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research collective

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

Re: File Number S7-03-22
(Submitted via email)

Dear Secretary Countryman,

Pattern Recognition: A Research Collective welcomes the opportunity to comment on the SEC's proposed rule on "Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews." We are a consultancy organized around the consequences of financialization, with a particular focus on higher education. Our publication platform, *Recognitions*, is directed toward a broad range of stakeholders in higher education (faculty, staff, administrators, students, alumni). One key aspect of that project is helping people in the humanities in particular understand finance and financialization so that they may better comprehend and respond to the kind of pressures under which they find themselves, especially since it has become fairly routine for the humanities to be targeted by budget cuts.

We applaud the Commission's initiative in requiring disclosures of private-equity fees and discriminatory side-letter arrangements as well as disclosures of portfolio holdings from private fund advisors. With respect to institutional investors as limited partners (e.g., pension funds, foundations, and university endowments) we think it would be highly beneficial for disclosures re: fees, real rates of return, and portfolio holdings (by sector, at the very least) be made public and available to all institutional stakeholders. For endowments, stakeholders would include alumni, trustees (especially those trustees not directly involved with endowment oversight), administrators, faculty, staff, and students (both graduate and undergraduate).

In what follows, we focus primarily on higher education and what we have learned from our work in that sector, but we also draw on decades of previous experience with regulatory research on fair-value measurement and accounting. We begin with a discussion of governance issues and challenges related to the current lack of disclosures, moving on to address problems of oversight. In conclusion, we offer some remarks on IRR, valuation complexity, and the use of the NAV expedient.

Governance

The scope, volume, and influence of private investment vehicles has increased substantially since the Investment Advisor Act of 1940, a circumstance acknowledged by the far-reaching and important changes that the SEC is now proposing. Although institutional investors like endowments are still routinely characterized as "sophisticated" investors, it would be a mistake to conflate them with the high-net-worth-individuals initially designated by the term. A nonprofit entity providing a public good like higher education is not meaningfully comparable to a high-net-worth individual pursuing private gain. This terminological ambiguity often results in downplaying or overlooking the central importance of stakeholder engagement with institutional governance and the centrality of transparency to that engagement.

Non-profit colleges and universities have historically been more democratically governed institutions than for-profit, private corporations, which are generally much more hierarchical in form. The existence of faculty councils, senates, associations, and unions attests to the fundamental institutional importance of collaborative, cooperative governance. Consequently, stakeholders need to be knowledgeable about and involved with fundamental decisions about how their institutions are governed and have clear channels for providing input.

However, in keeping with many endowments' increasing reliance on highly secretive alternative investments and private funds, many key stakeholders have been effectively excluded from obtaining information that would allow them to assess the financial condition of an endowment and its relation to general budgetary matters. For example, the current popularity of the so-called "Yale Model", which allocates high percentages to alternatives, has resulted in an extremely information-poor environment for the vast majority of stakeholders, who are generally unable to obtain clear, accurate information about costs/fees, returns, and types/sectors re: these investments. As Harry Truman once said, "Secrecy and a free, democratic government don't mix" – something as pertinent for university governance as it is for the country at large.

A severe and institutionally consequent informational asymmetry can result, in which typically only a handful of people possess information about what is actually going on with the endowment's investments, at the expense of everyone else. In our experience, this particular form of asymmetry is more than a merely routine, convenient, and necessary division of institutional labor because it undergirds a destructive dynamic, one in which democratic and

participatory governance increasingly gets undermined by autocratic managerialism related to the withholding of information such as total costs/fees and actual rates of return.

Currently, most stakeholders also have little or no access to basic information about the underlying investments, industries, and sectors included within their endowments' alternative holdings. Considerable research has been done on the extra-financial implications of alternatives' business-models, demonstrating, for example, the (often profoundly negative) effects of private-equity LBOs on labor and employment[1] and the ways they have exacerbated inequality.[2] Similar concerns have been amply documented regarding alternative investments in particular industries, such as healthcare/medicine.[3] Despite this wealth of research and materials, however, it can still be very challenging for individuals to figure out what their institutions are actually invested in. While sector or industry type can sometimes be ferreted out, we think that basic information concerning portfolio holdings should be a routine disclosure available to all stakeholders. Such information would be neither costly nor burdensome to provide, and would allow stakeholders a much clearer picture of where their institutions stand in relation to particular industries as well as the broader global economy.

Further, the complete lack of transparency concerning fees and actual rates of return leaves stakeholders without crucial information needed to assess, or challenge, austerity measures and cuts at their institutions, or even to understand basic budget flows.[4] In our experience, faculty and other stakeholders are routinely rebuffed or ignored when requesting information on actual returns and total costs/fees. At public institutions of higher education, which are accountable to the public because they are (though in increasingly smaller part) funded by taxpayers, such information cannot be obtained even with a FOIA request, which means that true accountability

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[1] See Eileen Appelbaum and Rosemary Batt's *Private Equity at Work: When Wall Street Manages Main* Street (New York: Russel Sage Foundation, 2014) and, for more recent case studies, the excellent work of The Private Equity Stakeholders Project, linked here.

[2] See for example: Ludovic Phalippou, "An Inconvenient Fact: Private Equity Returns and the Billionaire Factory" https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3623820; *Institutional Investor's* "The Rich List: the 21st Annual Ranking of the Highest-Earning Hedge Fund Managers" available here.

[3] For example, the COVID-19 pandemic was exceedingly difficult for hospitals, particularly where private-equity ownership had already transformed their medical business models into the image of shareholder sovereignty. PE ownership of nursing homes was shown to be deeply problematic and deadly during the pandemic, and PE ownership of group homes has resulted in declining care and preventable deaths. PE has also moved into ambulances while, at the same time, PE ownership (with its business-restructuring and emphasis on GP profits) has also been linked to increases in surprise billing. There is an important social policy question of whether private-finance investment in public health is a destructive contradiction in terms—but ahead of Congressional action, pension-fund stakeholders in particular have begun to mobilize. One example of this emergent fight was documented on 6 April 2022 in *The Lever*, in an article detailing efforts by PA State Senator Katie Muth (a trustee of the Pennsylvania Public School Employees' Retirement System, the state's largest) to get information from the fund's staff on portfolio holdings in alternatives invested in hospitals and ambulance companies—she had to sue the fund's staff for the information she requested. This is a clear oversight problem.

[4] The widespread adoption of the "Yale Model" (against David Swensen's own advice) should be understood in the context of broader and ongoing conflicts within higher education that fall outside SEC's remit. For simplicity's sake, we follow Jerry Z. Muller's *Tyranny of Metrics* (Princeton UP, 2018) in characterizing those conflicts in general as centered on the question of whether a university should be run on the model of a for-profit corporation and, if so, how the transpositions from one domain to the other should best be carried out. Metrics play a fundamental, and ambiguous role in all that. See Muller's Chapter 7, "Case Study, Colleges and Universities" pp.67-87.

is effectively limited. The Commission's proposed disclosures of fees, made available publicly, would allow much-needed light to be shed on what has till now remained a matter of stubborn and needless opacity.

Oversight

The opacity and secrecy of private funds create significant problems of both process and oversight for both pension funds and endowments, and the issue of private-equity fees - the ways they are disaggregated, reported and/or hidden – offers clear evidence of those problems (see pp. 24-7 of the current rule proposal and SEC's June 2020 Risk Alert).

Secrecy remains almost total when it comes to limited-partner agreements (LPAs). The blog *Naked Capitalism* has collected an archive of 23 LPAs, which has been an important resource for researchers. In a forthcoming article, William Clayton provides a glimpse of the process whereby the contracts are fashioned. LPAs are shaped fundamentally by a division of labor in their production that separates investment managers who initiate them from the legal representatives who negotiate them. This division of labor is physical and intellectual; because LPAs are quite technical, the latter extends to professional-linguistic competencies. Contract negotiations proceed through thousands of very expensive hours: they do not relying on boilerplate language to expedite the proceedings. Clayton's description of the process brings to mind Jorge Luis Borges' Pierre Menard and his project of writing--not copying--*Don Quixote* word-for-word.[5] Logically, it is obvious that this division of labor determines how fees are defined and distributed for accounting purposes and is the condition of possibility for the recurrent problem of institutional investment managers not knowing how much their funds pay for their alternative investments. But the climate of secrecy prevents us from saying more.

LPAs are highly technical documents. Investment manager oversight of their content happens in a context framed by attorney-client relations. Trustee oversight of these investments is more problematic. Given that endowments gambling with a college or university's educational mission is less existential than is a pension fund's doing so with the retirement benefits of working people, it is perhaps not surprising that oversight problems with the latter have drawn considerable critical attention. Jeffrey Hooke provides a striking image of these problems at the beginning of his recent book *The Myth of Private Equity*. He focuses on the social composition of the board of a Maryland public pension fund, one made up of political appointees, party donors, and people with significant social connections (all of whom have in common little-to-no expertise in finance), and describes a mode of oversight that essentially involves wielding a rubber stamp and passing the buck.

Available documentation and case-studies show problems of oversight to be widespread, as well as complex and conflictual, particularly where whistleblowers are involved. In addition to the

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[5] Clayton 2022, pp. 25-6. Borges' wonderful "Pierre Menard: Author of the Quixote" can be read here.

archive of LPAs noted earlier, *Naked Capitalism* has been tracking oversight problems with CalPERS for years and maintains an extensive archive of reporting, one that, read in chronological order, is like a modern-day version of Paolo Sarpi's *History of the Council of Trent*.[6] Edward Siedle and Chris Tobe have done some important work on exposing the links between alternative investments and the remuneration structure of officials at Ohio STRS in cooperation with the pro-transparency group Ohio STRS Watchdogs.[7] This work is most illuminating, but there needs to be much more light shed on problems of oversight and incentivized behaviors in the realm of institutional investors.

While we enthusiastically support SEC's proposed disclosures and the move to increased transparency that informs them, we also wonder to what extent regulation can address problems of oversight, in line with William Clayton's "Public Investors, Private Funds and State Law".[8]

IRR, Valuation Complexity, and the NAV expedient

We support SEC's proposed disclosures of assumptions and methodologies in the reporting of internal rates of return (p. 71). The Commission is aware of the problems with IRR[9] (note 85, for example) apart from a very narrow range of uses.[10] However, if IRRs are going to be used as the "least unwieldy" performance indicator, then we agree that more disclosures are better than fewer.

We think third-party fair-valuation specialists can play a useful role in stabilizing IRR and/or checking GP figures: they already engage the matter of comparability with Level 2 in the fair-

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[6] Basic information on Paolo Sarpi can be found here.
[7] See also note 4, above.
[8] Clayton 2020, Section B, "Problems with freedom of contract in private funds" pp. 308-310 and, especially, section C.1 "Pension Fund Management Problems." The Commission references this piece in the proposed rules at notes 8, 173 and 192. The second shows the SEC writers aware of the importance of the piece. His article raises questions about the enforceability of the proposed rules, if they are approved. Clayton notes that most PE funds operate in a legal context shaped by two main statutes: Delaware's Revised Uniform Limited Partner Act (because the vast majority of funds are registered in Delaware—that is to say offshore) and the federal Investment Advisor Act of 1940. Clayton explains that "the Delaware L.P. Act explicitly states that its guiding policy is "to give maximum effect to the freedom of contract and to the enforceability of partnership agreements." One consequence of this is that "investors can (and often do) even agree to contractually modify, or waive entirely, the default fiduciary duties owed to them by private fund managers under the Delaware L.P. Act." Under the Investment Advisor Act of 1940, Clayton argues, SEC has the authority to enforce the terms of the Investment Advisers Act, but, in practice, "this authority does not allow them to do very much." In n. 54, Clayton continues: "The SEC's authority is generally limited to policing fraud and enforcing the terms of the contracts between private fund managers and their investors." (307). SEC appears to share Clayton's understanding of the legal context in/on which it proposes to operate on pp. 150-3 of the rule proposal, in the one place that "onshore offshore" laws are mentioned, where the Commission asserts its authority to combat fraud and, by extension, to obviate specific LPA provisions that might be permitted under Delaware or Cayman Island law. But, if Clayton is correct, the question remains: is fraud prevention an adequate basis for the proposed rules as a whole? There is abundant research from inside and outside the academy to suggest that fraud is a non-trivial feature of alternative investments, but we are not sure that resolves the matter of enforceability. But we are not lawyers.
[9] In his *Private Equity Laid Bare*, Ludovic Phalippou refers to IRR as a "junk number."
[10] Rule Proposal, pp. 204. The Commission notes public-market equivalent (PME). For a short discussion see pp. 2-3 of the comment letter by Eileen Appelbaum and Jeffrey Hooke available here

value hierarchy; and, as Appelbaum and Hooke point out in their Comment Letter on S7-03-22 (18 March 2022), Prequin and Pitchbook already employ the requisite datasets,[11] so expanding from fair-valuation to include IRR would not be problematic.

At the same time, our experience with fair-value has shown that competence in valuation is not evenly distributed, even among auditors.[12] Especially with modelled calculations of fair value for illiquid instruments, the ability to understand how pricing information is arrived at and used is crucial, not least since the use of the NAV expedient may suggest an illusory liquidity for what amount to Level 3 instruments with no observable inputs. We would therefore suggest that adoption of the proposed disclosures on IRR and other metrics be supplemented by attention to training, possibly on the order of AICPA's offerings for fair-valuation.[13]

In passing, we should note that endowment size is defined as a prestige indicator by *US News and World Report* rankings of colleges and universities. Institutions who invest using the "Yale Model" treat positive IRRs as marketing material.[14] This is one among a host of perverse side-effects to these metrics.[15]

We call the Commission's attention to the criticisms of private fund usage of NAV as a practical expedient in the context of fair-value reporting outlined by Jeffrey Hooke in *The Myth of Private Equity*.[16] We also appreciate the SEC's attention to problems of funds delivering required disclosures to investors noted on p 85. Based on what the Commission adduces there, as well as the chicanery that has sometimes attended funds' "publication" of NAVs, it is clear that the Commission would have to stipulate exactly what that would entail materially, should it make the proposed disclosures as to holdings and fees public.

Recent events have drawn considerable attention to money-laundering. In closing, we would also urge an end to the exemption from money-laundering reporting requirements instituted by the Patriot Act which was extended to private equity and hedge funds (as well as to real estate).

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[11] Ibid, p. 3.
[12] See Daniel Souleles (2019): "The distribution of ignorance on financial markets", *Economy and Society*, DOI: 10.1080/03085147.2019.1678263 for an interesting dismantling of the (ideologically informed) assumption that economic actors have complete knowledge, done from an economic sociology perspective.
[13] This training should include issues of valuation fraud for which SEC's recent complaint against James Vesselaris might be a useful point of departure.
[14] The effects of this are bad for higher education but outside SEC's remit. They include (accusations of) endowment hoarding, one consequence of which is that stellar returns do nothing to alleviate the financial pressures under which a given college or university might be suffering. For a more detailed (and important) analysis of these and related problems, see Charlie Eaton's *Bankers in the Ivory Tower: The Troubling Rise of Financiers in US Higher Education* (Chicago: University of Chicago Press, 2022) Chapter 3, "The Top: How Universities Became Hedge Funds" pp. 54-75.
[15] While to the side of the Commission's remit, these side-effects are nonetheless important distortions in higher ed. For a primer, see Cathy Davidson's *Weapons of Math Destruction* (New York: Crown, 2016).
[16] Hooke, *Myth of Private Equity* pp 112ff.

We thank the Commission for the opportunity to comment on the proposed rule change for private funds. Should the Commission have any questions, please feel free to contact us via email.

Sincerely,

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Stephen Hastings-King, Partner
Pattern Recognition: A Research Collective