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April 21, 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:

I am writing in response to the request by the Securities & Exchange Commission (the "Commission" or "SEC") for comments on "Private Fund Advisers: Documentation of Registered Investment Adviser Compliance Reviews," published in Release No. IA-5955, File No. S7-03-22 (the "Proposal").[1] In this letter, I discuss what appears to be one of the most profound sources of disagreement between proponents and opponents of SEC intervention in the private funds industry: the question of whether investors and managers in private funds can be assumed to bargain effectively. To aid my analysis, I introduce proprietary institutional investor polling data obtained in fall 2021.

This letter's basic purpose is to emphasize the heightened importance of articulating and understanding the limits of private market bargaining as the SEC considers this new phase of regulatory activity. I also include a brief discussion of my research cited by the Commission in the Proposal.

I. A Fundamental Question: Is Private Bargaining Effective in the Private Funds Industry?

A. The Contractarian Critique of SEC Intervention in Private Funds

The Proposal marks the SEC's first attempt to impose broad mandatory disclosure obligations and various other forms of intervention in the private funds industry. This is a dramatic shift from the SEC's historical approach to this industry, and it is premised on the idea that private ordering has not been working very well in private funds. In the Proposal, the

[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 [hereinafter SEC Proposal].

Commission has included various claims about why bargaining in private funds is often ineffective and leads to problematic terms.[2]

Dissenting SEC Commissioner Hester Peirce has voiced a far more optimistic perspective on how bargaining works in private funds. In her February 9th statement, Commissioner Peirce argued that private fund investors do not need the SEC's help and that they are well-equipped to use their resources and sophistication to fend for themselves.[3] Commissioner Peirce's view suggests that, in reality, bargaining is working just fine in private funds, that investors and managers are generally satisfied with the terms that they receive in private fund contracts, and that the Proposal's recommendations are not responsive to the industry's actual needs.[4] Commissioner Peirce is certainly not alone in holding this contractarian view of private funds.[5]

Proponents and opponents of the Proposal thus hold starkly contrasting viewpoints—not just concerning the SEC's proper policy role in private funds, but also concerning more basic factual questions about how bargaining does (and does not) work in private funds.

B. Shadows of an Earlier Debate

Decades ago, scholars engaged in a similar policy debate in the public company arena. During this time, a group of scholars advanced the contractarian view that mandatory disclosure rules were unnecessary in the public company marketplace because companies could lower their cost of capital by voluntarily disclosing the information that investors find valuable.[6] In theory, successful companies should have a strong incentive to disclose relevant information voluntarily to distinguish themselves from firms that have something to hide. In fact, scholars contended that mandatory rules made things worse by producing excessive amounts of costly information and by stifling innovation and improvements in disclosure. Those arguments have much in common with arguments that have been voiced by opponents of the Proposal today.

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[2] *See infra* Sec. I.D.2.

[3] 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 ("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. Therefore, the 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. I disagree with both assessments; these well-heeled, well-represented investors are able to fend for themselves, and our resources are better spent on retail investor protection.").

[4] *Id.* ([T]he proposal's focus on protecting private fund investors by shaking information loose from what *we* deem to be uncommunicative private funds and shutting down practices *we* deem to be unfair is a departure from the Commission's historical view that these types of investors can fend for themselves.") (italics in original).

[5] *See, e.g.*, The Editorial Board, *The SEC's Private Market Takeover*, WALL ST. J. (Mar. 15, 2022) ("The SEC doesn't exist to protect sophisticated investors. Mr. Gensler wants to expand the agency's mission from protecting Granny's life savings to shielding deep-pocketed investors from risks they freely take. The California Public Employees' Retirement System (Calpers) manages more assets than KKR. How is it at a disadvantage?"); Harvey Pitt, SEC Comment Letter (Apr. 18, 2022), https://www.sec.gov/comments/s7-03-22/s70322-20123886-280060.pdf.

[6] *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).

This contractarian critique of mandatory disclosure prompted a rebuttal that emphasized some of the limitations of private ordering in the real world.[7] One defense of mandatory disclosure argues that public companies are likely to under-produce disclosure due to collective action problems.[8] 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.[9] 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" among securities law scholars today.[10] Thus, even though it theoretically should be in the best collective interests of public companies and their shareholders to provide optimal levels of disclosure on a voluntary basis, most scholars have come to agree that mandatory disclosure is useful due to limitations of private ordering in the real world.[11]

C. *Implications for Today's Private Market Policy Debate*

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.[12] 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

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[7] *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).
[8] *See* Coffee, *supra* note 7, at 721-23.
[9] *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).
[10] *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.").
[11] 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 "are not widely accepted tools for streamlining negotiation processes and have not achieved market-standard adoption").
[12] *See supra* notes 3 and 5.

companies, after all, are 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 bargaining limitations like collective action problems and principal-agent problems.

Second, an important difference between the public company mandatory disclosure debate and the current private markets debate is that private market policymakers and commentators seem much less aligned on what exactly the bargaining problems 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 understood and acknowledged. In the private funds context, by contrast, policymakers have expressed profound disagreement over the very existence and nature of bargaining problems in private funds. This is not entirely surprising, given the private status of this market, but it makes reaching a policy consensus far more difficult.

D. Bargaining Problems in Private Funds: Academic and Policymaker Perspectives

Below, I provide a high-level overview of some of the things that scholars have said about bargaining problems in private funds, followed by a discussion of the specific bargaining problems that the staff has identified in the Proposal. Note that this discussion focuses on private equity funds, though some of the issues discussed here could also be applicable to other types of private investment funds.

1. Academic Perspectives

Historically, private equity funds were held up by scholars as a model of efficient contractarian governance.[13] More recently, however, many scholars have found fault with various aspects of private equity fund governance, including lack of transparency and conflicts of interest, among other things.[14]

Scholars have set forth various possible theories for why there might be problematic bargaining outcomes in private equity funds. For example, scholars have pointed to possible coordination problems in private equity funds, including conflicts of interest between large

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[13] *See* Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. CORP. L. STUD. 59, 68 (2012) ("The generally accepted view of private equity is that it is a highly competitive market involving sophisticated players. Most observers deem it de facto efficient, such that the relationship between managers and investors requires no attention."); Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 298 (2009) ("Private-equity buyout firms provide a leading example of the use of partnership mechanisms in governing large firms.").

[14] *See, e.g.*, Ludovic Phalippou, *Beware of Venturing into Private Equity*, 23 J. ECON. PERSPS. 147, 162 (2009); James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 332 (2009); William Magnuson, *The Public Cost of Private Equity*, 102 MINN. L. REV. 1847, 1900 (2018).

investors and small investors[15] and incentives that cause investors to bargain for things that will bring individual (but not collective) benefits,[16] among others. Scholars have also argued that principal-agent problems can lead to suboptimal contracting in private equity funds. Some scholars have posited that these principal-agent problems may exist specifically within the institutions that invest in private equity funds,[17] and others have characterized principal-agent problems as a pervasive problem throughout the entire private fund investment ecosystem.[18] Scholars have also pointed to regulation itself—both at the level of the institutional investor[19] and also at the level of the federal securities antifraud rules[20]—as something that could be corrupting private equity bargaining. It has also been suggested that path dependence may explain the persistence of practices that seem problematic in private equity funds.[21]

Importantly, scholarly research on private equity over the years has been subject to a critical limitation: scholars have largely been prevented from gaining access to basic fund documents in private funds. That has made it much harder for scholars to contribute clear theory on how bargaining really works in this space.[22]

2. Bargaining Problems Invoked in the Proposal

The Proposal also includes various explanations for why bargaining in private funds might be leading to unsatisfying outcomes. Interestingly, 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 bargaining problems is scattered throughout the Proposal, and one might miss the descriptions of these bargaining problems if one is not looking carefully for them.

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[15] *See, e.g.*, Peter Morris & Ludovic Phalippou, *A New Approach to Regulating Private Equity*, 12 J. CORP. L. STUD. 59, 68 (2012) (arguing that large investors have incentives to accept unnecessarily complex contracts because doing so gives them a competitive advantage over smaller investors with fewer resources).
[16] *See, e.g.*, William W. Clayton, *The Private Equity Negotiation Myth*, 37 YALE J. ON REGUL. 67 (2020) (arguing that investors have incentives to prioritize bargaining for terms that benefit themselves and not other investors).
[17] *See, e.g.*, Paul Gompers & Josh Lerner, *The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements*, 39 J.L. & ECON. 463, 472 (1996) (positing that the staff members of institutional investors in private equity funds have incentives to structure contracts in opaque, inefficient ways to avoid career risk).
[18] *See, e.g.*, Rosemary Batt & Eileen Appelbaum, *The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?*, 35 ACAD. MGMT. PERSPS. 45, 52 (2021) ("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.'"); Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, WASH. U. L. REV. (forthcoming) (arguing that external law firms representing managers have perverse incentives to push back on investor requests to change the LPA).
[19] *See, e.g.*, William W. Clayton, *How Public Pension Plans Have Shaped Private Equity*, MD. L. REV. (forthcoming Apr. 2022).
[20] *See* James C. Spindler, *How Private Is Private Equity, and at What Cost?*, 76 U. CHI. L. REV. 311, 332 (2009) ("[A]voiding securities law liability entails some combination of reduced or no disclosure to limited partners, limited control rights for limited partners, and minimal liquidity of limited partnership interests.").
[21] *See* Magnuson, *The Public Cost of Private Equity*, *supra* note 14 at 1890-96 ("Private equity governance structures exhibit many of the features we would expect to see if the industry were subject to strong path-dependence effects.").
[22] Recently, scholars have been taking creative approaches to developing theory on private equity contracting. *See, e.g.*, Clayton, *High-End Bargaining Problems*, *supra* note 11 (using institutional investor surveys to obtain information about how private equity fund agreements are negotiated); de Fontenay & Nili, *Side Letter Governance*, *supra* note 18 (using a dataset of private equity side letters provided by LPs to theorize about private equity contracting).

The staff's comments (taken together) describe a complex bargaining environment that appears to deviate from optimal bargaining in various ways. Among other things, the Proposal points to various forms of coordination problems, with a strong emphasis on conflicts of interest between large and small investors.[23] According to the Commission, this is a world where investors are earnestly asking advisers to provide them with basic transparency, but their requests are often turned down and there is little that they can do about it.[24] The staff indicates that competition among investors for investment opportunities also reduces their incentives to work with each other to unify their positions or work towards standardization of terms.[25]

In addition to coordination problems, the Commission also suggests that private equity fund investors may sometimes lack sophistication to appreciate the full consequences of some of the terms that they agree to.[26] The Commission also points to basic incomplete contracting problems[27] that can arise even when all of the investors are fully sophisticated.[28] Interestingly,

[23] SEC Proposal*, supra* note 1 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.").

[24] *Id.* at 16,892 ("We have seen a significant increase in investors seeking transparency regarding fees and expenses. . . . Despite these efforts, many advisers still do not voluntarily provide adequate disclosure to investors. The proposed quarterly statement rule would mandate them to provide it. We recognize that many private fund advisers contractually agree to provide fee, expense, and performance reporting to investors. For example, advisers may provide investors with financial statements, schedules, or other reports regarding the fund and its activities. However, not all private fund investors are able to obtain this information. Others may be able to obtain information, but it may not be sufficiently clear or detailed reporting regarding the costs and performance of a particular private fund.").

[25] *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. For example, and as discussed above, developing an industry standard on fee and expense disclosures would require independent and competing investors and advisers to determine which of management fees, fund expenses, performance-based compensation, monitoring fees, and more should be disclosed and at what frequency.").

[26] *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. . . . Further, these contractual clauses may lead investors to believe that they do not have any recourse in the event of such a breach. To the extent that any such investors do not seek damages under this belief, the contractual clauses eliminating liability for breach of fiduciary duty would represent a harm to the investors.").

[27] *Id.* at 16,944 ("Certain practices, even if appropriately disclosed or permitted by private fund offering documents, represent potential conflicts of interest and sources of harm to funds and investors. 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.").

[28] *Id.* at 16,937 ("While our staff has observed that some advisers have begun to more fully disclose sales practices, conflicts of interests, and compensation schemes to investors and the practices that are associated with them, we 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. Further, some investors may find it relatively difficult to negotiate agreements that would fully protect them from

the Commission claims that principal-agent problems frequently arise between advisers and their investors[29] (though the Commission does not appear to discuss the possibility of internal principal-agent problems within institutional investors along the lines of what has been suggested in the academic literature[30]).

When the Proposal discusses these bargaining problems, the staff's descriptions tend to be somewhat impressionistic and anecdotal. Moreover, after setting out the list of activities that the staff proposes to prohibit, the Proposal acknowledges that there is a lack of data about how private equity industry business practices would be affected by the proposed prohibitions.[31] Again, this is not particularly surprising given the private nature of the bargaining interactions between investors and advisers, but it does make it more difficult to evaluate how well the policy responses are calibrated to respond to the relevant bargaining problems.

Interestingly, the Proposal generally does not seek industry commentary on its characterizations of the problems that prevent effective bargaining in private funds. Instead, the 900+ questions posed in the Proposal largely take for granted the existence of bargaining problems and instead focus on the scope and application of the proposed rules.

E. Bargaining Problems in Private Funds: Investor Perspectives

Institutional investors have substantial experience in 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 in mind, I collected live polling data from senior in-house counsel working at over 90 institutional investors in October 2021 during a session of the annual Private Equity Legal Conference of the Institutional Limited Partners Association ("ILPA"). 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 comment on how challenging the private equity bargaining landscape is. This input is consistent with statements that have been made by ILPA over the

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bearing unexpected portions of fees and expenses or from other decreases in the value of investments associated with the above-described practices.").

[29] *Id.* at 16,943 ("[F]und adviser incentives to develop and implement reforms, such as developing more detailed disclosures, are limited by principal-agent problems that are inherent to the relationship between fund advisers and clients. Advisers to private funds can potentially engage in opportunistic behavior ('hold up') toward the client in which they exploit their informational advantage or bargaining power over the client, after the client has entered into the relationship. Advisers may also face scenarios in which they have conflicts of interest between certain investors and their own interests (or 'conflicting arrangements'), reducing their incentives to act in the investors' best interests. Advisers may not have sufficient incentives and abilities to commit to a solution to these problems with existing governance mechanisms. These problems of information asymmetry and post-contractual hold-up are amplified by the inherent discretion that private fund advisers have over what information to disclose to prospective investors and the complexity of the disclosures that they provide.").

[30] *See* Gompers and Lerner, *Use of Covenants*, *supra* note 17.

[31] SEC Proposal*, supra* note 1 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, 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.").

years.[32] Given this background, I was curious to use this polling session to ask the audience two general questions: (1) "Why do investors accept terms in private equity funds that they find problematic?"; and (2) "Do investors want to see regulatory reforms?" The original survey consisted of 10 questions, and I discuss a few of the most salient results below.[33]

(1) Why Do Investors Accept Terms in Private Equity Funds That They Find Problematic?

To address this first question, I asked a senior in-house private funds attorney[34] to create a list of possible reasons 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 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[35]:

[32] *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 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 in order to achieve certain performance thresholds designed to allow them to meet their pension and other disbursement requirements. LPs, including even the nation's largest public pensions, with correspondingly reduced leverage in negotiations, have continued to face a market where they are forced to accept these reductions in the applicability of basic duties of fairness, loyalty and good faith owed to them by the investment advisers they invest with.").

[33] All live polling results, with the exception of the tenth question (which contained sensitive information), can be viewed in Appendix A.

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

[35] The respondents to this question included senior in-house attorneys at the following institutional investor types: 41 public pension plans, 16 endowments, 9 private pension plans, 8 insurance companies, 5 international development banks, 5 funds of funds, 4 family offices, 2 foundations, and 2 banks.

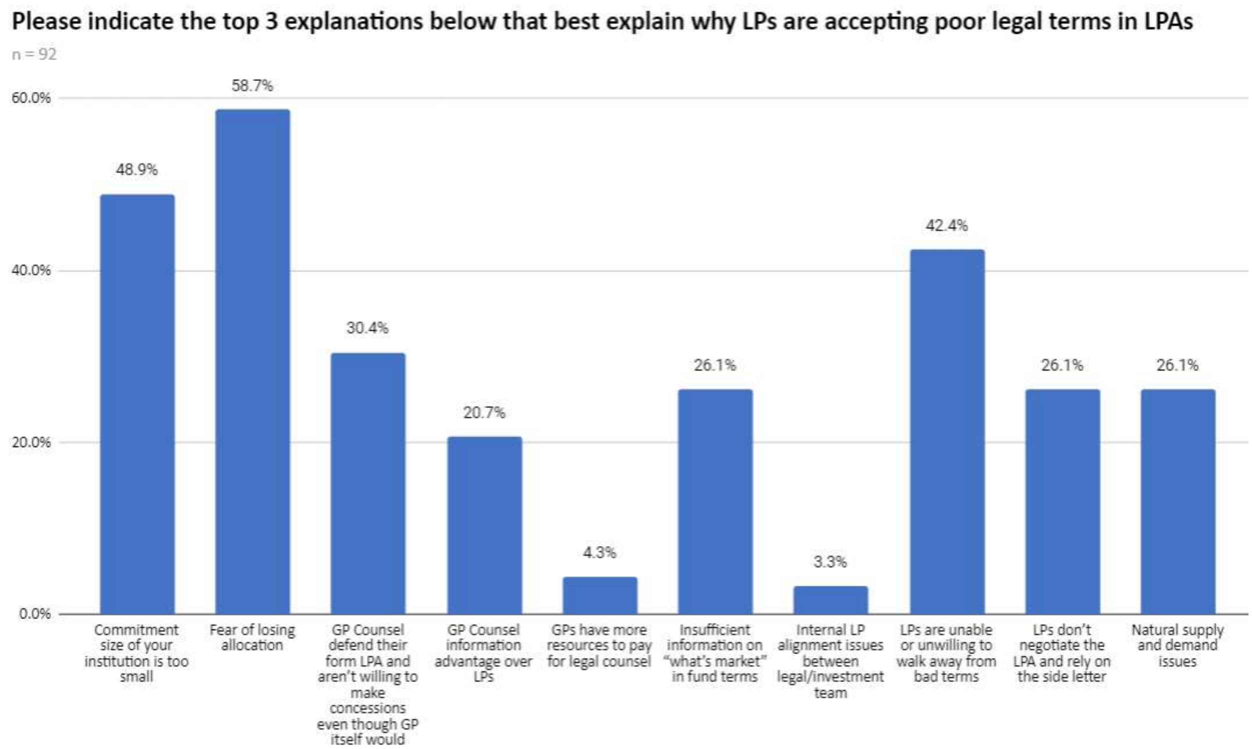

Figure A

The most common response from institutional investors (by far) was that they accept problematic terms because of a fear of losing allocation, which suggests that there may be a coordination problem among investors. If all investors were aligned in their bargaining priorities, they would not be 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 that are willing to tolerate weak terms. This describes a form of a prisoner's dilemma.

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.[36] Scholars provided evidence years ago, however, that this is not how it works in the private equity industry,[37] and these polling results reinforce that understanding.

The fourth most common response 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.[38] 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 bargaining problem.

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 not legitimate 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 entirely surprising, as in-house counsel responding to the polling question may not want to give the impression that they are less sophisticated than the adviser-side attorneys or that their institutions suffer from problems that might warrant any attention.

(2) Do Investors Want Regulatory Intervention?

Even if bargaining problems exist, 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

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[36] *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.").

[37] *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).

[38] *See* de Fontenay & Yaron, *Side Letter Governance*, *supra* note 18.

in-house attorney specializing in private fund investments.[39] 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[40]

Responses to this question are shown below[41]:

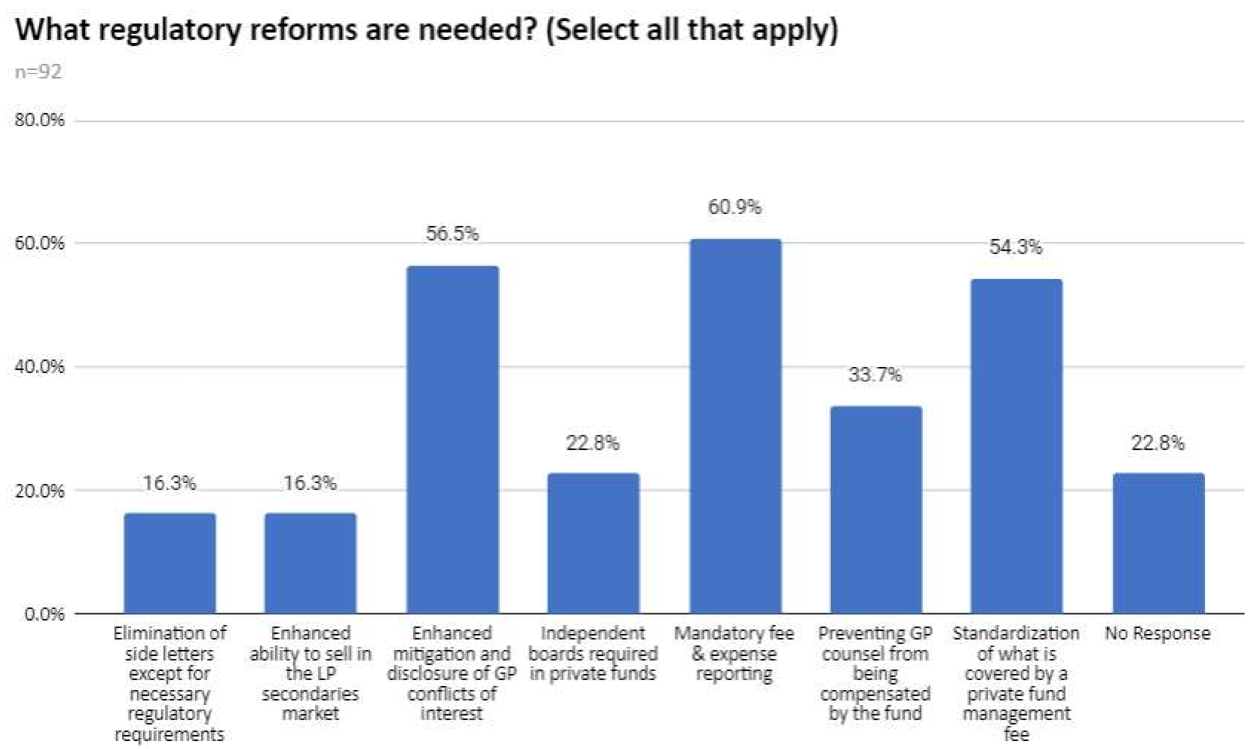

Figure B

[39] *See supra* note 34.

[40] 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.

[41] The affirmative respondents to this question included senior in-house attorneys at the following institutional investor types: 33 public pension plans, 10 endowments, 7 private pension plans, 7 international development banks, 6 insurance companies, 3 family offices, 2 foundations, 2 funds of funds, and 1 bank.

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.[42] 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 B, a significant number of investors did not respond to the poll, suggesting that there may be a material percentage of investors that (as of six months ago) preferred not to see an increase in regulatory interventions.[43] This mixed perspective on the role of regulatory reform was also reflected in the survey result below, which asked investors to indicate the roles that investors want ILPA to play in addressing bargaining problems in private equity.[44]

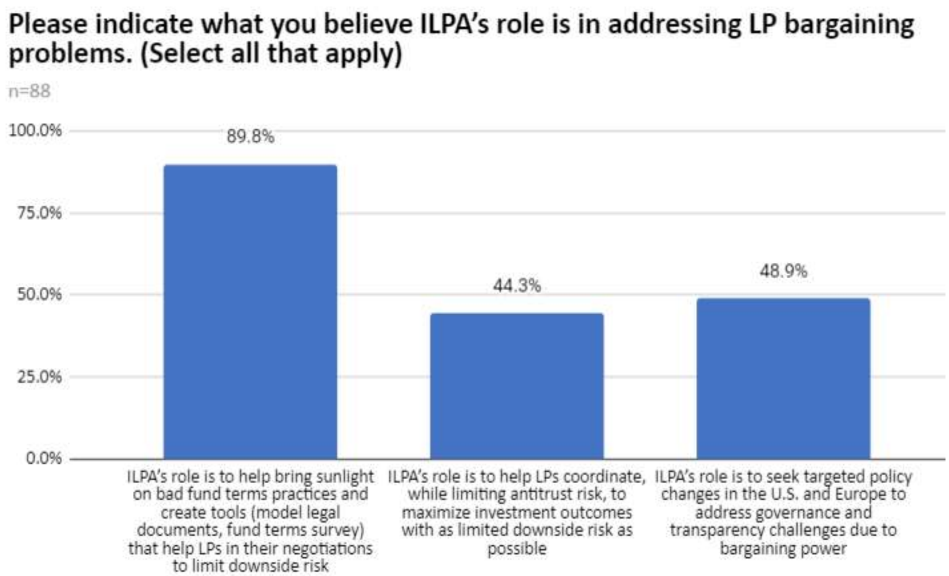

Figure C

(3) High-Level Takeaways from the Polling Results

What can be said of these results? On one level, they certainly raise questions about the contractarian view of the private fund industry that has been articulated by Commissioner Peirce and others. A substantial percentage of investors seems to think that the bargaining outcomes in

[42] 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).
[43] I interpreted the absence of a response to this question to mean that the investor did not believe any new regulatory interventions were needed. Note that if a sample size of 99 is used instead of 92, the percentage of non-responding investors rises from 22% to 28%. *See supra* note 40.
[44] The respondents to this question included senior in-house attorneys at the following institutional investor types: 36 public pension plans, 14 endowments, 11 insurance companies, 8 private pension plans, 7 international development banks, 5 family offices, 4 funds of funds, 2 foundations, and 1 bank.

private funds are problematic and desires various forms of regulatory intervention, though this number appears to fall short of either unanimous or super-majority support. Moreover, as discussed above, the preferred policy interventions of the respondents generally appear to align with some the dominant policy priorities of the Proposal.

These findings also provide some insight into the *nature* of bargaining problems in private equity funds. According to respondents, the most important factor leading to sub-optimal bargaining outcomes in private equity funds is an investor coordination problem. 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 claims in the Proposal that investors lack bargaining power and that investor competition for investment opportunities makes it harder for investors to bargain for effective outcomes.[45]

Interestingly, the coordination problem being described by institutional investors in this setting is quite different than the collective action problem that has factored so prominently in the public company mandatory disclosure literature.[46] The public company collective action problem grows out of the fact that information is disclosed to the public in public markets, which means that competitors and other market actors can act on the information in ways that could disadvantage the company making the disclosure. In that setting, the disclosure *producers* are the ones that are described as suffering from a problem that causes them to deviate from optimal private ordering, not necessarily the investors that consume the disclosures.

The same problem does not exist in private funds, as private equity advisers typically provide disclosures only to their investors and not to the general public. Instead, the coordination problem being alleged by investors seems to be that managers under-disclose information (and impose other problematic terms on investors) primarily because investors have a rational reason to be afraid of demanding strong terms.

(4) Principal-Agent Problems and Other Investor Issues

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.[47] 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.[48] In other words, the respondents themselves could be significant

[45] *See supra* notes 23-25 and accompanying text.
[46] *See supra* note 8 and accompanying text.
[47] *See* Gompers and Lerner, *Use of Covenants*, *supra* note 17.
[48] As noted above, the Proposal suggests that lack of sophistication may be an explanation for certain sub-optimal terms. *See supra* note 26 and accompanying text.

contributors to bargaining problems in the industry, and as a result their responses casting blame on other factors could be unreliable.

It is difficult to know what to make of this possibility, 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/or sophistication problems would serve as an even *stronger* challenge to the contractarian thesis that investors can be relied on to bargain for effective outcomes. If the in-house counsel and/or external counsel representing institutional investors suffer from widespread principal-agent problems and/or sophistication shortcomings, it could plausibly justify more aggressive policy responses than what would be appropriate in the absence of such problems.

F. My Suggestions

The SEC's ambitious proposed changes bring into focus the importance of having a sound understanding of the limits of private contracting in private funds. As Commissioner Peirce's dissent illustrates, the case for more aggressive regulatory intervention in private funds largely turns on whether the industry participants in this space can be assumed to structure their own affairs effectively or not. If there are impediments to effective private ordering, understanding what those problems are and how they affect contracting outcomes is important to inform which additional policy responses, if any, will be most effective.

The survey data that I have presented above (and in Appendix A) shows that many institutional investors think there are bargaining problems in private equity funds and want to see significant regulatory interventions to address those problems. It also provides insight into which specific problems investors think are having the most significant impact on bargaining outcomes. While this is helpful, the data admittedly raises nearly as many questions as it resolves. Moreover, because the questions were directed specifically to private equity fund investors, the results are not entirely relevant to other types of private investment funds.

I have two suggestions. First, if the Commission proceeds with a final rule, I encourage the staff to be even more explicit about articulating the bargaining problems in private funds that lead to problematic outcomes (based on its perspective gleaned from examinations, investigations, and elsewhere). As noted above, much of the analysis of bargaining problems in the Proposal is spread throughout the Proposal. I would encourage the staff to include a more robust and unified discussion of bargaining problems in its initial framing of the rule and be more explicit about how the various aspects of the rule respond to those problems. Moreover, to the extent that the Commission has access to more data that provides additional insight into bargaining problems or has received additional detail from industry commenters on bargaining problems during the comment process, I encourage the staff to include that information in the final rule.

Second, I think it is important to note that even if a final rule is issued, ongoing research into these issues will continue to be very important. Private funds have long been an understudied topic in the legal literature. While this fact is not surprising due to the challenges of researching this area, it is an extremely important policy area that needs more theoretical and empirical research contributions from scholars. Accordingly, I call on corporate finance scholars and securities law scholars to find thoughtful ways to make these contributions in coming months and years. The same need exists in the private operating company domain.[49]

II. Brief Discussion of My Research Cited in the Proposal

Below, I offer two brief comments on certain of my research papers that the Commission cited in the Proposal. Note that the final, publication version of one of those papers—*High-End Bargaining Problems*—was recently completed and made available on SSRN.[50]

A. Policy Arguments

The Proposal includes citations to three papers that are authored by me.[51] Importantly, while each of those papers discusses various problematic aspects of private equity fund governance,[52] they do not purport to measure the policy benefits of any regulatory interventions or weigh them against the policy costs. As such, they do not advocate for any particular policy responses by the SEC[53] (contrary to suggestions otherwise[54]), and they do not consider questions of the SEC's regulatory authority. My objective here is to emphasize that, for all of the reasons discussed in this letter, an explicit assessment of private fund bargaining limitations should play an important role in the cost-benefit analysis of the interventions set forth in the Proposal and in academic research going forward.

B. Conflicts Between Investors

One of the bargaining problems identified in the Proposal refers to conflicts of interest between large investors and small investors.[55] As the Commission noted in the Proposal,[56]

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[49] *See generally* Paul Kiernan, *SEC Pushes for More Transparency from Private Companies*, WALL ST. J. (Jan. 10, 2022).
[50] *See* Clayton, *High-End Bargaining Problems*, *supra* note 22. In the Proposal, the Commission refers to a Jan. 8, 2022 draft of this paper. The final, updated version of this paper can be found at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3900197.
[51] *See* SEC Proposal*, supra* note 1 at fns. 8, 146, 173, 192, and 250.
[52] *See generally* Clayton, *High-End Bargaining Problems*, *supra* note 22 (identifying signs of problematic bargaining outcomes and processes in private equity funds and discussing scholarly attempts to explain those problematic outcomes); William W. Clayton, *Public Investors, Private Funds, and State Law*, 72 BAYLOR L. REV. 294 (2020) (examining the challenges involved when state governments seek to use state law to address problems with public pension investments in private equity funds); Clayton, *Private Equity Negotiation Myth*, *supra* note 16 (identifying a possible conflict between the interests of large investors and small investors in private equity funds that leads large investors to under-prioritize the negotiation of LPA terms).
[53] *See* Clayton, *High-End Bargaining Problems*, *supra* note 22 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."); Clayton, *Public Investors, Private Funds, and State Law*, *supra* note 52 at 343-54 (discussing various possible policy responses, including modifications to state pension law, applying ERISA to public pension plans, and adjusting the application of investor qualification standards to public pension plans); Clayton, *Private Equity Negotiation Myth*, *supra* note 16 at 107-13 (discussing possible changes to state law fiduciary standards and challenging an argument for expanding private equity access to retail investors).
[54] *See* Pitt, *supra* note 5 at 4.
[55] *See supra* note 23.
[56] *See* SEC Proposal, *supra* note 1 at fn. 173.

certain of my research papers have discussed this question. In 2017 I published a paper on the rise of co-investments and separately managed accounts ("SMAs") in private equity.[57] That paper focused primarily on the question of whether co-investments and SMAs are likely to lead to advisers allocating their highest-performing deals and other scarce resources disproportionately to co-investors and investors in SMAs. That paper's most important claim is that advisers have significant incentives to avoid over-allocating their highest-performing deals to co-investment vehicles and SMAs because pooled fund track records are more useful for marketing to future investors than the track records of co-investment vehicles or SMAs.[58]

But, as acknowledged in the Proposal, deal allocation is not the only way in which preferential treatment can potentially harm other investors. In 2020, I analyzed one of the possible side effects that preferential treatment could have on the bargaining of LPA terms.[59] That paper argues that preferential treatment granted to pooled fund investors (including, but not limited to, low fee co-investments) could dilute their ex ante incentives to negotiate for LPA terms that benefit all investors (even if it does not lead to unfair deal allocation).[60]

That 2020 paper generally assumed that co-investments, fee discounts, and other preferential terms affecting economic value (either directly or indirectly) are commonly granted in side letters,[61] but recent research has challenged the extent to which economically significant terms are located in side letters.[62] If this claim is correct, it could mean that the Proposal's effort to mandate more explicit disclosure of preferential treatment in side letters[63] might yield less useful information than the Commission is anticipating.

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[57] William Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249 (2017).

[58] Importantly, that paper's characterization of the rise of co-investments and SMAs as an "efficient" development—in a broad sense—for the industry was overly-simplistic. That broader labeling failed to give weight to certain inefficiencies and transparency concerns that can be created by such practices, and it also did not speak to the dampening effect that side deals can theoretically have on large investors' ex ante incentives to negotiate LPAs, an issue that I took up in my 2020 paper.

[59] Clayton, *Private Equity Negotiation Myth*, *supra* note 16.

[60] *Id.* at 67 ("Because large private equity fund investors are commonly able to negotiate for individualized benefits outside of fund agreements, they have strong incentives to use their bargaining power to maximize individualized benefits before negotiating for better fund-wide protections.").

[61] This assumption was based primarily on various industry sources and survey reports. *See, e.g.*, PREQIN, PRIVATE EQUITY CO-INVESTMENT OUTLOOK 5 (Nov. 2015), 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. *See, e.g.*, Magnuson, *The Public Cost of Private Equity*, *supra* note 14

[62] *See generally* de Fontenay & Yaron, *Side Letter Governance*, *supra* note 18.

[63] SEC Proposal*, supra* note 1 at 162-78.

However, even if it is true that side letters rarely contain economically significant terms, that would not necessarily eliminate concerns about large investors using their influence to advocate for individualized benefits over things that would benefit the whole fund. For example, even if a fee discount is documented in an investment advisory agreement or LPA rather than a side letter, investors would likely still have incentives to prioritize that term over other terms that would benefit all investors in a fund. Moreover, even if co-investment opportunities are not explicitly granted at the side letter stage but are instead granted at the adviser's discretion throughout the life of the fund, it could still lead to a gap between the interests of large investors and small investors that is arguably worse. When co-investment entitlements are finalized during the side letter stage, that investor's incentives should not be affected by the allure of low fee co-investments during the life of the fund. But if co-investment entitlements are not finalized in the side letter, the effect could be to diminish large investors' incentive to advocate for fund-wide interests not just during the side letter negotiations, but also when they are voting on fund matters and/or serving on the LPAC during the life of the fund. This form of preferential treatment could plausibly be even more problematic than if it were explicitly documented in a side letter.

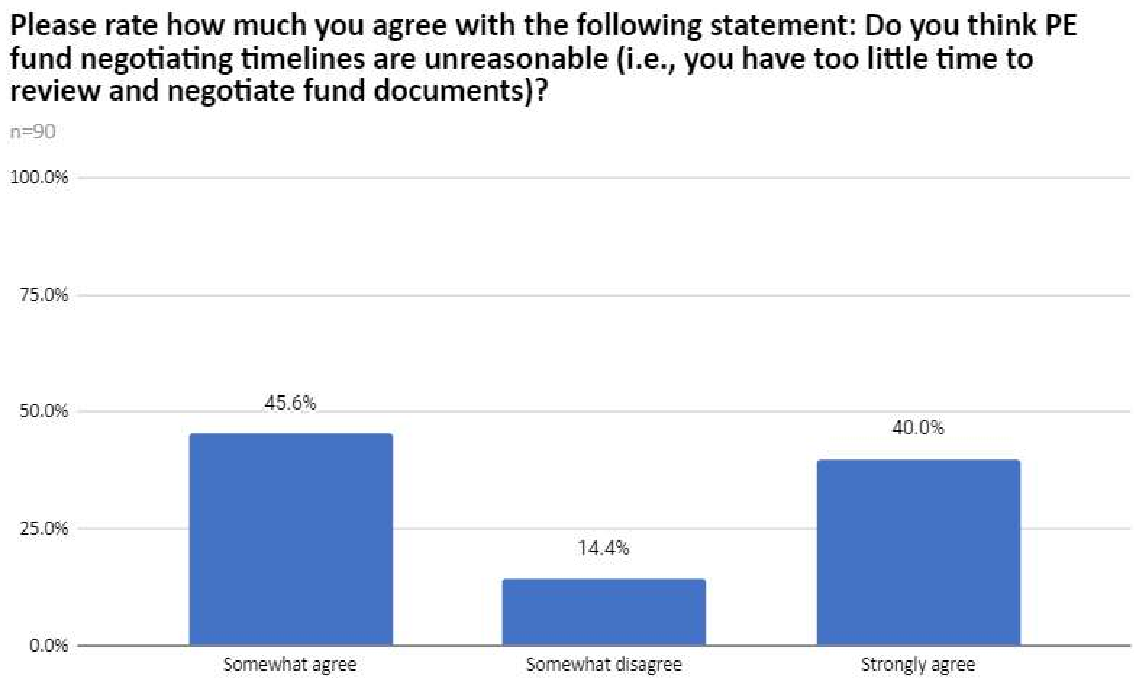
Conclusion

The Commission's Proposal and the range of reactions that it has elicited has underscored the importance of articulating and understanding the limits of private contracting in this new era of more aggressive private fund regulation. I hope this discussion has been useful to the Commission. Thank you, again, for the opportunity to comment.

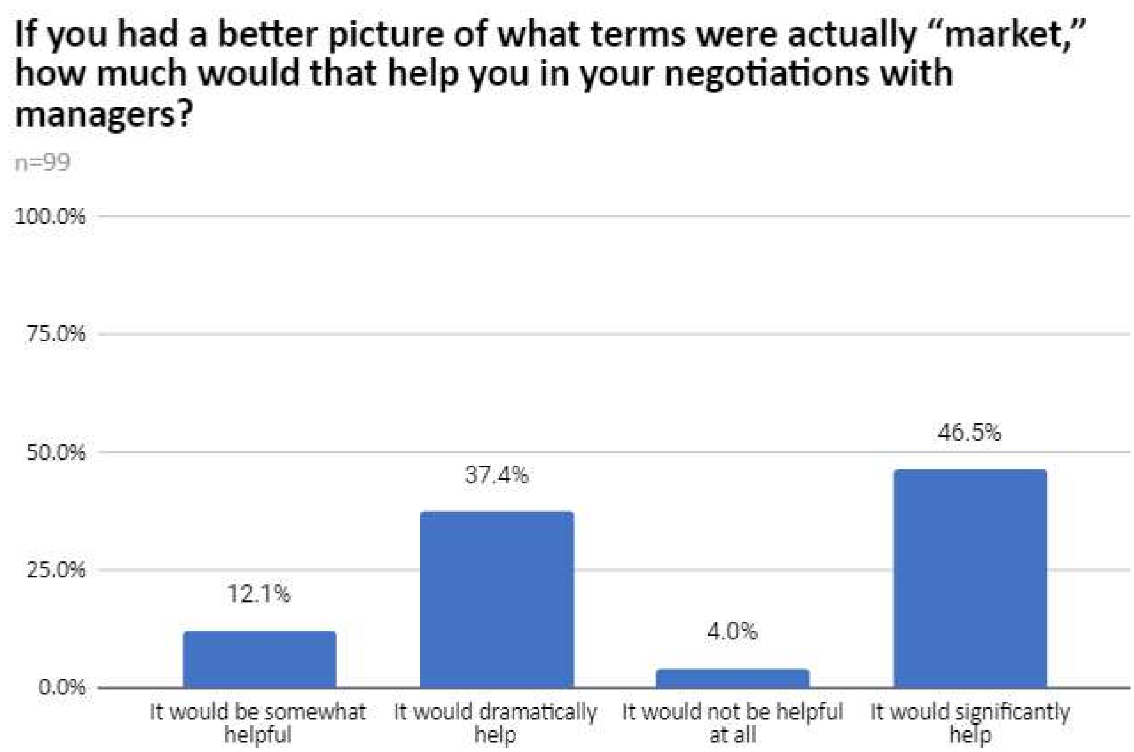
Sincerely,

William W. Clayton
Associate Professor
BYU Law School

Polling Question #1



Polling Question #2



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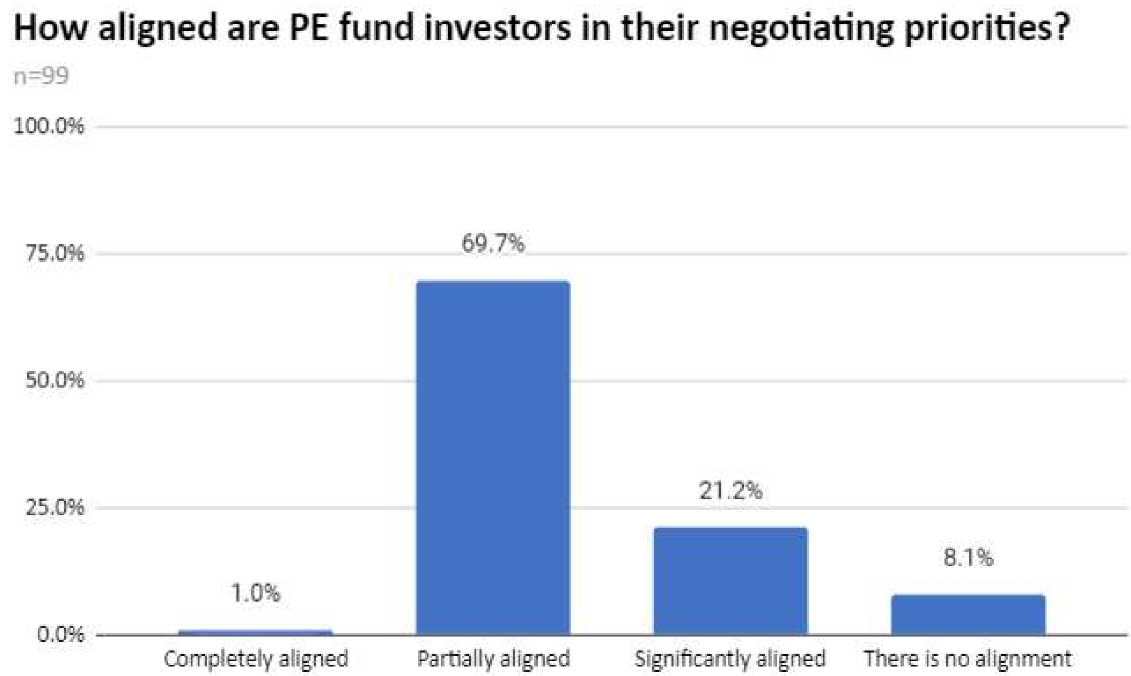

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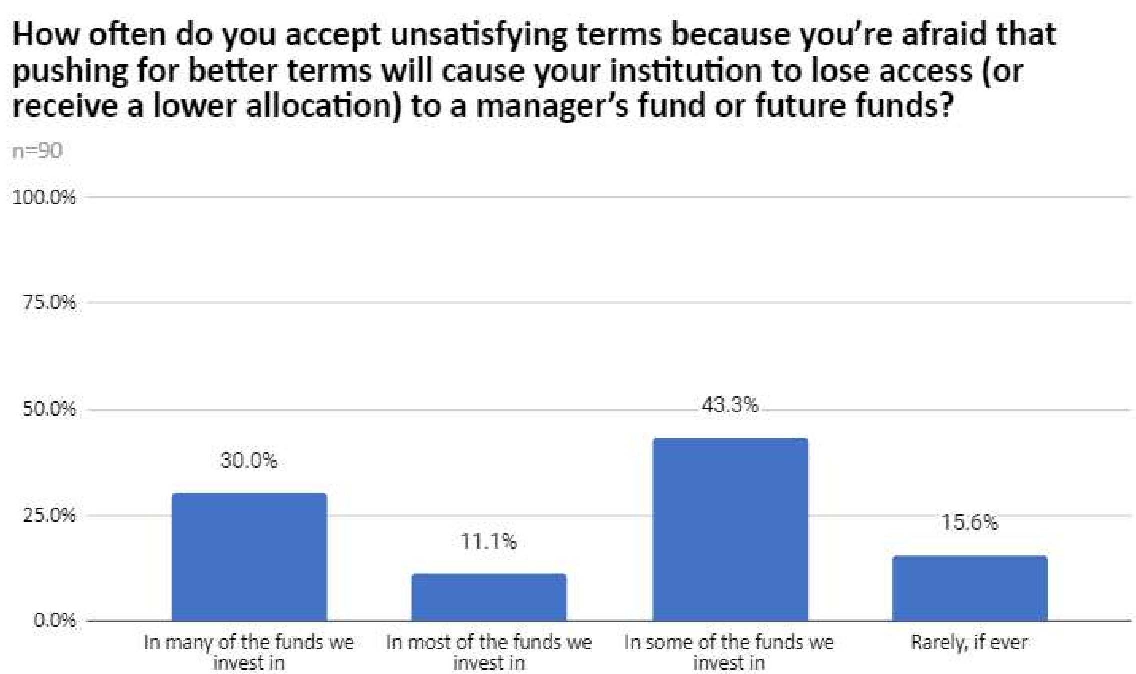

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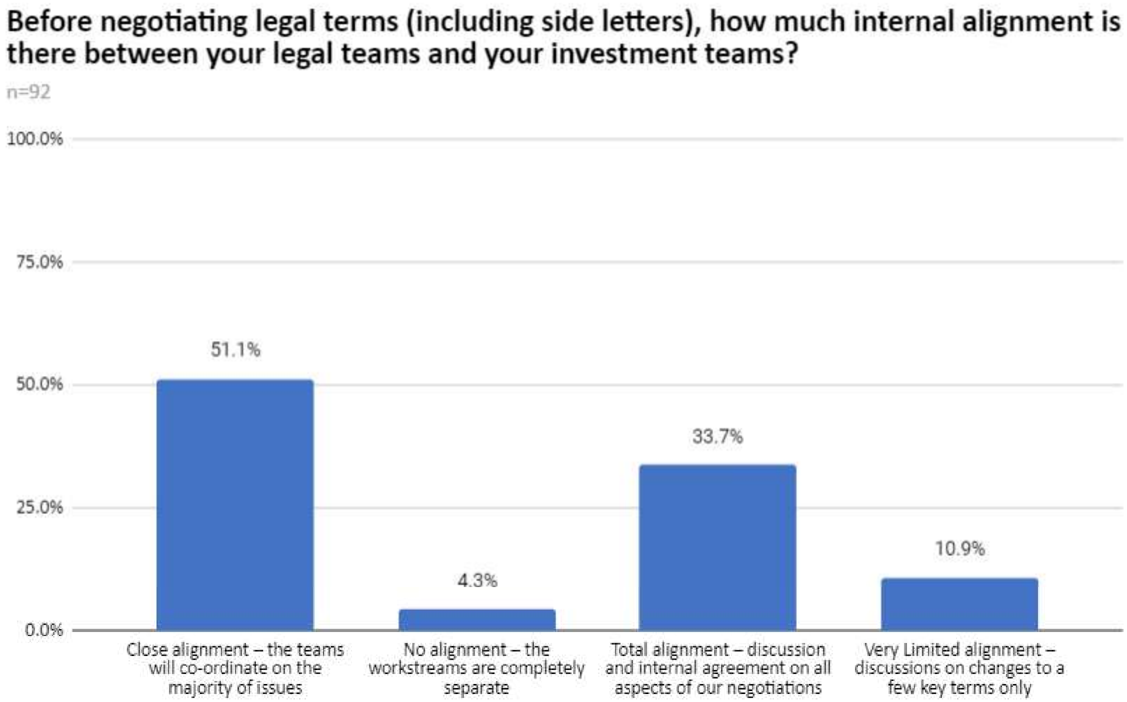

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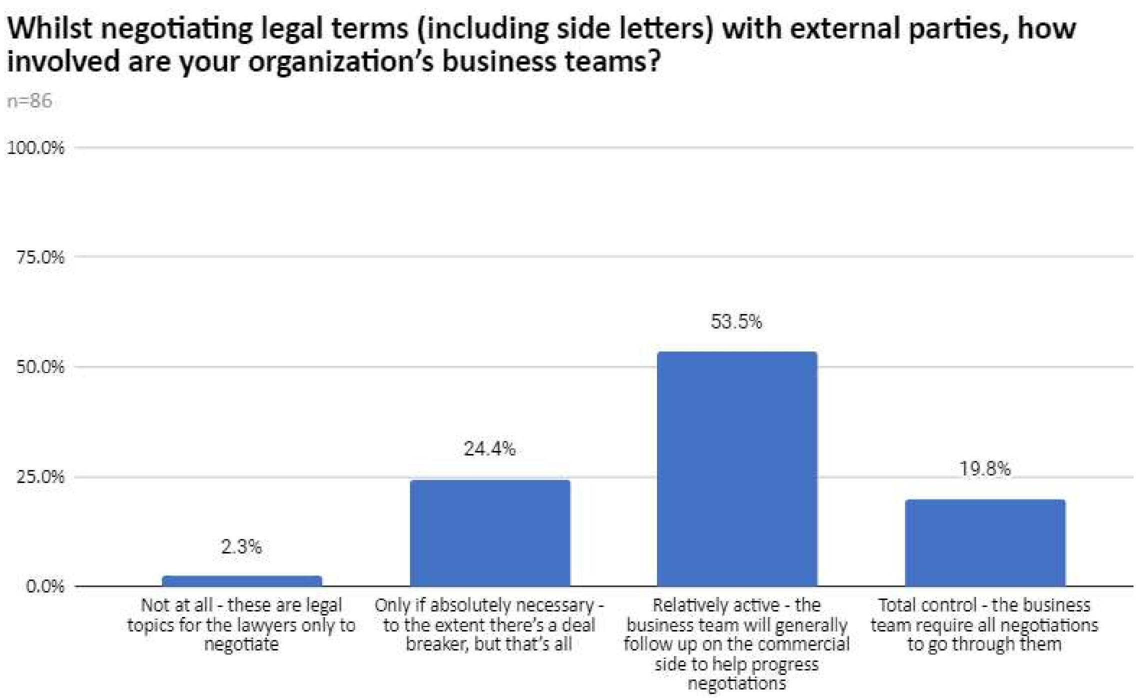

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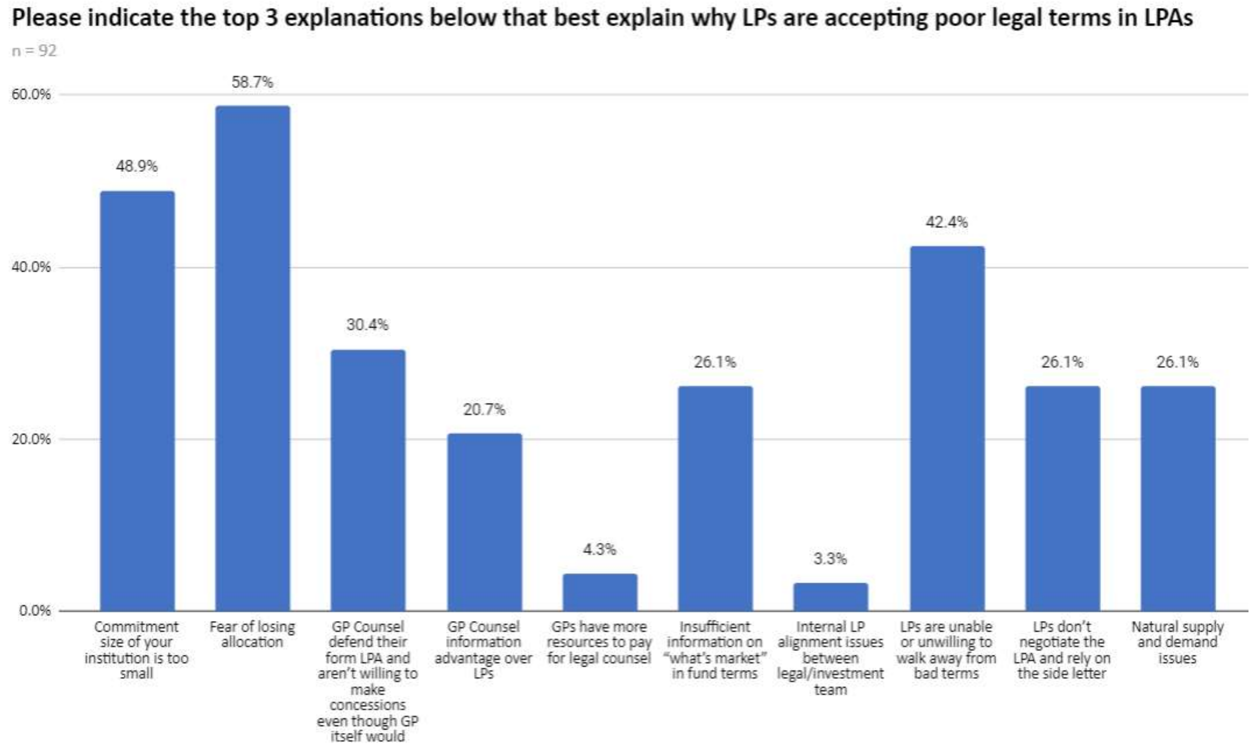

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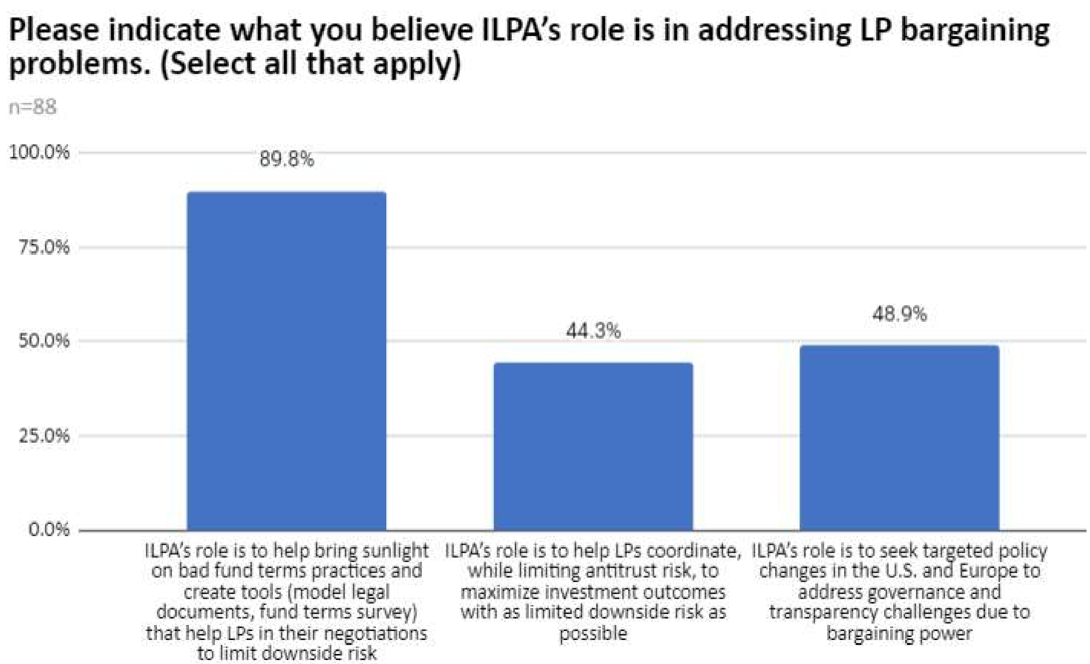

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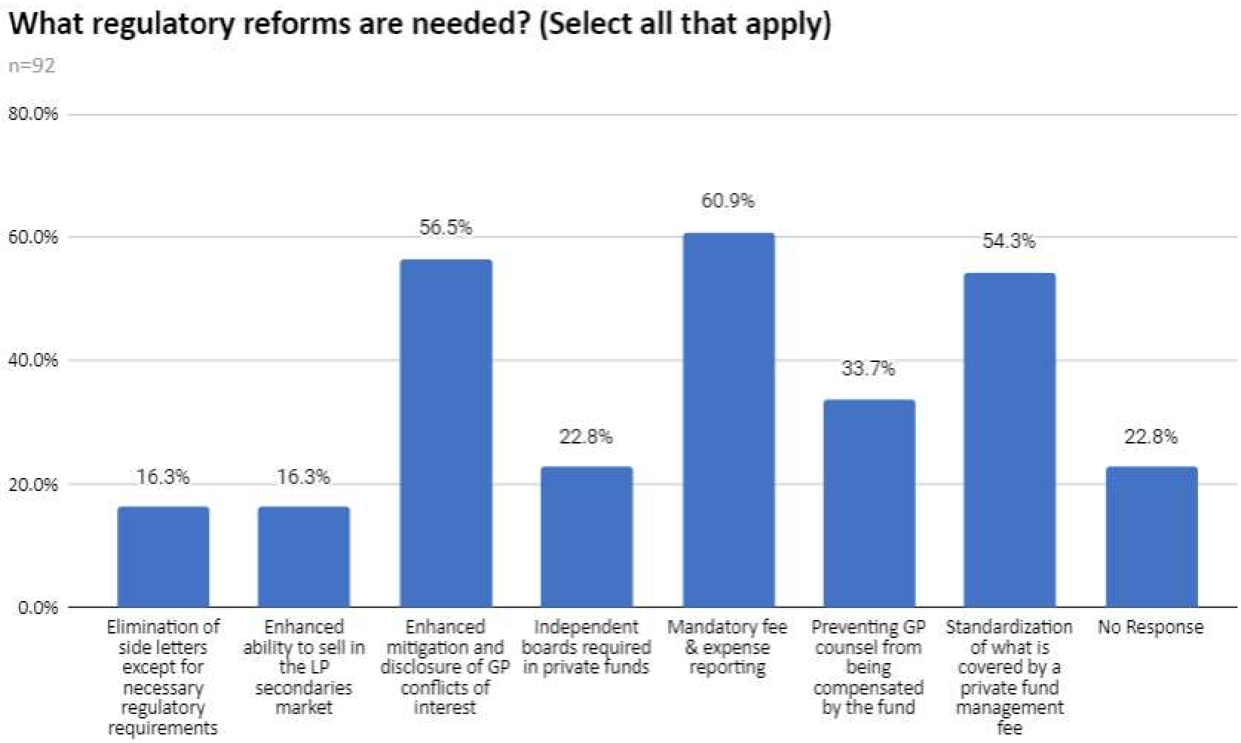

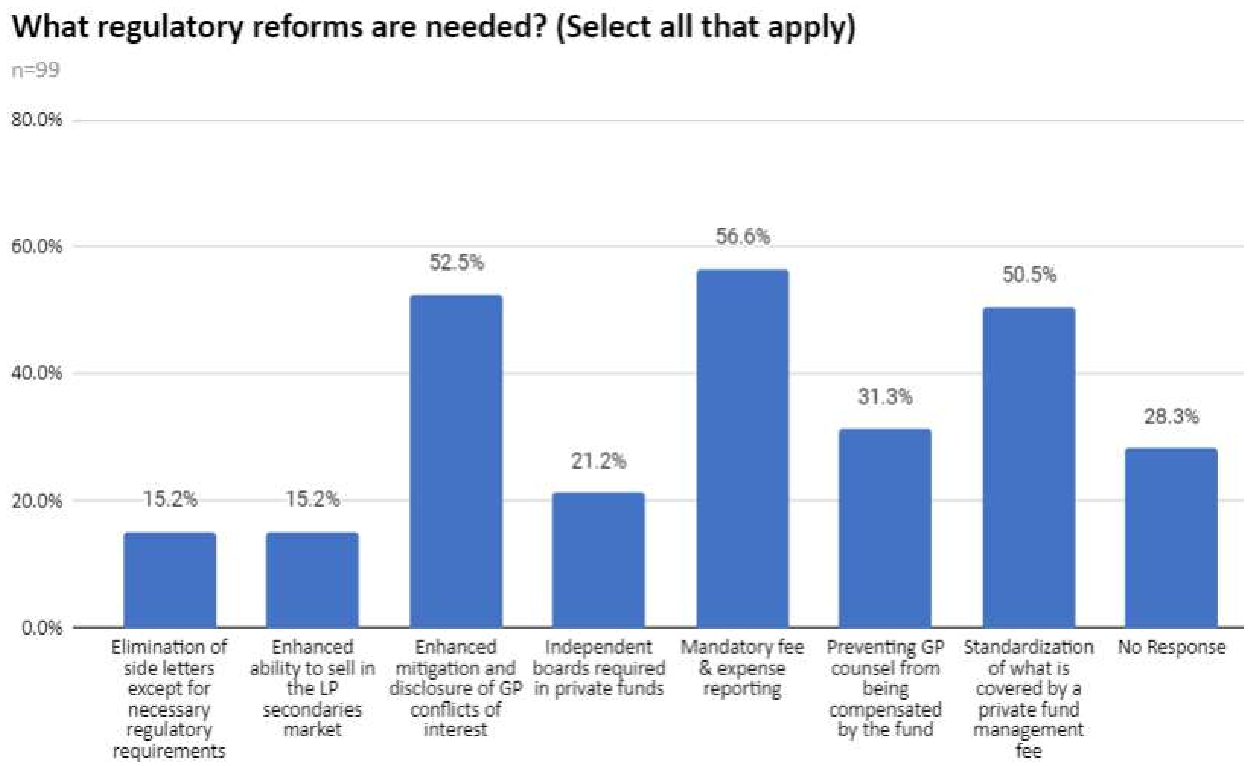

What regulatory reforms are needed? (Select all that apply)
n=99
80.0%
60.0%
40.0%
20.0%
0.0%
15.2%
15.2%
52.5%
21.2%
56.6%
31.3%
50.5%
28.3%
Elimination of side letters except for necessary regulatory requirements
Enhanced ability to sell in the LP secondaries market
Enhanced mitigation and disclosure of GP conflicts of interest
Independent boards required in private funds
Mandatory fee & expense reporting
Preventing GP counsel from being compensated by the fund
Standardization of what is covered by a private fund management fee
No Response