role in transforming—for the better—the way private fund policy gets made.[49]

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[44] *See infra* Section VI.B.
[45] *See infra* note 209 and accompanying text.
[46] *See infra* note 210 and accompanying text.
[47] *See infra* Section VI.C.
[48] *See, e.g.*, de Fontenay & Nili, *Side Letter Governance*, WASH. U. L. REV. (forthcoming) (using a dataset of private equity side letters provided by LPs to theorize about private equity contracting); Jessica S. Jeffers & Anne M. Tucker, *Shadow Contracts*, 1 UNIV. CHIC. BUS. L. REV. __ (2022) (using a dataset of private equity side letters to draw conclusions about how they are used in practice); Clayton, *High-End Bargaining Problems*, *supra* note 1 (using institutional investor surveys to obtain information about how private equity fund agreements are negotiated).
[49] *See infra* Section VI.C.

To be clear, unlike many critics of the Private Fund Proposal, I am very much open to the idea that appropriately calibrated regulatory interventions could benefit the private fund industry.[50] But I believe much more can be done to build confidence about what exactly the optimal set of interventions might be. Accordingly, I encourage the SEC to view the current moment not as a one-time opportunity to solve all the bargaining problems in the space, but as one step on an ongoing path towards better oversight.

Finally, I close by noting that while this Article has focused primarily on private investment funds, many of the principles discussed herein are applicable to any private, high-end setting with sophisticated bargainers. Most notably, in previous comments, the SEC has signaled an interest in regulating the vast market for private operating companies, ranging from start-ups to unicorns.[51] I strongly encourage the Commission to consider the principles set forth in this Article before enacting any such regulatory interventions.

This Article proceeds as follows: Part I provides a brief history of the evolution of private fund policy from a hands off, unregulated approach to the aggressive proposal being considered today. It also describes the polarized policy dialogue observed during the notice and comment period following the release of the Private Fund Proposal. Part II discusses the light treatment given to the causes of bargaining failure in the Private Fund Proposal and the virtual absence of such issues from the submitted comments. It explains why the underlying causes of bargaining failure are particularly important to the legitimacy and proper tailoring of regulatory interventions in private funds. Part III discusses the academic literature on the causes of bargaining failure in private funds and explains why a definitive theory does not exist in the literature. Part IV seeks to fill the void in the current policy discourse and in the literature by presenting live polling results from a set of nearly 100 senior in-house counsel employed at institutional investors in private equity funds. Part V discusses the most important takeaways, and limitations, of the study. Part VI provides a framework to guide decision-making about policy interventions in this space, and it concludes with a call to the SEC, industry participants, and legal scholars to work together more deliberately to overcome the distinct information challenges that make it harder to understand the causes of bargaining failure in private funds and private markets more broadly. An important part of this effort includes doing more to utilize the SEC's private fund examination program to better support policymaking efforts.

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[50] *See infra* Section II.A. In fact, I have previously argued that if uniform transparency standards are determined to be a useful intervention, federal regulators would be better positioned to implement them than state regulators. William W. Clayton, *Public Investors, Private Funds, and State Law*, 72 BAYLOR L. REV. 294 (2020). I have also argued that public pension investment in the industry has warranted increased interest in private equity generally by the SEC. William W. Clayton, *How Public Pensions Have Shaped Private Equity*, 81 MARYLAND L. REV. 840 (2022) ("[E]ven though private equity funds are considered 'private funds' under the federal securities laws, the enormous presence of public pension plans has both shaped how this industry operates and also increased the public's interest in what happens in this market. Thus, while one can argue about whether the past and proposed SEC interventions in this market are well-conceived or within the agency's legal authority, the SEC's growing interest in private equity over the years is not particularly surprising.").

[51] *See supra* note 15 and accompanying text.

I. HIGH-END SECURITIES REGULATION: THE ADVENT OF PRIVATE FUND INTERVENTION

For most of its history, the private investment fund industry operated with virtually no regulatory interference or oversight. But today, the industry has grown to manage $18 trillion (a huge percentage of the overall investment management industry[52]), and the SEC is considering a rule proposal that would impose broad, aggressive regulatory interventions on industry practices. This growth has tracked the enormous growth in private markets more generally in recent years.[53] The Private Fund Proposal has prompted a profoundly divided response, with a host of critics contending that regulatory influence serves no legitimate purpose in a high-end space like this.[54]

A. A Brief History of Private Fund Regulation and the Release of the Private Fund Proposal

1. Private Fund Regulation Before the Private Fund Proposal

The federal securities laws restrict who can and cannot invest in private securities markets. Under rules passed pursuant to the Securities Act of 1933, anyone that wants to invest in a privately held company must be an "accredited investor" meeting certain net worth thresholds. In general, this means that entities must have at least $5 million in net assets and individuals must have at least $1 million.[55] The avowed purpose of this standard is to ensure that the market is limited to sophisticated investors who can sustain the risk of loss.[56]

Even higher standards are applied to investors in private investment funds. Investment funds are pools of capital raised from institutions and individuals and invested by the manager of the fund.[57] Under the Investment Company Act of 1940 (the "Investment Company Act"), most investors in most private funds are required

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[52] *See supra* note 12 and accompanying text.

[53] In every year since 2009, companies have raised more money in private markets than public markets. *See* Scott Bauguess, Rachita Gullapalli & Vladimir Ivanov, U.S. Sec. & Exch. Comm'n, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017, at 7-9, 8 fig. 1, 9 tbl 1 (2018). The magnitude of this trend has only been growing in recent years. In 2019, the $2.9 trillion in capital raised private markets dwarfed the $1.4 trillion raised in public markets. *See* MCKINSEY GLOBAL PRIVATE MARKETS REVIEW (Mar. 2022), *Private Markets Rally to New Heights*,, https://www.mckinsey.com/~/media/mckinsey/industries/private%20equity%20and%20principal%20investors/our%20insights/mckinseys%20private%20markets%2 annual%20review/2022/mckinseys-private-markets-annual-review-private-markets-rally-to-new-heights-vf.pdf.

[54] *See infra* Section I.B.

[55] For the formal definition of "accredited investor," see 17 C.F.R. § 230.501(a) (2021).

[56] See U.S. Sec. & Exch. Comm'n, Report on the Review of the Definition of "Accredited Investor" 2 (Dec. 2015), https://www.sec.gov/files/review-definition-of-accredited-investor-12-18-2015.pdf (noting that the accredited investor standard is "intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment . . . render the protections of the Securities Act's registration process unnecessary").

[57] *See* John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1232.

to have at least $25 million in net assets if they are entities and $5 million in net assets if they are individuals.[58]

Historically, private funds could opt out of the registration requirements of each of the federal securities statutes, allowing them to operate almost entirely off the SEC's radar. The basic logic was always that the investors in this high-end market had the sophistication and resources to fend for themselves and the wealth necessary to sustain the risk of loss if anything went wrong, so they did not need the help of a regulator.

Incremental changes to this approach started to appear in the years immediately following the Financial Crisis of 2008. As part of a broad set of financial reforms, Congress amended the securities laws to require the vast majority of private fund advisers to register with the SEC pursuant to the Investment Advisers Act of 1940 (the "Advisers Act"). While this did not dramatically modify the substantive regulatory requirements imposed on private equity managers, it did grant the SEC much broader examination authority over the industry. The SEC also updated some of the basic public disclosures that registered investment advisers were required to make pursuant to the Advisers Act[59] and included a new requirement that registered investment advisers make an annual filing on Form PF to address systemic risk.[60]

With this newly expanded authority to examine private fund managers, the SEC launched an examination "sweep" of the industry, with a focus on the private equity area.[61] This initial sweep revealed many industry practices that were troubling to industry observers. The SEC's exam staff articulated serious concerns about fee and expense practices, transparency problems, and issues relating to conflicts of interest in the industry,[62] and the Commission brought several

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[58] See Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(51)(A) (setting forth the requirements for "qualified purchasers"); 15 U.S.C. § 80a-3(c)(7) (allowing a fund to raise an unlimited amount of money from an unlimited number of investors if they are all "qualified purchasers"). Various other exemptions to the Investment Company Act exist, but section 3(c)(7) is the most commonly used. Furthermore, in any private fund that charges investors incentive-based compensation, the investors must also meet the "qualified client" standard under the Investment Advisers Act, which requires both entities and natural persons to have a net worth of at least $2.2 million or an investment with the manager of at least $1.1 million. *See* 17 C.F.R. § 275.205-3 (2021) (defining "qualified client"); Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 5756 (U.S. Sec. & Exch. Comm. June 17, 2021), https://www.sec.gov/files/ia-5756.pdf.

[59] "Rules Implementing Amendments to the Investment Advisers Act of 1940," 17 CFR Part 275 and 279, Rel. No. IA-3221; Fle No. S7-36-10, https://www.sec.gov/rules/final/2011/ia-3221.pdf.

[60] "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF," 17 CFR Parts 275 and 279, Rel. No. IA-3308, File No. S7-05-11, https://www.sec.gov/rules/final/2011/ia-3308.pdf.

[61] *See* Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014), https://www.sec.gov/news/speech/2014--spch05062014ab.html [hereinafter "Sunshine in Private Equity"] (stating that the exam initiative was designed to "establish a presence with the private equity industry and to better assess the issues and risks presented by its unique business model").

[62] *See generally id.*; Marc Wyatt, Acting Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance

enforcement actions against private equity managers.[63] Alarmingly, the exam staff indicated that it found "violations of law or material weakness in controls" over 50% of the time and that over half of the firms they examined were cited for deficiencies in their treatment of fees and expenses.[64]

In the years following that initial wave of activity, the SEC's examination program continued unabated through the Obama, Trump, and Biden administrations. On a periodic basis, the staff of the SEC's Division of Examinations[65] released "risk alerts"[66] that were designed to share some of the most common problems found during the examinations so that industry participants could take them into consideration in their operations. Most of the issues cited by the examination staff in these alerts were thematically similar to the issues described after the SEC's initial examination sweep.[67]

Notwithstanding a smattering of incremental regulatory updates during this period,[68] interventions into private funds generally remained extremely light.[69] By and large, private fund regulation remained a principles-based regime that imposed relatively few affirmative obligations on managers beyond disclosing their conflicts

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Forum: Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015), https://www.sec.gov/news/speech/private-equity-look-back-and-glimpseahead.html.

[63] *See, e.g.*, In re Apollo Mgmt. V, L.P., Advisers Act Release No. 4493, 2016 WL 11467649 (Aug. 23, 2016); In re TPG Cap. Advisors, LLC, Advisers Act Release No. 4830, 2017 WL 6554183 (Dec. 21, 2017); In re Blackstone Mgmt. Partners, L.L.C., Advisers Act Release No. 4219, 2015 WL 5834037 (Oct. 7, 2015).

[64] *See* Sunshine in Private Equity, *supra* note 61.

[65] Prior to 2020, this office was referred to as the Office of Compliance and Inspections. *See* "Statement on the Renaming of the Office of Compliance Inspections and Examinations to the Division of Examinations (Dec. 17, 2020), https://www.sec.gov/news/public-statement/joint-statement-division-examinations.

[66] Off. of Compliance Inspections & Examinations, *The Five Most Frequent Compliance Topics Identified in OCIE Examinations of Investment Advisers*, U.S. SEC. & EXCH. COMM'N (Feb. 7, 2017), https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf; Off. of Compliance Inspections & Examinations, *Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds*, U.S. SEC. & EXCH. COMM'N (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf; Div. of Examinations, *Risk Alert: Observations from Examinations of Private Fund Advisers*, U.S. SEC. & EXCH. COMM'N (Jan. 27, 2022), https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf.

[67] *See supra* note 62 and accompanying text.

[68] *See, e.g.*, "Form ADV and Investment Advisers Act Rules," 17 CFR Parts 275 and 279, Rel. No. IA-4509, File No. S&-09-15, https://www.sec.gov/rules/final/2016/ia-4509.pdf; "Commission Interpretation Regarding Standard of Conduct for Investment Advisers," 17 CFR Par 276, Rel. No. IA-5248, File No. S7-07-18, https://www.sec.gov/rules/interp/2019/ia-5248.pdf; "Investment Adviser Marketing," 17 CFT Part 275 and 279, Rel. No. IA-5653, File No. S7-21-19, https://www.sec.gov/rules/final/2020/ia-5653.pdf.

[69] *See* Simpson Thacher White Paper, *Implications of New SEC Marketing Rule for Private Fund Sponsors* (Feb. 26, 2021), https://www.stblaw.com/docs/default-source/Publications/whitepaper_02_26_21 (saying that marketing rule changes just "formalized existing SEC guidance and compliance best practices"); Memorandum from Simpson Thacher & Bartlett LLP, SEC Rulemakings and Interpretations Addressing Investment Adviser and Broker-Dealer Standards of Conduct and Disclosure Obligations (June 20, 2019), http://www.stblaw.com/docs/defaultsource/memos/firmmemo_06_20_19.pdf ("For investment management firms that only advise private investment funds and other institutional clients, the SEC Releases should have a limited effect on their businesses.").

of interest, and the SEC's role was largely to police fraudulent activity through examinations.

2. The Private Fund Proposal "Sea Change"

The Private Fund Proposal, introduced in February 2022, would fundamentally transform the SEC's historical hands-off approach. The Private Fund Proposal would, among other things, do the following:

- Require that all registered private equity managers deliver quarterly statements setting forth detailed information about fund performance, fees, and expenses to investors;[70]
- Require that all registered private equity managers obtain an annual audit for each fund that they manage;[71]
- Prohibit private fund managers (including unregistered managers) from engaging in a list of common commercial practices that the SEC views as contrary to the public interest;[72] and
- Prohibit all private fund managers (including unregistered managers) from providing certain forms of preferential treatment.[73]

The Private Fund Proposal has appropriately been called a "sea change" in the SEC's approach to private markets.[74] If adopted, the changes in the Private Fund Proposal would fundamentally transform the way the industry is regulated and mark a significant step towards blurring the distinctions between public and private markets. Given the size and influence of this market, it is difficult to overstate just how significant these changes would be.

The SEC gives various explanations for proposing these changes. The Commission argues that notwithstanding the decade of examinations and enforcement actions brought by the Commission against private fund managers, problematic activities have continued to persist in the industry.[75] Specifically, in the introductory section setting out the background for the Private Fund Proposal

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[70] Private Fund Proposal, *supra* note 8 at 16,890-16,911.
[71] Private Fund Proposal, *supra* note 8 at 16,911-16,917.
[72] Private Fund Proposal, *supra* note 8 at 16,920-16,928.
[73] Private Fund Proposal, *supra* note 8 at 16,928-16,932.
[74] *See* Hester M. Peirce, Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking, U.S. SEC. & EXCH. COMM'N (Feb. 9, 2022), https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922 ("Today's proposal represents a sea change. It embodies a belief that many sophisticated institutions and high net worth individuals are not competent or assertive enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationships with private funds.").
[75] *See* Private Fund Proposal, *supra* note 8 at 16,877-16,888 ("During our decade overseeing most private fund advisers, our staff has examined private fund advisers . . . . The Commission also has pursued enforcement actions against private fund advisers for practices that have caused private funds to pay more in fees and expenses than they should have, which negatively affected returns for private fund investors, or resulted in investors not being informed of relevant conflicts of interest concerning the private fund adviser and the fund. Despite our examination and enforcement efforts, these activities persist.").

and the need for reform, the SEC highlights a number of ways in which private funds lack sufficient transparency, including a lack of transparency about the cost of fund investments,[76] a lack of transparency about how fund performance is calculated,[77] and a lack of transparency regarding preferred terms granted to certain investors and not others.[78] Given these transparency issues, the SEC reasons that mandating enhanced information regarding costs, performance calculations, and preferential treatment would make the private funds industry more efficient by increasing competition, lowering the cost of capital for portfolio companies, and increasing returns for investors.[79]

The Private Fund Proposal also points to widespread conflicts of interest in private funds and provides a long list of general examples of fund managers acting on those conflicts against the fund's interest. As examples, the SEC indicates that these conflicts can arise when managers pay themselves or an affiliate out of a portfolio company's assets for providing certain services to portfolio company,[80] when managers value fund assets for purposes of calculating the manager's compensation,[81] when managers raise a new fund vehicle (with new investors) that offers to purchase assets from an existing fund vehicle,[82] when managers allocate

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[76] *See* Private Fund Proposal, *supra* note 8 at 16,888 ("We continue to observe that private fund investments are often opaque; advisers frequently do not provide investors with sufficiently detailed information about private fund investments. Without sufficiently clear, comparable information, even sophisticated investors would be unable to protect their interests or make sound investment decisions. . . . In addition, advisers often provide private fund investors with laundry lists of potential fees and expenses, without giving details on the magnitude and scope of fees and expenses charged.")

[77] *See* Private Fund Proposal, *supra* note 8 at 16,888 ("Investors often lack sufficient transparency into how private fund performance is calculated. Advisers frequently present fund performance reflecting different assumptions, making it difficult to measure and compare data across funds and advisers or compare the fund's performance to the investor's chosen benchmarks, even where the assumptions are disclosed.").

[78] *See* Private Fund Proposal, *supra* note 8 at 16,888 ("[I]nvestors may not have information regarding the preferred terms granted to certain investors (e.g., seed investors, strategic investors, those with large commitments, and employees, friends, and family). . . . In some cases, these terms materially disadvantage other investors in the private fund.").

[79] *See* Private Fund Proposal, *supra* note 8 at 16,888 ("Enhanced information about costs, performance, and preferential treatment, would help an investor better decide whether to invest or to remain invested in a particular private fund, how to invest other assets in the investor's portfolio, and whether to invest in private funds managed by the adviser or its related persons in the future. . . . Ultimately, this information would help investors better understand marketplace dynamics and potentially improve efficiency for future investments, for example, by expediting the process for reviewing and negotiating fees and expenses. More competition and transparency also could lower the cost of capital for portfolio companies raising money and increase returns to investors, potentially bringing greater efficiencies to this part of the capital markets.").

[80] *See* Private Fund Proposal, *supra* note 8 at 16,889 ("We also have continued to observe instances of advisers acting on conflicts of interest that are not transparent to investors, provide substantial financial benefits to the adviser, and potentially have significant negative impacts on the private fund's returns.").

[81] *See* Private Fund Proposal, *supra* note 8 at 16,889 ("[A]dvisers have a conflict of interest with private funds and investors in those funds when they value the fund's assets and use that valuation as the basis for the calculation of the adviser's fees and fund performance.").

[82] *See* Private Fund Proposal, *supra* note 8 at 16,889 ("As an example of advisers acting on conflicts of interest, certain venture capital fund advisers use private funds to obtain a controlling or

fees and expenses unequally to clients,[83] and when managers limit their own fiduciary duties or their liability for breaching duties, among others.[84] The SEC describes the governance mechanisms built into private funds as weak and insufficient to rein in these conflicts.[85] The SEC then argues that these conflicts warrant the prohibition of certain terms in private fund contracts, and that doing so will protect investors, promote more efficient capital markets, and encourage capital formation.[86]

To help establish why these concerns should matter to the SEC, the Private Fund Proposal cites the dramatic expansion of private markets[87] and the profound impact of private markets on the broader economy.[88] The Private Fund Proposal also points to the fact that many of the largest investors in private funds are institutions like public pension plans, university endowments, and non-profit organizations, which means that private fund performance affects the financial well-being of everyday Americans.[89] The heavy participation of these kinds of institutions in this market creates concerns about distributional outcomes if it is true that private ordering is not working.

As noted above, many of these issues have been flagged by scholars—including myself—over the years as causes for concern,[90] but scholarly discussion of any possible interventions has generally been quite cautious and qualified.[91]

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influential interest in a non-publicly traded early stage company and then instruct that company to hire the adviser or its related persons to provide certain services. In these circumstances, the adviser often sets the terms of the engagement, including the price paid for the services.").

[83] *See* Private Fund Proposal, *supra* note 8 at 16,889 ("[W]e have observed situations where the adviser causes one fund to bear more than its pro rata share of expenses related to a portfolio investment. In these circumstances, an adviser may unfairly allocate fees and expenses to benefit certain favored clients at the expense of others, indirectly benefiting the adviser.").

[84] *See* Private Fund Proposal, *supra* note 8 at 16,889 ("[O]ur staff also has encountered instances where advisers seek to limit their fiduciary duty or otherwise provide that the adviser and its related persons will not be liable to the private fund or investors for breaching its duties (including fiduciary duties) or liabilities (that exist at law or in equity).").

[85] *See* Private Fund Proposal, *supra* note 8 at 16,889 ("[P]rivate funds typically lack governance mechanisms that would help check overreaching by private fund advisers.").

[86] *See supra* note 79 and accompanying text.

[87] *See* Private Fund Proposal, *supra* note 8 at 16,887 ("[P]rivate funds play an increasingly important role in the financial system and private funds continue growing in size, complexity, and number. There are currently 5,037 registered private fund advisers with over $18 trillion in private fund assets under management.").

[88] *See* Private Fund Proposal, *supra* note 8 at 16,887 ("[P]rivate funds and their advisers play an increasing role in the economy. For example, hedge funds engage in trillions of dollars in listed equity and futures transactions each month. Private equity and other private funds are involved in mergers and acquisitions, non-bank lending, and restructurings and bankruptcies. Venture capital funds provide funding to start-ups and early stage companies.").

[89] *See* Private Fund Proposal, *supra* note 8 at 16,887 ("Private funds and their advisers also play an increasingly important role in the lives of everyday Americans saving for retirement or college tuition. Some of the largest groups of private fund investors include state and municipal pension plans, college and university endowments, non-profit organizations, and high net worth individuals. Numerous investors also have indirect exposure to private funds through private pension plans, endowments, feeder funds established by banks and other financial institutions, foundations, and certain other retirement plans.").

[90] *See supra* note 1 and accompanying text.

[91] *See supra* note 32 and accompanying text.

B. Comments on the Private Fund Proposal

The release of the Private Fund Proposal on February 9, 2022 started a primary comment period that generated 270 letters, with comments from a wide range of industry trade associations, professors, institutional investors, and even a group of former commissioners and general counsels of the SEC.[92] Responses to the Private Fund Proposal were polarized, with fund managers and their representatives uniformly opposed to the proposed interventions and most institutional investors who submitted comments generally in support of them (though often with significant reservations).

1. The Contractarian Critique of SEC Intervention

Virtually all the comments submitted by institutions representing fund managers were extremely critical of the Private Funds Proposal. While that is not particularly surprising in and of itself, it was the extraordinarily dismissive nature of these criticisms that was remarkable. In nearly every case, critics of the Private Fund Proposal disputed the idea that there is any problem that needs to be solved by regulation. A review of the comment letters thus makes clear that proponents and opponents of the Private Fund Proposal hold starkly contrasting viewpoints—not just concerning the SEC's proper policy role in private funds, but also concerning more basic questions about whether there are any problems to fix in private funds. Commenters submitting critical comments included a vast assortment of trade associations, professional associations, and other interest groups, scholars, and independent attorneys and law firms.

Commenters made various arguments to support the claim that there is no need for intervention in private funds. The most common argument focused on the sophistication of the participants in the private funds market, arguing that there is no reason to intervene because sophisticated actors can take care of themselves.[93] Others contended that there is insufficient evidence to support the claims made in the Private Fund Proposal, arguing that the proposal over-relies on a small number of enforcement actions that are not necessarily reflective of broader market practice.[94] Some commenters also argued that even if the SEC's observations in the

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[92] Cartwright, Clayton, et al., SEC Comment Letter (Mar. 24, 2022) (including former SEC Chairmen Jay Clayton and Harvey Pitt, former SEC Commissioner Joseph Grundfest, former SEC General Counsels Brian Cartwright, Harvey Pitt, and Robert Stebbins, and former Chief Economist and Senior Counsel, U.S. House Comm. on Financial Services, J.W. Verret).

[93] *See, e.g.*, American Investment Council, SEC Comment Letter (Apr. 25, 2022) ("[I[nvestment in private equity is reserved for investors with significant holdings—who are well-positioned to appraise a private equity investment, have the experience and leverage to negotiate appropriate investment terms, and are best able to absorb investment losses should they occur."); New York City Bar, SEC Comment Letter (Apr. 25, 2022) ("[T]hese investors are typically sophisticated parties of considerable financial means who not only do not require the extra protections that the Proposal seeks to impose, but who we suspect would themselves prefer the flexibility to negotiate around (and, in most cases, have already negotiated) some of the restrictions that the Proposal would impose.").

[94] *See, e.g.*, Joseph A. Grundfest, SEC Comment Letter (Apr. 25, 2022) (arguing that "the Commission is relying on trivial incidence rates to support significant regulatory interventions"); American Investment Council, SEC Comment Letter (Apr. 25, 2022) ("The Commission cites just

Private Fund Proposal are true, it still would not lead to the conclusion that they represent problems that needed to be resolved through regulation. Such commenters insisted that some of the activities flagged by the SEC are not actually harmful after all or, better yet, that they actually serve useful purposes that are desired by industry participants.[95] Opponents of the proposal have also argued that even if contracting outcomes are not perfect in the industry, the SEC's resources would be better spent focusing on retail markets with unsophisticated investors.[96]

Importantly, many commenters also argued that the SEC does not have authority to pass the rules described in the Private Fund Proposal under the federal securities laws.[97] While this is an extremely important claim and one that is likely to play an important role in determining which of the proposed interventions might actually go forward,[98] I do not focus on the question of authority here. Even if it is determined that the SEC lacks authority to impose the interventions in the Private Fund Proposal, this issue is not going anywhere. Given the ongoing growth of the private fund market and private markets more broadly, congressional action in this area is entirely plausible in coming years, and some scholars have explicitly called for such action.[99] Congress could certainly decide to grant the SEC authority to apply stronger regulations in private funds or impose regulations by statute.

2. *Institutional Investor Comments on the Proposal*

The institutional investors that submitted comment letters, by contrast, were generally supportive of many of the SEC's proposed interventions.[100] As will be

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20 enforcement actions, many from a number of years ago, spanning a 16-year period (for an average of 1.25 actions per year), which is far from an adequate basis to justify such a drastic change in the regulatory regime.").

[95] *See, e.g.*, National Venture Capital Association, SEC Comment Letter (Apr. 25, 2022) ("The Commission's ban on indemnification and exculpation provisions would chill advisers' willingness to actively engage in a company's growth, ultimately diminishing fund performance and investor returns.").

[96] Commissioner Hester M. Peirce, Securities & Exchange Commission, *Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking* (Feb. 9, 2022), https://www.sec.gov/news/statement/peirce-statement-proposed-private-fund-advisers-020922 ("[T]he Commission judges it wise to divert resources from the protection of retail investors to safeguard these wealthy investors who are represented by sophisticated, experienced investment professionals. . . . [O]ur resources are better spent on retail investor protection.").

[97] *See, e.g.*, Cartwright, Clayton, et al., SEC Comment Letter (Mar. 24, 2022) (asserting that the Private Fund Proposal exceeds the SEC's statutory authority, that it fails to provide a quantifiable justification for the proposal relative to the costs they would impose, and that less disruptive measures could be taken instead to accomplish the Commission's goals).

[98] *See supra* note 205 and accompanying text.

[99] *See, e.g.*, de Fontenay & Rauterberg, *supra* note 16 at 1243 ("[T]he public/private divide in securities regulation is overdue for a fundamental reexamination. This rethinking must address not simply where to draw the line between public and private companies, but also whether to draw a line at all—and if so, on what basis—and how to regulate firms on each side of the divide.").

[100] *See, e.g.*, Institutional Limited Partners Association, SEC Comment Letter (Apr. 25, 2022) ("We are broadly supportive of these proposals in principle and believe they will serve to further improve transparency in the private markets and enhance the ability of ILPA's members, as fiduciaries, to meet their obligation to beneficiaries.").

discussed in greater detail below,[101] many investors found significant fault with individual provisions within the proposed rules, but for the most part they indicated that the increased transparency and the mitigation of conflicts of interest generated by the proposal would be very beneficial. Unfortunately, however, there is very limited investor input on *why* the interventions are needed,[102] as the SEC's request for comments did not include a request for comments on the causes of bargaining failure. Investor comments tended to focus more on specific details of implementation rather than the conceptual question of what is causing bargaining to break down and whether the interventions are addressing the right underlying causes.

II. WHAT'S MISSING FROM THE POLICY DEBATE: THE CAUSES OF BARGAINING FAILURE

One cannot conclude that just because a contracting space is filled sophisticated actors, regulatory interventions in that space are destined to be unhelpful. It is certainly possible for issues to arise that cause private bargaining to break down even when the contracting parties are sophisticated.[103] Below, I show why an emphasis on the underlying causes of bargaining failure is especially important for the regulation of high-end spaces like private funds, and I discuss the ways in which the Private Fund Proposal and the subsequent comment letter period neglected to engage with these issues in a robust way.

A. Shadows of an Earlier Debate

Decades ago, prominent scholars engaged in a debate on the topic of regulatory intervention in the public company realm. At that time, a group of scholars had advanced the contractarian view that mandatory disclosure rules were unnecessary in the public company marketplace because companies were already incentivized to lower their cost of capital by voluntarily disclosing any information that investors find valuable.[104] In theory, successful companies should have a strong incentive to disclose information voluntarily to distinguish themselves from firms that have something to hide. In fact, some scholars contended that mandatory rules might actually make disclosure less effective by producing excessive amounts of costly information and stifling innovation and improvements in disclosure. Those

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[101] *See infra* Section II.E.

[102] Of the investors that did comment on the causes of bargaining failure, a few pointed to a disparity of investor bargaining power between investors and managers. *See infra* note 137.

[103] *See, e.g.*, MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN (2013); Stephen J. Choi, Mitu Gulati & Robert E. Scott, *The Black Hole Problem in Commercial Boilerplate*, 67 DUKE L. J. 1 (2017); Robert E. Scott, Stephen J. Choi & Mitu Gulati, *Revising Boilerplate: A Comparison of Private and Public Company Transactions*, 2020 WISC. L. REV. 629, 632–39 (finding that agency problems and coordination problems contribute to sticky contract terms in commercial contracts).

[104] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); Stephen Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177, 183-93 (Franklin R. Edwards ed., 1979).

arguments have much in common with arguments that have been voiced by opponents of the Private Fund Proposal today.[105]

This contractarian critique of mandatory disclosure prompted a rebuttal that emphasized some of the underlying issues that can cause private ordering to break down in the real world.[106] One defense of mandatory disclosure argues that public companies are likely to under-produce disclosure due to collective action problems.[107] For example, even though market-wide voluntary disclosure would almost certainly be beneficial for diversified investors, individual firms may frequently decide that it is not in their firm's best interest to make certain disclosures when doing so would benefit competitors. Scholars also argued that public companies were unlikely to produce optimal levels of disclosure because of principal-agent problems within public companies.[108] In other words, even though it would generally be in the best interests of a public company's shareholders to produce optimal levels of disclosure voluntarily, the insiders who control the company's disclosures may frequently have self-interested reasons to disclose information much more selectively.

Over time, this rebuttal gained wide acceptance and it has been described as a "consensus view"[109] among most securities law scholars today.[110] Most scholars have come to agree that mandatory disclosure is useful due to underlying bargaining problems in the real world.[111]

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[105] *See supra* Section I.B.

[106] *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 755-66 (2006).

[107] *See* Coffee, *supra* note 106, at 721-23.

[108] *See, e.g.*, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1355-56 (arguing that agency problems help to explain why corporate managers will choose to disclose less than is optimal for shareholders).

[109] *See, e.g.*, Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339 (1999) (describing the "rough consensus" achieved in the mandatory disclosure debate during the 1980s); Andrew A. Schwartz, *Mandatory Disclosure in Primary Markets*, 2019 UTAH L. REV. 1069 (2020) ("Thanks to these two very powerful ideas [i.e., agency costs and information underproduction], the modern theory of mandatory disclosure has achieved hegemony in the field. Nearly all scholars support the idea, both in the United States and around the world.").

[110] While it is certainly true that most securities law scholars believe there is a role for at least some mandatory disclosure, the level of consensus should not be overstated. *See* George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J. L. & BUS. 221 (2021) ("Even though the vast majority of scholars have been supportive of some form of mandatory securities regulation, this debate was never settled.").

[111] Another argument is that mandatory disclosure can be beneficial because it enables standardization, which increases the comparability of information between firms. In general, this argument has gained less traction because scholars reasoned that private bodies (like stock exchanges) could help firms achieve standardization. In the private equity industry, however, no such private standard-setting body has emerged. *See* William W. Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703 (2022) (noting that the model LPA and templates created by ILPA "have not achieved market-standard adoption").

Recognizing this history in the public company domain has two important implications for today's policy debate in the private funds setting. First, the claim that sophistication by itself will ensure effective bargaining is questionable. As noted above, the general scholarly consensus is that public companies fail to produce optimal levels of disclosure voluntarily not because of unsophistication, but because of collective action problems and principal-agent problems. The dominant investors in public companies, after all, have historically been large and well-resourced institutions that have the sophistication to consume corporate disclosures and price those disclosures into their valuations. Thus, if collective action problems and agency problems can corrupt private ordering outcomes in the public company context, there is little reason to think that private markets are impervious to similar problems. Investor qualification standards may ensure that private market investors have access to resources, but they do not guarantee immunity from the various forms of bargaining limitations in the real world.

Second, an important difference between the public company mandatory disclosure debate and the current private fund debate is that private market policymakers and commentators seem much less aligned on what exactly the causes of bargaining failure are in private funds. Before a broad policy consensus could be reached on the need for mandatory disclosure in the public company context, the collective action problems and agency problems described above first had to be acknowledged and understood. In the private funds context, by contrast, policymakers have expressed profound disagreement over the very existence and causes of bargaining failure in private funds.

B. Private Fund Regulation Calls for a Special Emphasis on the Causes of Bargaining Failure

The distinction between problematic contracting outcomes and the causes of those problems can be analogized to the difference between medical symptoms and a disease. This analogy helps elucidate the benefits of identifying the causes of bargaining failure in two ways. First, diagnosing the causes of bargaining failure is helpful because it might be possible for observers to misunderstand a contracting practice and characterize it as problematic when that may not actually be the case. For example, if someone has a lump under their skin, it does not necessarily mean that person has cancer. A benign cyst may superficially resemble a malignant tumor. Before deciding how concerned to be about the lump, it is necessary to diagnose the underlying cause of the symptom. Note that many critics have sought to delegitimize some of the provisions in the Private Fund Proposal by making precisely this type of argument, as described above.[112]

The second benefit of identifying the causes of bargaining failure relates to the first. If all you see is the symptom and you have not diagnosed the underlying disease, you will not know how to apply an optimal treatment. Continuing with the medical analogy, this would be like using chemotherapy to treat a cyst when a minor intervention (or no intervention at all) would do. In business law settings, policymakers can apply a broad range of potential interventions, including, for

[112] *See supra* note 95 and accompanying text.

example, mandatory disclosure requirements, independent director requirements, auditor requirements, principles-based duties and bright-line rules, examinations to ensure compliance with contract, market checks, interventions designed to fix structural impediments to effective bargaining, and prescriptive prohibitions on conduct. Understanding the applicable underlying causes of bargaining failure is critical to selecting the appropriate intervention.[113]

Of course, identifying the causes of bargaining failure matters for regulation in any context. But these issues are especially important for securities regulation in a high-end space like private funds because of the sophistication of the participants in the market. Private fund regulation thus calls for an unusually strong commitment to identifying and analyzing the underlying causes of bargaining failure.

Most fundamentally, because sophisticated parties are presumed to act in a rational, utility-maximizing manner when they make contracting and investment decisions, there is naturally a greater need to verify the existence of these underlying issues to justify interventions in a high-end setting. If no such underlying causes exist, private fund investors should collectively be well-positioned to use private ordering to find contractual solutions to their problems, and the proper policy response would almost certainly be to let the parties contract freely.

In addition, because the contracting population is sophisticated, it naturally puts more pressure on the regulator to apply interventions narrowly to address the relevant underlying cause and nothing more. As noted above, regulators typically have a range of potential interventions to choose from when responding to one of these underlying causes. For example, if a sophisticated contracting population is affected by a principal-agent problem but is otherwise well-positioned to engage in private ordering, there is greater pressure on the regulator to use the intervention that will address the principal-agent problem without impinging on the parties' freedom of contract in other areas. Assuming that those sophisticated parties can exercise contractual freedom effectively once the underlying causes of bargaining failure are removed, this approach should lead to the most efficient and most effective outcomes. Accordingly, any interventions in a high-end setting like private funds ought to be thoughtfully calibrated to address the relevant underlying causes without going further.

This need for a heightened focus on the causes of bargaining failure is magnified by the fact that it is unusually difficult to identify these issues in private funds. Because private funds are exempt from the public disclosure requirements of the federal securities laws, there is very little publicly available data about private funds. As a result, it is often extremely difficult to establish basic facts about how private fund bargaining works, let alone provide compelling evidence of the existence of underlying issues that infect the contracting outcomes in the space.[114]

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[113] *See infra* Section III.B.

[114] *See* Appelbaum & Batt, *supra* note 1 at 62 ("This creates an important conundrum: evidence-based policy requires empirical research, but management scholars cannot undertake that research without adequate policy changes to address transparency and information asymmetries.").

One illustration of this difficulty can be observed in the recent policy discussion relating to preferential treatment in private funds. As discussed below,[115] in seeking to justify the proposed rule provisions, the Private Fund Proposal frequently refers to conflicts of interest between large investors and small investors created by preferential treatment granted to investors through side letters. In doing so, the SEC cited to scholarly work that discusses how conflicts can arise when managers provide preferential treatment through side letters, co-investment vehicles, and separately managed accounts.[116] The Private Fund Proposal asserts that these widespread conflicts of interest cause large investors and small investors to value different things and bargain for different priorities.[117]

Recently, scholars have sought to test empirically whether side letters in private equity funds contribute to these kinds of conflicts of interest or not. One paper has concluded that very few terms of economic significance are granted in side letters, with the implication being that side letters are unlikely to have a significant impact on the substantive bargaining outcomes in the space.[118] Yet a different paper—released around the same time—has come to some different conclusions, finding that things like management fee discounts and substantive co-investment rights are commonly granted in private equity side letters.[119] Such disparities are perhaps unsurprising in light of the information challenges in this market, but given how fundamental this detail is for understanding how private equity bargaining works, the lack of consensus[120] is striking.

This combination of factors—an elevated need to show the underlying causes of bargaining failure plus the inherent difficulty of identifying those issues in the private fund setting—suggests that policymakers engaging in high-end securities regulation should be particularly invested in identifying and understanding the underlying causes of bargaining failure. It also suggests that policymakers likely need to be creative and adaptable to find ways to study and verify these causes.

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[115] *See infra* note 121 and accompanying text.

[116] *See* Clayton, *The Private Equity Negotiation Myth*, *supra* note 1.

[117] *See, e.g.*, Private Fund Proposal, *supra* note 8 at 16,889 ("[T]he interests of one or more private fund investors may not represent the interests of, or may otherwise conflict with the interests of, other investors in the private fund due to, among other things, business or personal relationships or other private fund investments. To the extent investors are afforded governance or similar rights, such as LPAC representation, certain fund agreements permit such investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole. For example, certain fund agreements state that, subject to applicable law, LPAC members owe no duties to the private fund or to any of the other investors in the private fund and are not obligated to act in the interests of the private fund or the other investors as a whole.").

[118] de Fontenay & Nili, *Side Letter Governance*, *supra* note 48.

[119] Jeffers & Tucker, *Shadow Contracts*, *supra* note 48 at 27-28.

[120] *See* Ann Lipton, *de Fontenay and Nili and Jeffers and Tucker on Side Letters*, Business Law Prof Blog (July 23, 2022), https://lawprofessors.typepad.com/business_law/2022/07/de-fontenay-and-nili-and-jeffers-and-tucker-on-side-letters.html (noting that while de Fontenay and Nili find that side letters rarely offer financial preferences, Jeffers and Tucker "find that a significant percentage of side letters do confer financial benefits on favored investors, such as fee reductions and guaranteed co-investment opportunities").

C. *The Causes of Bargaining Failure Are Not a Central Focus of the Private Fund Proposal*

Unfortunately, this focus on the causes of bargaining failure is not reflected in the Private Fund Proposal. The proposal includes various explanations for why bargaining in private funds might be leading to unsatisfying outcomes. However, these claims are not presented as part of a clear and unified thesis for why suboptimal bargaining happens in this industry. Instead, the staff's discussion of the causes of bargaining failure is scattered throughout the Proposal, and one might miss the descriptions of these underlying causes if one is not looking carefully for them.

When it does speak to underlying causes, the Private Fund Proposal points to certain forms of coordination problems, with an emphasis on conflicts of interest between large and small investors.[121] Along these lines, the proposal also indicates that competition among investors for investment opportunities reduces their incentives to work with each other to unify their positions or work towards standardization of terms.[122] In addition, the Private Fund Proposal suggests that private equity fund investors may sometimes lack sophistication to appreciate the full consequences of some of the terms that they agree to.[123] The proposal also claims that incomplete contracting problems can arise[124]—notwithstanding the sophistication of investors—due to the complexity and long time horizons of these investments.[125]

Unfortunately, when the Private Fund Proposal discusses these underlying causes of bargaining failure, the staff's descriptions tend to be impressionistic and anecdotal, and there is no data presented to verify their existence or offer a more nuanced understanding. Moreover, after setting out the list of commercial activities that the staff proposes to prohibit, the Private Fund Proposal acknowledges that there is a lack of data about how private equity industry business practices would be affected by the proposed prohibitions.[126] While this statement is an honest

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[121] Private Fund Proposal, *supra* note 8 at 16,889 ("[T]he interests of one or more private fund investors may not represent the interests of, or may otherwise conflict with the interests of, other investors in the private fund due to, among other things, business or personal relationships or other private fund investments. To the extent investors are afforded governance or similar rights, such as LPAC representation, certain fund agreements permit such investors to exercise their rights in a manner that places their interests ahead of the private fund or the investors as a whole.").

[122] *Id.* at 16,943 ("[I]t may be difficult for private funds to adopt a common, standardized set of detailed disclosures and practices. This is because investors and advisers compete and negotiate independently of each other, and also because of the substantial complexity of information that fund advisers maintain on their funds and may potentially disclose.").

[123] *Id.* at 16,937 ("Some investors may not anticipate the performance implications of these disclosed costs, or may avoid investments out of concern that such costs may be present.").

[124] *Id.* at 16,944 ("Because many of these conflicts of interest and sources of harm may be difficult for investors to detect or negotiate terms over, full disclosure of the activities considered in the proposal would not likely resolve the potential investor harm.").

[125] *Id.* at 16,937 ("[W]e believe that it may be hard even for sophisticated investors with full and fair disclosure to understand the future implications of terms and practices related to these practices at the time of investment and during the investment.").

[126] *Id.* at 16,934 ("[T]he Commission is unable to quantify certain economic effects because it lacks the information necessary to provide estimates or ranges of costs. Further, in some cases,

reflection of the challenges of seeking to regulate in this private space, it reinforces the idea that the proposal lacks a confident understanding of the relevant causes of bargaining failure and how the provisions are calibrated to address those causes.

In addition to the references to underlying causes identified above, the Private Fund Proposal also describes certain issues that might appear to be underlying causes at first glance, but upon closer reflection it becomes evident that they are not. For example, to explain why significant conflicts of interest are so widespread in private funds, the proposal points to the fact that managers can extract compensation from portfolio companies without the knowledge of the fund or its investors.[127] However, this describes a symptom and not an underlying disease. Years ago, the SEC conspicuously called out the problem of transparency problems in private equity portfolio companies,[128] and this issue has been flagged repeatedly by the Commission. The operative question, then, is why investors have not demanded better transparency in the intervening years. What is stopping the market and the private bargaining process from demanding improved portfolio company transparency?

Similarly, the Private Fund Proposal also makes the argument that bargaining breaks down in private funds due to an information imbalance between advisers and investors regarding costs and performance.[129] The proposal claims that advisers often provide detailed information after the investor has committed to the fund and when it is too late to withdraw. Again, while these things may be true, they do not explain why market forces have not compelled managers to provide more information, and why investors will invest before such information is received.

D. Signs the Private Fund Proposal Might Be Insufficiently Tailored

As discussed above,[130] when interventions are not calibrated to address the relevant causes of bargaining failure, a regulator runs a risk of the intervention being overly broad or ineffective. Possible signs of this risk can be found in some of the positions taken in investor comment letters. While it is true that institutional investors were generally supportive of the Private Fund Proposal, many investors indicated that they thought the SEC went too far in promoting certain rights of investors. For example, one of the proposed rules in the Private Fund Proposal

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quantification would require numerous assumptions to forecast how investment advisers and other affected parties would respond to the proposed amendments and rules, and how those responses would in turn affect the broader markets in which they operate.”).

[127] *Id.* at 16,889 (claiming that issues with conflicts of interest “are widespread in the private fund context because, in many cases, the adviser can influence or control the portfolio company and can extract compensation without the knowledge of the fund or its investors”).

[128] *See, e.g.*, Sunshine in Private Equity, *supra* note 61.

[129] Private Fund Proposal, *supra* note 8 at 16,888 (“This lack of transparency regarding costs, performance, and preferential terms causes an information imbalance between advisers and private fund investors, which, in many cases, prevents private bilateral negotiations from effectively remedying shortcomings in the private funds market. . . . Moreover, certain advisers may only provide sufficiently detailed information following an investor’s admission to the fund when the primary bargaining window has closed.”).

[130] *See supra* Section II.B.

would prohibit any private fund manager from "seeking reimbursement, indemnification, exculpation, or limitation of its liability by the private fund or its investors for . . . negligence, or recklessness in providing services to the private fund."[131] In its comment letter, the Institutional Limited Partners Association ("ILPA") noted that even though such a provision would strengthen alignment between managers and investors, it was untenable because it would likely lead to "exorbitant insurance policies, the premiums for which would be passed on as a fund expense or via higher management fees or as the basis for excluding 'potentially litigious' LPs from certain funds."[132] In other words, even though the stronger version of the rule might theoretically be helpful in a narrow sense, when viewed in context, investors were concerned that the broad prohibition would ultimately harm them by increasing their overall costs. There are various other examples of investors pushing back on prescriptive rules that they believe went too far to protect investors.[133]

Comparative analysis also offers evidence that the SEC's proposed interventions were not narrowly calibrated to respond to specific underlying causes of bargaining failure. Various commenters[134] made the observation that many of the Private Fund Proposal's prohibited activity rules provide for protections that are even more robust than the protections afforded to retail investors and other less sophisticated investors in other settings.[135] Commenters noted that there are many settings where this is true, including the rules governing public company investments, the rules governing investment by natural persons in private operating companies, and the rules governing limited partnerships and LLCs under state

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[131] Private Fund Proposal, *supra* note 8 at 16,920.

[132] *See* Institutional Limited Partners Association, SEC Comment Letter (Apr. 25, 2022) ("While its inclusion would strengthen alignment, inserting an ordinary negligence standard among the activities for which the GP is prohibited to self-indemnify may be an untenable standard, used as a pretext for prolonged diligence to zero out risk in prospective deals. Other unintended consequences may include compliance with the rule as justification for exorbitant insurance policies, the premiums for which would be passed on as fund expense or via higher management fees or as the basis for excluding 'potentially litigious' LPs from certain funds.").

[133] *See, e.g.*, Regulatory Fundamentals Group, SEC Comment Letter (Apr. 25, 2022) (expressing lack of support by endowments and foundations for various aspects of the proposal, claiming that the preferential transparency prohibition will likely lead to decreased overall transparency and the preferential liquidity prohibition provision will do more harm than good, among other things); Alaska Permanent Fund Corporation, SEC Comment Letter (Apr. 7, 2022) ("To meet the needs of institutional investors, we write to urge flexibility and caution in advancing the private fund adviser proposal in its current form. We believe the proposal has the ability to increase, rather than decrease, our fees and expenses. We also worry it will dramatically reduce our investing opportunities and limit our ability to deliver returns to our beneficiaries.").

[134] *See, e.g.*, Joseph A. Grundfest, SEC Comment Letter (June 13, 2022); American Investment Council, SEC Comment Letter (Apr. 25, 2022).

[135] Joseph A. Grundfest, SEC Comment Letter (Apr. 25, 2022) ("The Prohibited Activity Rules also generate multiple, profound, and conspicuous internal contradictions within the federal securities laws. They provide greater 'investor protection' to the most sophisticated of all investors in venture capital, hedge fund, and private equity transactions than to the least sophisticated investors in public offerings and private placements. The Proposing Release provides no rational explanation for this inversion of traditional principles of investor protection.").

law.[136] Without providing a clear explanation of the underlying causes of bargaining failure that warrant granting private fund investors more robust protections than retail investors, these interventions raise legitimate questions.

Another possible sign of insufficient calibration is the level of polarization observed in the notice and comment process generally. As discussed above, many criticisms of the Private Fund Proposal were remarkably sweeping and dismissive in their discussion of the proposal. Instead of advocating for incremental adjustments to the proposal in the spirit of finding a mutually agreeable middle ground, most critics insisted that the Private Fund Proposal was altogether unnecessary and called for the complete abandonment of the initiative. The Private Fund Proposal has thus been a magnet for polarization.

Of course, it may very well be true that many critics of the Private Fund Proposal would have been dismissive of *any* proposal to regulate private funds, regardless of how well-conceived and supported by the facts it might have been. If private fund managers and their representatives have more to gain by allowing bargaining failures to persist than by eliminating them, it would be in their interest to publicly deny the existence of those failures even if they secretly know that they exist. Nevertheless, a more robust demonstration of underlying causes of bargaining failure would have left less room for sweeping dismissals and forced critics to engage on the substantive merits of the proposal.

E. The Causes of Bargaining Failure Are Not a Central Focus of the Comment Letters

Unfortunately, the issues described above were compounded by the fact that the Private Fund Proposal did not seek industry commentary on its characterization of the causes of bargaining failure in private funds. In the proposal, the SEC asked for comments on over 900 specific questions, but virtually no questions solicited feedback on *why* bargaining outcomes are falling short in private funds. Instead, the questions in the Private Fund Proposal generally took for granted the existence of bargaining failures and instead solicited input on the scope and application of the proposed rules.

Given their proximity to the bargaining process, industry participants are a useful potential source of information about the underlying causes of bargaining failure in private funds. But most of the letters from institutional investors focused on the practical challenges associated with putting the proposed rules into operation.[137] This was a missed opportunity, particularly given the fact that the

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[136] *See id.* ("[C]ontradictions with the federal securities laws are compounded by additionally conspicuous contradictions with state, federal, and foreign law, and with a large body of academic literature. Every state expressly permits indemnification. Federal and foreign law are consistent.").

[137] Of the investors that did comment on the causes of bargaining failure, a few pointed to a disparity of investor bargaining power between investors and managers. *See* Ohio Public Employees Retirement System, SEC Comment Letter (Apr. 25, 2022); New York State Insurance Fund, SEC Comment Letter (Apr. 25, 2022); New York Common Retirement Fund, SEC Comment Letter (Apr. 25, 2022). This response is consistent with the polling results discussed in Parts IV and V. Certain other investors commented on persistent information asymmetry between investors and managers, though these investors did not offer any explanations for why such disparities persist in private funds

Private Fund Proposal was not preceded by a concept release[138] or other form of preliminary solicitation for industry comments on whether the SEC had correctly identified the issues causing the problematic contracting outcomes in the industry.[139]

In addition, the lack of focus on the underlying causes of bargaining failure in the Private Fund Proposal also diminished the usefulness of the comments from critics of the proposal. If the proposal had presented a robust theory (or theories) of the causes of bargaining failure and asked for industry comments on those specific theories, critics would have been more likely to engage on a substantive level with those issues. Such input would have been more useful than the comments that ended up being submitted by critics, which, for the most part, simply insisted on the absence of problems.

III. THE ACADEMIC LITERATURE LACKS A DEFINITIVE THEORY OF THE CAUSES OF BARGAINING FAILURE

Scholars have offered various theories to explain the causes of problematic bargaining outcomes in the private equity industry. I provide a summary of those theories below.[140] Importantly, when these theories were generated, the scholarly debate over the causes of bargaining failure in private equity funds was largely academic in nature. Given the SEC's long-time hands-off approach to private fund regulation, it is unlikely that anyone foresaw that such aggressive regulatory interventions were on the horizon for future policy. The SEC's recent actions bring an extraordinary sense of urgency and practical relevance to the academic theories discussed below.

Unfortunately, these studies do not—by themselves—provide a definitive account of the causes of bargaining failure in private funds. Because private fund managers are not required to register their funds with the SEC under the 1933 Act or the Investment Company Act, very little fund-related information ever gets disclosed to the public. As a result, it is very difficult for scholars to test these theories, leaving many open questions.[141]

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if they are harmful. *See* American Federation of Teachers New Mexico, SEC Comment Letter (Apr. 25, 2022); Illinois Federation of Teachers, SEC Comment Letter (Apr. 25, 2022).

[138] *See infra* note 209 and accompanying text for an example of an open-ended SEC comment release soliciting conceptual feedback rather than implementation-focused feedback.

[139] It is possible that the SEC engaged in informal and off-the-record conversations with industry participants about these issues prior to releasing the Private Fund Proposal. However, given the relatively limited treatment of the causes of bargaining failure in the proposal, it appears that such meetings did not result in a robust theory of such causes.

[140] Importantly, there are also studies that conclude that private fund agreements reflect efficient bargaining outcomes. *See, e.g.*, Larry Ribstein, *Partnership Governance of Large Firms*, 76 UNIV. CHI. L. REV. 289 (2009) ("Private-equity buyout firms are a leading example of the use of partnership mechanisms in governing large firms."); David T. Robinson and Berk A. Sensoy, *Do Private Equity Fund Managers Earn Their Fees? Compensation, Ownership, and Cash Flow Performance*, 26 REV. FIN. STUDIES 2760 (2013) ("[E]vidence is most consistent with the view that private equity management contracts reflect efficient bargaining by sophisticated parties.").

[141] *See, e.g.*, Appelbaum & Batt, *supra* note 1 at 2020-21 ("[E]mpirical evidence is insufficient to assess the extent of opportunistic behavior . . . [T]his paper identifies the ways in which the PE

A. Academic Theories of the Causes of Bargaining Failure in Private Equity Funds

Most academic theories of bargaining failure in private equity funds fall into one of two categories: theories that blame the structure of private equity bargaining, and theories that blame the internal workings of institutional investors. I discuss these theories (along with a few additional explanations) below.

1. Flaws in the Structure of Private Equity Bargaining

Several theories blame the bargaining environment for problems in private equity funds. According to these theories, investor sophistication alone is not enough to overcome suboptimal contracting outcomes. Rather, due to coordination problems and other issues stemming from the structure of the bargaining process, these theories posit that problematic outcomes may persist even when all investors are fully competent.

a. A Commons Problem

As noted above,[142] one of the causes of bargaining failure most heavily emphasized in the Private Fund Proposal is a coordination problem stemming from conflicts of interest between large and small investors. Scholars (including myself) have argued that because investors can bargain for individualized benefits (like co-investment opportunities) in private equity funds, investors with bargaining power have a more complex set of incentives than one might expect.[143] Instead of prioritizing terms that will benefit all investors in a fund, investors may have incentives to prioritize individualized benefits.[144] This describes, in effect, a possible commons problem in the private equity industry.[145]

Recently, however, conflicting empirical data has been produced on the question of how much side letters contribute to the dynamic described above. Prior work has generally assumed that co-investments, fee discounts, and other preferential terms affecting economic value (either directly or indirectly) are commonly granted in side letters,[146] but one important recent study has challenged

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model creates perverse incentives that *may* lead adverse outcomes for stakeholders." (emphasis added)).

[142] *See supra* note 117 and accompanying text.

[143] *See* Clayton, *The Private Equity Negotiation Myth*, *supra* note 1; Magnuson, *supra* note 1 at 1887-88; Phalippou, *supra* note 1 at 75.

[144] *See id.* at 70 ("In general, the more that an investor can use its bargaining power to negotiate for individualized benefits before it negotiates for things that will benefit all investors in the fund (like fund agreement protections), it will be a more "efficient" use of that investor's bargaining power. . . . [W]hen individualized benefits are common, it is likely to have a dampening effect on the extent to which fund agreements are negotiated.").

[145] *See* Lee Anne Fennell, *Common Interest Tragedies*, 98 NW. U. L. REV. 907, 915–16 (2004) ("The person who cultivates a garden . . . internalizes all of the costs but (in a setting where the produce is open to the group as a whole) does not internalize all of the benefits. Therefore, she will invest too little time and effort into cultivation, because she will not receive the benefits of her work.").

[146] Various industry sources and survey reports over the years have supported this assumption. *See, e.g.*, PREQIN, PRIVATE EQUITY CO-INVESTMENT OUTLOOK 5 (Nov. 2015),

the extent to which economically significant terms are actually located in side letters.[147] Interestingly, however, another recent paper found that management fee discounts and guaranteed co-investment rights are actually quite common in side letters,[148] raising questions about the market reality more broadly and what explains the differing results.

b. Incentives to Leverage Resource Advantages

Other scholars have argued that a coordination problem exists in private funds stemming from a different conflict between large and small investors: the incentive for large investors to negotiate for unnecessarily complicated contracts.[149] Doing this might be in an institutional investor's best interest to the extent that they are primarily concerned about how their institution performs in comparison to the rest of the market. If this is the operative incentive, a staff member might sometimes agree to inefficient practices—even if they harm the institution's returns—so long as those practices will harm their peer investors more.

Phalippou and Morris argue that because of these incentives, large institutional investors might actually be better off when private equity contracts are complex and hard to benchmark across the marketplace. For larger institutional investors that hire large staffs, as contracts become more complex, the competitive advantage of those institutions should increase. Relative to smaller investors, large institutions should be able to use their resources to generate superior information about the true cost of contracts, which should enable them to pick better funds than other institutional investors and outperform industry benchmarks.[150]

c. Problematic Professional Advisor Incentives

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https://docs.preqin.com/reports/Preqin-Special-Report-Private-Equity-Co-Investment-Outlook-November-2015.pdf (reporting survey results showing that private equity advisers are significantly more likely to offer co-investment rights to LPs during the fundraising process than during the bid for a deal or after a deal is completed); Kelli L. Moll & Omoz Osayimwese, *Key Considerations and Tactics in Negotiating Side Letters for Private Funds*, REV. OF SECURITIES & COMMODITIES REGULATION (Dec. 2020), https://www.akingump.com/a/web/9QHk6tQWxQGyaQRwK7XAQK/moll_osayimwese_rscr_final-002.pdf ((“[S]ide letters are used to negotiate discounts to management fee and carry/incentive allocation rates, liquidity rights, transparency rights, and other reporting rights.”); Gardner, Sadler & Schiappacasse, *Private Fund Side Letters: Common Terms, Themes and Practical Considerations*, Dechert Client Memorandum, https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html (“Fee provisions may be included in a side letter to reflect any commercial deal agreed (for example, in relation to the rate of management fees/performance fees/carried interest).”). Other academics have made similar assumptions about side letters. *See, e.g.*, Magnuson, *The Public Cost of Private Equity*, *supra* note 1.

[147] *See* de Fontenay & Nili, *Side Letter Governance*, *supra* note 48.

[148] *See* Jeffers & Tucker, *Shadow Contracts*, *supra* note 48 at 27-28.

[149] *See* Morris & Phalippou, *supra* note 1.

[150] *Id.* (“[Large investors’] competitive advantage increases when private equity firms make their contracts more complex. Superior information about the true cost of contracts, past performance, etc., enables them to pick better funds than average. They will be able to outperform private equity industry benchmarks.”).

In addition, scholars have argued that as the industry has become increasingly institutionalized, a growing list of actors has a vested interest in maintaining the existing model, even if it deviates from optimality. Most obviously, the law firms that represent managers and investors clearly have strong incentives to avoid standardization and to maintain their role in the bargaining process.[151] Scholars have also posited that the external counsel to private equity managers have self-serving incentives to push back on investor-friendly terms, even when such terms might be acceptable to the manager.[152] Other parties that have incentives to avoid significant changes in the bargaining model include financial analysts, investment advisors and consultants, and investment banks.[153]

d. Typical Rules of Engagement Hamper Investor Bargaining

Another theory posits that the typical rules of engagement for bargaining in private equity funds create an unlevel playing field and make it difficult for investors to bargain effectively. Specifically, investors often complain that managers include confidentiality restrictions that prevent them from talking with other investors in the same fund (or even knowing who they are) or sharing fund documents with anyone.[154] In addition, it is often said that investors are typically required to pay the legal expenses incurred by the manager during a private equity fundraise, which presumably makes managers more willing to push back on investor requests and lengthen the bargaining process than they otherwise would be.[155]

Of course, one might reasonably ask whether these rules of engagement are actually symptoms of bargaining failure rather than causes themselves. In other words, if these terms are so problematic, why have investors not demanded better terms? That is a fair question. I include this factor here as a potential cause of bargaining failure because it seems highly plausible that the existence of such terms could hamper investors' efforts to negotiate the terms of private equity fund contracts generally. In fact, one could argue that the fact that these rules of

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[151] *See* de Fontenay & Nili, *supra* note 48 ("The small set of elite law firms that represent large sponsors view their respective limited partnership agreement templates as proprietary: they maintain their 'brand' by not permitting any investor-friendly modifications to the limited partnership agreement and by insisting that all documentation in the industry remain confidential. On the investor side, counsel has failed to settle on standardized language for common side letter provisions, because they have little economic incentive to coordinate and to reduce their billings.").

[152] *See id.*

[153] *See* Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACAD. MGMT. PERSPECTIVES 45 (2021) ("The institutionalization of the PE business model . . . mean that a larger web or network of players have a stake in the survival of the model—including creditors, investment banks, PE lawyers, financial analysts, and investment advisors or consultants.").

[154] *See* Clayton, *High-End Bargaining Problems*, *supra* note 1 at 738-39 ("These kinds of restrictions make it more difficult for investors to coordinate their bargaining efforts with each other. They also make it much more difficult for investors to benchmark and compare LPAs against each other across the market, which … hampers the diffusion of contracting innovations and improvements across the market-wide network of investors.").

[155] *See id.* at 737-38.

engagement exist makes it more difficult for investors to push back against these very terms, thereby indirectly helping to ensure their own survival.

2. *Internal Investor Problems*

Another type of theory directs blame at the investors themselves, rather than the structure of the environment in which the investors are operating. These theories posit that institutional investors suffer from internal problems—including agency problems and political pressures, among others—that diminish their ability to bargain effectively.

a. *Agency Problems Within Institutional Investors*

In an early study of the venture capital industry,[156] Gompers and Lerner showed that when demand for private equity investments increased, private equity fund managers did not charge correspondingly higher fees. This was a puzzling finding. As profit maximizers, one might have expected that managers would have taken advantage of higher bargaining power by demanding higher fees.[157]

Instead of negotiating for higher fee rates, Gompers and Lerner found, managers and investors instead negotiated for more flexible non-price covenant terms in private equity LPAs. By making LPA covenants more flexible, it made it easier for managers to extract private benefits from the funds that they managed. In other words, instead of demanding higher monetary compensation, private equity managers appeared to use their increased bargaining power to obtain governance terms that enabled them to enrich themselves through more opaque channels.

One explanation for this activity suggested by Gompers and Lerner points to the fact most of the capital invested in private equity funds comes from institutional sources.[158] Gompers and Lerner posited that investment officers within these institutions in may find it more attractive to dilute restrictive covenants in the fund's LPA than pay higher prices because those kinds of changes will be buried deep within the fund's LPA and, as a result, will be far less likely to be noticed by the investment officer's regulators or superiors. Diluting restrictive covenants could thus be viewed as an indirect—and inefficient—way to make price adjustments that

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[156] *See* PAUL GOMPERS AND JOSH LERNER, THE VENTURE CAPITAL CYCLE (1999).

[157] *See id.* (noting that it is "puzzling" that the adjustment to supply and demand dynamics takes place through the insertion and deletion of contractual restrictions in addition to explicit monetary compensation); Gompers & Lerner, *supra* note 1 ("If the demand for the services of experienced venture capitalists changes rapidly while the supply of those venture capitalists is fixed in the short run, the price of venture capital services should rise.").

[158] *See* Lakonishok, Shleifer & Vishny, *The Structure and Performance of the Money Management Industry*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY, MICROECONOMICS 339 (1992).

is less likely to attract the scrutiny of an internal manager's superiors[159] and thereby raise fewer concerns about censure and career risk.[160]

Importantly, many studies published in the decades following the article discussed above have claimed to find various forms of evidence of internal agency problems leading to suboptimal behavior by institutions that invest in private equity funds (with a particular emphasis on public pension plans).[161]

b. The Complicating Role of Investor-Level Regulation

Scholars have also noted that many of the investors in private equity funds are themselves regulated institutions that are subject to their own regulations and requirements, thus making them act differently than private, rational, self-interested actors.[162] While it is difficult to measure the precise impact of this kind of investor-level regulation, at least two effects are clear. First, to the extent that investors are required by law or regulation to obtain certain contractual terms from managers, those terms are not actually the product of bargaining between sophisticated parties. Instead, such terms are produced by legislatures and regulatory bodies through political and administrative processes that are not accounted for in the law and economics literature. Second, investor-level regulation has likely helped contribute to the complex, labor-intensive, and costly negotiating dynamic observed in the private equity industry by requiring bilateral bargaining between investors and managers.

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[159] *See* Gompers & Lerner, *supra* note 1 ("These covenants represent a less visible way to make price adjustments than explicit modifications of the split in capital gains. Deviations from the standard 80 to 20 percent division of profits are likely to attract widespread attention in the institutional investor community. The inclusion or deletion of covenants, however, is much less likely to attract notice. Investment officers responsible for choosing venture capital investments may find that concessions made in this manner attract less scrutiny from regulators or superiors.").

[160] *See* Morris & Phalippou, *supra* note 1 ("[A] rise in headline fees might . . . encourage [those with oversight authority] to take resources away from the agents, i.e., the organization's private equity department. Fewer resources might mean lower salaries and fewer jobs for the private equity department. . . . This means that private equity firms are able to raise prices, but have to do so using non-headline fees.").

[161] *See, e.g.*, Yael V. Hochberg & Joshua D. Rauh, *Local Overweighting and Underperformance: Evidence from Limited Partner Private Equity Investments*, 26 REV. FIN. STDS. 403 (2013) (presenting evidence of pension fund overinvestment in local private equity investments); Bernstein, Lerner & Schoar, *The Investment Strategies of Sovereign Wealth Funds*, 27 J. ECON. PERSP. 219 (2013) (finding that sovereign wealth funds overinvest in local private equity funds); Andonov, Hochberg & Rauh, *Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds*, 73 J. FIN. 2041 (2018) (finding that the presence of politicians on pension fund boards leads to weaker performance in private equity investments); Jackson, Ling, and Naranjo, *Catering and Return Manipulation in Private Equity*, Working Paper, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4244467 (finding that internal staff at institutional investors have perverse incentives to demand overstated reported returns from managers).

[162] For a discussion of the benefits and challenges associated with this kind of investor-level regulation, see William W. Clayton, *Public Investors, Private Funds, and State Law*, 72 BAYLOR L. REV. 294, 332-43 (2020).

c. Divided Functions Within Institutional Investors

Another possible explanation for problematic outcomes in private equity fund contracting is the widespread practice of two-staged bargaining by institutional investors in the industry. Institutional investors very commonly have separate investment teams and legal teams. It is therefore not unusual for the investment team to make a decision about whether to invest in the fund before the transaction is handed to the lawyers to work out the legal details. In an earlier paper, I collected investor survey data showing that it is very common for investment teams and legal teams to have extremely limited communications with each other.[163] In settings like this, when legal teams are finally given the opportunity to negotiate, they will have limited bargaining power (because they can no longer, as a practical matter, walk away).

3. Other Academic Theories

a. Multiple Agency Problems

Building on the observations described above, scholars have also used multiple agency theory to explain the challenge of using private equity fund contracts to align the interests of private equity fund managers with private equity fund investors. In effect, multiple agency theory combines elements of the two categories of theories described above (flaws in the structure of bargaining and internal investor issues). It argues that conflicts of interest are so complex and so deeply embedded in the structure of private equity bargaining and operations and the internal make-up of institutional investors that they are extremely difficult to overcome.

For example, Appelbaum and Batt examine the various roles played by fund managers and how those various roles generate conflicts of interest and reduce the alignment of interest between managers and investors.[164] Magnuson makes a similar argument.[165] Appelbaum and Batt point out that private equity managers are both principals and agents at the level of the private equity firm itself, as well as principals in the portfolio companies acquired by the fund and agents for the limited partners who invest in private equity funds.[166] Both managers and investors are also managing a web of ongoing relationships with other parties, further

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[163] *See* Clayton, *High-End Bargaining Problems*, *supra* note 1 at 755-57.

[164] *See id.* ("We argue that the PE model may be best understood as an example of multiple agency theory in which there is not just one principal-agent relationship but tiered relationships among a 'web of interrelated parties.'")

[165] Magnuson, *supra* note 1 at 1902 ("Given the multiplicity of reputations that private equity firms maintain, it is unclear whether, in any given case, private equity firms will place greater value on their reputation vis-à-vis investors than their reputation vis-à-vis creditors, targets, or along any of the many other dimensions of reputation.").

[166] *See id.* at 45 ("The PE general partner has multiple relationships to manage—as principal (partner) and agent (manager) in the PE firm, as principal (holding a small equity share) in the portfolio company that the PE fund acquires, and as agent for the limited partners who invest in the PE fund.").

muddying the waters.[167] This creates a complex and overlapping set of conflicts of interest that grow larger and more complex as the institutional parties get larger.

b. A Desire to Avoid the Reach of the Federal Securities Laws

Scholars have also argued that some of the core features of the private equity model reflect the parties' efforts to avoid the reach of the federal securities laws, and are not actually the product of rational negotiation between private parties.[168] At its core, this argument is more a criticism of the federal securities antifraud regime than an argument that private equity investors and managers are ineffective bargainers.[169] But to the extent that this is true, it means that the terms in private equity fund contracts are not the product of high-level bargaining at all. Accordingly, a policy approach that presumes free bargaining among the parties will miss an important part of the overall picture.

c. Contracting Path Dependence

Another theory is that problematic terms in private equity funds are simply the product of path dependence. As William Magnuson has argued, private equity fund contracting conventions adopted early in the industry's history might have continued even after they were no longer optimal for various reasons, including network benefits from standardization, herd behavior, and anchoring effects, among others.[170] In this respect, private equity fund contracts would be no different that contracts in various other settings.

B. Different Causes of Bargaining Failure Call for Different Policy Responses

Many of the theories described above would, if validated, warrant different kinds of policy responses. For example, if the SEC was confident that flaws in the structure of private fund bargaining[171] are the primary driver of bargaining failure, the best policy response might be to intervene in a manner that addresses the underlying structural flaw while otherwise leaving freedom of contract intact. Various levers could plausibly be pulled to address these kinds of problems, ranging from relatively minor actions[172] to major actions, including actions that could be taken by the SEC and actions that would need to be taken by other policymakers or organizations. Comparable policies include, for example, the

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[167] *See id.* at 45 ("The limited partner investors and GPs are also nested in a web of ongoing relationships that include banks and creditors who offer substantial loans for PE deals and financial advisors who play a key role in shaping the investment decisions of the limited partners.").
[168] *See* Spindler, *How Private is Private Equity*, *supra* note 1 at 312 ("The breadth of the law's reach, and what one must do to escape it, largely defines what private equity is.").
[169] *Id.* at 331 ("I question whether the private equity juggernaut has come to be because it is a technological innovation in its own right, or whether it is simply because the U.S. securities regime has become, by comparison, so bad.").
[170] Magnuson, *supra* note 1 at 1890-96.
[171] *See supra* Section III.A.1.
[172] As an example, ensuring that investors can communicate with other investors in the same fund would be a relatively straightforward step that might benefit fund negotiations. *See supra* Section III.A.1.d.

Williams Act in the context of public tender offers and the Trust Indenture Act of 1939 in the context of public bond issuances. Such policies seek to address structural coordination challenges without imposing substantive outcomes on the parties.

By contrast, if the SEC concluded that the predominant problem in private funds is that investors fail to fend for themselves due to internal agency problems and other forms of institutional dysfunction, the policy intervention would be quite different. One response to such problems might be to adjust the investor accreditation standards to ensure that private markets only include investors that can actually fend for themselves. If irrational bargainers cannot reasonably be removed from the investor population through accreditation standards, one might conclude that a pure disclosure-based regime may not be sufficient because the staff members could not be relied upon to respond appropriately to the disclosures that they receive. Following that logic, a more aggressive, prescriptive approach could plausibly be warranted under such circumstances.

Another possibility could be that *all* the theories above are material contributors to bargaining failures in private equity funds. If that were the case, crafting a targeted set of interventions would be difficult and complex. Alternatively, if *none* of the theories above are leading to significant bargaining failures, the best policy response would undoubtedly be to do nothing. Whatever the actual state of the world is, crafting an effective regulatory response demands a careful assessment of the causes of bargaining failure in private funds and weighing the pros and cons of intervening in light of those causes.

C. *Limits of Academic Theories*

Unfortunately, all the academic studies cited above suffer from a common limitation: a lack of publicly available information about how private funds operate.[173] In general, the only information that private funds must disclose about themselves is the information that they are contractually required to disclose to investors. Private fund documents—including limited partnership agreements, side letters, investment management agreements, private placement memoranda, subscription documents, and otherwise—are virtually never made available to the public by fund managers, and private fund investors are typically contractually prohibited from sharing these documents with the public or with each other.[174] Details about the process by which private fund agreements are negotiated are also typically closely guarded.

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[173] *See infra* Section II.B.

[174] *See* Madison Marriage & Chris Newlands, *Pension Funds Forced to Sign Non-Disclosure Agreements*, FIN. TIMES (Oct. 26, 2014), https://www.ft.com/content/94524a60-5b96-11e4-81ac-00144feab7de ("Anger has erupted over the practice of asset managers coercing pension funds into signing non-disclosure agreements."); Gretchen Morgenson, *Behind Private Equity's Curtain*, N.Y. TIMES (Oct. 18, 2014), https://www.nytimes.com/2014/10/19/business/retirement/behind-private-equitys-curtain.html ("[I]n exchange for what they hope will be hefty returns, many pension funds have signed onto a kind of omerta, or code of silence, about the terms of the funds' investments.").

For these reasons—as noted above—there is no definitive theory of the causes of bargaining failure in private funds.[175] Many of the theories summarized above relied on the SEC or other publicly available sources for their information and simply extrapolated their theories based on that information.[176] Others used creative methods to obtain access to primary transaction documents[177] or surveys with industry participants,[178] but these studies inevitably have smaller sample sizes and more potential for selection bias and other issues than you would find in studies of publicly traded entities.

These limitations may help to explain why these studies are typically somewhat cautious about the policy interventions that they propose.[179] When aggressive interventions are discussed, they are usually presented as one of many possible approaches along with more surgical approaches designed to support private ordering.[180] Interestingly, none of the scholars cited above advocated for interventions that are as aggressive as the collective policy interventions found in the Private Fund Proposal.[181]

IV. INVESTOR POLLING DATA: THE CAUSES OF BARGAINING FAILURE IN PRIVATE EQUITY

If adopted, the Private Fund Proposal would impose the most aggressive set of regulatory interventions—by far—ever seen in private markets. Yet, one of the critical questions for private fund regulatory policy has not been a primary focus: "What are the causes of bargaining failure in private funds?" The notice and comment period for the Private Fund Proposal missed an opportunity to learn what industry participants think about this fundamental issue.

In this Part, I present the first empirical study to examine what institutional investors think about the causes of bargaining failure in private equity funds. Institutional investors have substantial experience navigating the bargaining process in private funds. Many institutional investors are serial repeat players in private investment funds, with in-house legal personnel focused on making investments in a range of funds that are managed by a range of advisers. With this

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[175] *See* Clayton, *High-End Bargaining Problems*, *supra* note 1 at 740 (discussing the various theories that have been posited by investors over the years).

[176] *See, e.g.*, Spindler, *supra* note 1; Clayton, *Negotiation Myth*, *supra* note 1; Magnuson, *supra* note 1; Phalippou, *supra* note 1.

[177] *See, e.g.*, de Fontenay & Nili, *supra* note 48; Jeffers & Tucker, *supra* note 48.

[178] *See, e.g.*, Clayton, *supra* note 1.

[179] *See supra* note 32.

[180] *See, e.g.*, Magnuson, *supra* note 1 (offering various possible approaches to remedying problems in private equity funds, including multiple voluntary private market solutions in addition to regulation, without taking a position on which would be best); Appelbaum & Batt, *supra* note 1 at 62 (noting that for all of the possible policy proposals, "[f]urther investigation . . . is needed to determine what effects they may have on PE fund performance and whether they introduce other potential conflicts between the interests of LPs and GPs").

[181] *See, e.g.*, *Morris & Phalippou*, *supra* note 1 at 60 ("[R]egulators should as much as possible avoid prescribing specific behaviours. Instead, they should focus on improving information flow and ensuring market participants receive enough of the right kind of information to make markets more efficient without outside interference.").

in mind, I collected live polling data from senior in-house counsel working at institutional investors in October 2021 during a session of the annual Private Equity Legal Conference of the Institutional Limited Partners Association ("ILPA"). The number of respondents ranged from 86 to 99, depending on the question.[182] The respondents included public pension plans, endowments, private pension plans, international development funds, insurance companies, family offices, foundations, funds of funds, and one traditional bank.[183] All of the polling results—including the responses by investor type for each question—can be found in Appendix A.

In my interactions with institutional investors and their external counsel over the years, I have found that it is very common for institutional investors to complain about how challenging the private equity bargaining landscape is. This input is consistent with statements that have been made by ILPA over the years.[184] Economic theory would suggest that in a competitive market with no bargaining failures, sophisticated parties will bargain for "optimal" terms that will maximize the joint surplus shared between the parties, regardless of the distribution of bargaining power between them.[185] In such a market, theory would predict that investors would avoid investing in managers that offer unacceptable terms, creating competitive pressure for managers to offer terms that will be satisfactory to investors.

General investor sentiment suggests that many investors do not believe this principle holds true in the private equity market. Given this background, I used this polling session to seek to gain insight into two general questions: (1) "What are the underlying bargaining issues that cause investors to accept terms that they find problematic?"; and (2) "Do investors want to see regulatory reforms?" The original poll consisted of 10 questions, and I discuss some of the most salient results below.

A. What Are the Most Important Causes of Bargaining Failure?

To address this question, I asked a senior in-house private funds attorney[186] to create a list of possible explanations for why (from an institutional investor's perspective) investors might accept low-quality legal terms. Then, during the ILPA conference panel, investors were asked to respond to the following live polling prompt: "Please indicate the top three explanations below that best explain why

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[182] *See infra* note 192 for a description of the method for calculating the number of respondents for polling question #9.

[183] Respondents working at external law firms or other organizations that are not institutional investors were excluded from the sample.

[184] *See supra* note 17.

[185] *See, e.g.*, Douglas G. Baird, *The Boilerplate Puzzle*, 104 MICH. L. REV. 933, 934, 938 (2006); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1320–21 (1981); Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1074 (1977) ("Given . . . three [weak] assumptions, a firm will produce the same level of product quality regardless of whether the firm is a monopolist or a perfect competitor."); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 547 (2003) ("Bargaining power instead is exercised in the division of the surplus, which is determined by the price term. Parties jointly choose the contract terms so as to maximize the surplus, which the [parties] may then divide unequally.").

[186] This participating lawyer serves as the senior in-house lawyer for a large corporate institutional investor in private equity funds.

LPs are accepting poor legal terms in LPAs." Investors could choose from among the following options:

1. Commitment size of your institution is too small
2. Fear of losing allocation
3. GP counsel defend their form LPA and aren't willing to make concessions even though GP itself would
4. GP counsel information advantage over LPS
5. GPs have more resources to pay for legal counsel
6. Insufficient information on "what's market" in fund terms
7. Internal LP alignment issues between legal/investment team
8. LPs are unable or unwilling to walk away from bad terms
9. LPs don't negotiate the LPA and rely on the side letter
10. Natural supply and demand issues

The investors' responses are below:

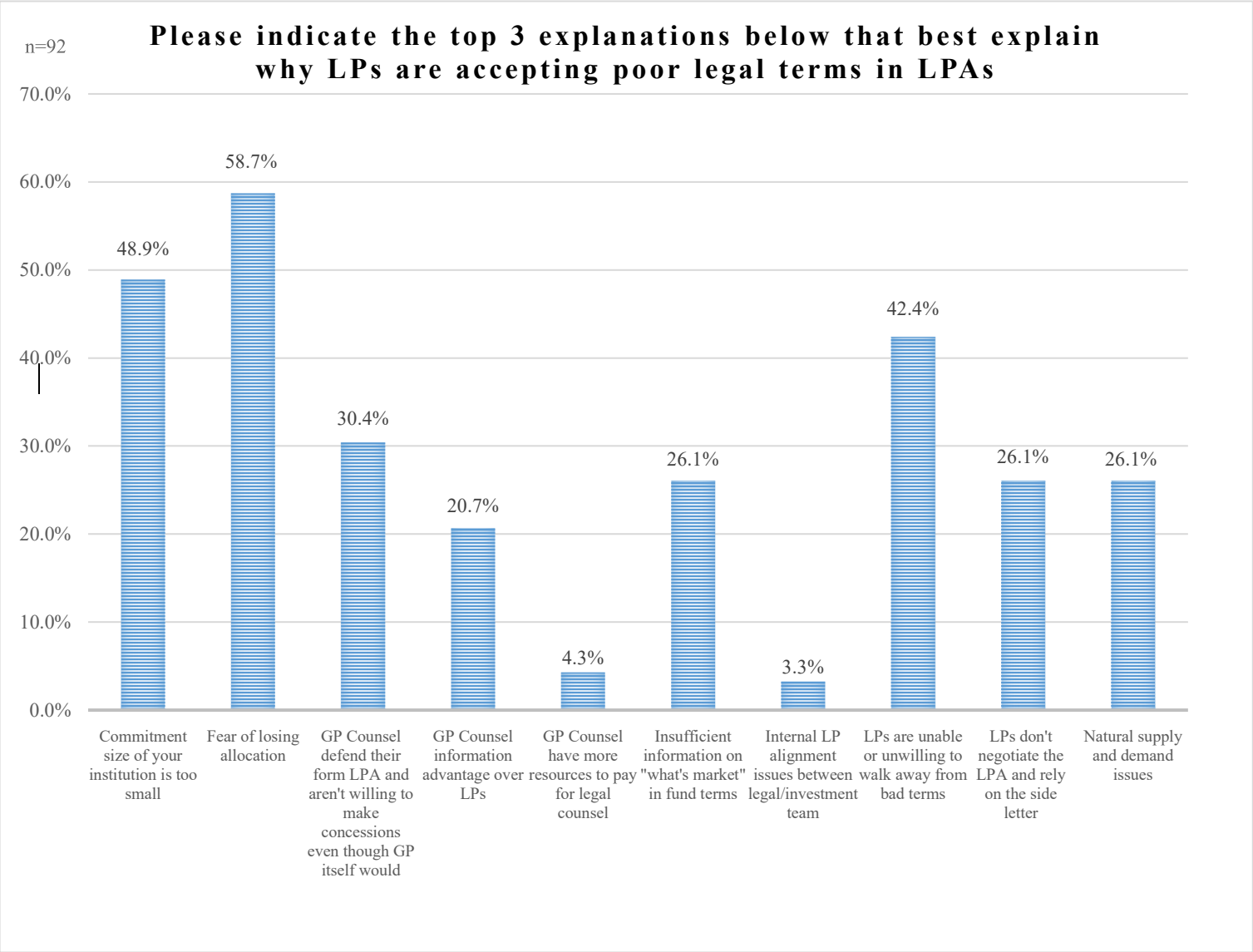

Figure A

The most common response from institutional investors (by far) was that they accept problematic terms because of a fear of losing allocation to managers' funds, which is another way of saying that investors are concerned they will be cut out of a manager's current or future funds if they bargain too hard.[187] This describes a form of a coordination problem among investors. If all investors were aligned in their bargaining priorities, they would be less concerned about losing allocation to funds in return for pushing back on fund terms that are legitimately problematic. But investors appear to be worried that if they insist on high-quality terms, their allocation to the current fund and/or future funds might be given to other investors

[187] *See* Heather Gillers, *Pension Funds Push for More Disclosure Rules for Private-Equity, Hedge Funds*, WALL ST. J. (June 6, 2022) (citing the survey findings presented herein regarding investors' concerns for allocation).

that are willing to tolerate weak terms. If this is an accurate reflection of market reality, it could be characterized as a form of a prisoner's dilemma.

To get a sense of the scale of this "fear of losing allocation" problem, I separately asked investors the following question: "How often to you accept unsatisfying terms because you're afraid that pushing for better terms will cause your institution to lose access (or receive a lower allocation) to a manager's fund of future funds?" Their responses are below:

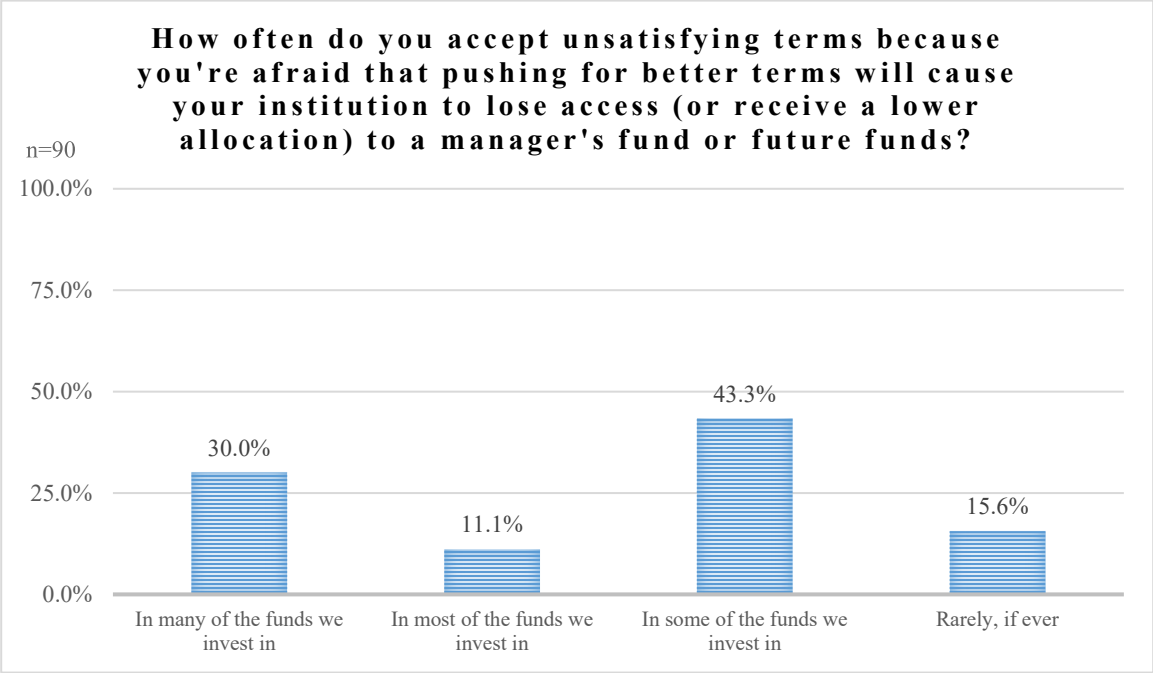

Figure B

Approximately 84% of investors indicated that they accept unsatisfying terms in at least "some" of the funds that they invest in. Most investors indicate that they do this in "some" or "many" of the funds they invest in, with only 11% reporting that this happens in "most" of the funds they invest in.

Going back to the polling results shown in Figure A, the second and third most common responses similarly reflect a sense among investors that they lack bargaining power—both individually and collectively—to push back on poor legal terms. Interestingly, there is a significant gap between these bargaining power-related problems and other issues that received fewer votes. The law and economics literature would suggest that bargaining power should not affect non-price contract terms because parties would be better off agreeing on non-price terms that maximize joint surplus and then using their bargaining power to negotiate only the price.[188] Scholars provided evidence years ago, however, that this is not how it

[188] *See supra* note 185.

works in the private equity industry,[189] and these polling results reinforce that understanding.

The fourth most common response in Figure A points to a particular kind of principal-agent problem in the private equity fund market. Private equity advisers typically hire an outside law firm to handle investor negotiations when they raise large funds. A large percentage of the overall market is dominated by a relatively small number of law firms, and it has been suggested that one way in which these law firms compete for clients is by claiming to have the most adviser-favorable LPAs.[190] If this is how adviser-side law firms actually think, then they may have self-interested reasons to avoid accepting negotiated changes to the LPA even when it would be beneficial to their client. The survey data suggests that some investors think this is an issue, with almost one-third of respondents including it as a top three cause of bargaining failure.

Interestingly, compared to concerns about losing allocation, investors were generally less inclined to blame other structural characteristics of private equity bargaining. These include concerns that the law firm-side advisers have an informational advantage over investors when they negotiate, concerns about the common practice of side letter contracting in the industry, and concerns that investors do not know what is "market" because fund documents are kept confidential. This does not necessarily mean, of course, that these are illegitimate issues (each of them did, after all, receive support from approximately a quarter of respondents). But it does emphasize just how concerned investors seem to be about losing allocation by comparison.

Finally, almost no institutional investors identified "GPs have more resources to pay for legal counsel" as one of the top contributors to sub-optimal legal terms in private equity funds. Similarly, almost no institutional investors identified internal alignment issues between in-house investment teams and legal teams as a top problem. These results may not be surprising, as in-house counsel responding to the polling question predictably would not want to give the impression that they are less sophisticated than manager-side attorneys or that their institutions suffer from internal problems that might warrant any scrutiny.

B. What Other Causes of Bargaining Failure Do Investors Point To?

While a fear of losing allocation and a general sense of weak bargaining power were the top responses for investors, the polling results also pointed to other possible issues. For example, investors indicated that one of the challenges they face is a lack of information about what terms are "market" in the industry due to the fact that private fund documents are not publicly available. 84% of investors indicated that it would either "significantly help" or "dramatically help" to have a better picture of what terms are actually "market." Again, this received far fewer votes when compared with a fear of losing allocation and other bargaining power

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[189] *See* PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE 31-32, 45-47 (1999) (finding that in periods of high demand for private equity fund investments, that in periods of high demand for private equity fund investments, private equity fund managers did not charge correspondingly higher prices, but instead bargained for less restrictive contractual covenants).

[190] *See* de Fontenay & Nili, *Side Letter Governance*, *supra* note 48.

related issues, but when considered on a standalone basis it appears that most investors think it is a problem.

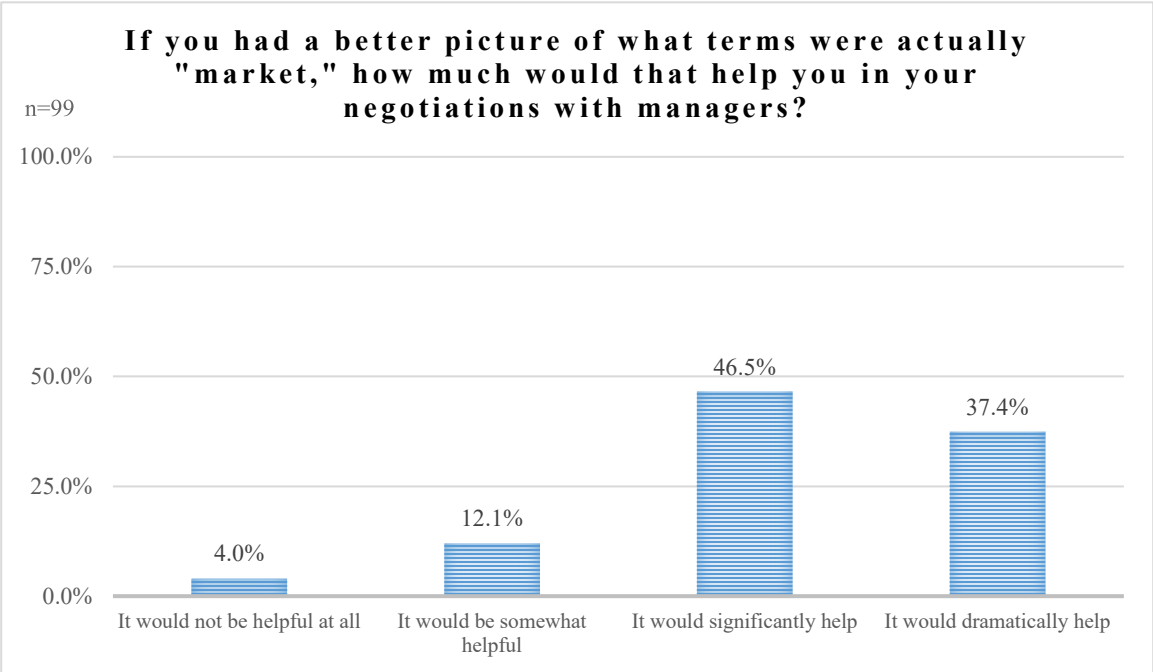

Figure C

Another issue identified by investors is that many managers give them insufficient time to review and negotiate fund documents. When asked to rate how much they agree with the statement "Do you think PE fund negotiating timelines are unreasonable (i.e., you have too little time to review and negotiate fund documents"), 86% reported that they either "strongly agree" or "somewhat agree."

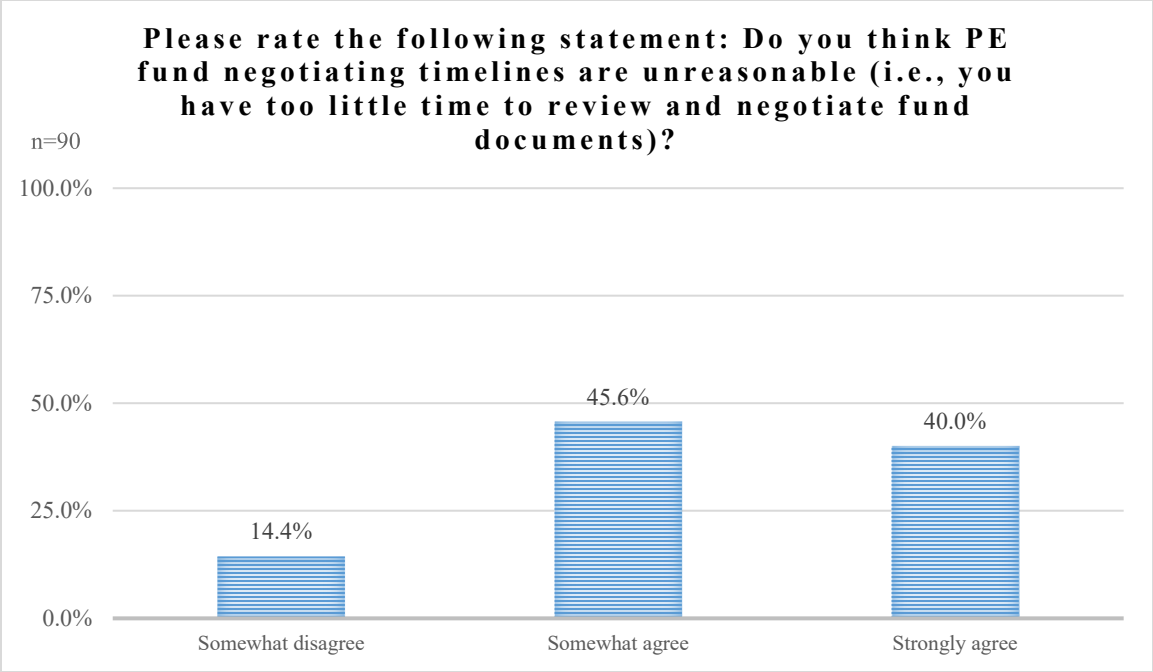

Figure D

C. Do Investors Want Regulatory Intervention?

Even if bargaining failures exist and the causes of those failure can be determined, it is a separate question whether and how regulators should respond. As a follow-up to the question above, respondents were asked if they think any regulatory interventions are needed. Again, a list of potential responses was compiled by a senior in-house attorney specializing in private fund investments.[191] Respondents were presented with the question "What regulatory reforms are needed?" and given the ability to select as many of the following options as desired:

1. Elimination of side letters except for necessary regulatory requirements
2. Enhanced ability to sell in the LP secondaries market
3. Enhanced mitigation and disclosure of GP conflicts of interest
4. Independent boards required in private funds
5. Mandatory fee and expense reporting
6. Preventing GP counsel from being compensated by the fund
7. Standardization of what is covered by a private fund management fee

[191] *See supra* note 186.

Responses to this question are shown below[192]:

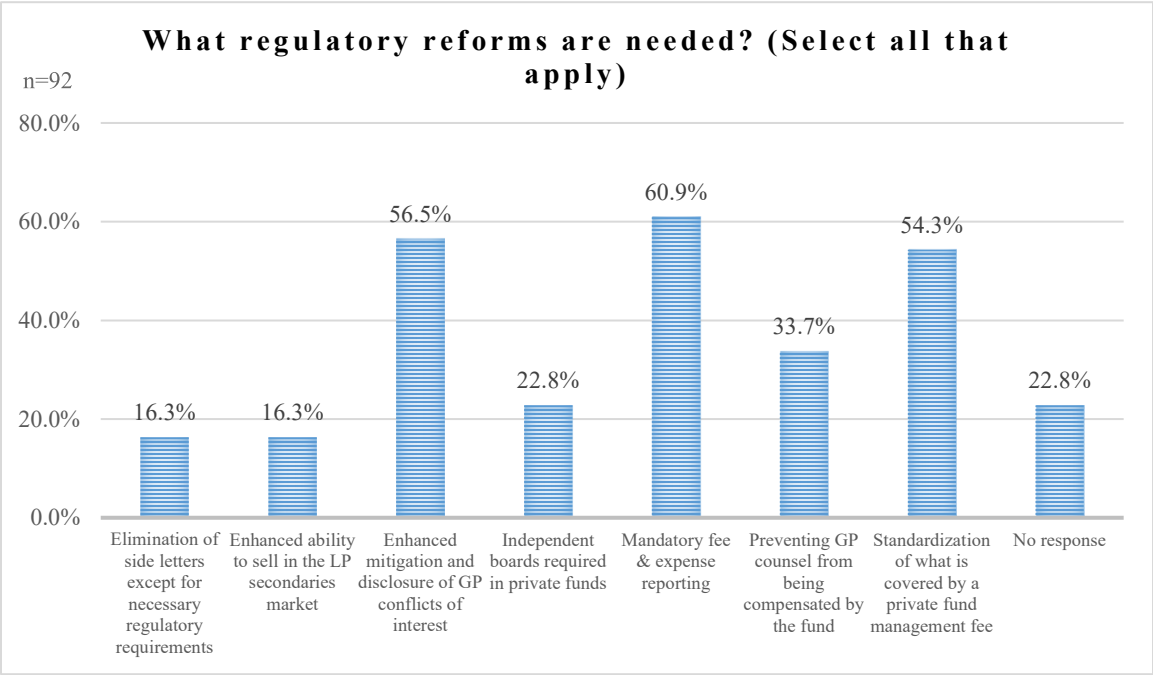

Figure E

Interestingly, the two reforms most frequently selected by respondents are consistent with two of the most important priorities of the Proposal: imposing mandatory fee and expense reporting requirements and dealing with adviser conflicts of interest. In addition, a large number of investors identified management fee standardization as a needed policy reform.[193] Other noteworthy results include the fact that a significant number of investors (approximately one-third) thought that preventing general partners from being compensated by the fund would be a helpful reform.

That said, support for regulatory reform did not appear to be unanimous among investors. As shown in Figure E, a significant number of investors did not respond to the poll, suggesting that there may be a material percentage of investors that preferred not to see an increase in regulatory interventions.[194] This mixed perspective on the role of regulatory reform was also reflected in the survey result

[192] As shown in Appendix A, this was the ninth question asked during the polling session. The sample size of 92 in the chart above was derived by taking the average number of responses to the eight polling questions immediately preceding this question. If the peak number of responses from the eight preceding polling questions is used instead, the sample size would be 99. A chart is provided in Appendix B setting forth what the results in Figure B would look like with a sample size of 99.

[193] In recent years, investors have expressed concern that advisers have been pushing various fees and expenses onto investors that historically had been covered by management fees. *See* Preeti Singh, *Coming to Terms: Private-Equity Investors Face Rising Costs, Extra Fees*, WALL ST. J. (Dec. 20, 2021).

[194] *See supra* note 192 for a description of how the sample size was determined for this question.

below, which asked investors to indicate the roles that investors want ILPA to play in addressing bargaining failures in private equity.

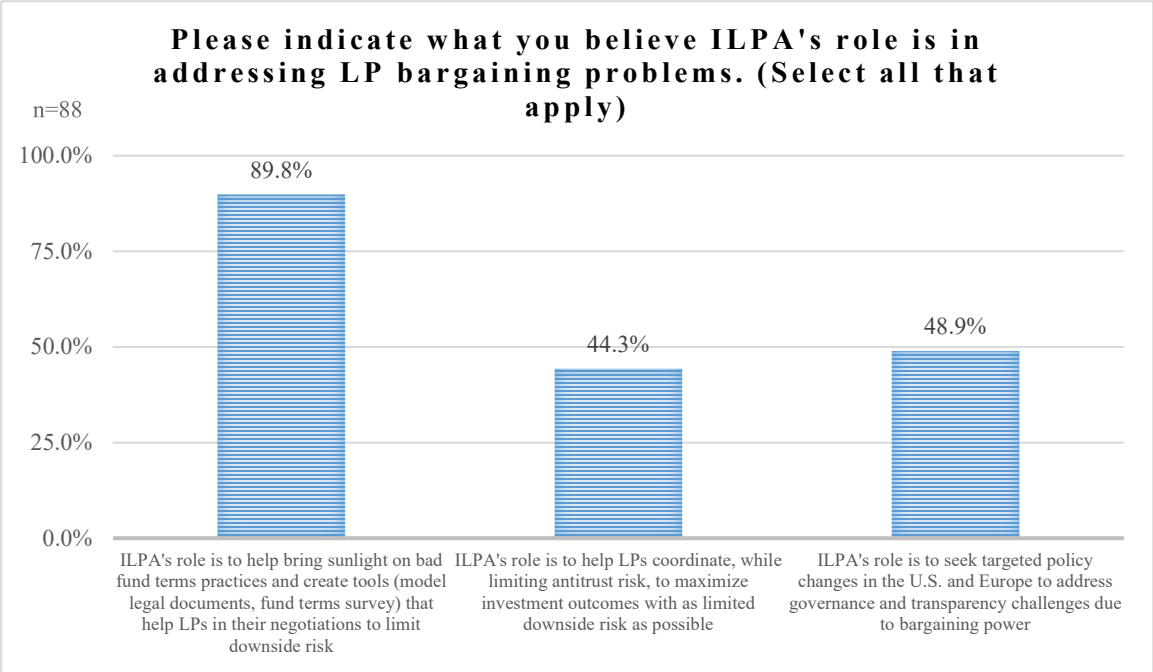

Figure F

This is an interesting finding. It suggests that most institutional investors view ILPA's role first and foremost as a "spider in the web"[195] that helps to facilitate informal information sharing amongst investors and creates model documents to aid in investor bargaining, and secondarily to seek regulatory changes to assist investors.

V. THE POLLING DATA'S PRIMARY TAKEAWAYS AND LIMITS

A. *High-Level Takeaways from the Polling Results*

What can be said of these polling results? On one level, they certainly raise questions about the contractarian view of the private fund industry that has been articulated by many critics.[196] A substantial percentage of investors seemed to think that the bargaining outcomes in private funds are problematic and desired various forms of regulatory intervention, though this number appeared to fall short of either unanimous or super-majority support. Moreover, as discussed above, the preferred

[195] *See* Ariel Porat & Robert E. Scott, *Can Restitution Save Fragile Spiderless Networks?*, 8 HARV. BUS. L. REV. 1 (2017); Robert E. Scott, *The Paradox of Contracting in Markets*, 83 L. & CONTEMP. PROBLEMS 71 (2020).
[196] *See supra* Section I.B.

policy interventions of the respondents generally appeared to align with some the policy priorities of the Private Fund Proposal.

These findings also provide insight into what might be causing bargaining to fail in private equity funds. According to respondents, the most important factor leading to sub-optimal bargaining outcomes in private equity funds is a coordination problem—a flaw in the structure of private equity bargaining that contributes to a bargaining power imbalance between investors and managers. Investors say that they shy away from demanding high-quality terms primarily because they are afraid that if they do so, their investment allocations will be given to more accommodating investors that are not raising such concerns. These results appear to be consistent with the general claims in the Private Fund Proposal that investors lack bargaining power and that investor competition for investment opportunities makes it harder for investors to bargain for effective outcomes.[197]

Interestingly, if this is, in fact, the most important driver leading to bargaining failure in private funds, it would caution against an overly prescriptive policy response. As noted above, one reasonable response to flaws in the structure of bargaining might be to apply a targeted intervention designed to fix the flaw that is generating the coordination problem. Like the Trust Indenture Act of 1939, the federal rules of civil procedure governing class action lawsuits, and the Williams Act amending the 1934 Act, this kind of response would seek to remove the structural impediments that prevent parties from bargaining effectively rather than dictate substantive outcomes. Another reason to avoid an overly prescriptive response is the fact that bargaining power typically is not a static characteristic. As noted above, private equity fund flows have historically been very cyclical, and recent evidence suggests that private fund managers' bargaining power is likely to be less robust in coming years.[198] If that is the case, the coordination problem that investors complain of could plausibly be resolved (or at least significantly improved) by market forces. If these assumptions are true, one could argue that this is precisely the wrong environment for imposing prescriptive interventions and that the best approach may be to see how market practices evolve if and when investor leverage increases.

That said, for the reasons discussed below,[199] the practical relevance of the polling data—in terms of informing a specific policy response—should not be overstated. I present the polling data here for two reasons. First, because the formal rulemaking process did not solicit this kind of input from investors,[200] it is useful to understand what institutional investors might have said if they had been asked on a large scale. Second, the data provides a starting point for understanding what (from the investors' perspective) the most important drivers of bargaining failure in private funds might be. These responses thus provide a focal point for future analysis, both by those who are seeking evidence to support the existence of bargaining failures in private funds and those who are seeking evidence to disprove

[197] *See supra* notes 122 and accompanying text.
[198] *See* Maria Armental, *Earnings Season Shows Private-Equity Firms Bracing for Slower Fundraising*, WALL ST. J. (Aug. 12, 2022).
[199] *See infra* Section V.B for a discussion of the limits of polling data.
[200] *See supra* Section II.E.

such claims. Whichever turns out to be true, focusing on the underlying causes of bargaining failure will almost certainly improve the policy dialogue and produce more useful policy insights.

B. Limits of the Polling Data

1. Limited to Private Equity Fund Investors

Importantly, it should be emphasized that because the polling questions were directed specifically to private equity fund investors, the results may not be relevant to other types of private investment funds. The interventions set forth in the Private Fund Proposal would, if adopted, apply to all types of private investment funds, including hedge funds, real estate funds, and infrastructure funds, among others. It should not be assumed that the poll responses generalize to other settings outside of private equity funds.

2. Potential for Respondent Bias and Unsophistication

The analysis above generally assumes that institutional investors are well-positioned to comment on whether they experience bargaining impediments that lead to problematic outcomes in their private fund investments. One reasonable objection, however, might be to question whether this is really true. Some of the senior attorneys responding to the polling questions could, for example, suffer from principal-agent problems and could be primarily concerned with limiting career risk rather than seeking the best interests of the institution that they work for.[201] This could lead them to advocate for regulatory reforms even if the expected costs (in the form of reduced competition and/or increased cost of capital) would outweigh the expected benefits for industry participants. Alternatively, they could be unsophisticated in the way that they operate in their roles.[202] In other words, the respondents themselves could be significant contributors to bargaining failures in the industry, and as a result their responses casting blame on other factors could be unreliable.[203]

It is difficult to know what to make of these possibilities, given the limited available data. However, if this argument is true, the effect would not necessarily be to bolster the contractarian critique of SEC intervention. To the contrary, one could argue that evidence of widespread principal-agent problems and sophistication problems could itself serve as a strong challenge to the contractarian thesis that investors can be relied on to bargain for effective outcomes.

Finally, it is also important to note that there is unavoidably selection bias in the sample of investors that responded to the poll. Far from a randomly

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[201] *See* Gompers and Lerner, *supra* note 1.

[202] As noted above, the Proposal suggests that lack of sophistication may be an explanation for certain sub-optimal terms. *See supra* note 123 and accompanying text.

[203] Evidence of this bias can arguably be observed in the polling data, as respondents generally did not identify internal problems as major contributors to bargaining problems in private equity funds. For example, in Figure A above, the two least common responses (by far) were "GP counsel have more resources to pay for legal counsel" and "Internal LP alignment issues between legal/investment team."

distributed cross section of the private equity investor universe, the sample includes a subset of investors that had the resources and personnel bandwidth necessary to send a representative to participate in ILPA's annual legal conference.

For all the reasons above, this kind of polling data should not be viewed as providing a definitive diagnosis of the causes of bargaining failure in private funds, but rather as a starting point to guide further investigation.

VI. POLICY PROPOSALS

This is a defining moment for securities regulation, and the basic public-private structure of the securities regulation regime as we have always known it is at stake. As the private marketplace continues its remarkable ascent, all the forces that have led to this moment will only grow more acute, regardless of how the SEC decides to proceed in any final rulemaking. I offer several suggestions to guide theory and policy in this uncharted territory.

A. A General Framework for High-End Securities Regulation

A review of the Private Fund Proposal suggests that the SEC did not appear to sufficiently prioritize the causes of bargaining failure in its framing of the need for intervention or the tailoring of the proposed interventions themselves. But where do policymakers go from here? As the SEC considers what actions to take next, and as courts review those actions, a framework for thinking about the underlying causes of bargaining failure will be helpful. The chart below sets forth basic principles to help guide the question when the SEC will—and will not—be justified in intervening. These principles apply not just in private funds, but in any private market where the parties are sophisticated and information about the causes of bargaining failure is difficult to obtain.

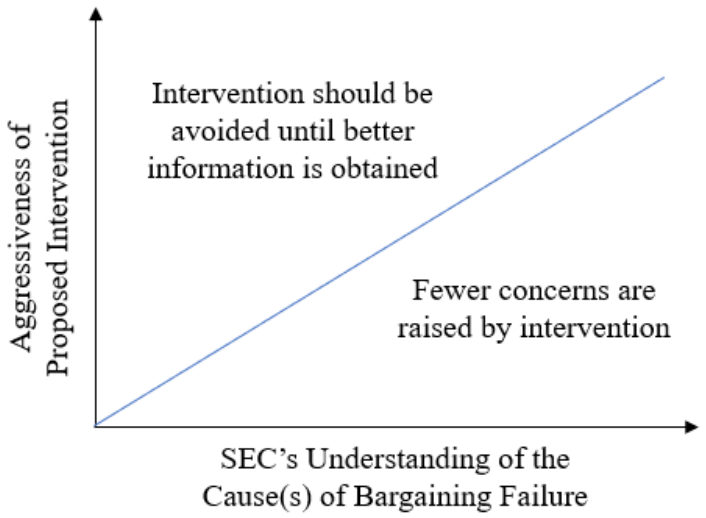

Figure G

The general idea behind this framework is simple: as the aggressiveness of a proposed intervention in a high-end space increases, the need for verifying and studying the underlying causes of bargaining failure increases as well.[204] On one hand, if a proposed intervention is relatively modest in nature, having a detailed understanding of the relevant underlying causes that are generating the need for an intervention is less important. A modest intervention will do less to impinge on the parties' freedom of contract, and it can be more easily reversed if it is determined not to be helpful. On the other hand, if a proposed intervention is aggressive, it becomes much more problematic if the SEC cannot say for certain what the relevant underlying causes of bargaining failure are. Before applying an aggressive intervention, it becomes especially important to ask whether the intensity of the intervention is really necessary, and this cannot be done if the SEC does not know for certain what the underlying causes are. Moreover, once an aggressive intervention is imposed, there is a much higher chance that it will be impossible to return to the status quo, as industry participants will invest time and resources adjusting their operations to the new rules.

Importantly, if a proposed intervention is aggressive and the SEC lacks a firm understanding of the relevant underlying causes of bargaining failure, this framework does not call for that the intervention to be taken off the agenda forever. Rather, I propose that the intervention be put on hold while the Commission focuses on gathering more information about the relevant underlying causes. If, upon gaining a solid understanding of the issues that are causing the relevant problems, the SEC still thinks that the aggressive intervention is appropriately calibrated to address those problems, then it may ultimately be appropriate to move forward with it.

Paying heed to the framework outlined above is particularly important in light of the recent Supreme Court decision in *West Virginia v. EPA*, which suggests that judicial review of the SEC's actions will be particularly demanding in coming months and years.[205] Accordingly, the SEC should not view the current rulemaking initiative as a one-shot opportunity to address the problems in private funds, but as the first step in a longer-term path towards effective regulation. Moreover, for the reasons discussed above,[206] a relatively modest approach in the short run may be warranted if, as the polling data suggests, a bargaining power imbalance really is the primary cause of bargaining failure.

B. A Call to the SEC, Industry Participants, and Legal Scholars

In the longer term, regardless of what decisions are made by the SEC and courts in coming months and years, this issue is not going anywhere. The expansion

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[204] My intention here is not to provide a brightline description of precisely when interventions will be appropriate and what form they should take, but a general framework for thinking about when a sound understanding of the underlying causes of bargaining failure is likely to be important.

[205] West Virginia et al. v. Environmental Protection Agency et al., 597 U.S. ____ (2022) (ruling that agencies "must point to a 'clear congressional authorization' for the power it claims," suggesting that any major rules that go well beyond the direct interpretation of Congressional mandates may be scrutinized under the major questions doctrine).

[206] *See infra* Section V.A.

of private markets and private funds continues apace, which means that there will only be increasing pressure and scrutiny on private market securities law policy—both at the level of the SEC and in Congress—in coming years.[207] In the meantime, institutions like public pension plans and endowments continue to invest more and more in private investment funds and private markets more broadly.

Some scholars have argued that an over-arching shake-up of the public/private divide in securities law is inevitable in response to the expansion of private markets,[208] suggesting that virtually anything is on the table from a policy perspective. Attaining a better understanding of how private ordering works (and does not work) in these high-end settings is a crucial part of the overall securities law policy agenda for the next decade and beyond.

One thing that the Private Fund Proposal and the attendant policy dialogue have taught us is that high-end regulation in private markets is an unusually challenging form of securities regulation. As discussed above, because the market participants have access to substantial resources, there is a greater need to demonstrate the underlying causes of bargaining failure and then calibrate any interventions to address those causes narrowly. At the same time, however, because private contracts and processes are largely hidden from the public's view, the basic task of verifying and demonstrating the existence of these underlying causes in private funds is unusually challenging. Without publicly available information, it also takes much more work to cultivate thoughtful policy dialogues between policymakers, industry participants, and legal scholars about how to tailor and refine interventions. In this context, private funds regulation is forced to proceed in the dark (or, at the very least, in a dimly lit environment).

Accordingly, I call for the SEC, scholars, and private market industry participants to work together more deliberately to overcome these information challenges. For the SEC's part, a commitment to stronger public engagement with industry to understand *why* bargaining outcomes fall short in private funds would be very beneficial. The more open-ended, conceptual approach taken in the SEC's 2019 "Concept Release on Harmonization of Securities Offering Exemptions" offers a useful example.[209] A similar release—with a similarly open-ended call for industry comment on the underlying causes of bargaining failure in private funds—would be helpful for improving our knowledge of the private fund market. Over the years, the SEC has also performed a large number of industry studies and reports with the intention of better understanding regulated industries and releasing their findings to the public.[210] A similar study on the bargaining process in private funds

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[207] *See supra* note 99 and accompanying text.

[208] *See supra* note 99 and accompanying text.

[209] Concept Release on Harmonization of Securities Offering, 17 CFR Parts 210, 227, 230, 239, 240, 249, 270, 274, and 275, Release Nos. 33-10649, 34-86129, IC-33512, File No. S7-08-19, https://www.sec.gov/rules/concept/2019/33-10649.pdf.

[210] *See, e.g.*, Study on Investment Advisers and Broker-Dealers (Jan. 2011), https://www.sec.gov/news/studies/2011/913studyfinal.pdf; Study Regarding Financial Literacy Among Investors (Aug. 2012), https://www.sec.gov/files/917-financial-literacy-study-part1.pdf; Report on the Municipal Securities Market (July 31, 2012), https://www.sec.gov/files/munireport073112.pdf; Research and Analysis – Market Structure,

might be beneficial, focusing on issues such as the influence of bargaining power on contracting outcomes, the role of side letters and co-investments, and the role of lawyers in the bargaining process. Last, but certainly not least, instead of providing solely qualitative information to the market[211] about bargaining in the private fund industry, the SEC could seek to find opportunities to release aggregated, anonymous data about private fund contracting practices based on its examination findings. I discuss this last possibility in greater detail below.[212]

Industry participants can also help unlock information about the industry to support more effective policy efforts. Specifically, in addition to responding to SEC requests for comments, industry participants can also support private market scholarship by providing anonymized fund documents to scholars for research purposes and making themselves available for interviews and surveys. A handful of scholars has recently tapped into these kinds of sources of information,[213] adding valuable insights to the literature on private funds, but these efforts have only scratched the surface of what is possible. In recent years, technology firms have entered the market with a goal of using software and data science to improve the transparency of private market contracting.[214] As these companies build their platforms and customer bases, information that would be extremely useful to private fund policy and theory may become increasingly easy to unlock. In addition, for many years ILPA has been gathering input from investors (through surveys and other techniques) on bargaining practices in private equity funds.[215] While investor-provided data is subject to the limitations described above,[216] this information can nevertheless be helpful in expanding the SEC's and the public's understanding of the bargaining process in private funds. Going forward, informed theory that is built on accurate information about how this industry really works will help to support better policy, and sound policy is an outcome that most market participants should want.

Finally, I also call on more corporate and securities law scholars to find thoughtful ways to make contributions to this space in coming months and years. Private funds have long been an understudied topic in the legal literature. While this fact may not be surprising given the challenges of researching in this space, the reality is that this is an extremely important policy area that would greatly benefit from more theoretical and empirical research contributions. There is enormous

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https://www.sec.gov/marketstructure/research-and-analysis; Div. Econ. & Risk Analysis, Staff Papers and Analyses, https://www.sec.gov/dera/staff-papers.

[211] *See supra* note 66 and accompanying text.

[212] *See supra* Section VI.C.

[213] *See supra* note 48.

[214] *See* Marc Vartabedian, *JPMorgan Leads Investment Into AI-Powered Financial Analytics Startup*, WALL ST. J. (Aug. 26, 2021); Luis Garcia, *Recycled Fund Capital Can Pad Return Multiples, Colmore Tells SEC*, WALL ST. J. (June 9, 2022); Press Release, "NVCA and Aumni Announce New Enhanced Investors' Rights Agreement and Enhanced Model Term Sheet v.3.0" (June 14, 2022), https://nvca.org/pressreleases/nvca-and-aumni-announce-new-enhanced-investors-rights-agreement-and-enhanced-model-term-sheet-v3-0/.

[215] *See, e.g.*, 2021 ILPA Industry Intelligence Report and 2020 ILPA Private Market Fund Terms Report, https://ilpa.org/fundtermsurvey/.

[216] *See supra* Section V.B.

potential for high-quality scholarship to lead to better policy in private funds and private markets more generally.

C. Utilizing the SEC's Private Fund Examination Program

Because the causes of bargaining failure in private funds are so difficult to study without publicly available information, any efforts to generate empirical data in this area will be a step in the right direction. But it should not be assumed that all data on these issues is of equal value. In this Article, I have attempted to redirect the policy dialogue towards the causes of bargaining failure by presenting the results of an investor polling study. However, for the reasons discussed above,[217] investor polling and survey data suffers from inherent limitations, including potential respondent bias and selection bias, among other challenges. When gathering data about private fund bargaining, the more sizable and unbiased the data sources are, the more useful they will be.

The SEC's examination program offers a valuable opportunity to produce exactly this kind of data about private investment funds. As discussed above, since the early-2010s, the SEC has operated an extensive examination program overseeing registered advisers throughout the private fund industry.[218] By introducing simple changes to existing practices, these examinations could be structured to collect information that would help provide data-based answers many important questions about private fund bargaining. Such questions include, for example, what terms are contained in private fund LPAs and side letters, how contract terms evolve over time and across market cycles, how law firm representation influences contract terms, how manager size and reputation influence terms, how pooled fund contracts compare with the contracts of separately managed accounts for single clients, and how investor size and investor type influence terms, among many others. With this kind of data, we could start to work out many of the issues that were the subject of profound disagreement and acrimony during the comment process, paving the way for a clearer, less controversial path forward.

Unfortunately, as discussed above, it does not appear that the SEC has been systematically collecting this kind of information. There are no references to such data in the Private Fund Proposal, and all the "risk alerts" that have been issued by the SEC over the past several years have been almost entirely anecdotal in nature.[219] The private fund examination program, it appears, has generally been used primarily as a tool to support the SEC's enforcement function, and its potential for supporting the SEC's policymaking function has not been realized.

One possible concern with this proposal, of course, is confidentiality. Examination data has always been handled with great sensitivity. This careful approach is required by Section 210(b) of the Advisers Act, which mandates that

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[217] *See supra* Section V.B.

[218] *See* Off. of Compliance Inspections & Examinations, *Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds*, U.S. SEC. & EXCH. COMM'N (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf ("OCIE examines hundreds of private fund advisers each year.").

[219] *See supra* note 66.

the SEC "shall not make public the results of or any facts ascertained" during an examination.[220] Without a doubt, sensitive information obtained about managers and their operations during examinations should generally be kept from the public's view. But if information about private fund contracting is presented to the public on an anonymous and aggregated basis, it is difficult to see how any individual managers or investors could be harmed.[221] At the same time, the benefits (in terms of supporting more informed and effective policymaking) of such an approach would be extremely tangible.

Utilizing the exam program in this way would set the table for a much more robust and informed policy dialogue and help to build more of a consensus about both the need for policy intervention and how any interventions should be structured. That kind of change should be attractive to industry participants on both sides of the aisle.

D. Applications to Other High-End Markets

The principles identified in this Article are applicable to any attempt to enact securities regulation in a high-end, private setting with sophisticated market participants. The most obvious example is the market for large private operating companies. The SEC has previously signaled that it has considered enacting regulatory reforms in this space.[222] Just like private investment funds, the size and influence of the market for private operating companies has become truly massive in recent years.[223] While the investor qualification standards for private operating companies are not as stringent as they are for private funds, many of the same issues discussed above will apply.

Compared to private investment funds, more attention has been paid by scholars to possible regulatory interventions in the market for private operating companies. For example, scholars have affirmatively advocated for special disclosure regimes for unicorn companies,[224] for whistleblower protections for private company employees,[225] and for more stringent enforcement of the anti-fraud provisions of the securities laws to private fund managers.[226] However, no effort has been made to identify the unique characteristics that make securities regulation in these high-end, private markets unusually difficult. Given the distinct

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[220] Section 210(b) of the Advisers Act [15 U.S.C. 80b-10(b)].

[221] To the extent that any doubt exists regarding whether such actions are permitted under the Advisers Act, Congress should act to eliminate such doubt.

[222] *See* Paul Kiernan, *SEC Pushes for More Transparency from Private Companies*, WALL ST. J. (Jan. 10, 2022).

[223] *See supra* note 25 and accompanying text.

[224] *See, e.g.*, Fan, *supra* note 6 at 585 ("[O]nce a private company reaches unicorn status, it should be subject to some of the same reporting obligations as public companies to provide greater transparency and protect minority stockholders"); Pollman, *supra* note 6 at 294 (arguing that the SEC should require "a specified minimum level of disclosure" for trading in secondary markets for private company securities); Guttentag, *supra* note 6 (arguing for disclosure requirements for large private companies)

[225] *See, e.g.*, Winship, *supra* note 6.

[226] *See, e.g.*, Pollman, *supra* note 6; Winship, *supra* note 6.

characteristics of each market,[227] some of the specific causes of bargaining failure in private operating companies are likely to be different than the causes of bargaining failure in private investment funds, but the same overarching barriers to establishing effective theory and policy exist in both settings.

E. Possible Concerns

One criticism of the analysis above might be to say that if we insist on demonstrating the underlying causes of bargaining failure before intervening in an environment where information is so hard to come by, useful interventions might *never* be implemented in private funds. I have two responses to that critique. First, my goal here is not to argue that all interventions should be taken off the table until we have a perfect, data-supported theory of the causes of bargaining failure in private funds. Rather, my goal is simply to encourage the SEC to operate with a clear-eyed assessment of where it does—and does not—have a firm understanding of the underlying causes of bargaining failure in this space and incorporate that more deliberately into its decision-making. As noted above, unlike many critics of the Private Fund Proposal, I am very much open to the idea that appropriately calibrated regulatory interventions could help the private fund industry function better.[228] But I believe much more can be done to understand exactly what the optimal set of interventions might be.

Relatedly, I encourage the SEC to view the current moment as one step on a multi-stage path towards better regulation, and not as a single opportunity to remedy every bargaining problem in the space. To the extent that the SEC can help to unlock more data and other information about the causes of private fund bargaining failures, it would be enormously helpful for future progress in private fund policy.

Another criticism of this Article's analysis might be to question whether a clearer understanding of the causes of bargaining failure in private funds will end up being very useful for informing how to structure interventions in this space. Earlier in this Article, I used a medical analogy involving a straightforward disease and diagnosis to illustrate why it might be useful to have a firm grasp of the underlying causes of bargaining failure.[229] But it is also possible that the causes of bargaining failure in private funds may be so complex and interconnected that understanding them better will not yield particularly clear policy prescriptions. This is, in significant part, the view of the "multiple agency theory" approach to private funds: because the institutional and personal conflicts of interest run deep in private funds, there are no easy answers for the proper policy response.[230]

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[227] For example, many of the issues identified by scholars in recent years in private operating companies revolve around the fact that employees are often equity shareholders in growing private operating companies. *See, e.g.*, Elizabeth Pollman, *Private Company Lies*, 109 GEORGETOWN L.J. 353 (2020) ("Employees are typically not financially sophisticated and do not qualify as accredited investors who would be permitted to participate in a private placement of their employers' securities."). This issue does not exist to the same extent in private investment funds.

[228] *See supra* note 50 and accompanying text.

[229] *See supra* Section II.B.

[230] As noted above, Appelbaum and Batt, the primary advocates for applying the multiple agency theory to private equity, concluded recently that further investigation is needed to determine what

While it is entirely possible that there could end up being validity to this latter concern, more needs to be done before that conclusion can be reached with any confidence. I am optimistic that the SEC—in coordination with industry participants and scholars—can do more to cultivate a more effective policy dialogue. I am also optimistic that with a more concerted effort, private market scholarship can achieve breakthrough developments that help to inform better policy.

VII. CONCLUSION

The SEC's Private Fund Proposal would fundamentally transform the structure of the securities regulation regime as we have always known it. Unfortunately, the policy dialogue behind this initiative has failed to adequately address one of the most important considerations. This Article argues that any efforts to impose high-end securities regulation in private markets should revolve around a simple question: "What are the causes of bargaining failure?" Using proprietary polling data, I present the results of the first empirical study asking institutional investors to identify the underlying issues that they think are causing private equity bargaining to fall short of optimal outcomes. I also provide a novel framework to help determine when the SEC has (and has not) sufficiently taken the underlying causes of bargaining failure into account before intervening, and I show how the optimal policy responses will depend on these underlying causes. Looking to the future, I call on the SEC, industry participants, and scholars to work together more deliberately to study these issues going forward, and I call for the SEC to do more to utilize the private funds examination program to support data-based policymaking efforts. As private markets continue their stunning growth trajectory, these actions will help to ensure a stronger foundation for the future of private market policy for years to come.

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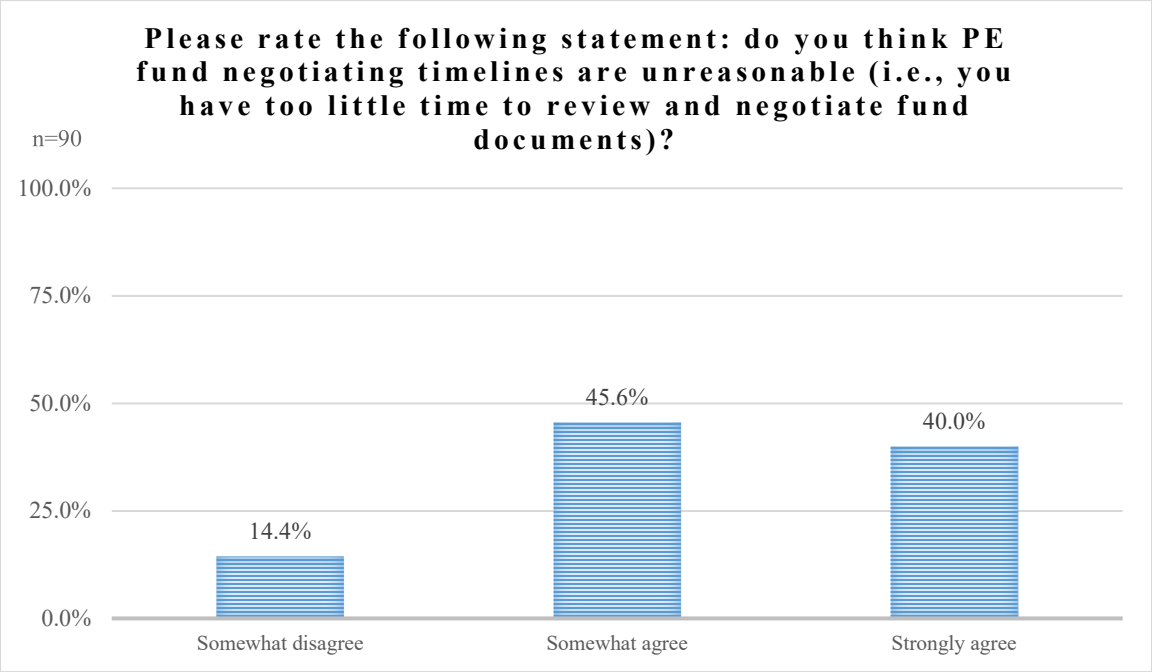
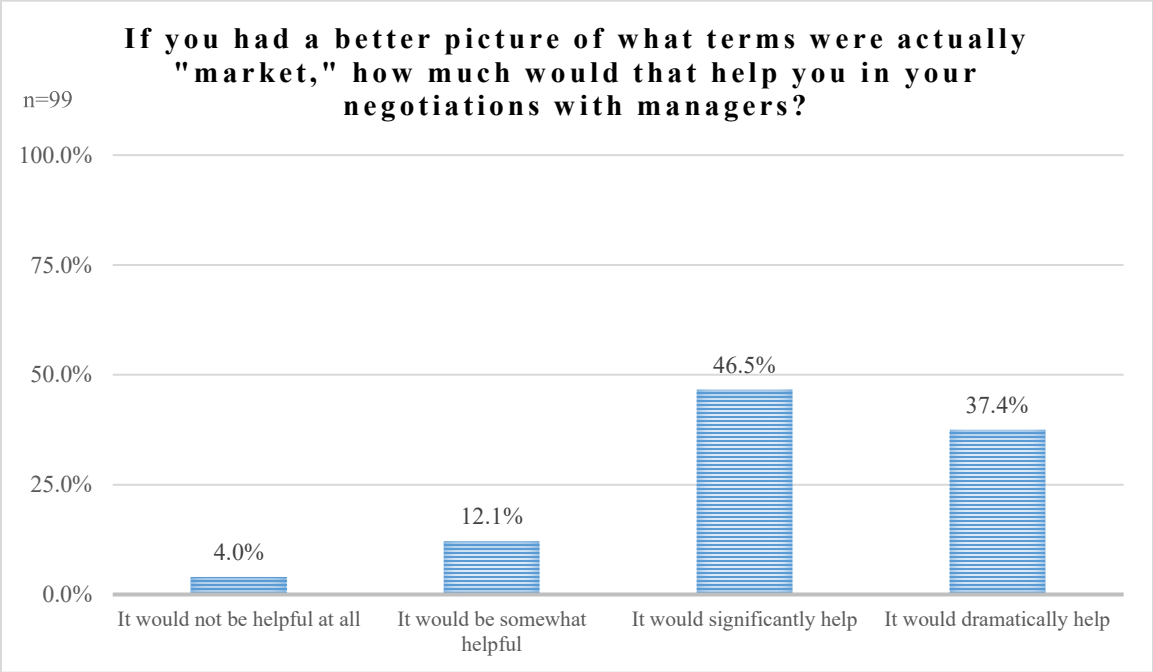
kinds of policy interventions will be helpful and whether they will introduce other unanticipated conflicts. *See supra* note 180.

Polling Question #1



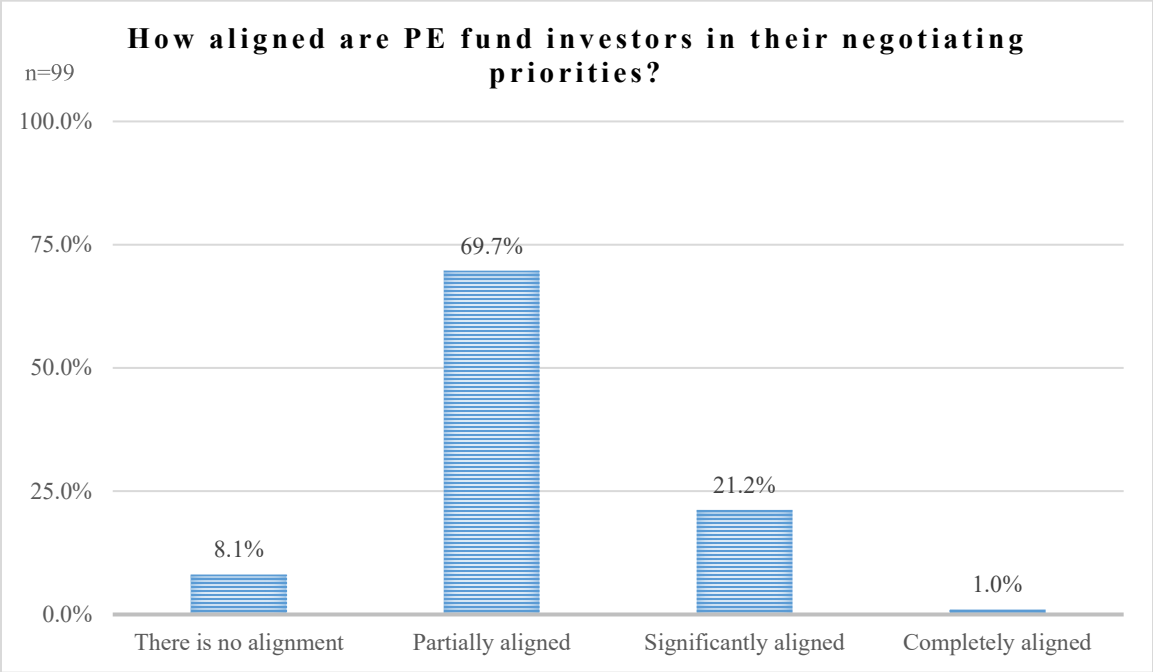
	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
Somewhat disagree	6	3	1	1	0	2	0	0	0	13
Somewhat agree	13	7	5	6	2	5	2	1	0	41
Strongly agree	9	9	4	3	3	2	4	1	1	36

Polling Question #2



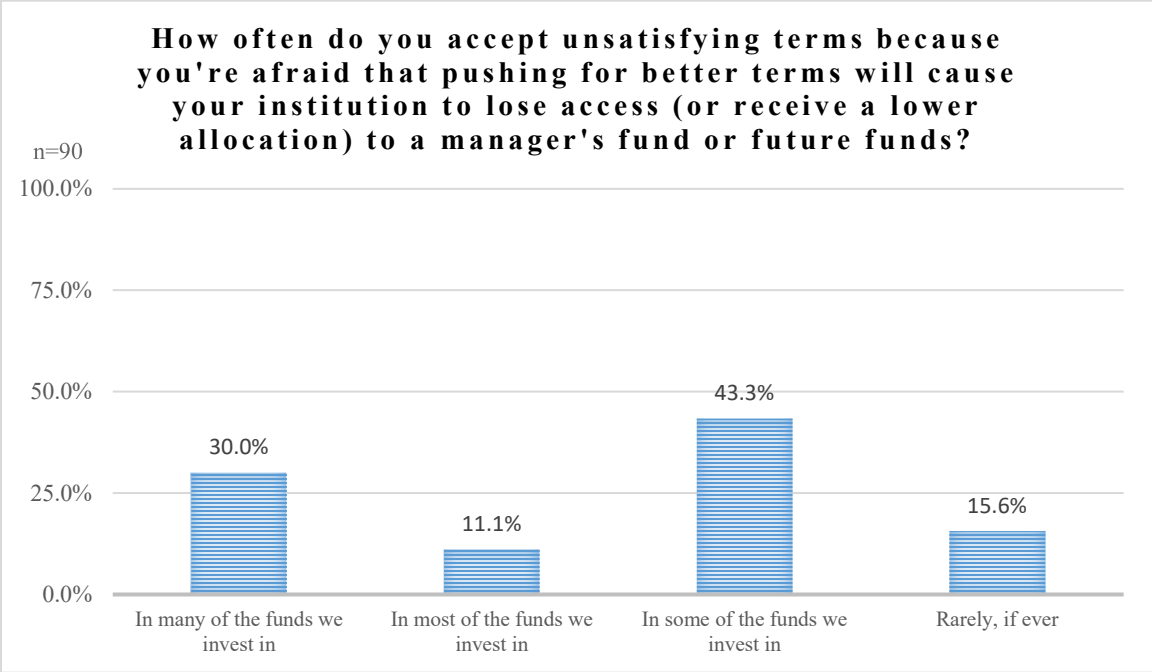
	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
It would not be helpful at all	3	0	0	0	0	0	1	0	0	4
It would be somewhat helpful	6	3	0	2	0	0	1	0	0	12
It would significantly help	17	9	3	3	4	6	2	2	0	46
It would dramatically help	11	4	7	6	1	3	4	0	1	37

Polling Question #3



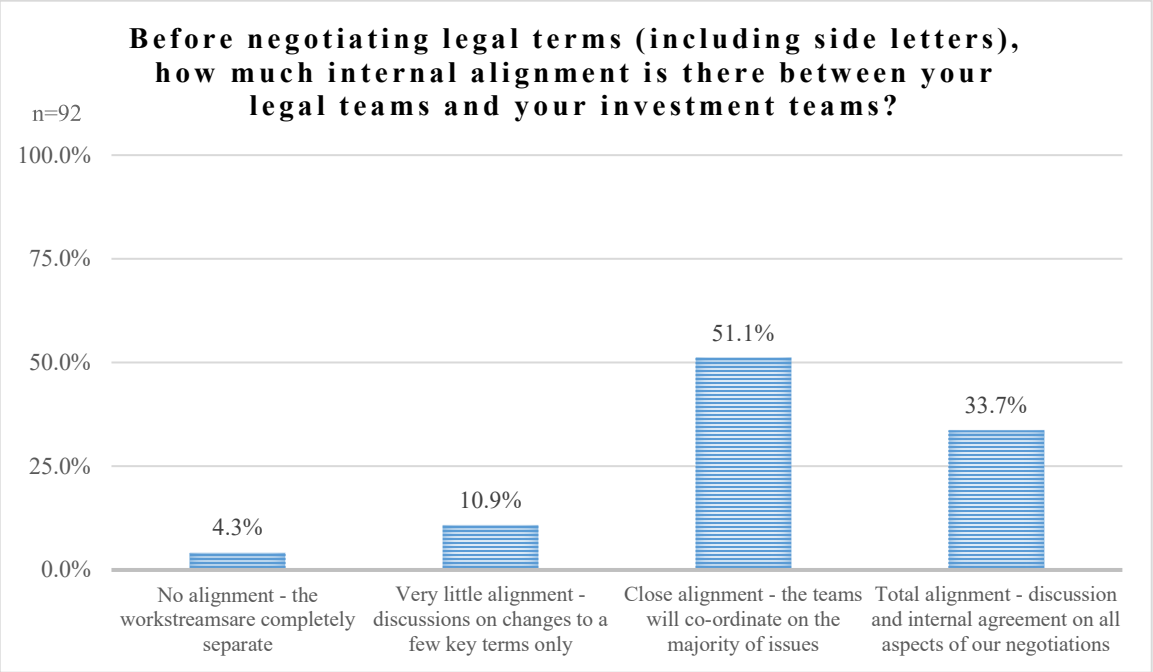
	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
There is no alignment	4	3	1	0	0	0	0	0	0	8
Partially aligned	20	14	8	7	4	8	6	2	0	69
Significantly aligned	11	2	1	3	0	0	3	0	1	21
Completely aligned	0	0	0	1	0	0	0	0	0	1

Polling Question #4



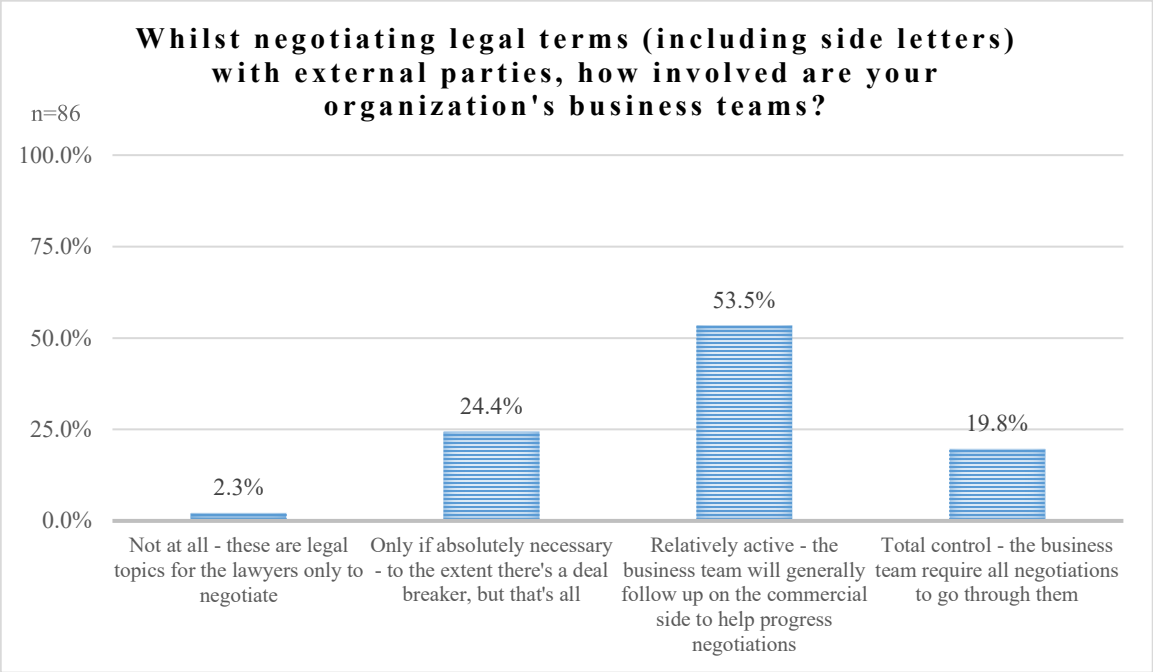
	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
In many of the funds we invest in	11	2	2	2	3	3	3	0	1	27
In most of the funds we invest in	4	2	1	2	0	0	0	1	0	10
In some of the funds we invest in	16	8	5	4	0	2	4	0	0	39
Rarely, if ever	5	2	3	1	0	1	1	1	0	14

Polling Question #5



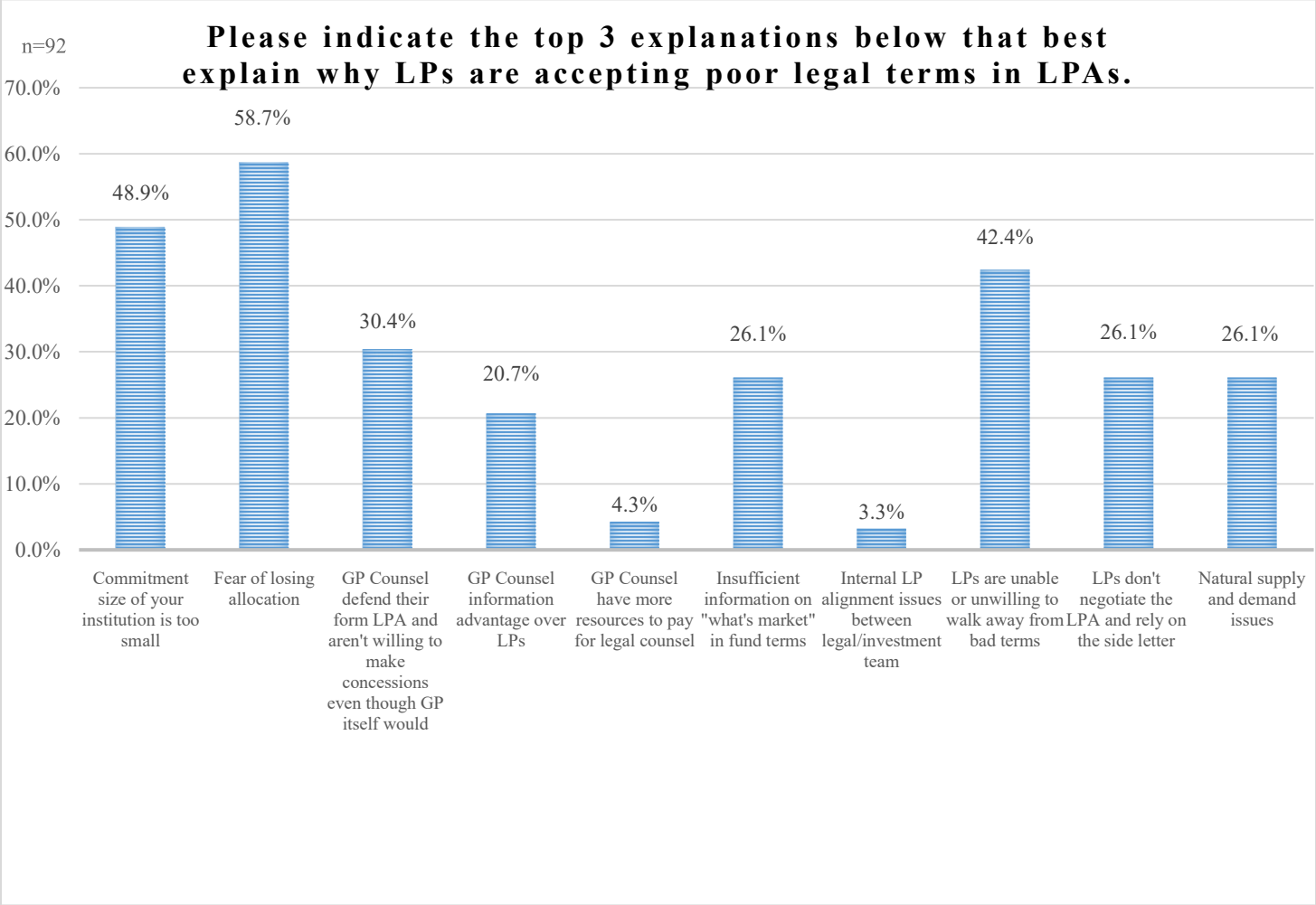
	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
No alignment – the workstreams are completely separate	1	3	0	0	0	0	0	0	0	4
Very limited alignment – discussions on changes to a few key terms only	5	2	0	2	0	0	0	1	0	10
Close alignment – the teams coordinate on the majority of issues	17	6	7	3	1	6	5	1	1	47
Total alignment – discussion and internal agreement on all aspects of our negotiations	11	5	5	4	2	1	3	0	0	31

Polling Question #6



	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
Not at all – these are legal topics for the lawyers only to negotiate	1	0	1	0	0	0	0	0	0	2
Only if absolutely necessary – to the extent there's a deal breaker, but that's all	3	4	3	5	2	0	2	1	1	21
Relatively active – the business team will generally follow up on the commercial side to help progress negotiations	19	10	6	2	0	4	4	1	0	46
Total control – the business team require all negotiations to go through them	9	3	1	3	0	0	1	0	0	17

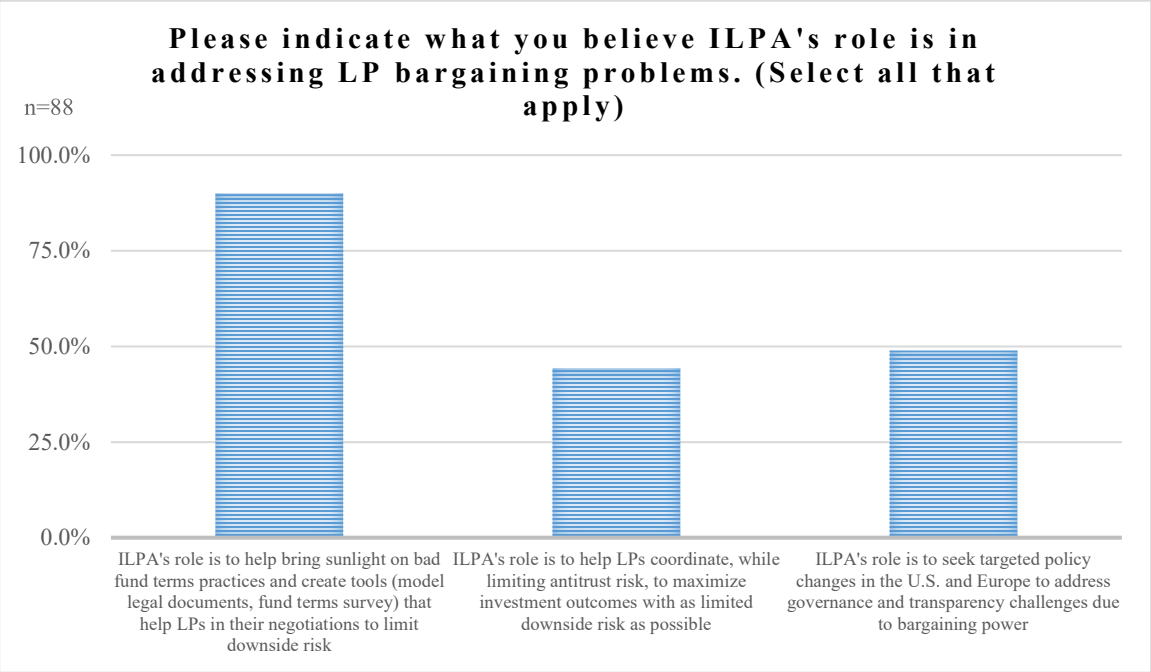
Polling Question #7



	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
Commitment size of your institution is too small	14	10	5	6	2	4	2	0	2	45
Fear of losing allocation	25	11	3	3	3	4	3	1	1	54
GP Counsel defend their form LPA and aren't willing to make concessions even though GP itself would	12	2	4	5	0	1	3	0	1	28
GP Counsel information advantage over LPs	10	3	2	1	0	0	1	1	1	19

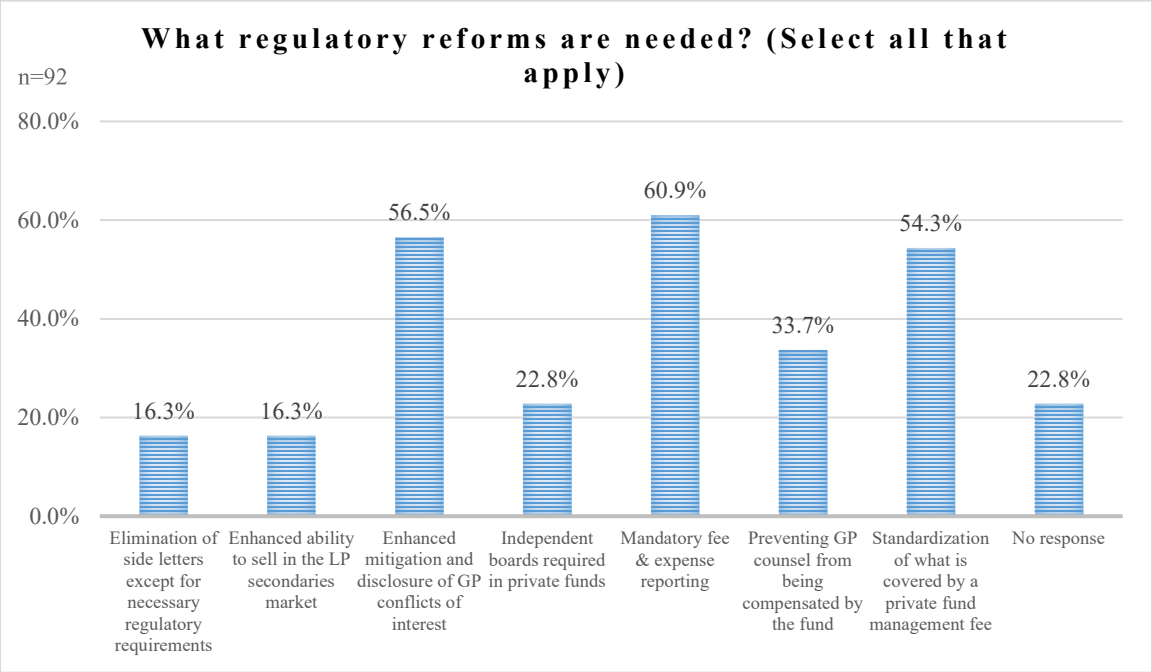
GPs have more resources to pay for legal counsel	3	0	1	0	0	0	0	0	0	4
Insufficient information on "what's market" in fund terms	11	3	3	1	1	0	3	1	1	24
Internal LP alignment issues between legal / investment team	3	0	0	0	0	0	0	0	0	3
LPs are unable or unwilling to walk away from bad terms	21	6	3	4	0	3	2	0	0	39
LPs don't negotiate the LPA and rely on side letter	10	6	2	2	1	2	1	0	0	25
Natural supply and demand issues	11	5	4	1	2	1	0	0	0	25

Polling Question #8



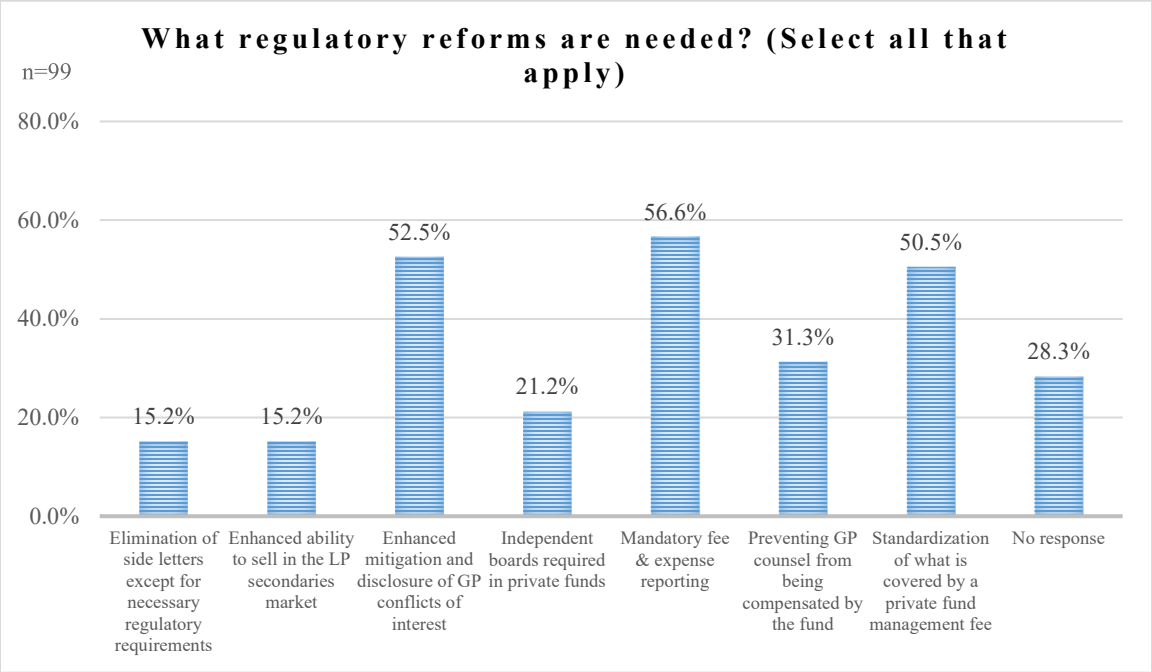
	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
ILPA's role is to help bring sunlight on bad fund terms practices and create tools (model legal documents, fund terms survey) that help LPs in their negotiations to limit downside risk	31	12	9	10	5	4	5	2	1	86
ILPA's role is to help LPs coordinate, while limiting antitrust risk, to maximize investment outcomes with as limited downside risk as possible	17	4	6	4	2	1	4	0	1	45
ILPA's role is to seek targeted policy changes in the U.S. and Europe to address governance and transparency challenges due to bargaining power	20	6	3	7	2	2	2	0	1	47

Polling Question #9 (assuming n=92)



	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
Elimination of side letters except for necessary regulatory requirements	8	1	1	1	0	1	1	2	0	15
Enhanced ability to sell in the LP secondaries market	5	3	2	0	0	1	3	0	1	15
Enhanced mitigation and disclosure of GP conflicts of interest	26	10	4	4	1	1	4	1	1	52
Independent boards required in private funds	10	2	3	1	1	0	3	0	0	20
Mandatory fee & expense reporting	25	9	6	6	2	0	6	1	1	56
Preventing GP counsel from being compensated by the fund	16	3	3	3	2	0	3	0	1	31
Standardization of what is covered by a private fund management fee	27	7	5	4	2	0	4	0	1	50
No response	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	21

Polling Question #9 (assuming n=99)



	Public Pension Plans	Endowments	Private Pension Plans	Insurance Companies	Family Offices	Fund of Funds	Dev. Funds	Found-ations	Banks	Total
Elimination of side letters except for necessary regulatory requirements	8	1	1	1	0	1	1	2	0	15
Enhanced ability to sell in the LP secondaries market	5	3	2	0	0	1	3	0	1	15
Enhanced mitigation and disclosure of GP conflicts of interest	26	10	4	4	1	1	4	1	1	52
Independent boards required in private funds	10	2	3	1	1	0	3	0	0	20
Mandatory fee & expense reporting	25	9	6	6	2	0	6	1	1	56
Preventing GP counsel from being compensated by the fund	16	3	3	3	2	0	3	0	1	31
Standardization of what is covered by a private fund management fee	27	7	5	4	2	0	4	0	1	50
No response	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	28