Talking Asset Management with KPMG

Five SEC Priorities for Private Funds

The following is a transcript of Talking Asset Management with KPMG. In this episode, **Matt Giordano**, deputy leader of the KPMG Public Investment Management practice, and **Igor Rozenblit**, founder of Iron Road Partners, discuss the five SEC priorities for private funds as outlined by SEC Chair Gensler during a recent speech to the Institutional Limited Partners Association.

Transcript:

Matt Giordano:

Hello, and thank you for listening to Talking Asset Management with KPMG. I'm really excited to have one of my former SEC colleagues and founder of Iron Road Partners, Igor Rozenblit here with me today to talk about the SEC's private fund priorities that were mentioned during Chair Gensler's recent speech to the Institutional Limited Partners Association. How are you today, Igor?

Igor Rozenblit:

Great. Thanks for having me here today, Matt.

Matt Giordano:

So let's jump right into it. As part of the speech Chair Gensler said that it's time to bring more sunshine and competition to the private fund space. And he goes on to site three policy principles, which give us what I would call some sunshine on how the Chair intends to regulate or view private funds during his tenure. The first one is efficiency, competition, and transparency. The second is around market integrity. And the third around resiliency. So let's talk about fees and expenses because that's the first thing that the Chair mentioned. And in his speech, he mentioned that private funds have multiple levels of fees, among them management fees, performance fees, and fees that are in the portfolio companies that really don't blow up through the fund financial statements.

And he adds that he wonders whether fund investors have enough transparency with respect to these fees and whether limited partners have the consistent and comparable information that they need to make informed decisions. He also talks about how transparency brings down fees. So I guess my ask to you, Igor, under this fee area, is where are the disclosure rules around fees not transparent enough? And when we think about financial statements, we typically see these management and performance fees. Is it really related to those portfolio company fees and also what type of rules can we see coming out of this?

Igor Rozenblit:

Thanks, Matt, for the question. So to first take a step back and talk about Chair Gensler's approach and Chair Gensler's speech here from a high level, these five rule proposals that Chair Gensler has put on the table are potentially industry transformative. It's unclear at this moment whether or not these rules will actually be implemented, or what form they'll take. And it's not even clear whether these rules will be proposed. But if these rules are proposed and are implemented, we may be looking at a very different private equity industry in ten years. As to fees and expenses, there's a lot of fee and expense complexity in private equity. And some of the fees and expenses are disclosed to investors on financial statements and in other ways, but there is really no set way, there is no form and standard way to disclose fees and expenses.

And because of the complexity of some of these private equity managers, and because, as you said, fees can come from the portfolio companies, they can come from the fund, and they can come from related party service providers, having a uniform way to communicate those fees to investors would potentially allow those investors to better compare their investments across different managers. What's interesting here, another interesting thing here around the fee and expense speech is that Chair Gensler talks about transparency. And if taken at his word, it could mean transparency to the public, not just to the investors. So one can foresee a situation where fees and expenses are disclosed. Perhaps on the Form ADV, which will all be open to press, to public, and that could create substantial pressure on fees and expenses in the private equity industry.

Matt Giordano:

Thanks, that's really helpful. So that's interesting. When I initially heard of the fees and expenses, I was thinking from a financial statement standpoint. But this is really something more like a potential either website disclosure or in ADV or PF or another form that would be helpful. So really, really neat to understand. The second piece that I wanted to bring up is around side letters. And the Chair talks about how side letters can create preferred liquidity terms or disclosures. It can create a really uneven playing field among the limited partners based on how they negotiate their own terms. And research in this area has suggested that similar pension plans consistently pay different private equity fees and the range of fees can actually be pretty significant. He goes on to mention that he's asked the staff to consider how they can level the playing field and really strengthen transparency when it comes to these side letters. I was reading into this a little bit. Are there side letters that you think that the Chair will essentially bar or that wouldn't be permitted? Or again, is this just around transparency?

Igor Rozenblit:

So this is potentially a very big deal. I think for most middle market private equity managers, this is not going to be something that affects them. But for some larger managers that have significant side letters around economics, liquidity, information or co-investment provisions, this could be very impactful. My read of the speech was that Chair Gensler wasn't proposing banning all side letters, but was proposing banning certain items in those side letters. And those items revolve around economics, liquidity and information. And if you can imagine a world where the investor with the most negotiating leverage sets the pricing for all other investors in the industry, that's a world again, where there will be significant fee compression in the private equity space.

Matt Giordano:

Great. Thank you. Another item that the Chair brought up in the speech is performance metrics. And there's an ongoing debate as to whether private equity outperforms the public markets, net of fees or taking into account leverage and liquidity. And I think, regardless of the overall economic debate, it's clear that the Chair believes that there may be benefits to fund investors to increase transparency of these performance metrics. And he's asked the staff to consider what they can do to enhance the transparency. So I guess my question to you is, do you think the staff is against the IRR calculation? Would they rather see something like we see in mutual funds like total returns or again, is this just about transparency as to what's in the calculation and what the returns truly are?

Igor Rozenblit:

Yeah, I think that's a great question, Matt. I think the staff is not against IRR calculations. But if you've been reading some of the popular press around private equity, there is a significant aversion to IRR and IRR is not a great measurement of a performance in the private equity space. The thing about IRR is that I think over the years, most investors have adjusted our investment styles to see through some of these comparisons and to take with a grain of salt IRR metrics that the manager puts up for them. So, this would not be a significant, very impactful, I think, to the current state of the private equity industry.

What I read here in the speech is this partly about transparency. Partly it really sounded like he wanted to ban IRR. And one thing that came to my mind here is that I don't think this is going to really change things in the industry as it is now, but on and off again, and continually, there's this discussion about private equity being available to retail investors. And enhancing performance metrics like this, while not particularly impactful to the institutional space, might be one step forward in taking private equity to the retail marketplace.

Matt Giordano:

Great. That's really helpful to know. The next item is around fiduciary duties and conflicts of interest. And I found this one interesting. So the Chair has mentioned that sometimes general partners would seek waivers at the state level of their fiduciary duties to investors. And he goes into this in a little detail and basically says, make no mistake, private funds have a federal fiduciary duty to the fund that's enforceable under the Advisor's

Act and it cannot be waived. And then the Chair asks the staff, or says he'll ask the staff, how they can better mitigate the effects of conflicts of interest between general partners, their affiliates, and investors. And this could potentially include certain prohibitions of conflicts in practices. And I guess my question is, are there certain conflicts that you think the Chair is explicitly trying to prohibit?

Igor Rozenblit:

Yeah. So I read this as a little bit more innocuous. I read this as the Chair thinking about passing a rule prohibiting hedge clauses. And hedge clauses, as you know, are clauses in limited partnership agreements that blanket waive fiduciary duty obligations of the manager. I think in the past, the SEC has viewed those as fairly benign clauses, ones that they didn't think would have any effect on the SEC's ability to continue to do its work. But I think there's been an outcry around those hedge clauses from the investor community. And the investors don't like it for two reasons. One is they feel like it closes off some avenues for a private right of action, maybe under Delaware law, that they might have otherwise.

And number two, they just find them confusing. It's unclear to them whether or not their fiduciary duties are actually, whether manager fiduciary duties are actually being waived or whether something else is happening. They've advocated for banning these kinds of clauses. And I think Chair Gensler is being reactive to that. If this rule is actually broader than that, and the Chair is thinking about banning actual conflicts of interest, then it becomes an incredibly difficult rule to write and implement. And because of that, I just don't think that's where he's going with it.

Matt Giordano:

Great, Igor. I think that's really insightful. In the last item that the Chair had mentioned, and he kind of says this in just a handful of words, but basically says it's time to freshen up Form PF. The way that I looked at that, or the way that I thought through that statement was we have these other things that we've just mentioned, and we think Form PF may be a decent place for it. So, for example, could we see fees and expenses or some of the ratios as a line item in Form PF? Or could we see performance metrics in Form PF? Or what can we really expect from the SEC as it comes to freshening up Form PF?

Igor Rozenblit:

Yeah, Matt, it's very possible we could see all those things in Form PF. I think though for years, and after a significant amount of experience with Form PF, especially with the private equity industry, I think most practitioners believe that there are two ways that it could be enhanced. One is the questions could be freshened up. Some of the questions, especially in section four of Form PF, may not be incredibly relevant to how the private equity industry works or in helping the regulators monitor the systemic risk or protect investors using the data that they collect from Form PF. Another way where Form PF can be enhanced is clarification of some of the instructions. The Form PF data has been noisy and one of the reasons is that everyone interprets the instructions a little bit differently. And so clarification around that I think would be welcome by everyone. Ultimately, it will probably be some combination of simplification, rationalization, and enhancement, some of the additional points that you brought up.

Matt Giordano:

Igor, thank you for joining me today. It sounds like we have a lot of things to think about and to prepare for in the months ahead. To all of our listeners, thank you for joining us today as well. We'd love to hear from you. Please reach out to me, Igor or any of our KPMG colleagues if you have questions about private funds or anything else. Thank you.

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