April 22, 2022

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F. Street NE
Washington, DC 20549-1090

Submitted by email to rule-comments@sec.gov

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

Dear Secretary Countryman:

The Interfaith Center on Corporate Responsibility ("ICCR") is a broad coalition of institutional investors collectively representing over $4 trillion in invested capital. ICCR members are a cross section of faith-based investors, asset managers, pension funds, foundations, and other long-term institutional investors, and have over 50 years of experience engaging companies on environmental, social, and governance issues that are critical to long-term value creation.

ICCR appreciates the opportunity to comment on the new rules and amendments proposed by the Securities and Exchange Commission (the "Commission") under the Investment Advisers Act of 1940 (the "Proposed Rules") that would promote needed transparency and mitigate conflicts of interest in private fund investing.

The private fund industry represents more than $11 trillion in invested assets and plays an increasingly important role in our financial system and economy. In 2021, private equity enjoyed the second-best fundraising year ever, and private equity deal value hit a new high.[1] ICCR's members invest in private funds and are exposed to the risks stemming from the industry's opacity and practices that benefit private funds' investment advisers or general partners ("GPs") at the expense of limited partner ("LP") fund investors.

While ICCR primarily helps organize member engagements with public companies, ICCR members' stewardship commitments extend to private companies as well. For example, the Investor Toolkit for Human Rights, published by ICCR's initiative

[1] https://www.bain.com/insights/private-equity-market-in-2021-global-private-equity-report-2022/

the Investor Alliance on Human Rights, describes actions investors can take to satisfy their responsibility to avoid contributing to adverse human rights impacts, including clearly communicating expectations to private fund managers.[2] Among best practices for investors' human rights governance structures and processes, the Toolkit cites "clear procedures for selection, engagement, oversight, and review of all business partners…including GPs in the context of private equity." [3]

ICCR strongly supports the Proposed Rules because they would give investors consistent and comparable information on fees, expenses, and performance in order to make decisions about private fund investments individually and as an asset class. As ICCR member investors are subject to fiduciary obligations, the information that would be supplied pursuant to the Proposed Rules would assist with satisfying those obligations. As well, investment advisers to private funds would be prohibited by the Proposed Rules from engaging in certain practices that pose the most serious risks related to conflicts of interest, for which disclosure is insufficient to protect investors.

Improving Investor Protections -- Evening the Playing Field

Private fund advisers suffer from agency conflicts as managers of other people's money, due to their superior knowledge and broad control rights. As former head of the Commission's Office of Compliance Inspections and Examinations ("OCIE") Andrew Bowden put it, "With this control [over portfolio companies] and the relative paucity of disclosure required of privately held companies, a private equity adviser is faced with temptations and conflicts with which most other advisers do not contend…We have seen that these temptations and conflicts are real and significant."[4]

In theory, those conflicts could be addressed through provisions in the limited partnership agreement ("LPA") pursuant to which LPs invest in private funds. Private fund GPs and some scholars argue that LPs negotiate the terms of LPAs, making minimum or standardized disclosures and protections unnecessary. Assuming the existence of robust negotiation justifies a hands-off regulatory approach, and some service providers to private funds have objected to the Proposed Rules on that ground.[5]

The notion that LPs vigorously negotiate the terms of LPAs has been largely discredited, however. According to two experienced Delaware judges, "Based on the

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[2] https://investorsforhumanrights.org/sites/default/files/attachments/2022-03/Full%20Report-%20Investor%20Toolkit%20on%20Human%20Rights%20May%202020_updated.pdf, at 19-20, 26.
[3] https://investorsforhumanrights.org/sites/default/files/attachments/2022-03/Full%20Report-%20Investor%20Toolkit%20on%20Human%20Rights%20May%202020_updated.pdf, at 16.
[4] https://perma.cc/QK8R-XKV8
[5] See, e.g., https://corpgov.law.harvard.edu/2022/03/01/sec-continues-march-towards-more-intrusive-regulation-of-private-funds/; https://www.klgates.com/SEC-Proposes-Significant-New-Rules-for-Private-Fund-Advisers-4-7-2022;

cases we have decided and our reading of many other cases decided by our judicial colleagues, we do not discern evidence of arms-length bargaining between the sponsors of the alternative entities and the investors in the governing instruments of alternative entities that raise capital from diverse investors. Rather, these governing instruments seem to be drafted unilaterally by the sponsors and proposed on a take-it-or-leave-it basis to the investors."[6] A 2020 empirical study using a large set of public fund net-of-fees returns data found evidence that "investors in most funds are grouped into one of two tiers of fees" and that large funds tend to pay lower fees than small ones.[7] The study estimated that being in the lower fee tier cost the funds in the study $19 billion. [8]

In a 2019 article[9] in the *Yale Journal on Regulation*, author William Clayton cast doubt on the claim that the largest LPs use their clout to negotiate more favorable LPA terms that redound to the benefit of smaller LPs like ICCR members. Instead, he concluded, large LPs have an incentive to negotiate private benefits for themselves, such as co-investments. "[A] large investor," Clayton urges, "will generally be better off using its bargaining power to obtain as many individualized benefits as possible before it 'spends' its bargaining power on benefits that other investors will also enjoy."[10]

There is abundant evidence that market forces and the current regulatory regime do not adequately address disclosure shortcomings or abuses by private fund advisers. A recent Bloomberg analysis of data from public pension funds concluded that "most of those investors aren't tracking details of so-called partnership expenses across their private equity portfolios. Some say the task is too difficult because fund managers are reporting the costs in vastly different ways or fail to break out expenditures at all."[11] Bloomberg reported that 45% of partnership costs paid by the Washington State Investment Board, for example, were characterized simply as "other" and that the level of detail provided by private fund managers varied a great deal.[12] It is telling that a state pension fund with a private equity portfolio valued at $41.5 billion[13] has to "hope" for private fund managers to "use more consistency in how they deliver information."[14]

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[6] https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.26853.15.pdf, at 2.

[7] https://www.hbs.edu/ris/Publication%20Files/20-073rev3-15-22_e618b34f-d9c8-4c4b-9958-300e3efb56a1.pdf, at 2, 4.

[8] https://www.hbs.edu/ris/Publication%20Files/20-073rev3-15-22_e618b34f-d9c8-4c4b-9958-300e3efb56a1.pdf, at 5-6.

[9] (William Clayton, "The Private Equity Negotiation Myth," Yale Journal on Regulation Volume 37, Issue 1, Article 2, Dec. 18, 2019) (hereinafter, "Negotiation Myth").

[10] Negotiation Myth, at 91.

[11] www.bloomberg.com/news/articles/2022-03-29/private-equity-firm-fees-create-headache-forpension-plans

[12] www.bloomberg.com/news/articles/2022-03-29/private-equity-firm-fees-create-headache-forpension-plans

[13] https://www.sib.wa.gov/financial/pdfs/annual/ar21.pdf, at 15.

[14] www.bloomberg.com/news/articles/2022-03-29/private-equity-firm-fees-create-headache-forpension-plans

The OCIE issued Risk Alerts in January 2022 and June 2020 noting numerous compliance issues observed in examinations of registered advisers that manage private funds, including inadequate or misleading disclosures about fees, preferential arrangements, conflicts of interest, and provisions purporting to limit fund advisers' liability to investors.[15] Examinations conducted by the OCIE in the years after private fund advisers were required to register with the Commission found many problematic and even unlawful practices. The OCIE found that "When we have examined how fees and expenses are handled by advisers to private equity funds, we have identified what we believe are violations of law or material weaknesses in controls over 50% of the time."[16] These examinations revealed, among other practices, that private fund advisers were charging portfolio companies and/or funds for consulting on operational improvements; shifting expenses from the adviser to clients without disclosure; and boosting performance metrics by using different valuation methodologies than those disclosed to LPs.

According to the OCIE, LPAs provided little protection against these abuses. It found that "[m]any limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors."[17] With respect to disclosure, "most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager."[18]

Commissioner Crenshaw cited this extensive record in explaining her support for the Proposed Rules. She stated:

> After a decade of oversight of private fund advisers, and multiple risk alerts, it seems requiring better disclosures alone is likely not enough to adequately protect investors. For example, we have seen private fund advisers structure deals to benefit advisers at the expense of the private fund and its investors, charge fees for services the adviser never intends to provide, obtain reimbursement from clients for expenses that don't directly relate to the activities of the private fund, and attempt to convince investors they have fewer rights and avenues for redress in the event of adviser misconduct than the law actually provides. Such practices unfairly enrich advisers by putting their interests ahead of the fund and its investors, and private fund investors often have little or no meaningful opportunity to identify or address this conduct. Given the evidence that many private fund

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15 https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf; https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf

16 https://perma.cc/QK8R-XKV8

17 https://perma.cc/QK8R-XKV8

18 https://perma.cc/QK8R-XKV8

investors lack sufficient bargaining power to demand greater protections and to have their interests placed first, disclosures alone don't appear to be sufficient. And the Commission should help ensure all investors are getting the protections they need.[19]

Investors Need Consistent and Comparable Disclosure of Fees, Expenses, and Performance

ICCR supports the Proposed Rules' provisions requiring private fund advisers to provide investors with quarterly statements setting forth fees and expenses paid by the fund and portfolio companies to the private fund adviser and/or related persons, as well as performance calculations.[20] These disclosures would enable investors to accurately track fees and expenses, which would improve investors' monitoring of private fund advisers for adherence to LPAs and facilitate compliance with fiduciary duties for the investors subject to them. They would also allow investors to compare the returns of private funds to each other and to lower-fee alternatives in the public market.

The Proposed Rules' disclosure requirements are in line with the recommendations of the Institutional Limited Partners Association ("ILPA"), whose 500-member institutions have over $2 trillion in private equity assets under management. ILPA petitioned the Commission last year to "mandate the regular reporting of all direct and indirect fees and expenses charged by private fund advisers and their affiliates to investors in private funds."[21] Leaving such disclosure to "market forces," ILPA argued, "constrains capital formation" and "disproportionately limits access for smaller institutional investors."[22] ILPA also urged that the disclosures it requested would also allow public pension funds in California and Texas to comply with state laws requiring them to obtain (and then disclose to the public) information each year about the funds' share of fees and expenses.[23]

Full and consistent disclosure of performance metric calculations is critically important given the role of those calculations in determining whether a private fund adviser is entitled to carried interest under typical compensation formulas. GPs are generally entitled to receive a percentage of profits earned by the fund, but only if a specified internal rate of return ("IRR") or hurdle rate is achieved. The Proposed Rules would require private fund advisers to disclose the assumed fee rates used in calculating the required performance measures for closed-end (or illiquid) funds—IRR and multiple of invested capital—as well as assumptions used in calculating net total return for open-end funds. Performance metrics must be calculated for illiquid funds net of any impact of subscription credit facilities, which

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[19] https://www.sec.gov/news/statement/crenshaw-private-fund-20220209
[20] https://www.sec.gov/rules/proposed/2022/ia-5955.pdf
[21] https://ilpa.org/wp-content/uploads/2021/10/26.10.21_ILPA-Member-Letter-to-SEC-on-Fee-Transparency.pdf
[22] https://ilpa.org/wp-content/uploads/2021/10/26.10.21_ILPA-Member-Letter-to-SEC-on-Fee-Transparency.pdf
[23] https://ilpa.org/wp-content/uploads/2021/10/26.10.21_ILPA-Member-Letter-to-SEC-on-Fee-Transparency.pdf

can distort performance metrics.[24] We believe that disclosing these items and standardizing performance metrics as the Commission has proposed would curb manipulation of performance calculations by private fund advisers, which has been shown to occur,[25] especially when advisers are under pressure to raise funds.[26]

ICCR urges the Commission to seriously consider requiring private funds to provide an additional performance measure, the public market equivalent, as discussed in the comment submitted by the American Federation of Teachers ("AFT") and the National Education Association ("NEA"),[27] both of whose members have significant experience interpreting private fund performance measures as trustees of public pension funds. The AFT and NEA capably highlight the weaknesses of IRR and the interpretive difficulties it presents, using a real-world example.

More robust fee and performance disclosure would empower investors to evaluate private fund advisers. ICCR agrees with Commissioner Crenshaw's assertion that the "information [required under the Proposed Rules] should help private fund investors better assess the adviser's performance and decide whether to remain invested in a particular private fund, how to invest other assets, and whether to invest in private funds managed by the adviser in the future."[28]
Such disclosure would also strengthen reputational constraints as a protection for LPs.[29] Accordingly, ICCR urges the Commission to adopt the disclosure enhancements in the Proposed Rules, and to consider the AFT and NEA's recommendation to require disclosure of public market equivalent as an additional performance metric.

Providing Assurance Would Protect Investors by Deterring Misconduct

The Proposed Rules would require private fund advisers to obtain annual independent audits of private funds' financial statements. ICCR believes that this requirement would provide a valuable protection for investors by providing a check on advisers' subjective judgments and deterring misconduct.

Private fund advisers exercise significant discretion in valuing funds' investments, given the absence of a public market for the holdings of most funds. Fees may be based on these valuations, which may also be factored into performance metrics used to raise capital for new funds. An audit would evaluate the reasonableness of valuations; financial projections, taxes, discount rates, trading multiples, the lack of comparable companies, and reliance on financing transactions to establish

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24 https://uncipc.org/wp-content/uploads/2019/07/DistortingPrivateEquityPerformance_07192019.pdf
25 https://www.reit.com/news/blog/market-commentary/irr-is-an-easily-manipulated-performance-metric
26 https://www.institutionalinvestor.com/article/b1qhc5mxfwvgkl/Private-Equity-Firms-Try-to-Manipulate-Their-Performance-When-Raising-Money
27 See https://www.sec.gov/comments/s7-03-22/s70322-20123179-279455.pdf
28 https://www.sec.gov/news/statement/crenshaw-private-fund-20220209
29 See Negotiation Myth, at 81.

valuations have been identified as items that often arise in audits or that require particular attention.[30] By testing the reasonableness of an adviser's assumptions and methodologies, an audit would give investors assurance regarding valuations and reduce the frequency of poor practices and, in extreme cases, fraud.

Prohibiting Practices That Create or Exacerbate Conflicts of Interest Would Protect Investors

ICCR supports the Proposed Rules' prohibition on practices that create or exacerbate conflicts of interest, to establish a floor for LP protections given the impediments to private negotiation discussed above. Although we support all of the Proposed Rules' provisions, the most important are discussed below.

Preferential arrangements for certain investors are among the most troubling practices, especially in light of the impact they can have on fees and fund performance. Some investors enjoy preferential terms contained in "side letter" agreements with the private fund manager. These terms range from rights to information not available to all investors to transfer and/or early redemption rights and "most favored nation" provisions, which entitle the investor to receive the most favorable terms negotiated by other investors.[31] Early redemption provisions, in particular, can affect fund performance and ICCR thus supports the Proposed Rules' prohibition on preferential terms regarding liquidity or certain kinds of information access. For other kinds of preferential arrangements, ICCR favors requiring disclosure to all investors to allow them to assess the potential impact on their own returns and inform decisions about whether to invest in another fund advised by the adviser.

The existence of co-investments, where a fund LP invests in a portfolio company alongside a fund, also can create risks for investors. The OCIE found in examinations that in some cases investors were unaware that an investor had obtained co-investment rights. We support the Proposed Rules' provision requiring private fund managers to allocate "broken" deal fees pro rata to co-investment vehicles to avoid disadvantaging those LPs that do not benefit from a co-investment opportunity.

The Proposed Rules would prohibit private fund managers from charging portfolio companies "accelerated" fees for monitoring, consulting, or other services if the manager has not performed the services and does not reasonably expect to provide them. ICCR supports this prohibition, which addresses the practice of private fund managers entering into long-term agreements with portfolio companies pursuant to

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[30] https://www.jdsupra.com/legalnews/what-you-need-to-know-about-private-65254/; https://www.bdo.com/getattachment/0ad53206-dd72-431d-8c76-7d93b9c94579/attachment.aspx?FS-Asset-Mgmt-Insights_VC-Funds_11-16_WEB-(1).pdf, at 2-3.

[31] https://www.dechert.com/knowledge/onpoint/2018/9/private-fund-side-letters--common-terms--themes-and-practical-co.html

which the companies are required to pay all fees due under the agreement upon exit from the fund, thus paying the adviser for services never performed. This practice is viewed as a route by which private fund managers increase their fee income without adding any value.[32]

Significant controversy has attached to efforts by private fund advisers to obtain indemnification, exculpation and limitation of liability for fiduciary duty claims by investors. ICCR supports the Proposed Rules' prohibition on a private fund adviser seeking such protections because fiduciary duties provide a key backstop for investors. That backstop is especially important given the imbalances of power discussed above as well as the problem of incomplete contracting—the impossibility of contemplating and drafting provisions addressing every situation that may arise. We agree with former Delaware Supreme Court Chief Justice Leo Strine and Delaware Vice Chancellor Travis Laster that "[t]he requirement of a non-waivable duty of loyalty in these [private fund] settings would promote investor confidence, create a predictable body of case law, and enable contract drafters to simplify the tangled web of provisions that currently attempts to substitute for traditional duty-of-loyalty analysis."[33]

The Lack of Transparency and Accountability in the Private Equity Industry has Broader Negative Consequences for Society

Finally, we would be remiss not to note the broader societal consequences of the kind of extractive practices that are enabled by the current lack of transparency and regulation. The extraction of substantial fees from financially troubled companies has benefited private fund advisers at the expense of other stakeholders, including workers, consumers, and communities. Those impacts add weight and urgency to the Commission's task of promoting transparency and eliminating the most egregious conflicts of interest.

Some examples include:

- **Toys R Us:** In 2005, two private equity funds (Bain and KKR) and a real estate fund (Vornado) took struggling retailer Toys R Us private.[34] Toys R Us employees reported significant changes to working conditions after the transaction, including reduction of positions, increases in workload, and increasing irregularity in scheduling. These changes placed particular strain on the companies' disproportionately female workforce. Between 2005 and 2017, the ownership group saddled Toys R Us with more than $3 billion of additional debt. Over this time, Bain, KKR and Vornado took more than $470 million in fees and interest payments from the company. The debt

[32] E.g., https://cepr.net/images/stories/reports/private-equity-fees-2016-05.pdf, at 2
[33] https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.26853.15.pdf, at 5.
[34] https://money.cnn.com/2005/03/17/news/fortune500/toysrus/

service and fee payments placed acute strain on Toys R Us, which operated in a retail industry characterized by low profit margins. In September 2017, Toys R Us was forced into bankruptcy, and in the spring of 2018 the ownership group announced its intention to liquidate, closing all stores and laying off all 33,000 employees. It wasn't until a highly publicized campaign by affected investors and stakeholders that private fund managers contributed $20 million to a severance fund for the former employees.[35]

- **Packers Sanitation Services Inc (PSSI):** PSSI specializes in cleaning food processing plants. Private fund giant Blackstone purchased the company from previous private equity fund owners in 2018. In July 2021, the US Department of Labor's Occupational Safety and Health Administration (OSHA) cited Packers Sanitation Services Inc, and three other companies in connection with a nitrogen leak that caused the deaths of six workers and injured almost a dozen others at a Georgia poultry processing plant. PSSI employees have suffered severe occupational injuries in the three years of Blackstone's ownership, and PSSI has incurred hundreds of thousands of dollars in OSHA fines.[36] PSSI has paid out more than $430 million in dividends to Blackstone, which loaded more than $500 million in debt refinancing on the portfolio company.[37]

- **PetSmart:** A BC Partners-led consortium of funds bought PetSmart in 2015, funding the transaction primarily with debt,[38] and then caused PetSmart to buy online pet retailer Chewy two years later. (In 2019, Chewy was spun out and taken public.) In 2018, BC faced lenders' claims that it had engaged in asset stripping when it moved $500 million in Chewy shares to entities that were beyond the reach of creditors.[39] BC's bet on PetSmart paid off handsomely during the pandemic because so many people bought pets, but allegations of chronic understaffing have dogged PetSmart. Four PetSmart employees told Vice media that cost-cutting in the form of severe understaffing, the consolidation of jobs, a lack of sufficient job training, and denial of veterinary care and proper habitats for animals has meant that pets

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[35] Private Equity Stakeholder Project, "Toys R Us Employees Call on KKR, Bain Capital, and Vornado to Pay Severance out of $470 Million in Monitoring Fees, Interest," May 24, 2018; Mary Childs, "Who Really Ruined Toys R Us? Hedge Funds and Private Equity Are Playing the Blame Game," Barron's, Nov. 21, 2018; https://www.theatlantic.com/magazine/archive/2018/07/toys-r-us-bankruptcy-private-equity/561758/

[36] Private Equity Stakeholder Project, "Profit Over Safety: Private Equity's Highly Leveraged Bet on Packers Sanitation"

[37] Moody's affirms Packers Holdings' B3 CFR following dividend recap; outlook stable," Moody's, May 2, 2019, https://www.moodys.com/research/Moodys-affirms-Packers-Holdings-B3-CFR-following-dividend-recap-outlook--PR_401554; "Moody's says Packers Holdings' term loan add-on is credit negative," Moody's, Nov 17, 2020, https://www.moodys.com/research/Moodys-says-Packers-Holdings-term-loan-add-on-is-credit--PR_436355; "Pitchbook Profile re: Packers Sanitation Services Debt" https://my.pitchbook.com/profile/10503-28/company/profile#deal-history/159779-26T.

[38] https://www.retaildive.com/news/private-equity-owned-petsmart-under-scrutiny-from-elizabeth-warren-after-ac/607680/

[39] https://www.ft.com/content/bb212e94-3048-45c8-9fac-d01b592c6898

> are falling sick, forgoing treatment, and dying at alarming rates in their stores. Meanwhile, many workers are still making $12.50/hour without healthcare as business booms.[40] Accounts of PetSmart's treatment of workers and animals led Senator Elizabeth Warren to publicly criticize a proposed transaction in which PetSmart would go public through a merger with a special purpose acquisition corporation backed by KKR.[41]

ICCR commends the Commission's proposal to promote transparency and curb abusive practices by private fund advisers. As smaller investors, ICCR members lack the leverage enjoyed by larger funds to negotiate favorable information rights, redemption provisions, and co-investment opportunities. As a result, we strongly support the Proposal Rules' establishment of a floor for both disclosure and avoidance of conflicts of interest.

Thank you again for the opportunity to comment. If you have any questions, please contact Josh Zinner at jzinner@iccr.org.

Sincerely,

Josh Zinner
Chief Executive Officer

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[40] https://www.vice.com/en/article/3ab4ek/some-understaffed-petsmarts-are-dealing-with-freezers-overfilled-with-dead-pets

[41] https://www.pymnts.com/spac/2022/sen-warren-criticizes-petsmarts-14b-spac-plans/