CAPITAL MARKETS

Private Markets: Governance Issues Rise to the Fore

Based on a Global Survey of CFA Institute Members

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Research & Policy Center

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EXECUTIVE SUMMARY

Propelled by meteoric growth since the Great Financial Crisis, private markets have become important to both financial markets and the real economy in numerous ways: their size; the scale of capital raised and deployed; the number of jobs in portfolio companies receiving private market investments and credit; the impact on credit markets and, indirectly, on public equity markets; and the potential impact on financial stability. Responding to this growth, regulators have turned their attention to private markets with heightened interest, even urgency. In the United States, which has a dominant market share of private markets, the securities regulator recently adopted sweeping and controversial new rules for private fund advisers. Regulators in other markets around the world, including Europe and China, are also focusing on private markets.

Yet public information about the actual functioning of private markets remains elusive. Private markets, after all, are private. Along with wide gaps in our knowledge, there are sharply differing views on the health of private markets. Proponents present a story of remarkable growth powered by superior performance. In legal parlance, they laud private markets as a paragon of private ordering, meaning that private markets have developed optimally for the mutual benefit of participants without the need for government or other third-party intervention. Critics, in contrast, paint private markets as a market failure, meaning that participants on their own have been unable to resolve significant shortcomings in private markets and, therefore, regulatory intervention is needed.

Core questions remain the subject of vigorous public debate: Can the institutional investors that invest in private markets fend for themselves to protect their interests (and that of their own beneficiaries, which include the participants of pension plans)? Or do asymmetries of information enable private fund managers to dominate negotiations over the terms of investments, the management of private funds, and the distribution of profits?

This report seeks to examine these questions in two main ways: by presenting a primer that explains key issues in private markets and by pairing the primer with findings from a global survey of members. There is a dearth of public knowledge about private markets, and this report aims to help fill some of the gaps. The primer presents key issues and gives the context in which to understand the survey findings. The survey findings contribute to public understanding of the perspectives of investment professionals around the world, including both private fund investors and managers.

The purpose of the report is neither to tout nor condemn private markets. Instead, we seek to provide an even-handed, unbiased account of private markets that will advance public understanding. The report is written for an audience of investment professionals, policymakers, and others interested in financial markets.

Rising inflation and interest rates have caused private markets to enter a new era. Governance issues and questions of private ordering have risen to the fore in this new environment. These issues revolve around the relationships between the limited partners (LPs), which invest in private markets, and the general partners (GPs), which are the firms that sponsor and manage private market funds. (For a brief explanation of the role and terminology of LPs and GPs, see **Box 1**.)

The primer explores the following issues:

- *Multilayered conflicts of interest* between investors and fund managers, among investors, and within investor institutions
- *LP–GP relations*, including a reported imbalance of negotiating power and a perceived dominance by fund managers
- *Opacity*, or gaps in disclosures to investors
- *Valuation issues*, including smoothed volatility and lagging prices compared to public market prices
- *Fees and expenses*, including those that are hidden or otherwise problematic
- *A new regulatory focus* in which policymakers are considering a tighter approach to private markets after years of light-touch, hands-off treatment

These questions were the subject of the global membership survey, conducted in October 2023. In addition, the survey queried members' views on climate disclosure issues; Appendix A presents those findings.

The survey is distinguished by its global scale, its sample target of investment professionals, its focus on issues of governance and private ordering, and its impartiality. CFA Institute speaks for all members, rather than a specific sector or type of market participant, such as GPs or LPs. Survey respondents worked at a variety of firms, including both LPs and GPs.

Finally, a word on the scope of the report. It focuses on illiquid private funds, such as private equity funds, private credit funds, venture capital funds, real estate funds, and infrastructure funds. The report excludes hedge funds because they allow periodic redemptions, often once a quarter. We focus exclusively on illiquid private funds—those that offer few if any redemption rights for the life cycle of the fund—because illiquidity magnifies the importance of investor trust and governance issues.[1] If investors can dispose of their shares on a periodic or daily basis, they can always simply walk away if they are dissatisfied. The less liquid the fund, the greater the importance of governance

[1]Rather than redeeming shares, investors may be able to sell their positions on secondary private markets. Those markets are far less liquid than public markets, however, and selling investors generally should be prepared to face significant price discounts. See Brown, Crouch, Ghent, Harris, Hochberg, Jenkinson, Kaplan, Maxwell, and Robinson (2022, p. 11), citing Nadauld, Sensoy, Vorkink, and Weisbach (2019).

structures to protect investors. Absent exit rights, investors must rely on the fund's governance terms to define such things as the operations of the fund, the authority of the fund manager, the information that the fund manager will disclose to them, and the scope of fees, expenses, and distribution of profits.[2] By limiting our research to illiquid funds, we place maximum emphasis on the importance of governance structures.

For an overview of this report, this Executive Summary should be read in conjunction with the two following brief sections:

- Key Findings
- Recommendations

[2]Yale Law School professor John Morley (2014, p. 1246) argues that in theory, "as fund investors' exit rights become stronger, control rights and contractual protections become weaker, and as exit rights become weaker, control rights and contractual protections become stronger. The separation of funds and managers is thus most problematic in closed-end funds and private equity funds, where exit is relatively limited, and is least problematic in mutual funds and hedge funds, where exit is relatively free." Morley (2014, p. 1286) notes, however, that in practice, the Investment Company Act of 1940 does not take this approach and instead imposes a shareholder governance structure that is "deeply inappropriate for open-end funds."

1. KEY FINDINGS

- A majority of respondents (51%) believe that some practices could be improved but problems in private markets are not significant. A significant minority—24% overall, including 20% of respondents with limited partner experience and 17% with general partner experience—say there are substantial problems or even market failures in private market practices. In contrast, 17% believe that private markets function well, with little or no problems.
- Respondents identified three top concerns:
  - The frequency and accuracy of valuation reporting
  - The frequency, comparability, and accuracy of performance measures
  - The fairness and transparency of fees
- A plurality (44%) believe that GPs hold nearly all the power in negotiations with investors. A substantial minority (38%) disagree, saying negotiating power depends on a variety of market factors, including the size of the institutional LPs and the GPs' track record.
- A majority (52%) support new regulations—but only limited ones—for private markets. Respondents showed a preference for required disclosures rather than regulatory prohibitions.
- Solid majorities support three requirements in particular:
  - 70% supported quarterly statements that include information on the private fund's fees, expenses, and performance;
  - 79% supported an annual financial statement audit of the private fund performed by an independent public accountant; and
  - 61% supported a fairness or valuation opinion of any adviser-led secondary transaction.

The SEC has included all three requirements in its new Private Fund Adviser Rules.

- GPs and LPs voiced similar views on most questions. They differed most in their views on the disclosure of fees and expenses: A slight majority of GPs found such disclosures adequate, while a majority of LPs did not.

2. RECOMMENDATIONS

We offer the following recommendations for investors and policymakers.

2.1. Recommendations for Investors

While deciding whether to invest in a private fund:

1. As with any investment, perform due diligence and do not allow FOMO—fear of missing out—to drive your investments.[3]
2. If your investment firm has separate legal and investment departments, ensure that the legal team has adequate time to conduct a thorough review of the contract terms before committing to the deal.
3. Make sure you are satisfied that any asymmetry of information between you and the fund sponsor or GP will not lead to unacceptable risk on your part.
4. Do not be afraid to walk away from a deal if you find the terms too problematic or unacceptable.

Once you have invested in a private fund:

5. Ensure you have adequate information to monitor your investment and the operations of the fund in which you have invested.
6. Maintain vigilance after the deal is signed.[4] An attitude of "set it and forget it" invites norms that fail to protect investors' interests.
7. Recognize that neither audited financial statements nor fairness opinions of adviser-led secondary transactions can guarantee the accuracy of asset valuations (although these safeguards will help increase valuation quality).

At all times:

8. Beware of internal agency conflicts. Have mechanisms, policies, and procedures to address them.

2.2. Recommendations for Policymakers

1. Recognize the Role for Regulators

Private markets, by their very nature, will never have the transparency, prescriptive rules, and regulatory oversight of public markets. Nonetheless, private markets need some level of regulation.

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[3]For a standardized framework, see the Institutional Limited Partners Association's (ILPA's) due diligence questionnaire (ILPA 2021).

[4]It is salutary to recall Bowden's (2014) observation, "While investors typically conduct substantial due diligence *before* investing in a fund, we have seen that investor oversight is generally much more lax *after* closing" [italics in original].

Our survey makes clear that CFA Institute members see a role for regulators—but one that requires balance. Regulators must address the macro issues—conflicts of interest, opacity, and asymmetries of information—even while allowing investors and fund managers to decide for themselves on the optimal terms governing their relationship and the operations of the fund. In general, regulators can best fulfill that role by adopting a disclosure-based regime rather than leaning on prescriptive rules and proscriptive prohibitions of fund manager conduct.

2. Focus on Transparency, Conflicts of Interest, Fees and Expenses, and Valuations

Disclosure-based regulation should focus on the key governance challenges of transparency and conflicts of interest. In particular, disclosure mandates should include a focus on fees and expenses and valuation standards and methodologies.

3. Resist Any Temptation to Weaken Public Market Regulations

Resist any temptation to weaken public markets in an effort to attract more listings from private companies. As stated in a CFA Institute report (Rosov 2018, p. 35), "We believe the correct set of policy responses is not to weaken the integrity of public markets in a likely vain attempt to attract more activity."

4. Be Cautious of Expanding Retail Access to Private Markets

Retail investors already have limited access to private markets (IOSCO 2023, p. 37) and, in addition, can purchase shares of publicly held companies of asset managers that sponsor private equity (PE) funds. Nonetheless, retail access to private markets is largely confined to niche products, such as business development companies (BDCs) or closed-end funds.[5] This retail investor indirect access to illiquid, private assets has been called "a fringe phenomenon" (Spamann 2022, p. 29). Allowing retail investors unfettered access to private markets would mark a major change. As noted later in Sections 6.1.2 and 6.1.3, the challenges that retail investors face in private markets—asymmetrical information, adverse selection risks, and the absence of indirect investor protections—are formidable, perhaps overwhelming, and unfettered access would likely exacerbate these challenges.

We urge policymakers that seek to expand retail access to private markets to demonstrate two key points:

1. There is a problem that demands a regulatory solution.
2. The proposed solution will actually solve the problem (i.e., that retail investors would have a reasonable likelihood of investing successfully by diversifying risks and enhancing returns).

[5]The assets under management (AUM) of closed-end funds and BDCs in the United States constitute less than 1% of the AUM of US-registered investment companies, based on statistics in the "2023 Investment Company Fact Book" (Investment Company Institute 2023) and the website of the Small Business Investor Alliance (accessed 12 March 2024): https://sbia.org/bdc-council/.

It is easier to make a case for the first proposition. There is at least a problem of perception, if not one in reality, when retail investors are deprived of access to private markets that promise higher returns, greater diversification, and low correlation with public markets. As Rosov (2018, p. 35) stated, "With the global move toward self-funded retirement, it is not credible to allow an entire generation of retail investors to be left with only diversified public market exposure to generate retirement returns, while institutional investors crowd into innovative business models that offer potentially higher returns."

Overly restrictive retail access to private markets leads to popular perceptions that markets and regulators are unfair or unethical.[6] If left unaddressed, such perceptions will undermine investor trust and, moreover, will likely beget future bubbles, just as they helped inflate the special purpose acquisition company (SPAC) bubble.

The second proposition—that retail investments in private markets would actually succeed—is far more challenging. Direct retail investment into private markets is infeasible in most cases given that funds are typically designed to accept multi-million dollar investments and are not set up to handle retail accounts. Moreover, there is little in the structures that would protect retail investors from adverse selection.

Nor do we believe that regulators can solve the problem of direct retail investments simply by relying on fiduciary duty obligations or similar professional standards of retail investment advisers and brokers. Our concern lies not with the fiduciary relationship between the investment adviser or broker/dealer and the retail customer but, rather, with the fiduciary relationship between the private fund adviser, on the one hand, and the fund and its investors, on the other.

In public markets, financial advisers can guide retail investors and advise them against common pitfalls, such as undiversified assets, excessive trading, and panic selling in a market downturn (though even that view has been challenged).[7] But offering useful advice in public market investing does not *per se* qualify fiduciary advisers to address the challenges confronting retail investors in private markets. We question whether retail advisers would have the necessary knowledge, access to information, or ability to place their retail customers into top-tier private funds. Moreover, we will discuss how the indirect protections that retail investors rely on in public markets are largely absent in private markets (see Section 6.1.3). The "freedom" for retail investors to invest

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[6]Brown et al. (2022, p. 11) maintain that "it seems unethical to categorically exclude investors from substantial and still growing opportunities in private investment funds that are afforded to all types of institutional investors and wealthy individuals."

[7]A study of the advice and personal trading of a sample of Canadian advisers found that they "trade frequently prefer expensive and actively managed funds, chase returns, and under-diversify.... These results suggest that many advisors offer well-meaning, but misguided, recommendations rather than self-serving ones. Policies aimed at resolving conflicts of interest between advisors and clients do not address this problem." (Linnainmaa, Melzer, and Previtero 2021, Abstract).

directly in private markets could carry the risk of producing systematically inferior investment outcomes.[8]

A more promising avenue would be to allow defined contribution retirement plans to offer participants the option of investing in institutional intermediaries, which would function as funds-of-funds or feeder funds for private markets. Such intermediary funds, however, would add another layer of management fees, and it is unclear whether they could reconcile the liquidity needs of retail investors with the illiquid nature of private market investments.[9] Thus, building an institutional infrastructure to accommodate retail investments in private markets could end up vitiating the benefits of such investments.

[8]We acknowledge that investment advisers and broker/dealers can recommend a number of products—including nonlisted REITs, nonlisted BDCs, leveraged and inverse exchange-traded funds, and penny stocks—that are unsuitable for at least some retail investors. So why not allow for recommendations of private market products as well? We believe that argument is a slippery slope. The question is not the current scope of permissible advice but whether extending that scope to private market products would result in inappropriate retail investments and systematically poor returns.

[9]For a thoughtful evaluation of the pros and cons of including private equity fund investments in defined contribution plans, see Brown et al. (2022).

3. INTRODUCTION: PRIVATE MARKETS, THE END OF CHEAP MONEY, AND THE RISING IMPORTANCE OF GOVERNANCE ISSUES

The end of the era of cheap money is ushering in a new era for private markets.[10] In this transition period, governance issues—such as conflicts of interest and opacity of information—have risen to the fore.[11] Governance risks have seized the attention of both investors and regulators, and they have motivated this report and the member survey on which it is based.

3.1. Private Markets and the End of the Era of Cheap Money

The era of cheap money, which prevailed at least from the Global Financial Crisis until 2022, was marked by remarkable growth and superior performance. Global assets under management (AUM) of private markets grew by more than 3× in a single decade to $12.8 trillion in 2022, from $3.5 trillion in 2012, according to a Bain & Company report.[12] Private credit AUM grew more than 5× since 2009 (Averstad, Beltrán, Brinkman, Maia, Pinshaw, Quigley, Sanghvi, Spivey, and Vickery 2023, p. 49) and tripled in size since 2015, to about $1.6 trillion (see, e.g., Benitez 2023, p. 1). Although the performance of private funds is the subject of some dispute,[13] several studies have shown that private markets outperformed public markets by impressive margins. According to the International Organization of Securities Commissions (IOSCO 2023, p. 37), private funds have earned almost double the annualized returns of their public equivalents for the past two decades.[14]

Cheap and plentiful money was a key factor fueling the growth of both private equity and private credit. Low interest rates made possible the financial leverage that helped to propel the success of leveraged buyout (LBO) and other private

[10]Easy money has fueled the financial markets and the global economy for the last four decades (Preece, Munson, Urwin, Vinelli, Cao, and Doyle 2023, p. 31). During that period, a secular fall in interest rates coincided with a rise of alternative asset managers. Within that longer-term trend, a wave of private equity growth began with quantitative easing and near-zero interest rates stemming from the Global Financial Crisis (Ivashina 2022, p. 1).

[11]*Governance* refers to the framework of structures, rules, and practices that define the relationship between fund investors and the fund manager. Governance includes structures to address conflicts of interest, information rights of investors, and the authority of the fund manager to make investment decisions and conduct the business of the fund.

[12]Global AUM includes buyout, venture capital, real estate, growth equity, infrastructure, direct lending, secondaries, and other. The time period was 2012 to Q2 2022 (Bain & Company 2023, p. 7).

[13]For a brief summary of two academic papers challenging the claim that private equity funds outperform (net of fees), see Brown et al. (2022, p. 9). See also Phalippou (2020).

[14]Private equity returns turned negative in 2022 for the first time since 2008, according to McKinsey (based on data through 30 September 2022). Even so, private equity returns outperformed public equity: Private equity delivered a −9.2% net internal rate of return, compared to a return of −25.1% for the MSCI World Index (Averstad et al. 2023, pp. 4, 11).

equity (PE) transactions. Other strategic factors included private equity's ability to generate operating improvements and to align financial incentives for the executives of portfolio companies.[15]

Private credit likewise flourished in an era of cheap money, attracting institutional investors looking for higher yields in an environment of low interest rates. Regulatory arbitrage also played a critical role in the growth of private credit. When commercial banks sharply curtailed their lending in response to tighter regulations following the Global Financial Crisis, private credit rushed in to fill the void.[16]

The era of cheap money ended in 2022 with the sharp rises in inflation and interest rates. In the second half of 2022, a higher–interest rate environment began to take a toll on private equity, which saw reductions in fundraising, performance, valuations, and exit transactions (Averstad et al. 2023, pp. 2, 6, 26). A McKinsey review of developments in 2023 bears the title, "Private Markets: A Slower Era" (Dahlqvist, Green, Maia, Nee, Quigley, Sanghvi, Mangan, Spivey, Schneider, and Vickery 2024).

Higher interest rates are affecting leveraged buyouts in two ways. First, higher rates render previously acceptable deals infeasible. "With benchmark rates hovering near their highest since 2007, an LBO with typical terms and debt that was easily affordable two years ago could have negative cash flow today," Lee (2023) explains. Second, traditional lenders have balked at financing buyouts at leverage rates that the lenders previously found acceptable (Ruckin and Brown 2023). Inflation, meanwhile, takes a toll on operating companies by making inputs more expensive, leaving less cash flow to service interest costs and other expenses.

In response to higher interest rates, private markets have turned to less conventional sources of financing. In particular, private equity funds have resorted to higher-rate, more subordinated debt and payment-in-kind (PIK) loans to finance deals. The PIK loans will free up cash—at least in the short run. But that entails a big risk: The portfolio companies would likely be unable to service their debt if interest rates stay higher for longer than expected.

It is difficult to estimate the volume of PIK loans or put it in context because the information is generally private, although Lee (2023) reports tracking "at least $73 billion outstanding on various types of PIK borrowings." The use of less

[15]See, e.g., Kaplan (2023, pp. 12–14, saying that private equity builds its strategies on financial, governance and operational engineering). Bernstein and Sheen (2016) documented operational improvements in restaurant chains acquired by PE firms.

[16]See, e.g., Averstad et al. (2023, p. 49): "Coupled with post-GFC regulatory changes that forced banks to dramatically reduce their exposure to risky loans, market conditions could hardly have been more favorable for private debt managers to succeed." See also IOSCO (2023, p. 12): "Recalibration of business models and regulatory changes, particularly since the GFC, have led banks to withdraw from certain types of lending. This has created an opportunity for private funds to step into many of these markets, particularly in lending to middle-market businesses."

conventional financing may explain why the amount of private equity leverage stayed about the same, at least through the end of 2022.[17]

Higher interest rates also have increased risks in private credit, which typically provide loans with floating rates (Benitez and Gyftopoulou 2023). That practice is a double-edged sword: It helps to protect the interest earned by private credit lenders as interest rates have risen, but it also puts stress on the borrowers to meet their interest obligations, refinance their loans, or take on new debt (Benitez and Gyftopoulou 2023). Higher inflation adds to the stress on the borrowing companies by increasing their input costs.

As of early 2024, private credit defaults remain low. Nonetheless, some market observers contend that private credit has distorted gauges of corporate debt stress and has made corporate debt look less risky than it is. A Bloomberg report (Crombie 2024) notes that the flexibility of private credit funds allows them to "amend and extend" loan terms to accommodate borrowers unable to make an interest payment. Had such events occurred in public debt markets, they likely would be deemed to be defaults. Are private credit funds, therefore, hiding de facto defaults?

That would mischaracterize how private credit works, in the view of some private credit practitioners. At a US investor conference in March 2024, for instance, a partner at a major private credit firm contrasted what he called the rigidity of public debt with the flexibility of private credit, which deploys patient, long-term capital to offer borrowers flexible arrangements should the need arise. Such adaptability, he argued, does not violate the terms of private credit agreements but, on the contrary, activates a key design feature. He added that his private credit firm always insists that the equity sponsor contribute more capital in any refinancing.

3.2. The Rising Importance of Governance Issues

Private funds (comprising private debt, infrastructure, real estate, and private equity funds) face these challenges armed with an estimated $4 trillion of dry powder (BlackRock 2023, p. 3), a term referring to capital that investors have committed but for which the funds have not yet been put to use. In addition, private funds can draw on impressive strengths, which we summarize in this report. These strengths include strong incentive structures, long-term capital, and an ability to weather financial turbulence. Moreover, times of change may present special opportunities for private funds.[18]

Nonetheless, the challenges magnify long-standing questions about the private ordering of private markets in general[19] and governance issues in particular. These issues include the following:

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[17]Private equity maintained about the same level of leverage in 2022 as in the previous year, or 6.9 times EBITDA, according to Averstad et al. (2023, p. 28).

[18]Some of the best private equity returns were generated by cohorts that continued to invest through the dot-com bust and the Global Financial Crisis, according to IOSCO. (see IOSCO 2023, p. 18).

[19]Private ordering refers to practices that have evolved in a light-touch regulatory regime, leaving investors and private fund managers to themselves to order their business relations.

- *Multilayered conflicts of interest* between investors and fund managers, among investors, and within investor institutions
- *LP–GP relations*, including a reported imbalance of negotiating power and a perceived dominance by fund managers
- *Opacity*, or gaps in disclosures to investors
- *Valuation issues*, including smoothed volatility and lagging prices compared to public market prices
- *Fees and expenses*, including those that are hidden or otherwise problematic

To a considerable extent, these governance risks have always existed. Critics have pointed out the risks for more than a decade,[20] but their criticisms seemed to gain little traction as the good times continued. But now, with a new macroeconomic environment constraining private markets, investors and regulators are paying increasing attention to governance concerns.

The situation has reached a crescendo in the United States, which holds the lion's share of private markets.[21] In 2023, the US SEC adopted sweeping changes to the rules governing private fund advisers. The new rules have stirred strong opposition from private market participants—hedge funds, venture capital funds, private equity funds, and others—who have challenged the ruling in court.[22] On the other side, a group of private fund investors and industry associations submitted an *amicus* brief in support of the SEC.[23] (An *amicus*—Latin for "friend of the court"—brief is a legal brief submitted to a court by a person who is not a party to the lawsuit.) The Institutional Limited Partners Association (ILPA), a trade association of LPs, led the group, which included two other industry associations and 11 pension funds. Thus, the spotlight in the United States continues to shine on private markets and questions of fund governance.

Regulatory concerns, however, are not limited to the United States. In China, where private funds have experienced strong growth in recent years, the country adopted its first administrative regulation of the industry in 2023, focused on risk management and standardization of the funds' operations.[24]

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[20]"Starting around 2010, various industry observers raised concerns about whether private ordering was working in private equity funds," one law professor writes (Clayton 2023). Another scholar, Ludovic Phalippou, has written or cowritten articles dating back to 2009 that discuss conflicts of interest in private funds. And in 2014, an SEC official revealed the agency's findings about shortcomings in private equity (see Box 2).

[21]North America has a dominant (54%) share of private market AUM, more than twice that of Asia (22%) and Europe (20%), according to Averstad et al. (2023, p. 10).

[22]See "Petition for Review, National Association of Private Fund Managers; Alternative Investment Management Association Ltd.; American Investment Council; Loan Syndication and Trading Association; Managed Funds Association; and National Venture Capital Association v. Securities and Exchange Commission," No. 23-60471 (US Court of Appeals, 5th Circuit, 1 September 2023; hereinafter "Petition for Review").

[23]See "Brief for Amici Curiae, Institutional Limited Partners Association, Council of Institutional Investors, Chartered Alternative Investment Analyst Association, and 11 Public Pension Funds in Support of Respondent," No. 23-60471 (US Court of Appeals, 5th Circuit, 22 December 2023; hereinafter "ILPA et al., Amicus Brief"): https://ilpa.org/wp-content/uploads/2023/12/ILPA-Amicus-Brief-in-Support-of-SEC-12.22.23.pdf.

[24]See IOSCO (2023, pp. 6–7): "The Chinese private investment funds sector has grown significantly in recent years and has become an important part of the Chinese financial system, particularly as providers of direct financing for

In the EU, similar debates have occurred, concerning how to further align regulatory requirements for retail-oriented investment funds (funds governed under the Directive on Undertakings for Collective Investment in Transferable Securities, or UCITS) and alternative investment fund managers (whose activities are governed under the Alternative Investment Fund Managers Directive 2011, or AIFMD). In September 2023, a series of amendments was proposed for both regulatory frameworks in which the European Commission exposed the three main issues it was aiming to address: (1) Regulators are still experiencing difficulties in obtaining the information they need to properly manage financial stability risks posed by alternative investment funds; (2) inefficiencies in liquidity risk management practices are producing an unlevel playing field, especially concerning loan-originating funds (private debt); and (3) a divergence exists in the interpretation of the rules related to the delegation to third-parties of critical functions, including portfolio and risk management, which directly touched on the governance of the investment funds by the various parties involved (see European Parliament 2023).

In the United Kingdom, the Financial Conduct Authority (FCA) announced in 2023 that it would launch a review of how investment funds value private assets. In a 2024 "Dear CEO" letter to asset managers, the FCA confirmed that this review will take place, "including examining the personal accountabilities for valuation practices in firms, governance of valuation committees, the information reported to boards about valuations and the oversight by relevant boards of those practices" (FCA 2024, p. 4; see also Noonan 2023). The FCA noted that "a higher interest rate and tighter credit environment has placed pressure on the valuations of some assets. … As more investors seek access to private markets, it is vital that they can trust that valuations are robust and reliable in all market conditions" (FCA 2024, p. 3).

At an international level, in 2023 the International Organization of Securities Commissions, an international association of securities regulators, published "Thematic Analysis: Emerging Risks in Private Finance" (IOSCO 2023). The report highlighted potential risks regarding governance and financial stability. Meanwhile, another international financial authority—the Financial Stability Board (FSB)[25]—has announced plans to draft recommendations on the leverage of nonbank financial intermediaries by late 2024 or early 2025 (Comfort 2023, citing FSB Secretary General John Schindler).

This recent regulatory focus appears to mark a new era. Regulators traditionally took a hands-off approach, viewing private market investors as big, wealthy, sophisticated, and capable of fending for themselves. Instead, regulators focused on protecting investors—retail investors in particular—in public markets.

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technological innovation, supporting corporate equity financing, and by introducing more institutional investors into the market."

[25]The FSB, as its name implies, promotes international financial stability. It coordinates national financial authorities and international standard setters to develop strong regulatory, supervisory, and other financial sector policies. It seeks to foster a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions.

This suited the private market industry, which has credited freedom from regulatory intervention as a key ingredient in its success.[26]

But private funds have become too big for regulators to ignore, according to advocates of greater regulation (IOSCO 2023, p. 1). Private funds have become intertwined with public finance and the real economy, raising potential financial stability risks.[27] Moreover, pension funds have become a prime investor in private funds, thus indirectly exposing ordinary people to the governance risks of private markets.[28] In short, private markets have taken on public consequences.

Meanwhile, the question of expanded retail investor access to private markets has become a major subject of public policy debate.[29] Pressures to expand the access of retail investors are perhaps inevitable given the perception that they have been shut out of lucrative private markets, with little upside left once private operating companies enter public markets. Similar perceptions drove the meteoric rise of SPACs, which were described as the poor man's private equity, before disappointing returns punctured the recent bubble.[30] Policymakers already have opened up private markets to retail investors to a limited extent in recent years.[31]

If retail investors gain significantly expanded access in coming years, the success or failure of that approach will hinge in no small part on how private markets resolve governance risks.

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[26]See "Opening Brief for Petitioners, National Association of Private Fund Managers; Alternative Investment Management Association Ltd.; American Investment Council; Loan Syndication and Trading Association; Managed Funds Association; and National Venture Capital Association v. Securities and Exchange Commission," No. 23-60471 (US Court of Appeals, 5th Circuit, 1 November 2023; hereinafter "Opening Brief for Petitioners"): https://static1.squarespace.com/static/64dd0be199957023c1e17006/t/6543b414a971721026a63962/1698935828339/041+-+Opening+Brief+for+Petitioners.pdf.

[27]See, for example, IOSCO (2023, p. 1), noting that private equity and private credit "are taking on ever more important roles in financing the real economy."

[28]US SEC Commissioner Caroline A. Crenshaw (2023) has noted that, as a result of increased pension fund exposure to private funds, "the 26.7 million working and retired US public pension plan beneficiaries are more likely to have increased exposure to private funds."

[29]The private markets industry and some legislators are among those seeking to expand retail access. See, for example, IOSCO (2023, p. 3) and Cumming (2023).

[30]SPACs have been around since 2003 but exploded in the United States starting in 2018. In 2021, the 613 SPAC IPOs in the United States accounted for 61% of all US IPOs, but SPAC IPOs have fallen precipitously since then (SPAC Research 2024). For a primer on how SPACs work, see CFA Institute (2022).

[31]In the European Union, for example, the European Parliament approved regulatory changes to European long-term investment funds in 2023 to relax investing restrictions on retail investors. In the United States, inflation has eroded the income and net worth thresholds in the US accredited investor definition, which restricts retail investor access to private markets. Retail investors can participate in private markets by purchasing shares in private companies directly or indirectly through BDCs or closed-end funds (see IOSCO 2023, pp. 36–38; Averstad et al. 2023, p. 13). For more on the US accredited investor definition, see Lee (2019) and Clayton (2020a, note 104 and surrounding text).

Box 1. Private Fund LPs, GPs, and Other Participants

The Fund Firm

Private fund firms are companies in the business of establishing and providing a management team to run a series of private funds. The life cycle of a fund begins when it is established by the fund firm, which is also known as a *fund sponsor*.

Fund Investors: The Limited Partners

Investors consist mainly of pension funds, endowments, insurance companies, family offices, and high-net-worth individuals. The private fund firm raises capital for the fund by soliciting capital from the investors. The investors are called *limited partners* (LPs). They are passive partners, committing capital but not managing the fund.

The Fund Manager: The General Partner

The private fund firm supplies the management team that makes the investment decisions and is responsible for the fund's operations. The fund manager is an affiliate of the fund firm. The fund manager is also called the *fund adviser* or the *general partner* (GP).[32]

The Fund

The fund itself is a separate legal entity from the fund sponsor and the fund manager. The fund is a vehicle that holds the capital from investors and at a later stage—when that capital is used to purchase assets—holds those assets. Thus, a private equity fund holds stakes—often controlling stakes—in the portfolio of operating companies that were purchased with the capital in the fund. The fund has no employees or other operating assets of its own.[33]

What Makes Them Private

Private markets, as their name implies, are not open to investments from the general public. Nor are they subject to the legal and regulatory framework that governs public markets and public funds (such as mutual funds and

[32]We use the terms GP and fund adviser interchangeably. Technically, some private funds have both a general partner and a fund adviser, mainly for tax and compensation purposes, but the distinction is not meaningful for our analysis (see Morley 2014, note 23).

[33]For a more detailed but still basic summary of fund structures, see Morley (2014, pp. 1238–40).

exchange-traded funds).[34] High minimum investment thresholds and illiquidity place private markets out of the reach of almost all direct retail investors.[35] In the United States, to qualify for one of the most commonly used exemptions from the federal securities laws, all of a private fund's investors must meet not only the accredited investor definition but also the more stringent "qualified purchaser" definition, which generally sets a net worth threshold of $25 million for certain entities and $5 million for individuals (Clayton 2020b, note 59).

[34]In the United States, for example, private funds are excluded from regulation under the Investment Company Act of 1940 (US SEC 2023, p. 63215).

[35]The standard minimum investment is about $5 million, according to Korteweg and Westerfield (2022, p. 6).

4. THE SIZE AND GROWTH OF PRIVATE MARKETS

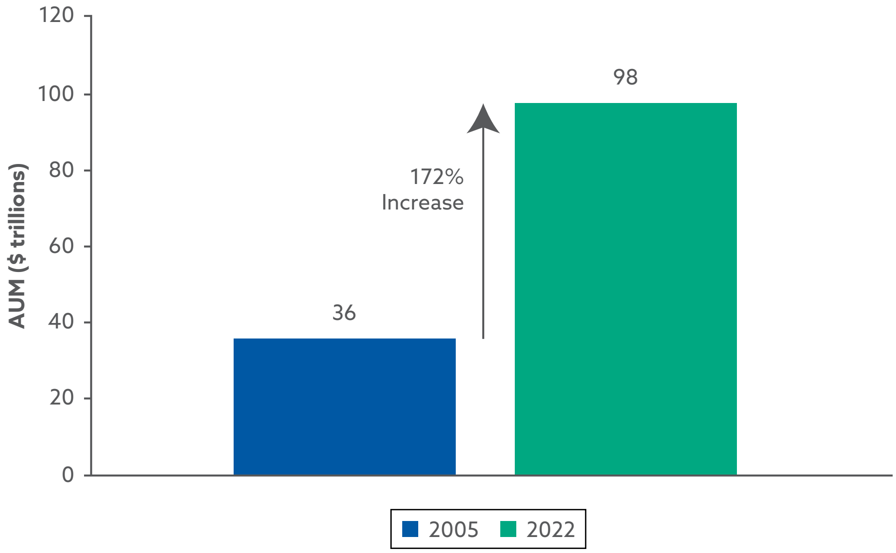
This paper focuses on the portion of the alternative investments sector that deals with direct illiquid private investments and real assets—namely,

- private equity,
- private debt and credit,
- real estate, and
- infrastructure.

A number of data providers can be used to assess and compare the size of this market. Our purpose in this section is to provide a general sense of global assets under management and their breakdown per type and region, to put these numbers in perspective.[36] We proceed from general to specific, starting in **Exhibit 1** with all professionally managed assets globally.

Next, in **Exhibit 2** and **Exhibit 3**, we show data for all alternative assets managed globally.

Exhibit 1. Total Size of Professionally Managed Assets Globally, 2005 and 2022



[36]This section, including Exhibits 1–4, was created using data and information from McIntyre, Alsubaihin, Bartletta, Bianchi, Carrubba, Czerepak, Frankle, et al. (2023); Burke (2023); Averstad et al. (2023).

Exhibit 2. Total Global AUM in the Alternatives Sector, 2005 and 2022

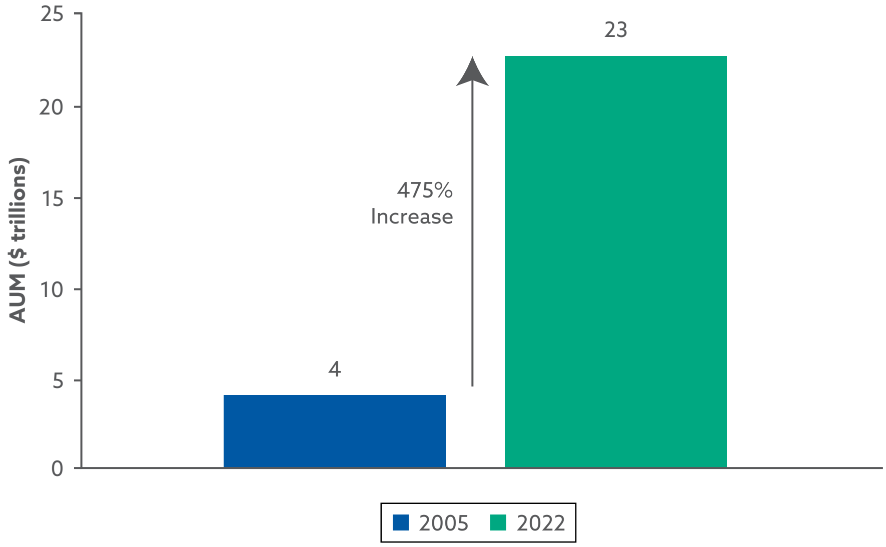
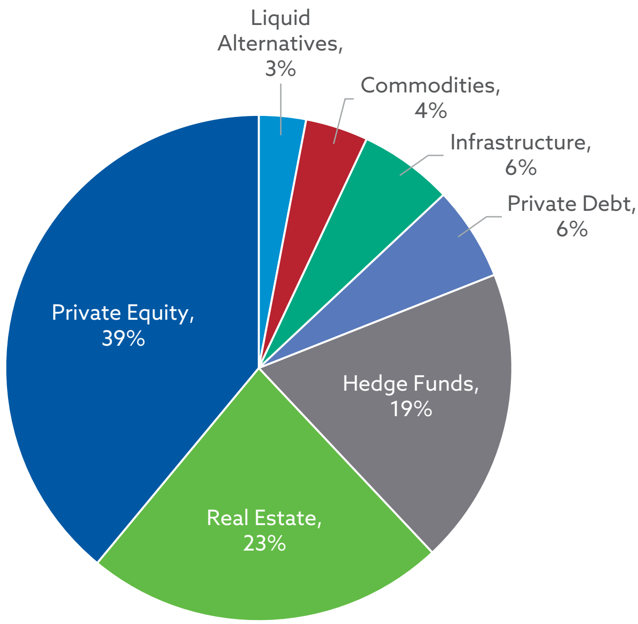


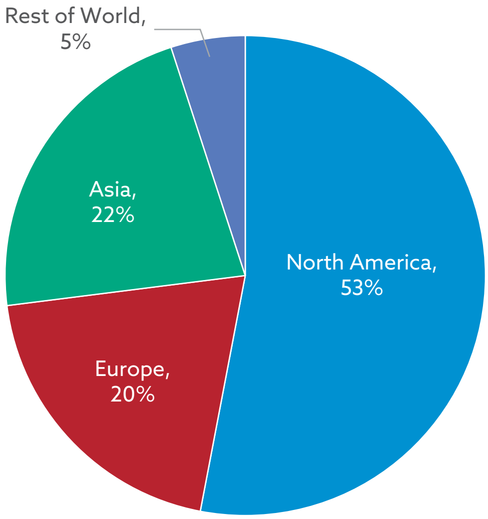
Exhibit 3. Breakdown of Total Global AUM in the Alternatives Sector at Year-End 2022



Against that background, in **Exhibit 4** we provide data specifically on private markets, a subset of alternative assets.

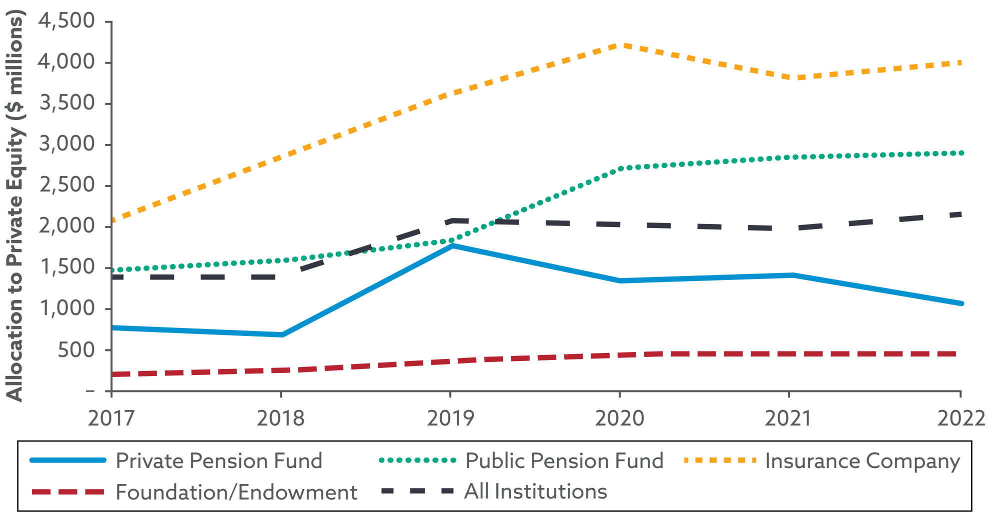
Institutional investors are the primary investors in private markets. **Exhibit 5** shows the exposure of various types of institutional investors and how that exposure has grown over five years (with the sole exception of private pension funds).

Exhibit 4. Breakdown of Total Global AUM in Private Markets by Region at Year-End 2022 in Terms of Location of Raised Investor Capital



Note: Includes all private equity, private debt, real estate, and infrastructure investment funds.

Exhibit 5. Average Private Equity Exposure by Institution Type, 2017–2022



Source: IOSCO (2023, p. 33, Figure 12, citing Lynn and Le (2023).

5. SURVEY METHODOLOGY AND DEMOGRAPHICS

We conducted an online survey from 10 October to 22 October 2023. We sent the survey to a random sample of 60,000 CFA Institute members—20,000 in each of three regions: the Americas; Europe, the Middle East, and Africa (EMEA); and Asia Pacific. We received 848 valid responses, for a response rate of 1.4% and a margin of error of ±3.4% at the 95% confidence interval.

The following charts (**Exhibits 6–10**) present demographic statistics on the survey respondents.

Exhibit 6. Regional Distribution of Respondents

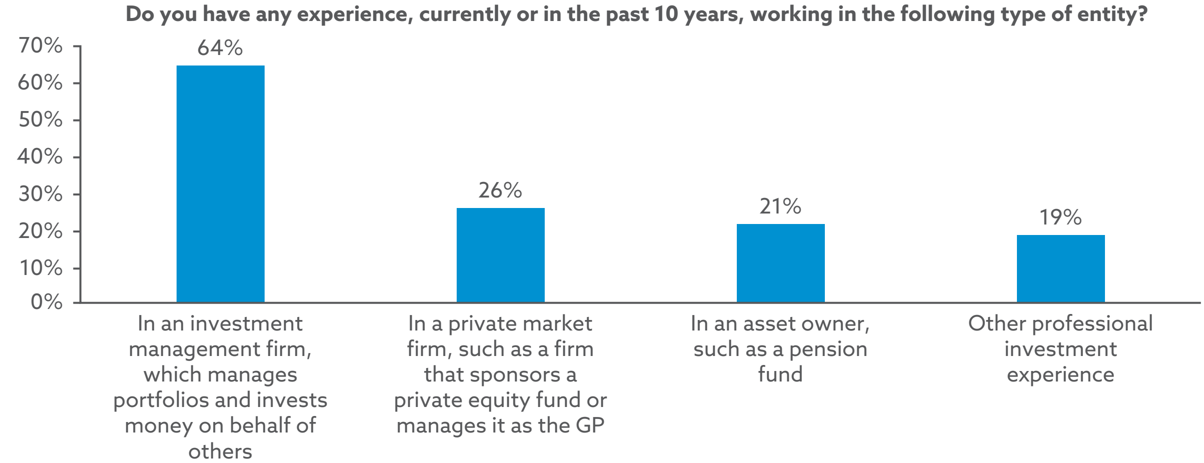
Region	Responses
Americas	295
Asia Pacific	200
EMEA	353

Note: The Americas includes both North and South America.

Exhibit 7. Distribution of Respondents

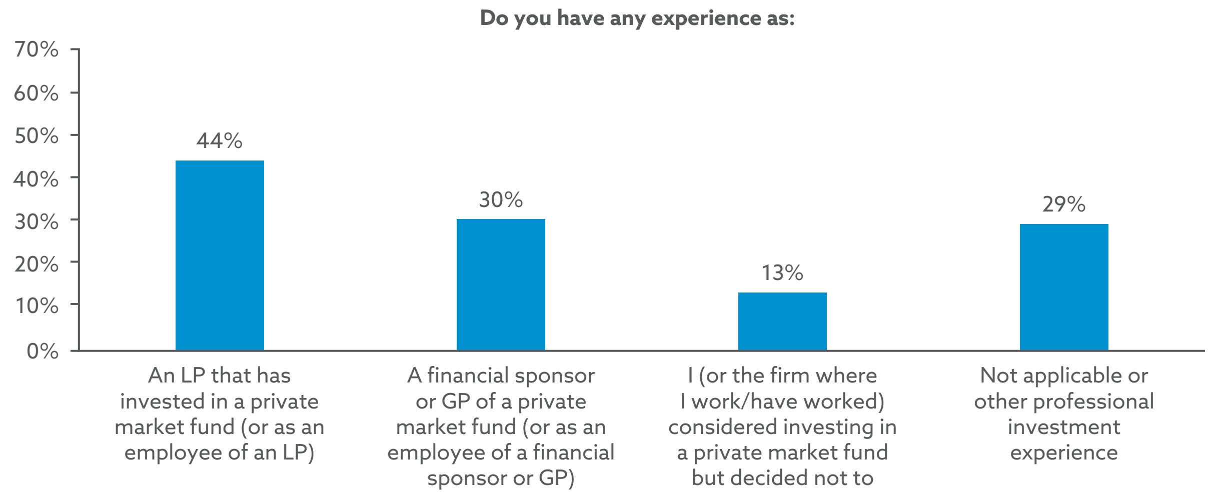
Market	Responses
United States	230
United Kingdom	66
Switzerland	53
Canada	51
Mainland China	44
Germany	33
Australia	30
Hong Kong SAR	25
Singapore	20
Netherlands	20
Rest of world	276

Exhibit 8. Distribution of Respondents According to Professional Investment Experience in Past 10 Years



Note: Multiple selections were permitted.

Exhibit 9. Distribution of Respondents According to Professional Investment Experience with Private Markets



Notes: 12% of respondents (101 out of 831) had experience as both GPs and LPs. Multiple selections were permitted.

Exhibit 10. Distribution of Respondents According to Years with CFA Charter

Years with the CFA Charter	Responses
<2 years	144
2–5 years	147
6–10 years	154
11–15 years	94
16–20 years	107
>20 years	150
No charter	52

6. A PRIMER ON GOVERNANCE ISSUES IN PRIVATE MARKETS

There are two competing narratives about private markets, which encompass private equity, private credit, venture capital, private real estate, and private investments in infrastructure. While both narratives agree on the spectacular growth in private markets, they disagree fundamentally on how well or poorly private markets function.

In the positive narrative, their growth validates the functioning of private markets: They have succeeded in earning increasing levels of investments from pension funds, endowments, and other institutional investors by delivering superior returns.[37] In this version, private funds are a win-win for both investors and private fund sponsors and managers. This narrative credits the success of private markets to such factors as (1) an alignment of interests among investors, private fund managers, and their portfolio companies, furnishing powerful incentives that drive superior profits; (2) focusing the management of portfolio companies on long-term goals, rather than quarterly results; and (3) light-touch regulation, which leaves fund managers and investors free to negotiate tailored investment terms to meet their needs.[38]

The negative narrative disputes each of these points. Where the positive narrative sees market growth and success, the negative narrative sees problematic practices and market failures. Where the positive narrative sees an alignment of interests, the negative narrative sees misaligned incentives and multilayered conflicts of interest. Where the positive narrative sees optimal privately negotiated arrangements, the negative narrative sees information asymmetries, investor collective action problems, and overly dominating negotiating power on the part of fund managers. Where the positive narrative sees the flexibility to produce optimal terms, the negative narrative sees opacity of disclosures, missing regulations, and lax investor monitoring. And where the positive narrative sees outperformance, the negative narrative sees questionable valuations and hidden fees and expenses.

6.1. Interests Aligned and Misaligned

Incentive structures are a source of both potent strengths and significant weaknesses for private markets. On the one hand, private funds draw great strength from incentive structures designed to align the interests of LPs, GPs, and portfolio company managers. On the other hand, other incentive structures are misaligned and produce significant potential conflicts of interest. We discuss both the strengths and weaknesses of these incentive structures.

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[37]See Kaplan (2023, p. 43), who states that buyout funds have outperformed the S&P 500 Index in every vintage year since 1992. See also Opening Brief for Petitioners (p. 1).

[38]Petition for Review.

6.1.1. Where Incentives Are Aligned

Compensation and incentives for GPs are designed to align their interests with those of both LPs and portfolio company managers. Profit sharing in the form of carried interest, for instance, incentivizes GPs to add value throughout the life cycle of a private equity fund: selecting companies in which to invest, building up the value of the portfolio companies through financial and operational leverage and strong management, and eventually disposing of portfolio companies in exit sales for hefty profits, which are shared by GPs and LPs alike.[39]

Carried interest is a term denoting the share of fund profits that the GP receives as performance compensation. In a typical "2 and 20" compensation structure, the GP receives an annual management fee of 2% of committed capital[40] and 20% of fund profits that exceed a specified hurdle rate (such as an 8% annual return for five years).[41] The GP receives carried interest only if and when the hurdle rate is met, thus ensuring that the LPs earn their required share of investment returns before the GP takes its share of fund profits.[42]

Other incentive structures align the interests of the fund and its portfolio companies. The GP's close monitoring and control over portfolio companies goes a long way toward eliminating the agency problem that arises from the separation of management and dispersed ownership in public companies.[43] Private equity funds typically hold a majority of the equity of portfolio companies as well as a majority of board seats. Concentrated ownership gives the PE firm the economic incentive to effect changes to enhance the value of portfolio companies, and the board gives the GP vital information on which to base its decisions. Compensation incentives also align the interests of the portfolio company executives with the PE fund. The executives receive equity grants and options that give them strong financial incentives to build long-term company value. Such arrangements can enable portfolio companies to undertake investments and complex changes that require a long-term perspective and would be more difficult or perhaps impossible to undertake in public markets, which might exert more short-term pressures.[44]

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[39]These advantages notwithstanding, the incentive structure for GPs is not immune to criticism. One scholar argues that the incentives have an option-like character that encourages venture capital GPs to take excessive risks; the GPs will gain more from the upside than they will lose from the downside (Gilson 2002, p. 24).

[40]In practice, funds often levy the management fee on committed capital for the first five years (the commitment period) and on remaining invested capital thereafter (the postcommitment period), tapering off to about 1% (see Ivashina 2022, note 11 and surrounding text; US SEC 2022, p. 3).

[41]Here is a definitional example of carried interest: "When the total distribution to the limited partners has reached an amount equal to the limited partner's commitment times 1.5 [which corresponds to about 8% return over five years], then each amount distributed is split 80%–20% between the limited partner and the general partner" (Morris and Phalippou 2012, Appendix C).

[42]Carried interest is controversial because in certain jurisdictions, including the United States, it enjoys a preferential investment income tax rate. Specifically, carried interest is typically taxed as long-term capital gains, rather than ordinary income (see, e.g., Peter G. Peterson Foundation 2023).

[43]Nonetheless, US SEC commissioner Caroline Crenshaw argues that private equity has a dispersed and widespread ownership base if one counts the beneficiaries of the pension funds that invest in private equity (Crenshaw 2023, citing Coates 2023).

[44]For a description of the governance advantages of private ownership, see Brown, Dompé, and Kenyon (2022).

But there is an important potential challenge to private equity control over portfolio companies. Even while it solves the agency problem seen in dispersed ownership of public corporations, it may spawn a new conflict of interest between the GP, on the one hand, and the fund and its investors, on the other. The conflict arises because the GP might benefit if it caused portfolio companies to pay inappropriately high fees for financial, consulting, or other services performed by the GP or its affiliates.[45] By reducing the profits of the portfolio company, this would indirectly harm the returns of the private equity fund and its investors. We consider these conflicts of interest next.

6.1.2. Conflicts of Interest

Despite their strengths, private funds are also beset with misaligned incentives and potential conflicts of interest on multiple levels: conflicts between GPs and LPs, conflicts between the LPs that invest in private funds, and internal agency conflicts within LP organizations themselves.

6.1.2.1. Conflicts of Interest between GPs and LPs

Perhaps the most obvious conflicts of interest arise between the GP and the LPs. If LPs and GPs were commensurately well informed and balanced in negotiating power, LPs would be able to protect their own interests, negotiate mutually satisfactory terms, and monitor the funds effectively. They would be able to identify and resolve any conflicts of interest that develop with the GP in the management of the fund.

This may not be the case, however, according to regulators,[46] academics,[47] and some LPs themselves.[48] In their collective view, GPs enjoy asymmetries of information, which give them a bargaining advantage over even large and resource-rich institutional LPs. Smaller, less sophisticated LPs may find themselves at an even greater disadvantage.[49] It is unclear whether negotiating clout depends on economic conditions. If so, GPs could enjoy greater negotiating power in a seller's market, but LPs could gain greater clout if economic conditions cause a shift back to a buyer's market. Alternatively,

[45]See, e.g., Bowden (2014, pp. 3–4): "When we think about the private equity business model as a whole, without regard to any specific registrant, we see unique and inherent temptations and risks that arise from the ability to control portfolio companies, which are not generally mitigated, and may be exacerbated, by broadly worded disclosures and poor transparency."

[46]See US SEC (2023, p. 63210): "Without specific information, even sophisticated investors cannot understand the fees and expenses they are paying, the risks they are assuming, and the performance they are achieving in return."

[47]Clayton (2020a, p. 109) speculates on the bargaining incentives that large investors might have if they are able to negotiate superior terms that are not shared with other investors. In later work, however, he cautions that there is limited empirical evidence to support such a hypothesis (see Clayton 2024, pp. 62–63). See also Morris and Phalippou (2012) and Magnuson (2018, p. 1851).

[48]See, e.g., ILPA et al., Amicus Brief.

[49]According to one survey, "small endowments with less than $500 million in assets represented 60% of all endowment plans investing in private equity funds, but only 6% of the total capital invested by endowments in private equity" (see Clayton 2020a, note 106, citing Borda 2016). A small LP may employ only one professional devoted to private equity and other alternative investments (Morris and Phalippou 2012).

asymmetries could represent a fundamental character of private markets, regardless of economic and market conditions.[50]

For now, however, many market participants insist that the negotiating power between the GP and LPs is heavily weighted in favor of the former. An investor amicus brief[51] in support of the SEC Private Fund Adviser Rules asserts that GPs enjoy the following advantages:

- They benefit from informational asymmetry as to what constitutes commonly accepted terms in the marketplace. Investors have very limited visibility into marketplace terms. Individual investors must negotiate bilaterally with the GP, the negotiations are secret, and the terms of agreements are typically subject to nondisclosure clauses (except for most favored nation provisions, as described later).[52]

  A GP's outside law firm, in contrast, represents the fund manager in each of its bilateral negotiations with LPs. "Major adviser counsel can compile significant amounts of data about the LPAs [limited partnership agreements] they negotiate," according to the amicus brief.[53] But if investors seek to share information or negotiate better terms, the GP's counsel often accuses them of collusion.

- GPs can afford to be relatively insensitive to legal costs because they are allowed to pass on the costs to the fund, up to a cap. LPs, in contrast, are highly sensitive to legal fees and may feel they must effectively pay two sets of them—one for themselves, the other for the GP.
- Prohibitive switching costs make it difficult for investors just to walk away from deals, making it more likely that they will accept problematic terms.
- Given these constraints, LPs must focus only on their top negotiating priorities, without seeking to contest other problematic deal terms.

According to investors, this imbalance of negotiating power has led to numerous outcomes that are suboptimal for LPs and, indirectly, for the LPs' beneficiaries (such as pension fund beneficiaries), including schoolteachers, police, fire fighters, and others who rely on pension funds for their retirement security. These problematic outcomes include

- governing terms in which LPs agree to limit or waive the fiduciary duties of GPs;
- problematic fees and expenses, including self-dealing charges to the fund's portfolio companies that benefit the GP or its affiliates but not the fund itself;

[50]Ivashina (2022, p. 10) predicts that "the pendulum of bargaining power will start to shift to limited partners, but this time more permanently than what we saw during the Global Financial Crisis." Clayton (2020a, p. 109) queries, however, whether collective action problems among investors would still persist even if investor negotiating power increases.

[51]ILPA et al., Amicus Brief.

[52]This may be ameliorated to some extent with large LPs, who negotiate multiple agreements with multiple GPs. ILPA (2023a, p. 4), however, argues, "GP external counsel [are] often being found by LPs to use their negotiations with other GPs against them precedentially in negotiations."

[53]ILPA et al., Amicus Brief, p. 26.

- complex and opaque disclosures, especially regarding fees and expenses;[54]
- artificially smooth volatility and stale valuations—what critics call "volatility laundering"—that do not reflect the ups and downs (especially the downs) of public market prices; and
- an alleged practice of systematically overstating fund valuations and performance, which sponsors use in marketing to raise capital for new funds.[55]

To be clear, private equity funds have several governance mechanisms designed to define investors' rights and address potential conflicts of interest. One such mechanism is the limited partnership agreement (LPA), which sets out the governing terms of the fund. The fund's GP and LPs collectively negotiate the contractual terms of the LPA, a long, technical document that often exceeds 100 pages.

Notwithstanding its length, the LPA has weaknesses that might limit its effectiveness. As discussed later, large investors may negotiate privileged terms in separate side letters or in co-investment arrangements that supersede the LPA. Scholars have speculated that this might incentivize large LPs to concentrate their negotiating power on these privileged terms rather than terms in the LPA (Clayton 2020a, p. 109; Morris and Phalippou 2012; Magnuson 2018, p. 1851), although recent research on how much this phenomenon occurs is nuanced.[56]

In addition, regulators have criticized LPAs for poorly defined and vague terms that give GPs excessive leeway and hamper monitoring by LPs. For example, Andrew J. Bowden, director of the SEC Office of Compliance Inspections and Examinations at the time, observed in a 2014 speech titled "Spreading Sunshine in Private Equity":

> Many limited partnership agreements are broad in their characterization of the types of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors. Poor disclosure in this area is a frequent source of exam findings. We've also seen limited partnership agreements lacking clearly defined valuation procedures, investment strategies, and protocols for mitigating certain conflicts of interest, including investment and co-investment allocation. (Bowden 2014)

[54]See, e.g., ILPA (2018, p. 3): "The private equity market continues to face a lack of transparency around the true cost of a private equity investment." In another example, fund sponsors may keep headline fees and expenses flat while burying cost increases in obscure terms. In such cases, there may be an alignment between the interests of the fund sponsor and the private fund specialists in institutional LPs, both of whom may wish to avoid calling attention to the cost increases (Morris and Phalippou 2012).

[55]See Box 4.

[56]See Clayton (2024, p. 97).

In 2015, the SEC announced a $30 million settlement with Kohlberg Kravis Roberts & Co. (KKR) that further illustrates gaps in its LPA, as well as a conflict of interest between the GP and co-investors, on the one hand, and LPs, on the other. (See Section 6.1.2.3 for more on the role of co-investors). Specifically, the SEC charged KKR "with misallocating more than $17 million in so-called 'broken deal' expenses to its flagship private equity funds in breach of its fiduciary duty" (US SEC 2015). The GP and other co-investors benefited from those practices at the expense of the LPs, according to the SEC:

> An SEC investigation found that during a six-year period ending in 2011, KKR incurred $338 million in broken deal or diligence expenses related to unsuccessful buyout opportunities and similar expenses. Even though KKR's co-investors, including KKR executives, participated in the firm's private equity transactions and benefited from the firm's deal sourcing efforts, KKR did not allocate any portion of these broken deal expenses to any of them for years. KKR did not expressly disclose in its fund limited partnership agreements or related offering materials that it did not allocate broken deal expenses to the co-investors. (US SEC 2015)

A second governance structure is an advisory board called the limited partner advisory committee (LPAC). Select LPs serve as members of the LPAC. Their position gives them greater visibility into the fund's operations, and they may be asked to give consent to conflicted transactions that arise.[57]

The SEC, however, has questioned the LPAC's effectiveness: "For example, current private fund governance mechanisms, such as the LPAC, may not have sufficient independence, authority, or accountability to effectively oversee and consent to conflicts or other harmful practices" (US SEC 2023, p. 63262).

Moreover, LPAC members owe no fiduciary duty to the fund or the other investors (US SEC 2023, p. 63210). For this reason, the LPAC can create its own conflicts of interest between LP members and the fund's other investors, as we discuss later.[58] But first, we discuss a special type of conflict between fund sponsors and investors: a conflict that can arise between a private equity fund and a private credit fund controlled by the same parent firm.

[57]The SEC describes the LPAC's functions as follows: "A fund's LPAC or board typically acts as the decision-making body with respect to conflicts that may arise between the interests of the third-party investors and the interests of the adviser. In certain cases, advisers seek the consent of the LPAC or board for conflicted transactions, such as transactions involving investments in portfolio companies of related funds or where the adviser seeks to cause the fund to engage a service provider that is affiliated with the adviser" (US SEC 2023).

[58]For this reason, the SEC asserts, "To the extent investors are afforded LPAC representation or similar rights, certain fund agreements may 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" (US SEC 2023, note 40).

6.1.2.2. Conflicts between Private Equity and Private Credit Funds Controlled by the Same Parent

Some portfolio companies receive investments from sister private equity and private credit funds that are owned by the same parent firm (with the PE fund investing in the portfolio company's equity and the private credit fund lending it money).[59] Indeed, private debt began by financing PE deals, and today many of the largest PE firms finance their deals with credit provided by sister private credit funds (Benitez and Gyftopoulou 2023). PE firms may find it easier to close deals when their sister firm provides the credit. Such arrangements also confer deal flow and informational synergies, with the PE and private credit funds sharing due diligence on—and a deep understanding of—an existing relationship with the operating company. But perhaps the greatest synergy is in sourcing the financing for private credit deals. The financial sponsor can return to the largest investors in its PE funds and raise new money for private credit financing. The sponsor will have both the relationship with the investor and the credibility to say that it already knows and is comfortable with the portfolio company.

If the operating company falls into financial distress, however, the synergies can quickly transform into conflicts of interest between the sister PE and private credit funds. And as noted in Section 3.1, risks of financial distress have risen along with interest rates. Private credit markets could see a sharp rise in defaults under a "higher-longer" interest rate scenario, let alone a recession.

If a company cannot make required interest payments, perhaps the parent private market firm can find an optimal solution under the circumstances. The firm and its private credit and PE arms may have restructuring expertise to assist companies to navigate troubled financial waters.[60] Moreover, the parent firm's reputation as a fund sponsor may compel it to reach into its own pockets (which may be deep ones) and extend a financial lifeline to the distressed company. If it returns to financial health, that will be a win-win-win solution for the operating company and the investors of both the PE fund and the private credit fund.

It is also possible, however, that irreconcilable conflicts of interest could arise between the PE fund and the private credit fund. The PE fund, seeking to salvage its investment in the operating company, might apply pressure on its sister private credit fund to show forbearance—to "pretend and extend" or "amend and extend." That is, the private credit fund would pretend that the distressed company was in better shape than it was, amend the covenant terms, and extend the debt payment deadline.

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[59]It is difficult to say how prevalent such arrangements are, although IOSCO (2023, p. 23) cites a survey finding that 25% of US and 40% of European private credit firms were affiliated with a private equity firm. One US-based credit rating analyst told us he suspected the actual numbers were higher.

[60]See IOSCO (2023, p. 15): "Private credit lenders may have expertise in restructuring loans in troubled times, thus helping their portfolio companies avoid defaults and bankruptcies." One credit market specialist, however, told us he believes that most private market firms have thin restructuring resources because they had little need for workout specialists in the period of benign interest rates.

Such forbearance, however, could harm the private credit fund (and its investors) by merely postponing an inevitable bankruptcy and destroying value in the meantime. The private credit fund would be better off foreclosing on the debt immediately and salvaging as much value as possible. And if the distressed firm eventually files for bankruptcy, the PE and private credit funds could find themselves clashing in bankruptcy court over collateral. In that case, distressed credit markets could offer the spectacle of internally conflicted private fund sponsors—in addition to so-called creditor-on-creditor violence, in which competing groups of creditors seek to gain the collateral of distressed debtors at the expense of other creditors.[61]

6.1.2.3. Conflicts between LPs

In public securities markets, a core principle holds that shareholders owning the same class of shares must be treated equally.[62] Thus, for example, all investors have access to the same material information that public corporations are required to disclose. The situation in private markets is different: Each individual investor is on its own to gain access to information and to negotiate investment costs and other terms. Unequal, privileged terms for individual investors represent one of the most important distinguishing features of private markets.

Because negotiations take place in secret and on an individual basis with each investor, some regulators and others see this as a collective action problem that prevents investors from negotiating for their common interests. Large investors, for example, may have little incentive to push for strong LPA agreements, preferring instead to use their clout to negotiate exclusive privileges for themselves in side deals.[63]

Moreover, conflicts of interest may emerge between investors of different sizes, sophistication, and resources. Thus, where smaller investors may see opaque and complex terms as a stumbling block, large and sophisticated investors may see the same terms as a source of a competitive advantage, allowing them to use their superior resources to make better investment decisions.[64]

Depending on their size and negotiating clout, investors may be able to negotiate individually with the GP to secure privileged terms exclusively for themselves, including reduced expenses and fees, co-investment opportunities,

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[61]The term "creditor-on-creditor violence" refers to situations in which creditors compete aggressively with each other to refinance distressed debt, exploit loopholes in debt agreements, and wrest control over claims to collateral at the expense of the other creditors. See, for example, Pérez (2023); Morpurgo (2023); Indap and Platt (2023); Yerak (2023).

[62]See, e.g., Clayton (2020a, note 11,) who notes, "One of the core principles of corporate law is that shareholders holding the same class of shares should be treated similarly."

[63]See, e.g., Clayton (2022b, p. 16), who, in referring to a previous paper he had written, says, "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)."

[64]See, e.g., Morris and Phalippou (2012): "Superior information about the true cost of contracts, past performance, etc., enables them to pick better funds than average."

and separately managed accounts (SMAs).[65] In a co-investment arrangement, the fund manager offers privileged investors the right to invest in a single deal alongside the fund rather than through it. SMAs offer similar advantages but are designed not for just one deal but for many deals over longer periods of time. Both co-investments and SMAs may significantly reduce or even eliminate the fees and expenses charged to investors in the fund itself.

While recent research has called into question how much of this individualized treatment takes place in side letters,[66] other research suggests that top investors do focus their bargaining power on receiving better terms in co-investments and other "alternative investment vehicles" (Lerner, Mao, Schoar, and Zhang 2022).

The exclusivity of side letters is mitigated to some extent by an industry practice known as most favored nation (MFN) status. MFN status typically entitles an investor to see the privileged terms given to other investors who have made the same or lower capital commitments and to elect to receive the same privileged terms. But an investor typically has no right to see privileged terms granted to investors with greater capital commitments.

Some institutional investors that generally support regulatory reform of private markets nonetheless insist that side letters are essential to their investments in private market funds.[67] Nonetheless, one can see how separately negotiated side letters could result in conflicts of interest between LPs.

Finally, conflicts can emerge among LPs if one of them is interested in purchasing others' positions in the fund. The latter LP could seek to block a GP-led secondary transaction in an effort to avoid the increased transparency and competition from new bidders.

[65]An SMA, as its name implies, is an account that is managed by an investment professional. Unlike a mutual fund, the money in the SMA is not pooled with that of other investors and then used to purchase securities or other assets. In the context of private market funds, a GP will manage the investments in an SMA account, but the SMA nonetheless sits outside the private market fund that the GP also manages. The SMA owner account directly owns the securities in the account. This arrangement allows the SMA owner to acquire equity in the same assets that the private fund acquires yet avoid the fees and carried interest that the private fund charges its LPs. The SMA account owner may pay separate fees to the investment manager but often at a substantial discount to those fees paid by the LPs in the private fund. As a result, SMA arrangements, like co-investment opportunities, can be highly coveted.

[66]Clayton (2024, p. 97) stated, "Recently, scholars have sought to test empirically whether side letters in private equity funds contribute to these kinds of conflicts of interest or not. One paper has concluded that very few terms of economic significance are granted in side letters. … Yet a different paper … came to some different conclusions, finding that things like management fee discounts and substantive co-investment rights are commonly granted in private equity side letters." Clayton (2024) cites de Fontenay and Nili (2023) and Jeffers and Tucker (2022). De Fontenay and Nili (2023, p. 907) analyze a sample of side letters and conclude, "Contrary to the conventional wisdom, we find that side letters very rarely grant fee discounts to investors or otherwise reallocate the fund economics among investors. Instead, side letters are mostly designed to accommodate a fund investor's regulatory and tax concerns."

[67]See, e.g., Ohio Public Employees Retirement System (2022): "Investors like OPERS utilize the side letter process to negotiate individual terms and different treatment—including statutory requirements (e.g., mandatory forum selection clauses) and OPERS Board-approved policies (e.g., external manager insurance)—that help tailor and mitigate its risks. If OPERS is unable to protect itself by negotiating these necessary terms, it could be forced to walk away from a fund, which carries its own risks, including missing out on increasingly limited opportunities to deploy capital."

6.1.2.4. Internal Agency Conflicts within Institutional LPs

Internal agency conflicts can arise within a single LP organization. For example, some scholars argue that the private fund specialists employed in a pension fund have self-interests that can diverge from the interests of the fund itself (see, e.g., Morris and Phalippou 2012). One academic who studies private markets notes, "Studies have found that, in order to protect their jobs, pension employees sometimes engage in obfuscatory activities to deflect responsibility for poor performance. Though these strategies are often costly to the pension plan, they help pension employees avoid negative personal consequences" (Clayton 2020b, p. 313). Bloomberg columnist Matt Levine puts it more colloquially:

> If your job is to manage a pension, you want to go to your bosses at the end of the year and say "this pension is now 5% less underfunded than it was last year." And if you have to instead say "this pension is now 5% *more* underfunded than it was last year," you are sad and maybe fired; if the pension gets too underfunded your regulator will step in. You want to avoid that. (Levine 2022, italics in original)

To be sure, all asset owners and managers want their investments to show attractive returns. What sets private markets apart, however, is the discretionary aspect of valuations. Public funds, in contrast, generally are exposed to the sunlight of constant price transparency. Mutual funds, for instance, determine and publish their net asset values on a daily basis, and they do so based on mark-to-market prices of publicly traded securities. GPs, in contrast, have far greater discretion in determining when and how to calculate valuations of fund assets. This situation is inevitable given the illiquidity of the assets.

Incentives could explain why some investors may actually prefer artificially smoothed volatility and lagging private market valuations. Those practices could put in a better light the allocation choices and investment performance (and the Sharpe ratio) of pension funds and other institutional LPs (or the employees within those institutions who specialize in private markets). We discuss the question of valuations further in Section 6.3.2.

In sum, institutional investors are right to point to GP conflicts of interest. But as this analysis of internal agency conflicts suggests, institutional investors may also be part of the problem.[68]

[68]See Clayton (2022b, pp. 13–14): "In other words, the respondents themselves could be significant contributors to bargaining problems in the industry, and as a result their responses casting blame on other factors could be unreliable."

6.1.2.5. Alternative Explanations

Other types of conflicts of interest may exist. For example, there may be misalignments between the interests of GPs and the outside counsel who represents them in negotiations with LPs.[69]

And while agency conflicts offer compelling explanations as to why investors sometimes tolerate—or even prefer—problematic practices in private markets, there may be alternative explanations. Other factors include political pressures, uncompetitive salaries, inadequate resources, and a lack of sophistication or competence on the part of certain institutional LPs.[70]

Finally, an alternative explanation of suboptimal bargaining involves failures of communication and coordination between the investment and legal teams within a pension fund or other institutional LP. One survey of internal counsel at institutional LPs found limited communication between the legal and investment teams (Clayton 2022a, pp. 755–76). The findings offer some empirical support for the theory that, in a significant number of cases, the LP investment team, eager to lock in access to a private fund, rushes an agreement before the legal team has had time to fully examine the deal terms. This situation would leave the legal team essentially with a fait accompli, with no room to negotiate improvements in problematic terms.[71]

6.1.3. Implications for Retail Access

Collective action problems; asymmetry of information; bilateral, secret negotiations; and potential conflicts of interest between investors all have important implications for retail access to private markets.

Public markets provide not only direct investor protections but also indirect protections that, akin to Adam Smith's invisible hand, arise as a byproduct of the self-interested actions of various market participants (Spamann 2022). These indirect protections are largely absent in private markets, and it is unclear how they could be fostered.[72]

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[69]In a live poll at an ILPA conference, audience members were asked to select the top reasons why LPs accept poor legal terms in LPAs. The fourth most popular choice, at 30.4%, was that "GP counsel defends their form LPA and aren't willing to make concessions even though [the] GP itself would" (Clayton 2022b, pp. 8–9).

[70]For example, overly restrictive compensation limits at public pension funds may give an edge to private funds competing for investment talent. As an example of political pressure, politicians may appoint pension fund trustees who have little investment experience. See Clayton (2020b, p. 315).

[71]Nonetheless, a different poll of LP in-house counsel—the ILPA audience poll referenced by Clayton (2022b, pp. 8–9), in a previous note—failed to support this conclusion. Asked to select the top three reasons why LPs accept poor legal terms in LPAs, only 3.3% selected the option "internal LP alignment issues between legal/investment team." That choice polled last among the 10 options presented.

[72]Holger Spamann (2022), a Harvard law professor, argues that indirect investor protections rely on public disclosures (to enable a plaintiff's bar, which can police markets and has a deterrent effect) and open and wide trading (which enables hedge fund activism and takeover markets). The plaintiff's bar, hedge fund activism, and the market for corporate control all serve indirectly to protect investors, even though this protection is a byproduct (a beneficial externality) and not the intention of the players directly involved. But two essential ingredients—public disclosures and liquidity—are conspicuously absent in private markets.

Consider, for example, how public markets enable the formation of approximately unbiased prices, which all investors can then rely on:

> An unbiased price emerges as the byproduct of selfish trading by savvy speculators. The speculators would prefer to sell to naïve investors at a higher price or to buy from naïve investors at a lower price. But two-sided competition—i.e., speculators compete to buy *and* (short-)sell—in the centralized market for publicly traded securities precludes this: The speculators outbid each other until they trade with anyone at a price that is neither (much) too high nor (much) too low. ... By contrast, in a privately negotiated transaction, unskilled or uninformed investors may trade at a highly unfavorable price and thus lose most of their investment—and not even notice. (Spamann 2022, p.16; italics in original)

To be sure, there are also compelling arguments to allow retail access to private markets. Chief among them is the perception—and perhaps the reality—that otherwise, retail investors are shut out of high-performing markets (see Section 2 for more). Nonetheless, the governance concerns depicted here show the challenges that retail investors would face if they gained access to private markets.

6.2. Fees and Expenses

Fees and expenses have risen to the top of the list of problematic practices that regulators and investors have identified in private markets. To critics of private markets, fees and expenses have become the symbol of self-dealing in an environment of opacity and conflicts of interest. To understand why fees and expenses have become such a lightning rod in private markets, we consider developments over the past decade in the United States.

The SEC raised an alarm in 2014 after gaining newly expanded authority to inspect private fund advisers.[73] Following an industry-wide "sweep" of inspections, the SEC's most common observation centered on advisers' collection of fees and allocation of expenses. In a startling finding on the handling of fees and expenses, senior SEC official Bowden reported in his May 2014 speech that more than 150 SEC exams of private equity advisers had identified "violations of law or material weaknesses in controls over 50% of the time" and that, overall, "lack of transparency and limited investor rights have been the norm in private equity for a very long time"[74] (Bowden 2014). Bowden drew special attention to problematic practices involving what he called a "back door" fee, which LPs were not aware of (see **Box 2**).

[73]The SEC gained the authority under the Dodd–Frank Act, which required almost all private fund advisers to register with the SEC and thus become subject to SEC inspections.

[74]Bowden (2014) contrasted investor due diligence in selecting investments with lax oversight once the investment is made: "While investors typically conduct substantial due diligence *before* investing in a fund, we have seen that investor oversight is generally much more lax *after* closing" (emphasis in original).

Box 2. Hidden Fees

Excerpts from SEC Official's Speech, "Spreading Sunshine in Private Equity"

The following are excerpts from a 2014 speech by Andrew J. Bowden, director of the SEC Office of Compliance Inspections and Examinations at the time:

> Some of the most common deficiencies we see in private equity in the area of fees and expenses occur in firm's use of consultants, also known as "Operating Partners," whom advisers promote as providing their portfolio companies with consulting services or other assistance that the portfolio companies could not independently afford.
>
> Many of these Operating Partners, however, are paid directly by portfolio companies or the funds without sufficient disclosure to investors. This effectively creates an additional "back door" fee that many investors do not expect, especially since Operating Partners often look and act just like other adviser employees. They usually work exclusively for the manager; they have offices at the manager's offices; they invest in the manager's funds on the same terms as other employees; they have the title "partner"; and they appear both on the manager's website and marketing materials as full members of the team. Unlike the other employees of the adviser, however, often they are not paid by the adviser but instead are expensed to either the fund or to the portfolio companies that they advise. …
>
> [S]ince these professionals are presented as full members of the adviser's team, investors often do not realize that they are paying for them à la carte, in addition to the management fee and carried interest. The adviser is able to generate a significant marketing benefit by presenting high-profile and capable operators as part of its team, but it is the investors who are unknowingly footing the bill for these resources. …
>
> Another similar observation is that there appears to be a trend of advisers shifting expenses from themselves to their clients during the middle of a fund's life—without disclosure to limited partners. In some egregious instances, we've observed individuals presented to investors as employees of the adviser during the fundraising stage who have subsequently [been] terminated and hired back as so-called "consultants" by the funds or portfolio companies. The only client of one of these "consultants" is the fund or portfolio company that he or she covered while employed by the adviser.

Not long after the SEC's revelations, the largest US public pension plan made a stunning acknowledgement of lax oversight. The California Public Employees' Retirement System (CalPERS) acknowledged that it could not say how much carried interest[75] it had paid out over the years to private equity firms because it did not track the amount. To fill the data gap, CalPERS sent out inquiries to some of its fund managers, and the pension plan came up with a figure of $3.4 billion paid out in carried interest from 1990 to 30 June 2015.[76] Those events helped to shape public perceptions of problematic practices in private markets.

In the years since then, investors[77] and regulators[78] have continued to focus on fees and expenses in private markets. While this recent history specifically relates to the United States, the lessons learned have more universal scope. Those outside the United States might ask whether similar practices of self-dealing and hidden fees, along with lapses in investor oversight, could happen in their markets as well.

6.3. Valuations

Valuation methods and outcomes for private market funds have long been controversial. More specifically, the accuracy and timeliness of valuations have stirred the most debate. Other issues include the inconsistent use of valuation methodologies and the use of subscription financing to boost internal rates of return (IRRs).

6.3.1. A History of Concerns

For a decade, the SEC has called out a variety of inconsistent or inappropriate valuation methodologies (Bowden 2014). Examples include

- using a valuation methodology different from that disclosed to investors;
- changing methodologies over time without a valid reason, such as switching from backward-looking to forward-looking measures to boost values for struggling investments;
- cherry-picking comparable companies or transactions to derive valuations from multiples; and
- adding or subtracting inappropriate items to determine EBITDA (earnings before interest, taxes, depreciation, and amortization).

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[75]Technically, LPs do not directly pay carried interest; instead, carried interest comes from the profits of the fund itself. But LPs indirectly pay carried interest because it diminishes the profits that the LPs receive.

[76]This account is based on Clayton (2020b, pp. 323–24); for further details, readers should refer to that article.

[77]See, e.g., ILPA (2018) and ILPA (2022). In addition, according to Preqin (2018), a survey found that investors listed transparency as the second most important area where the interests of managers and investors could be better aligned (as cited in Clayton 2020b, note 173).

[78]For example, the SEC has targeted the calculation and allocation of private fund adviser fees and expenses as examination priorities for 2024 (see US SEC 2024, p. 10). In addition, the SEC published "Risk Alerts" in 2020 and 2022 highlighting issues involving the calculation of management fees (US SEC 2020, 2022).

Funds also have used subscription financing to boost the internal rate of return (IRR). In subscription financing, private fund managers borrow money against the fund's committed capital to finance purchases of portfolio assets. The loans enable the funds to delay calling capital from investors. The delay will boost the fund's IRR since it is a time-based metric, which will enable the GP to report a higher IRR than it could otherwise.

As a result, subscription financing can "distort fund quartile rankings to the advantage of the funds employing them," according to ILPA (2020, p. 3). "Therefore, many GPs feel compelled to use subscription lines to appear competitive on a benchmarked return basis to attract investors."

There is no standard methodology, however, for calculating returns with and without the use of subscription lines (ILPA 2020, p. 3). According to ILPA (2020, p. 4), LPs' views on subscription financing are mixed, with some embracing its use as a cash flow management tool and others preferring that it not be used at all.

6.3.2. Interim Valuations and Volatility Smoothing

Private funds typically hold portfolio companies and other assets for years before selling them. In the interim, fund managers generally have discretion in estimating the value of fund assets.[79] They generally determine valuations based on internal models, but there is no standard methodology to value the assets. Nor are there liquid secondary markets on which to base private market valuations, in contrast to public securities. The timing and frequency of private market valuations is another issue. Fund valuations take place on a regular basis, often quarterly but sometimes annually, in contrast to the nearly instantaneous pricing in liquid public markets. Valuation time lags can run two to three quarters compared to public markets, according to IOSCO.[80] In practice, these valuations are often stale, showing disproportionally low intertemporal rates of change as compared to public market pricings. Thus, private fund valuations typically differ from prices in liquid public markets in two important ways: They often appear smoother than the prices in public markets, and they often lag price changes of public securities.

As a result, critics charge, private market prices can fail to reflect the reality of what the assets are currently worth. Private market valuations display an artificially smoothed volatility, according to critics who dub the process "volatility laundering."[81] In a public market downturn, this situation can lead to jarring contrasts between fallen prices in public markets and still buoyant private

[79]According to Averstad et al. (2023, p. 37), there is less discretion in open-end real estate funds, which rely on quarterly third-party valuations.

[80]"There is usually a 2 or 3 quarter lag between a decline in public market valuations and the impact becoming fully evident in private markets" (IOSCO 2023, p. 20).

[81]"Investors and managers are playing a dangerous game of 'volatility laundering,'" proclaims the subtitle of an article by Cliff Asness, the co-founder of AQR Capital Management. Asness (2023) says that private equity can ride out a bear market of one to three years "using its patented ostrich technique" but could not withstand a bear market lasting 10–20 years.

market valuations (see **Box 3**). In the United States, some analysts see "extreme markups in private valuations that have little chance of ever being fully realized" (IOSCO 2023, p. 21, quoting Preqin 2023).

Box 3. REITs: A Graphic Example of a Valuation Disconnect

For an example of how valuations can fall out of sync with the prices of publicly traded securities, recall the diverging values of publicly traded and nontraded real estate investment trusts after the onset of COVID-19. Some high-profile nonlisted REITs maintained positive net asset values in 2022, even as their publicly traded counterparts fell by 25%. When skittish investors rushed for the exits, some nontraded REITs imposed gates to limit redemptions and at least one mortgage fund froze redemptions altogether. While REITs generally permit redemptions, the funds that are the subject of this report do not. Nonetheless, the REIT example illustrates the disparity that can develop between internally modeled valuations and mark-to-market prices (for more, see Armstrong 2022; Burgess 2023).

Proponents of private market valuations counter by questioning the accuracy of public market prices (Schelling 2022). Some insist that private market valuations are superior because their long-term orientation avoids the irrational shifts in public sentiment that can drive short-term prices in public markets. In this view, the long-term perspective of private valuations also aligns better with the long-term investing horizon of private funds and their investors.

Moreover, some have questioned the importance of interim valuations in the first place. As the private market industry has noted, fund valuations do not determine the compensation of fund managers.[82]

Some chief investment officers (CIOs) or deputy CIOs of large US public pension funds, in response to our questions, spoke of private fund interim valuations in ways that appeared to downgrade their importance. The CIOs noted that their institutions' capital will be locked up for years in illiquid private funds. The one value that counts will only come years later, when the fund disposes of its assets and fluid interim valuations become concrete realized returns.

What are the preferences of the pension funds, endowments, and other institutions that invest in private funds? Do they invest because of or in spite of smoothed volatility and stale prices? Some observers insist that LPs actually prefer artificially smoothed valuations, for reasons ranging from self-interest to perceived advantages

[82]Fund managers receive compensation from (1) management fees, which typically are levied as a percentage of investors' committed capital, and (2) carried interest, which is a percentage of realized profits that goes to fund managers after investors first receive their stipulated return (or "hurdle rate"). Though interim valuations do not determine the compensation of fund managers, they can use the valuations in marketing to raise capital for new funds.

of a long-term valuation perspective.[83] Some private fund managers who participated in our study insist that they are giving investors just what they desire.

If that is true, internal agency conflicts within investor institutions could explain why they prefer smoothed valuations. As we have seen, smoothed valuations would put the allocation choices and investment performance of pension funds (or their employees who specialize in private markets) in the best light, especially in volatile and down markets.

The debate over valuations is important, because both fund sponsors and investors rely on them. Institutional LPs, such as pension funds and endowments, use interim valuations to measure and periodically rebalance their asset allocations. If private market valuations diverge from the prices in public markets—for instance, if public markets fall while private funds remain flat—the disparity could produce the false appearance that private market assets are over- or underweighted relative to public market assets. This phenomenon is called the denominator effect.[84] It could cause a pension fund's actual allocation to appear to deviate from its target allocation. The pension fund might respond by erroneously rebalancing its portfolio to bring its allocations back in alignment with the target. Yet rebalancing errors could be particularly harmful, because allocations have been shown to drive the variability of pension plan returns or, in other words, their level of risk.[85] Thus, if deviations between public and private market valuations lead a pension fund allocator to make erroneous rebalancing decisions, that could raise the level of portfolio risk.

Institutional LPs also use interim valuations in their selection of private fund managers. The performance record of fund sponsors—based on the actual returns rather than estimated interim valuations—plays a key role in the selection process. Nonetheless, investors may view those data points as dated or stale if economic conditions have changed since the fund's vintage year. Investors may wish to consider fresher valuations of the sponsor's current private funds in addition to past performance based on realized returns.[86]

For the same reasons, fund sponsors use both past performance and current valuations in marketing new funds to investors. According to regulators[87] and some but not all academic studies, some private fund managers manipulate

[83]Other advantages may include a higher Sharpe ratio and low correlations with returns in traditional public markets. And two financial reporting experts, one European and the other American, also told us that financial preparers prefer reporting stable values and low volatility.

[84]Among LPs that were public pension funds, endowments, and government agencies, nearly 50% had PE allocations exceeding their target at the beginning of 2023, according to the 2023 McKinsey Global Private Markets Review. The LPs responded in various ways: cutting or ceasing new PE investments, selling portfolios to the extent they could (e.g., through secondary transactions), or raising their targets to fit the allocation (Averstad et al. 2023, pp. 16–17).

[85]See, for example, Ibbotson and Kaplan (2000, p. 26), noting that "more than 90 percent of the variability of a typical plan sponsor's performance over time is attributable to asset allocation."

[86]See, for example, Karpati (2013): "While everyone understands that the true measure of value is a realization event, data from older realized investments may not be relevant to a decision to commit capital to a new fund and interim valuations may be the best data available to investors at any particular time."

[87]See Karpati (2013): "One type of manager misconduct that we've observed involves writing up assets during a fund raising period and then writing them down soon after the fund raising period closes."

their performance record. Some GPs inflate fund valuations and returns during fundraising for new capital, only to write down the assets after the fundraising period closes. Other GPs time their fundraising activities to coincide with periods of peak fund performance (see **Box 4**). Such practices reflect the importance that both sponsors and investors attach to proper valuations.

Box 4. Do GPs Inflate Valuations before Fundraising?

Academic research finds mixed results, as shown in the following select papers (in reverse chronological order):

- Hüther (2022, p. 1) found no systematic increase in valuations just before fundraising: "In contrast to previous findings of a smoking gun at the fund level, I do not find any evidence of inflated performance at the deal level."
- Brown, Gredil, and Kaplan (2019, p. 1) provide a differentiated view: Top-performing PE firms are conservative; underperforming PE firms are aggressive, but investors see through that. "We find evidence that some underperforming managers inflate reported returns during times when fundraising takes place. However, those managers are less likely to raise a next fund, suggesting that investors can see through the manipulation on average. In contrast, we find that top-performing funds likely understate their valuations."
- Barber and Yasuda (2017, p. 6) found that GPs time their fundraising to coincide with periods of peak performance. Low-reputation GPs (i.e., small, young GPs that lack a top-quartile fund in their track record) upwardly manage valuations at the time of fundraising, which fall after fundraising. "[L]ow reputation GPs with low realization rates also experience bigger and more frequent markdowns post-fundraising. For buyout funds, we are able to detect reliable erosions in performance during the post-fundraising period. In combination, these results lend credibility to the SEC's concerns regarding the valuation of private equity investments during fundraising periods."
- Jenkinson, Sousa, and Stucke (2013, pp. 2–3) found that valuations are conservative over the lifespan of the fund—except during fundraising. Valuations are inflated during fundraising and gradually fall afterward. "First, over the entire life of the fund we find evidence that fund valuations are conservative, and tend to be smoothed (relative to movements in public markets). … Second, the exception to this general conservatism is the period when follow-on funds are being raised. We find that valuations, and reported returns, are inflated during fundraising, with a gradual reversal once the follow-on fund has been closed."

Finally, some investors use interim valuations as an input to their own forecasting and planning models. In this context, interim valuations serve as an important variable to determine future cash needs or reinvestment amounts. Here, the quality of valuations has a direct impact on the efficiency of operations of investors' institutions: Low-quality valuations could translate into misdirected initiatives and higher operational costs.

The CFA Institute Global Investment Performance Standards (GIPS®) provide guidance on determining private fund valuations (see **Box 5**).

Box 5. GIPS Guidance

The GIPS standards provide guidance for determining private fund valuations and fair value. The GIPS standards, however, acknowledge that private market investments are often fair valued using either the last available historical price or a preliminary, estimated value. If and when final values are received, the adviser should assess the difference in valuations and determine whether any adjustment to previously reported performance should be made. Advisers should also disclose the use of historical prices or preliminary estimates, including the percentage of fund assets invested in such assets. For more information, see the GIPS standards for firms (CFA Institute 2019).

6.4. Regulations

Divergent views on the proper role of regulation have emerged in the United States with the SEC's adoption of sweeping new Private Fund Adviser Rules (US SEC 2023). In August 2023, the SEC adopted a package of new rules, which, though far reaching, were a scaled-back version of the initial proposal made 18 months earlier.[88] Whereas the initial proposal contemplated outright prohibitions on various forms of adviser conduct, the final rules replaced some of the prohibitions with required disclosures (some coupled with investor consent requirements).[89]

Those changes did not mollify the private fund industry. One week after adoption of the rules, a coalition of private market trade associations[90] filed a lawsuit to strike down the rules. In response, a group of investors—led by ILPA and including 14 investor associations and pension funds—came out in support of the SEC. In December 2023, they filed an amicus brief with the court.[91]

[88]For an SEC staff overview of the final rules, go to www.sec.gov/files/2023-oasb-private-fund-adviser-rules-chart.pdf. For a law memo summarizing the final rules, see Ropes & Gray (2023).

[89]Interestingly, the SEC's reforms generally went further than what most previous academic studies had contemplated; see Clayton (2024), describing the policy recommendations in prior studies as "relatively cautious in their scope and substance."

[90]The plaintiffs are the National Association of Private Fund Managers, the Alternative Investment Management Association, the American Investment Council, the Loan Syndications and Trading Association, and the National Venture Capital Association (see Petition for Review).

[91]In addition to ILPA, the signatories were the Council of Institutional Investors, the Chartered Alternative Investment Analyst Association, and 11 public pension funds, including the California State Teachers' Retirement System, the Florida State Board of Administration, and the Washington State Investment Board (see ILPA et al., Amicus Brief).

Our member survey took place in the midst of these developments. We conducted the survey in October 2023, two months after the SEC's adoption of the final rules, one month after the legal challenge by the private fund groups, and two months before the investors' friend-of-the-court filing. Indeed, we asked about several of the measures found in the new rules. To avoid prejudicing the responses, however, we did not reveal the connection between the question and the SEC rules. Nonetheless, it is likely that the SEC's final rules loomed large for survey respondents affected by the reforms.

The dueling court briefs encapsulate the overall debate on the health of private market funds. Whereas the private funds extol what they call a "market-oriented, contract-based approach" and "tailored commercial arrangements that are only possible due to the existing market-based regulatory framework," the investors warn of misaligned incentives, information asymmetry, and a "structural imbalance of power between advisers and investors." (See Appendix C for excerpts from the filings.)

The SEC rules require private fund advisers to

- provide quarterly statements that include information on the private fund's performance, fees, and expenses;
- obtain an annual financial statement independent audit for each private fund; and
- obtain a fairness or valuation opinion in connection with an adviser-led secondary transaction.

The rules allow private fund advisers to offer preferential rights to investors only when the adviser discloses the preferential treatment in written disclosures to current and prospective investors. Advisers must disclose any material economic terms in advance of an investor's investment in the private fund and all terms after the investment. The SEC defines material economic terms as including the cost of investing, liquidity rights, fee breaks, and co-investment rights (US SEC 2023, p. 63286).[92]

The new rules also restrict advisers from charging or allocating to the private fund any regulatory, examination, or compliance fees or expenses unless they are disclosed to investors.[93] The rules do not prescribe any standardized valuation methodologies.

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[92]The rules prohibit two particular types of preferential treatment (related to preferential redemptions and information about portfolio holdings or exposures). Both prohibitions would generally apply to hedge funds and not to the types of illiquid private funds that are the subject of this report. See Appendix B for survey findings regarding preferential redemptions.

[93]In addition, the rules restrict private fund advisers from "charging or allocating to the private fund fees or expenses associated with an investigation of the adviser without disclosure and consent from fund investors" (see the SEC's fact sheet on the rules at www.sec.gov/files/ia-6383-fact-sheet.pdf). Further, the rule contains one outright prohibition: An adviser may not charge fees or expenses related to an investigation that results or has resulted in a court or governmental authority imposing a sanction for a violation of the Investment Advisers Act of 1940 or the rules promulgated thereunder.

7. SURVEY RESULTS

A number of surveys have reported on private markets (see **Box 6**). Our survey stands apart in a combination of ways. It is global in scale. It confines its sample to investment professionals, rather than lawyers or other service providers to private markets. It seeks out the views of the investment profession as a whole, rather than a particular subset, such as LPs or GPs. The survey focuses on questions of fund governance and private ordering, rather than market outlook or other aspects of private markets. Same as the report as a whole, the survey is unbiased. It does not shrink from sensitive questions, including those involving conflicts of interest between GPs and LPs, between LPs, and within institutional LPs themselves. The results are nuanced: Most respondents steer clear of either unqualified praise or condemnation of private markets. They see the need for improvements and support limited new regulation but do not believe that problems are significant or represent market failures.

Box 6. Other Surveys on Private Markets

A number of market participants—including investment managers, private market firms, financial services firms, and accounting firms—have published surveys of limited partners, general partners, or both. The surveys generally focus on respondents' market outlook, portfolio allocations, and investor preferences. English-language surveys include those offered by Acuity Knowledge Partners (2023), Adams Street (2023), BDO (2023), Deloitte (2021), Goldman Sachs (2023), Russell Investments (Spencer and Leverett 2023), and State Street (2023).

In March 2023, ILPA, a trade association of limited partners, released an analysis and a data packet comprising three member surveys and a conference audience poll. The releases were a response to the criticisms over the SEC's then-pending proposal on private fund adviser rules (see ILPA 2023b, 2023a).

William Clayton, a law professor, collaborated with the ILPA to survey senior in-house lawyers at 70 institutional investors in advance of a conference in October 2020. The survey focused on the bargaining process between private equity LPs and GPs (see Clayton 2022a, pp. 755–56). In addition, Clayton conducted a live audience poll at an ILPA Private Equity Legal Conference in October 2021. The audience consisted of senior in-house counsel working at more than 90 institutional investors, and the poll focused on negotiating problems between LPs and GPs and views on regulatory reform (see Clayton 2022b, pp. 7–13).

One goal of the survey has been to measure the degree of alignment or difference in perspectives of LPs and GPs. To that end, we break out results according to whether respondents had experience working for an LP or GP. Throughout this report, when we speak of an LP response, we are referring to responses of survey respondents who said they had experience with an LP that has invested in a private market fund (or who was an employee of an LP). Likewise, reference to a GP response refers to those with experience with a financial sponsor or GP of a private market fund (or who was an employee of a financial sponsor or GP).[94]

Both LPs and GPs generally gave similar responses, with a few noticeable divergences, including disclosure of fees. Their basic alignment of views is unsurprising, given that LPs trust GPs to manage billions of their investment dollars.

Another goal of the survey was to ascertain any differences in perspectives based on region or market. While differences emerged, they did not seem to be the defining features of respondent views.

Our survey sample represented a mix of investment professionals, including those with experience in investment management firms, experience at asset owners such as pension funds, and other professional investment experience. We broke out responses by those working for GPs and LPs. See Exhibits 8 and 9.

7.1. Overall Results: Middle-of-the-Road Perspectives

Overall, most respondents took a moderate or middle-of-the road view on how well private markets function. LPs and GPs were directionally similar to global averages but more positive in their responses (**Exhibit 11**).

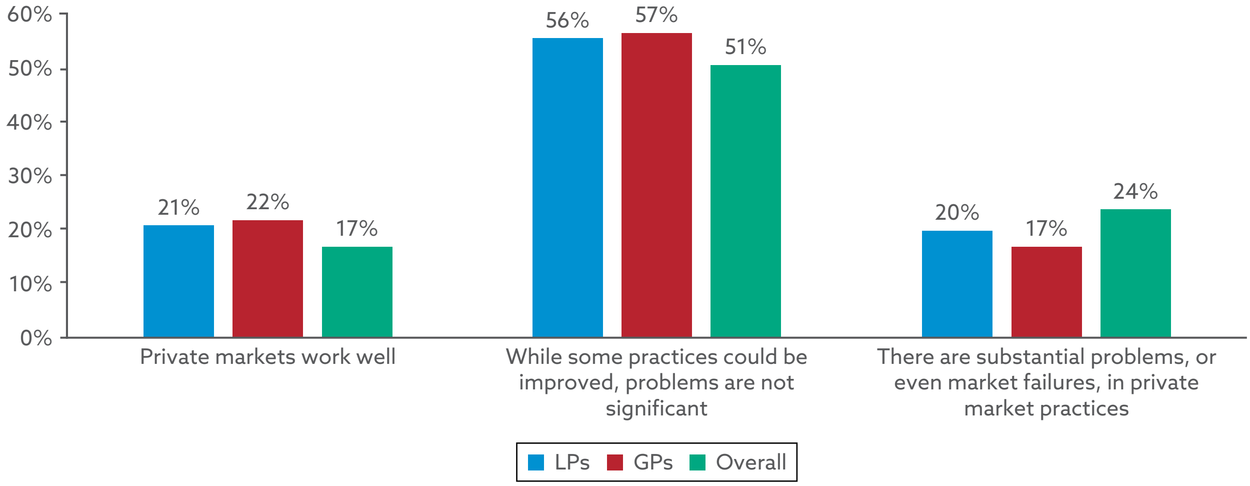
Across regions, the moderate choice was by far the dominant response in all markets except Switzerland, and even there, it led all other choices (**Exhibit 12**). Respondents in Canada were the most likely to agree with the moderate choice. Canada is well known for its large, sophisticated pension funds, and the moderate choice may reflect the view that those pension funds are capable of protecting their interests and keeping private market problems in check.

7.2. Top Concerns

More specific questions followed the same pattern. Presented with seven issues that private markets critics have identified as problematic, a plurality of respondents agreed that each of the practices could be improved but problems were not significant.

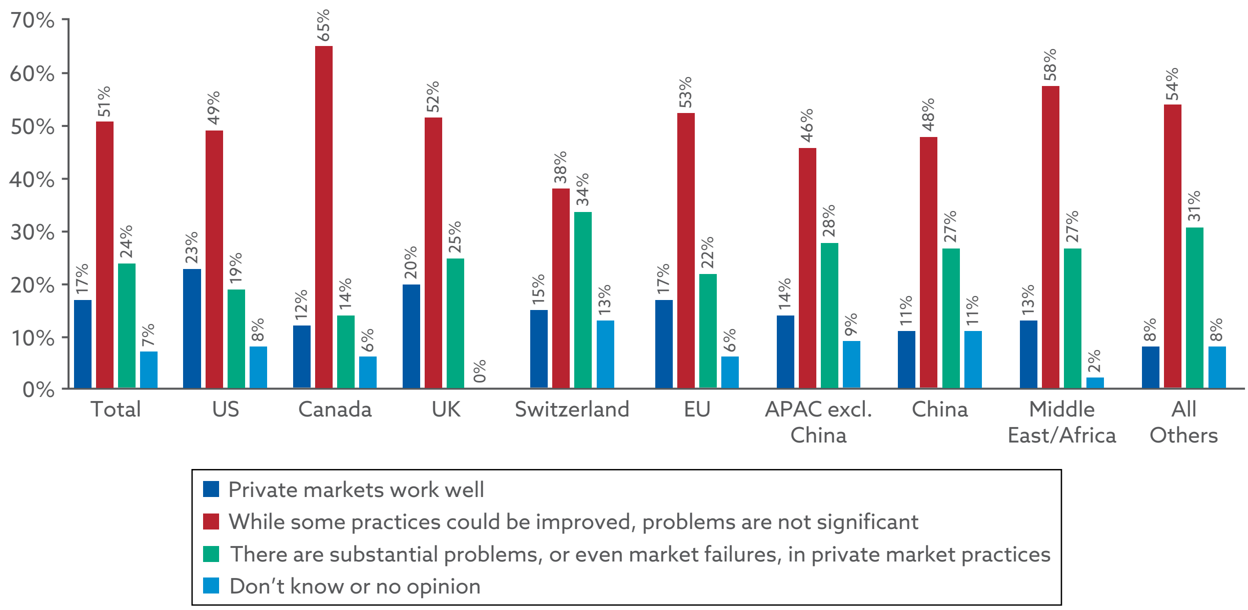
[94]We also identified those with GP experience that was current or within the past 10 years and compared the views of those with any GP experience to those with GP experience within the past 10 years. The response rates were similar and almost always within the margin of error.

Exhibit 11. How Well Do Private Markets Function? (*n* = 841)



Note: Responses do not sum to 100% because of rounding and because two responses, "don't know or no opinion" and "other," are not shown.

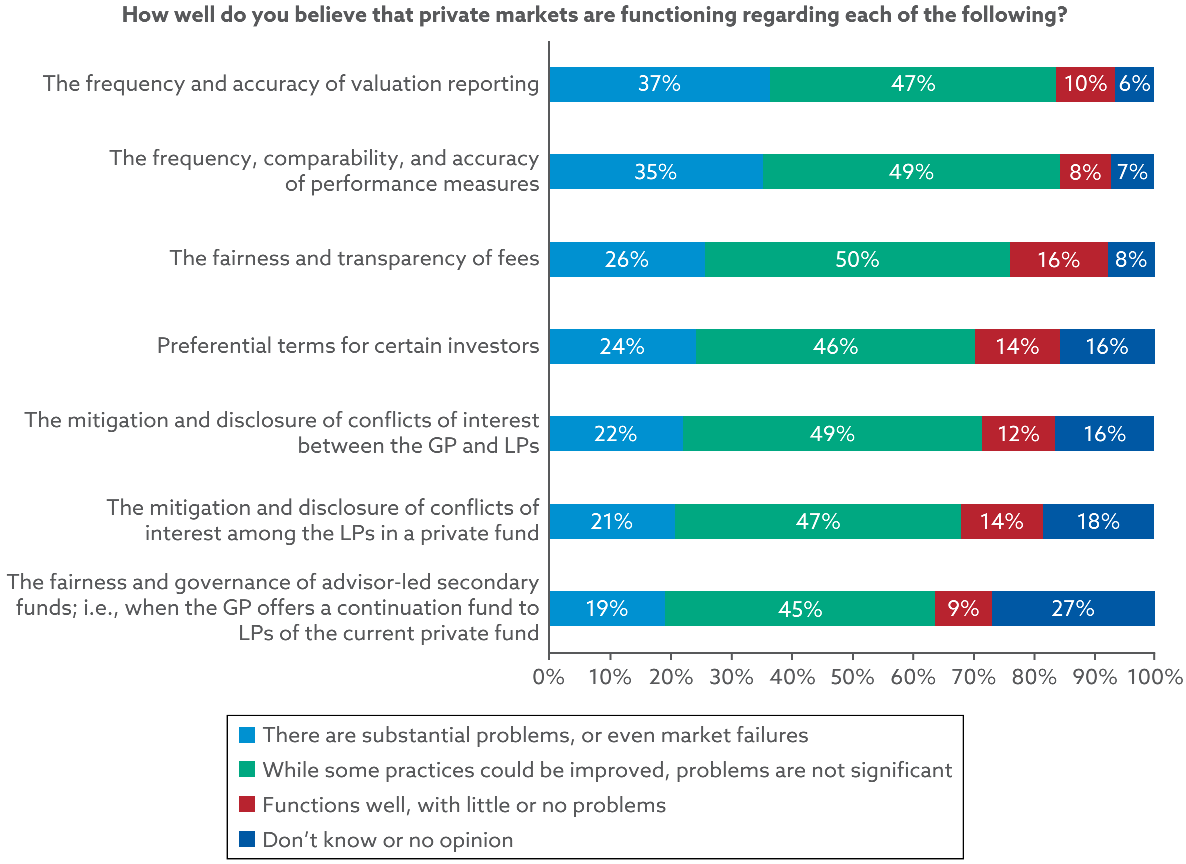
Exhibit 12. How Well Do Private Markets Function? Country and Regional Breakdown (*n* = 841)



Based on the percentage of respondents who indicated that an issue represented substantial problems or market failures, the survey identified three top concerns (**Exhibit 13**):

- The frequency and accuracy of valuation reporting
- The frequency, comparability, and accuracy of performance measures
- The fairness and transparency of fees

Exhibit 13. Top Issues



Question	*n*
The frequency and accuracy of valuation reporting	841
The frequency, comparability, and accuracy of performance measures	839
The fairness and transparency of fees	838
Preferential terms for certain investors	842
The mitigation and disclosure of conflicts of interest between the GP and LPs	840
The mitigation and disclosure of conflicts of interest among the LPs in a private fund	837
The fairness and governance of advisor-led secondary funds; i.e., when the GP offers a continuation fund to LPs of the current private fund	840

Note: Responses may not sum to 100% because of rounding.

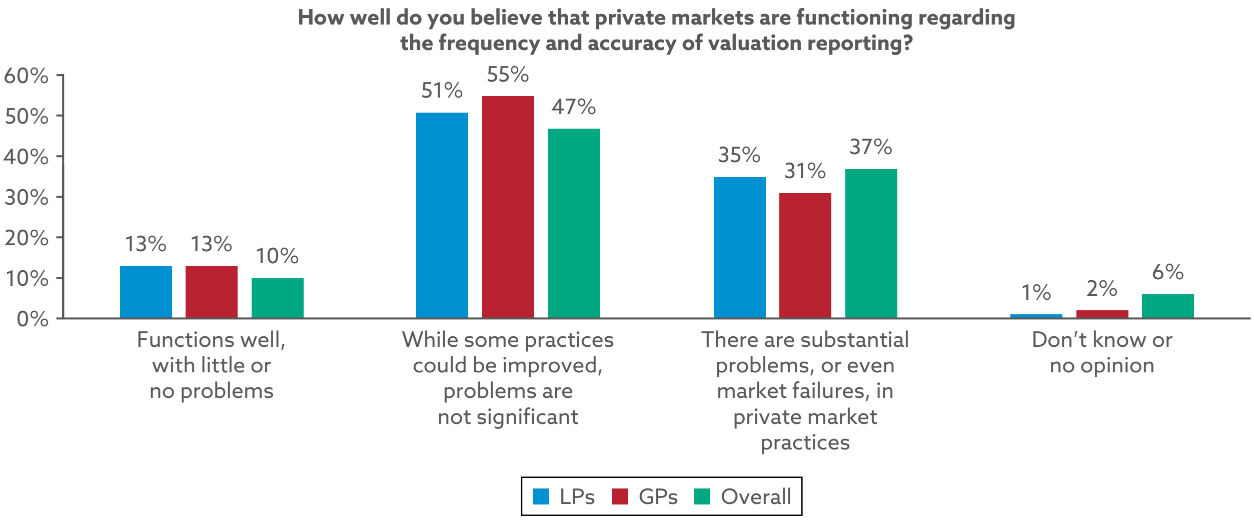
Respondents showed relatively less concern over four issues that have been targets of regulatory, investor, and academic focus (see, e.g., Clayton 2020a; Bowden 2014; US SEC 2023):[95]

- Preferential terms given to certain investors in private investment funds
- Conflicts of interest between the GP and LPs
- Conflicts of interest within institutional LPs themselves (such as pension funds)
- The fairness and governance of adviser-led secondary funds (also called continuation funds)

LPs and GPs were somewhat more optimistic than respondents overall in their views on valuation disclosures (**Exhibit 14**).

Concern over valuations is not surprising, given the debates over their accuracy and complaints of "volatility laundering," discussed in Section 6.3.2. Presented with an array of choices about valuations, a majority globally (56%)—along with 55% of LPs and 45% of GPs—affirmed that valuations are important and should be improved (see Panel A of **Exhibit 15**). But the second most popular response, in contrast, held that valuations are less important because the money is locked up for years. While this choice fell short of an overall majority, it drew a majority of GPs and close to a majority of LPs.

Exhibit 14. Valuation Reporting

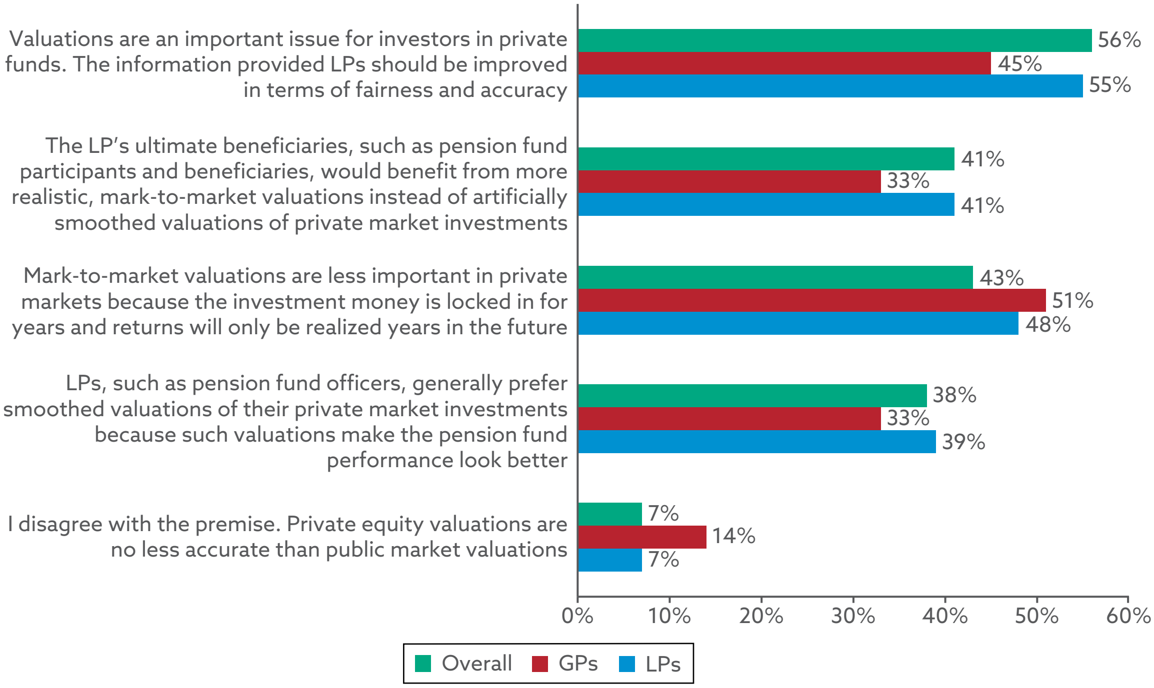


Note: Responses may not sum to 100% because of rounding.

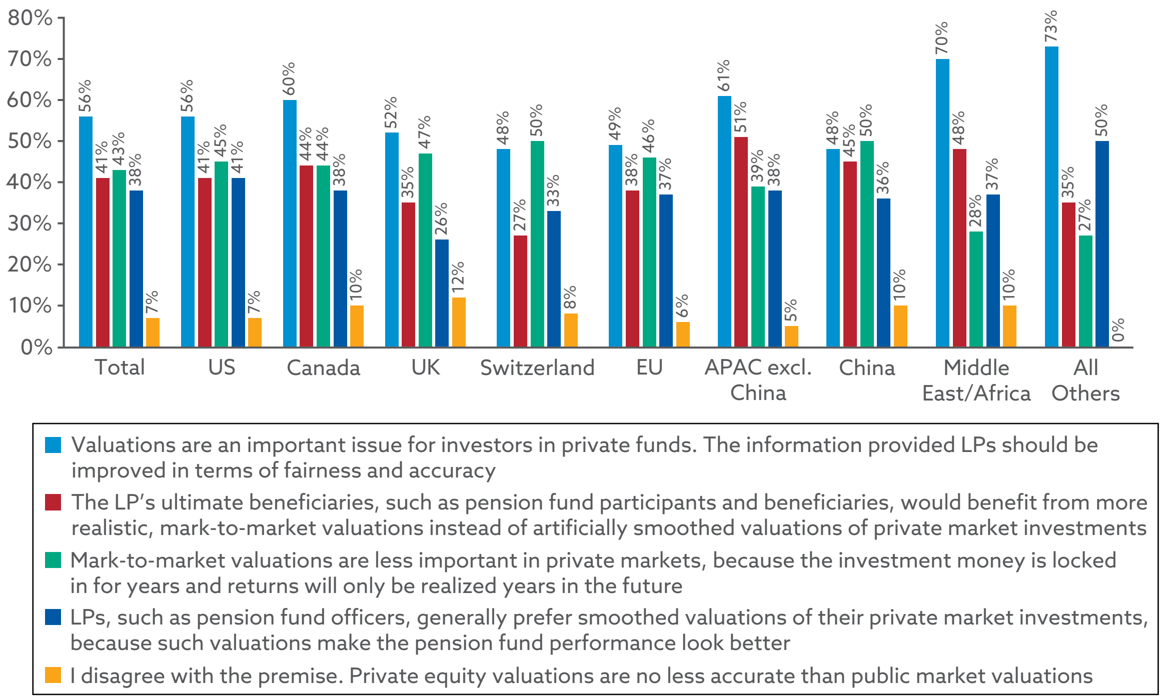
[95]See, e.g., Will Clayton 2020a, "The Private Equity Negotiation Myth"; Bowden 2014; and US SEC (2023).

Exhibit 15. Importance of Valuations (*n* = 833)

A. Private market valuations often appear less volatile than public market valuations and lag behind changes in the valuation of public markets, such as declines in stock market prices. Which of the following, if any, do you agree with?



B. Country and regional breakdown



Note: Respondents were allowed to select more than one item.

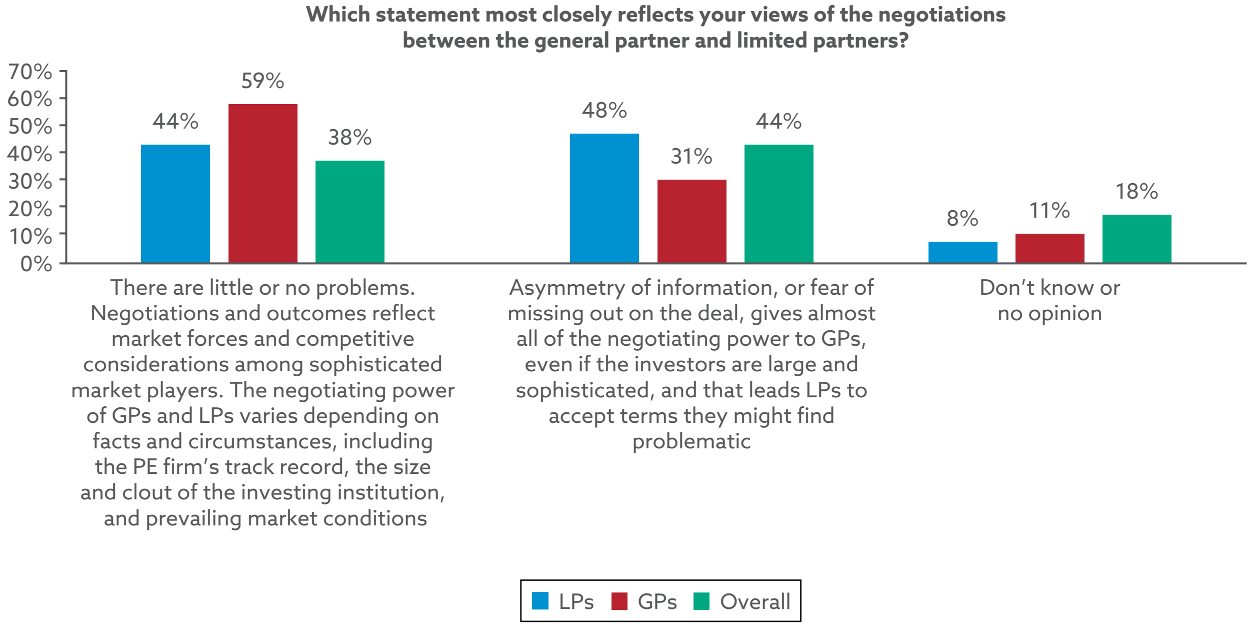
Substantial minorities—including 39% of LPs—also believe that pension fund officers prefer smoothed valuations because it makes their own performance look better.[96] There was little support for the notion that private fund valuations are no less accurate than public market valuations.

Responses appeared fairly consistent across regions, with the top choice in all but one market (Switzerland) affirming that valuations are important and should be improved (see Panel B of Exhibit 15).

7.3. LP–GP Relations: Negotiating Power and Information Asymmetries

As discussed in Section 6.1.2.1, a central question about private markets concerns negotiating power: Are LPs able to negotiate on a level playing field, or do GPs maintain an overwhelming advantage? The survey found adherents of both viewpoints: A plurality believes that GPs hold nearly all the negotiating power, regardless of the size of the LP, but a substantial minority disagrees (**Exhibit 16**). A fairly large share of respondents (nearly one in five) said they did not know or had no opinion.

Exhibit 16. GP and LP Negotiations (*n* = 839)



Note: Responses may not sum to 100% because of rounding.

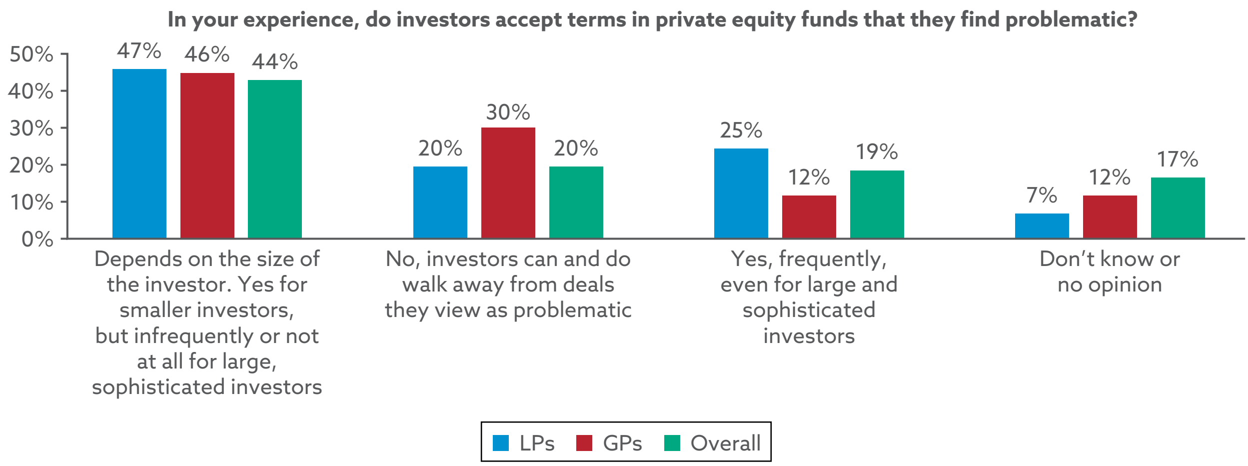
[96]This selection drew even higher percentages of the more general categories of investment managers (42%) and asset owners (44%). The broader category of asset owners includes both LPs and asset owners that do not invest in private markets.

LPs and GPs differed more on this question than on most others in the survey, with GPs far more likely to say there are little or no problems with negotiations. The question elicited a far wider range of responses across markets than any other survey question. Responses did not appear to fit a discernable pattern.[97]

Separately, the survey asked whether, in the experience of respondents, investors accept terms in PE funds that they find problematic (**Exhibit 17**). A plurality responded that it depends on the size of the investor. LPs were more likely than GPs and respondents overall to agree that acceptance of problematic terms happens frequently, while GPs were more likely than LPs and respondents overall to say it does not happen because investors can and do walk away. A plurality of respondents in the United Kingdom agreed that investors walk away from problematic deals, whereas only 6% of respondents in Canada agreed with that response. Little is known about investors who walk away from deals, and this issue merits further study.

Why do some investors accept problematic terms? The survey directed this question to the 63% who answered the previous question (Exhibit 17) in the affirmative (the 19% who said investors accept problematic terms "frequently" plus the 44% who said it depends on the size of the investor). **Exhibit 18** shows the top reasons given. Respondents with experience in LPs gave similar responses but with greater emphasis on the importance of commitment size (67% agreed).

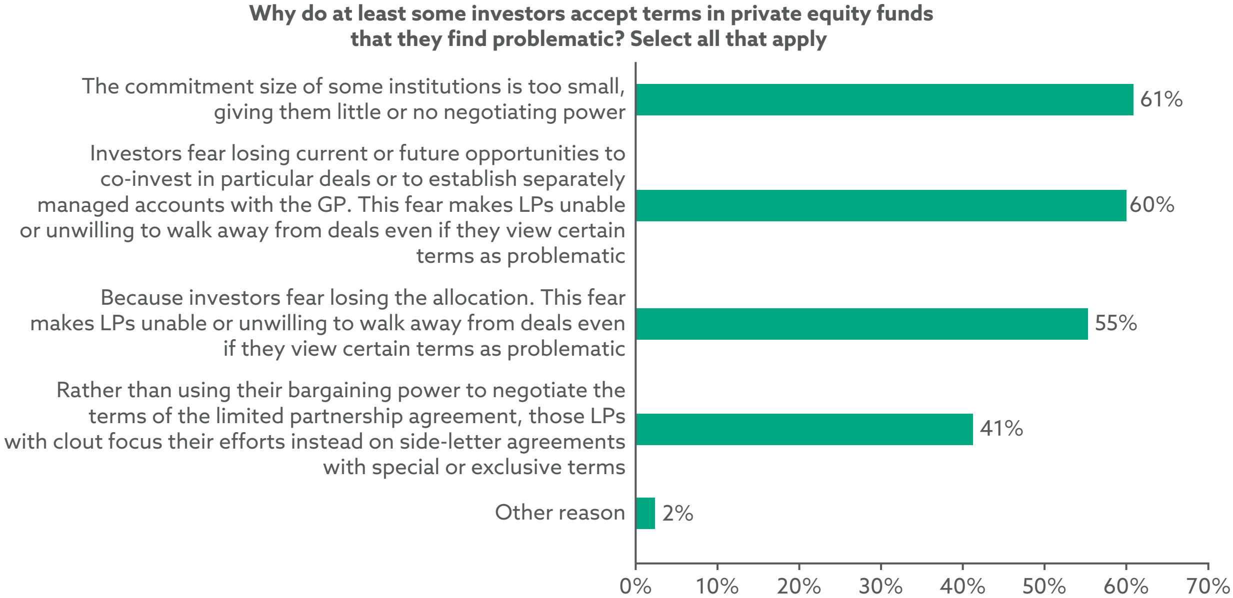
Exhibit 17. Problematic Terms (*n* = 842)



Note: Responses may not sum to 100% because of rounding.

[97]Responses were split virtually evenly in two markets: the United States (39% selected the "asymmetry of information" choice versus 40% who selected instead the "little or no problems" choice) and Middle East/Africa (42% for the "asymmetry of information" choice versus 43% for the "little or no problems" choice). The "asymmetry of information" choice drew more responses in four regions/markets—Switzerland (55%), APAC excluding China (51%), Canada (46%), and the EU (46%). The "little or no problems" choice received a higher share of responses in another two markets: the United Kingdom (48%) and China (45%). The response from China appears puzzling given those respondents' negative assessment of the adequacy of information provided to LPs.

Exhibit 18. Why Do Investors Accept Problematic Terms? (*n* = 468)



Notes: Answers were from respondents who believe at least sometimes investors accept problematic terms. Respondents were allowed to select more than one item.

Questions of information asymmetry do not end when the LP signs an investment contract. As discussed in Section 6.2, regulators have raised concerns about the ability of LPs to monitor their investments in private funds. Respondents overall gave transparency a mixed scorecard: Half the respondents (50%) said information was adequate for LPs to monitor their investments, but slightly more than half said it was inadequate to monitor fees and expenses or operations of the PE manager (**Exhibit 19**).

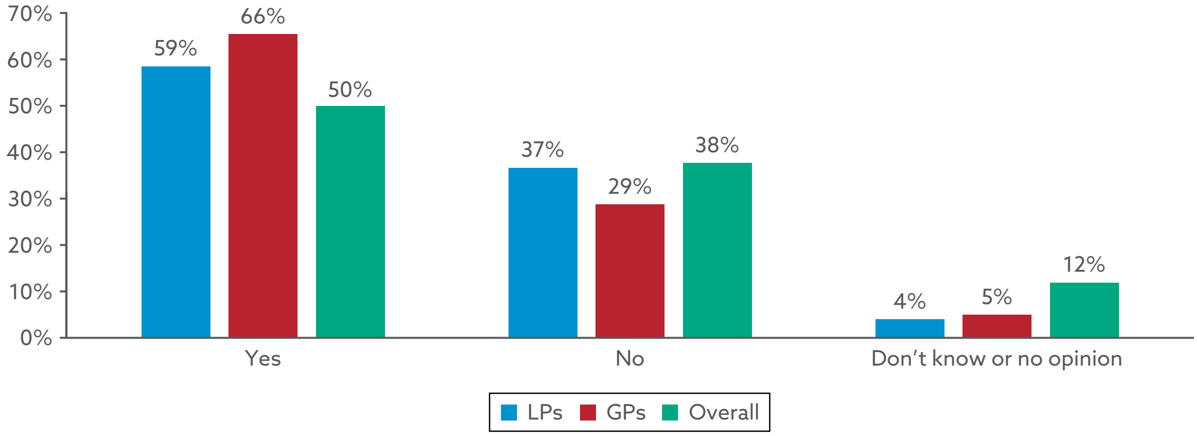
In all but two markets, a majority said that information was adequate for investors to monitor their investments, with a high of 59% affirmative responses in the United Kingdom. The two exceptions were China and APAC excluding China. China was the only market with a majority negative response—and by a wide margin: There were twice as many negative responses (56%) than positive responses (28%). In APAC excluding China, views were split equally between negative and positive responses (45% each).

The transparency of fees and expenses appeared to be particularly problematic, according to responses overall and among LPs but not among GPs.

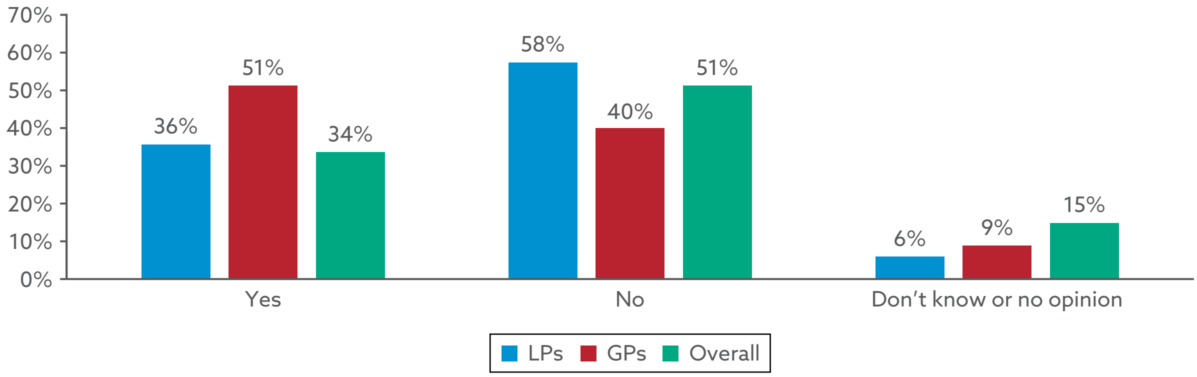
LPs were particularly likely to judge fee and expense disclosures as inadequate, marking a sharp contrast with the GP responses on this question and also with the general pattern of LP responses on most questions. On most other questions, in contrast, LPs tended to join with GPs in offering a relatively more favorable view of private markets compared to the view of respondents overall. Turning to a regional perspective, negative responses to this question outnumbered positive responses in every market.

Exhibit 19. Do You Believe That Investors in Private Markets Receive Sufficient Information to Adequately Monitor

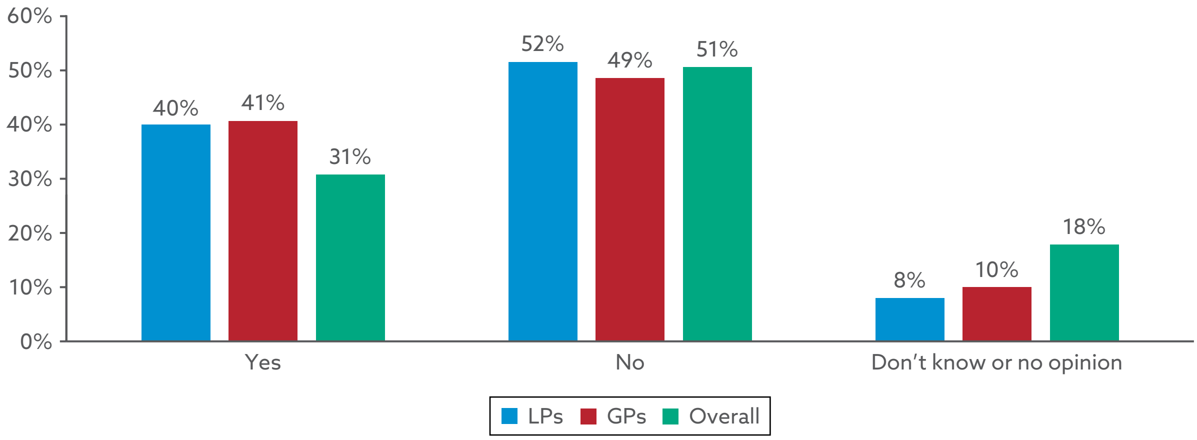
A. Their investments in the private funds? (*n* = 838)



B. Fees and expenses that the PE manager receives, either directly from the LP investors or indirectly from portfolio companies? (*n* = 837)



C. The operations of the PE manager? (*n* = 841)



Negative responses exceeded positive responses for GPs, LPs, and respondents as a whole on this question of operations transparency. Likewise, across regions, respondents in every market, including the United States, were more likely to say "no" than "yes." The most negative response came from China, where 74% said no.

Taken as a whole, the survey results show that respondents saw gaps in the transparency of private markets, particularly with respect to fees and expenses.

Asked about the mitigation and disclosure of conflicts of interest between GPs and LPs, a majority of both LPs and GPs and almost a majority of respondents overall believed that problems were not significant (**Exhibit 20**).

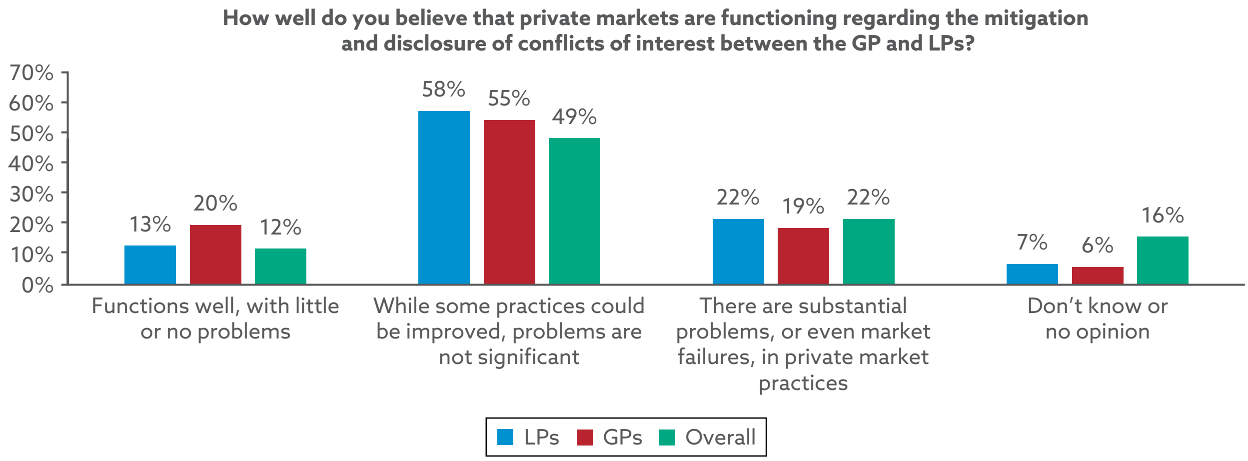
7.4. Regulation

The survey asked respondents about their views on a variety of policy choices, including mandatory quarterly statements, annual audits, and fairness or valuation opinions, as well as policy approaches to privileged terms and compliance fees and expenses.

7.4.1. Support for Only Limited New Regulation

A majority of respondents supported new regulations on private markets—but with an important qualification. They favored only limited regulation, with an emphasis on required disclosures (or disclosure and consent) rather than outright prohibitions. This finding is consistent with respondents' middle-of-the-road assessment that private market practices can be improved but problems are not significant.

Exhibit 20. LP and GP Conflicts of Interest (*n* = 840)



Note: Responses may not sum to 100% because of rounding.

Most respondents supported limited new regulation when presented with three policy choices: no additional regulation, only limited additional regulation, or significantly expanded regulation (**Exhibit 21**).

The middle option of only limited additional regulation was the top choice in every market without exception. Canadian respondents voiced the strongest support for this option (64%), with a mere 8% supporting significantly expanded regulations. This result is consistent with the view that Canada's large and sophisticated pension funds can fend for themselves without the need for major new regulations.

While respondents across regions and countries all selected the same first choice, they differed in their second choices. In the Middle East and APAC excluding China, the second choice was in favor of significantly expanded regulations. In all other markets, including North America and the EU, the second choice was to reject any new regulation.

The overall pattern of responses suggests that most respondents associate limited regulation with a disclosure-based regime and, conversely, associate significantly expanded regulation with outright prohibitions.

7.4.2. Required Quarterly Statements, Annual Audits, and Fairness or Valuation Opinions

The survey also asked about three specific requirements (see **Exhibit 22**):

- Quarterly statements that include information on the private fund's fees, expenses, and performance
- An annual audit of the private fund performed by an independent public accountant
- A fairness or valuation opinion of any adviser-led secondary transaction

Exhibit 21. Attitudes on Regulation (*n* = 842)

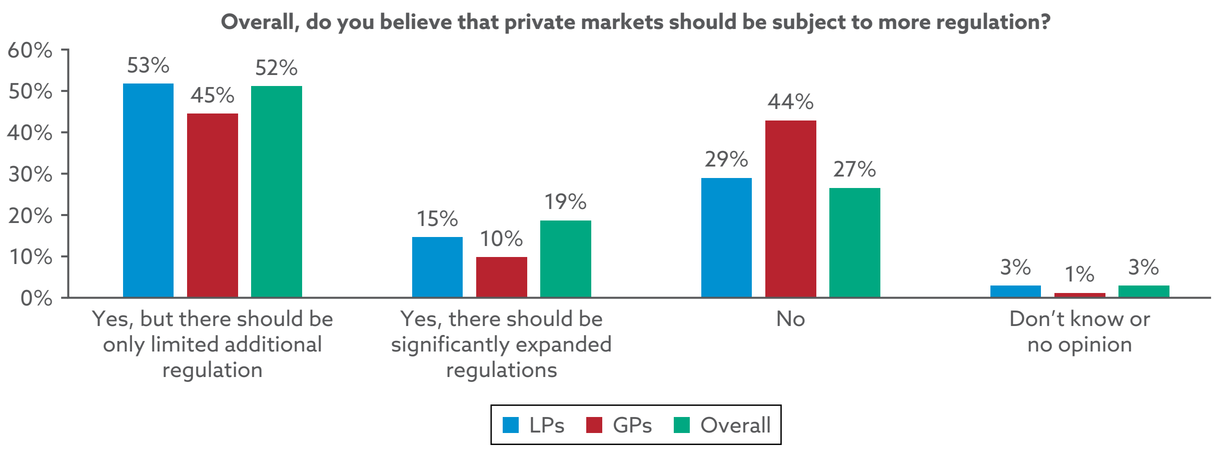
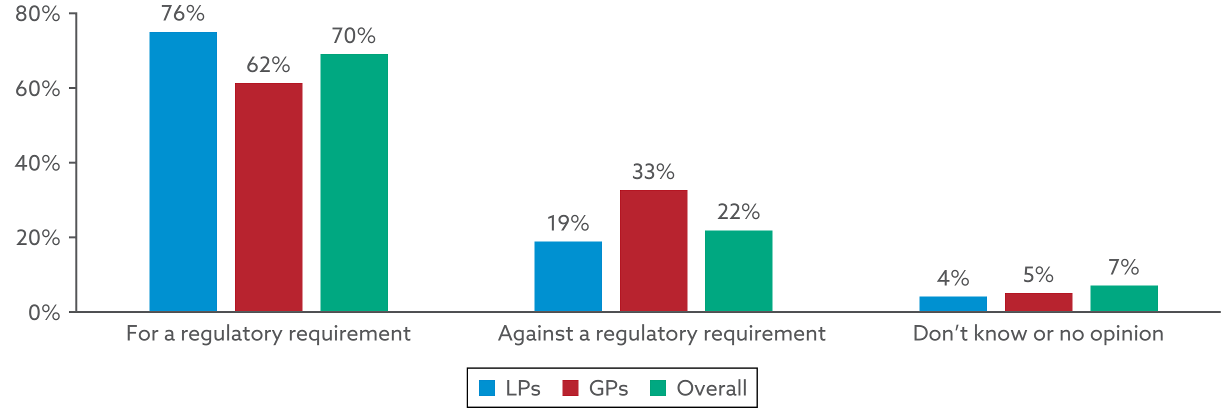
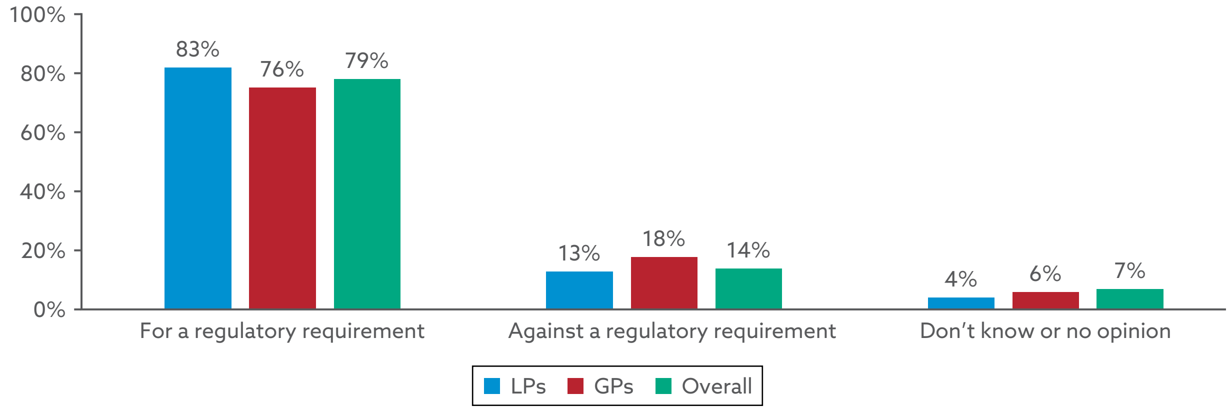


Exhibit 22. Would You Be for or against a Regulatory Requirement for Private Fund Advisers to Provide Fund Investors With

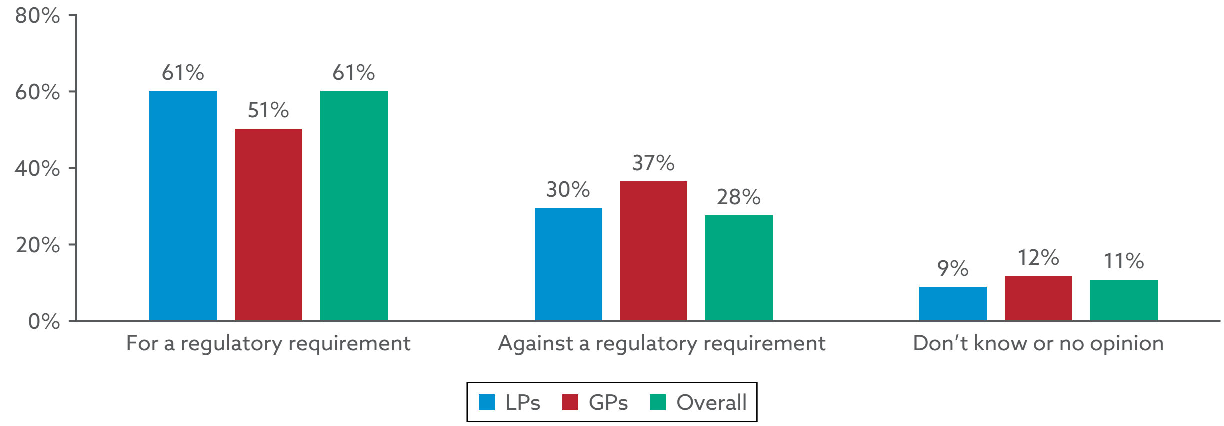
A. Quarterly statements that include information on the private fund's fees, expenses, and performance (*n* = 841)



B. An annual financial statement audit of the private fund performed by an independent public accountant (*n* = 839)



C. A fairness opinion or a valuation opinion from an independent opinion of any adviser-led secondary transaction (*n* = 838)



Note: Responses may not sum to 100% because of rounding.

These three measures are all contained in the SEC's final rules, although the survey question did not explicitly refer to the SEC.[98] Solid majorities of respondents overall supported all three measures—as did a majority of both GPs and LPs. This finding is noteworthy since the groups representing hedge funds and other private market funds have challenged the rules in court (see Section 6.4 and Appendix C).

In every market without exception—including the United States—a majority of respondents supported all three regulatory requirements:

- Panel A of Exhibit 22: In the United States, 66% supported the requirement for quarterly statements, while 27% opposed it. Several other markets approached that level of opposition: Canada and Switzerland (26% against), the United Kingdom (24% against), and the EU (22% against).
- Panel B of Exhibit 22: In the United States, 70% favored an audit requirement, while 24% opposed it, a significantly higher level of opposition than in most other markets.
- Panel C of Exhibit 22: In the United States, 52% supported the measure, while 34% opposed it.[99] This result reveals a significantly higher level of opposition than in most other markets.

7.4.3. Side Letters and Privileged Terms

The survey also asked about three other practices addressed in the SEC rules (see Section 6.4)—again, without tying the policy options to the SEC: side letters and privileged terms, compliance fees and expenses, and special redemption privileges. We cover the first two questions here and the third, on privileged redemptions, in Appendix B.

There was a clear hierarchy in survey responses, as shown in Panel A of **Exhibit 23**. A majority of respondents overall supported a requirement for GPs to disclose the terms of all side letters to prospective and current investors, while redacting information that would identify the investor. Half that number, including a relatively high percentage of GPs, said that regulators should not intervene. And half of that number believed, in contrast, that regulators should ban this practice.

The majority response aligns with the SEC rules, which require disclosure of any material economic terms in advance of an investor's investment in the private fund and disclosure of all terms after the investment.

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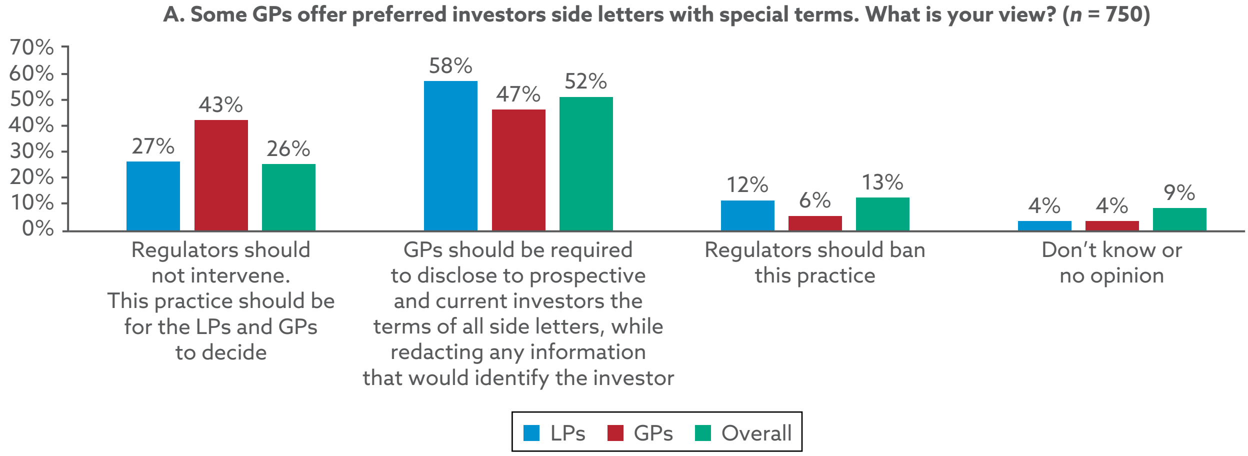
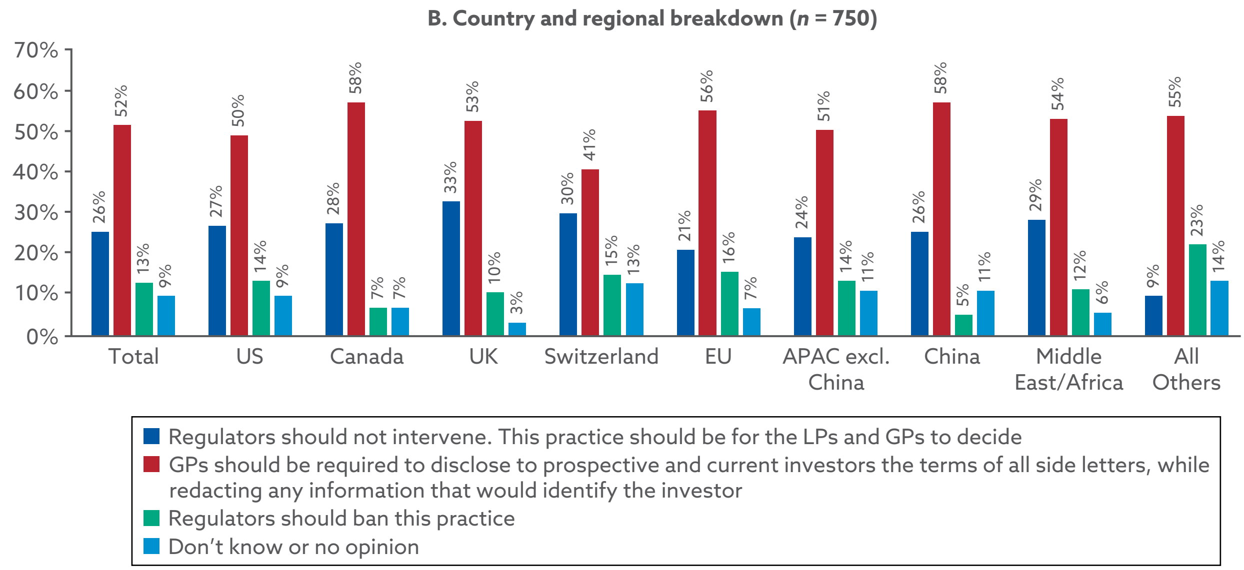
[98]Omitting mention of the SEC rule had two advantages. First, it made the question more universal in scope and thus more appropriate for a global survey. Second, we wanted respondents to focus on the regulatory policy options and not the regulator.

[99]Among US respondents, 14% said they did not know or had no opinion.

Exhibit 23. Side Letters





Note: Responses may not sum to 100% because of rounding.

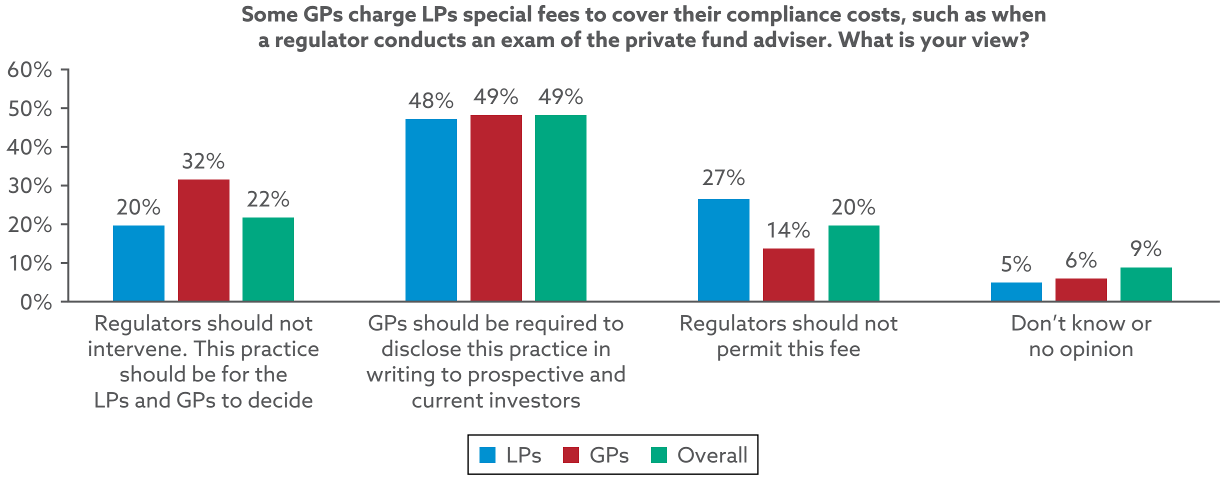
A majority of respondents agreed that side letters should be permitted, but their terms should be disclosed to current and prospective investors.

At the regional level, requiring disclosures also dominated responses (Panel B of Exhibit 23).

7.4.4. Compliance Fees and Expenses

Near-majorities of LPs, GPs, and respondents overall favored requiring GPs to disclose special fees they charge to cover compliance costs (**Exhibit 24**). Aside from those who expressed no opinion, the remaining responses were split

Exhibit 24. Compliance Fees (*n* = 749)



Note: Responses may not sum to 100% because of rounding.

almost evenly between those who believe that regulators should not intervene and those who believe that regulators should ban the practice.

The survey's consensus view aligns with the new SEC rules, which, as we have seen, restrict advisers from charging or allocating to the private fund regulatory, examination, or compliance fees or expenses of the adviser unless they are disclosed to investors (see Section 6.4).

8. CONCLUSION: LOOKING AHEAD THROUGH A GOVERNANCE LENS

We introduced this report by observing that the end of cheap money has ushered in a new era for private markets, one that presents both opportunities and risks for private funds. Among those risks, governance issues have risen to the fore. We conclude, first, by suggesting how governance issues may play out in particular areas, most of which revolve around potential conflicts of interest. Potential risks may become particularly acute or may be realized in the following areas of private fund governance:

- **The negotiating balance of power between GPs and LPs.** On the positive side, it is possible that a more challenging operating environment (see Section 3.1) for private markets will confer greater negotiating power to investors, thus reducing the dominance of GPs and improving the overall imbalance. If this occurs, it will support the view of a sizable minority of survey respondents (38%) who attribute negotiating balance to market forces and competition. If the negotiating balance does not improve, however, even in the more challenging environment that GPs face, it would support the plurality view (44%) that other forces—asymmetry of information or fear of missing out—give almost all the negotiating power to GPs.
- **Expenses and fees.** If it becomes increasingly difficult for private funds to achieve profits through exit sales of portfolio companies,[100] fund managers will face greater pressure to achieve firm profits in other ways (here, "firm profits" refers to profits for the private fund sponsor, as opposed to profits of the fund itself, which investors and fund sponsors share). Such pressures may elevate the importance of fees and expenses as an income stream for private market firms. One way to achieve higher fees and expenses would be to increase committed capital, which could be a natural consequence of any consolidation in the industry. An unscrupulous way, however, could involve self-dealing and hidden fees, in particular through charges to portfolio companies controlled by the fund manager.
- **Valuations and performance metrics.** Private market firms (like many investors) have an incentive to keep volatility low, and such pressure can lead to smoothed valuations and, arguably, a sacrifice in reporting quality. The current environment can be expected only to add to the pressures. If private market firms find it more difficult to realize profits from existing investments and to raise capital for new funds, they may feel greater pressure artificially to maintain current valuations of portfolio companies, even in the face of public market price declines. A recession would only add to those pressures. Likewise, such pressures would apply

[100]Private market exit transactions slowed in 2022, with particularly sharp declines in private equity exits, according to the 2023 McKinsey Global Private Markets Review. PE exits (excluding venture capital funds) fell 65% in North America, 37% in Europe and 32% in Asia compared with the previous year (Averstad et al. 2023, p. 26).

to the performance metrics that fund sponsors use as marketing to raise new capital.

A difficult environment for exit sales, however, could force a reckoning on stale valuations. There are already reports that private equity funds, resigning themselves to a new reality, have begun to "capitulate" on prices (Massoudi, Chassany, and Gara 2024).

- **Conflicts of interest between private credit and private equity funds.** As discussed, there is a distinct possibility that inflation and higher interest rates, if they persist, could throw operating companies into financial distress. A recession would exacerbate the risks and could result in bankruptcies. This would pose special conflict-of-interest challenges for firms that have PE and private credit arms that have both invested in a distressed portfolio company. In such a situation, it is quite possible that interests of the PE fund and its investors will conflict with the interests of the private credit fund and its investors. That said, it is also true that private funds may also bring some advantages to the handling of distressed portfolio companies, including deep pockets and experience in restructuring distressed firms and their debt burdens.
- **Increases in secondary transactions.** A new era of tight money—coupled with reduced exit opportunities and greater investor liquidity needs—is likely to drive increases in both adviser-led and investor-initiated secondary transactions. A growth in secondaries holds both promise and risk for investors.

  On the positive side, by transferring the legacy fund's assets into a new fund, the GP preserves control over portfolio companies that may be more valuable than current exit values indicate. The new fund can continue to hold those assets until the exit sale environment improves. Doing so will benefit legacy fund investors who invest in the new fund. Secondary transactions also deliver money to LPs who do not roll over their investment in the new fund.

  An increasing number of secondary transactions can also be an extraordinary opportunity for new investors to buy into the new funds and thus purchase the fund's assets at a discount.[101] Investors in secondaries, however, face risks of information asymmetry and adverse selection. This may be especially true with adviser-led secondaries because the adviser has information about the portfolio companies—their operating performance, their profitability, their risks—that investors generally do not have. Information asymmetries make it difficult for investors to ascertain whether the adviser is engaging in self-dealing or placing its own interests ahead of investors. Compounding those challenges, investors in secondaries often have only limited time to evaluate their options.

[101]See, for example, Arvedlund (2023), quoting Mark Anson, the CEO and CIO of Commonfund and former CIO of CalPERS: "We love secondaries in every recession. The financial crisis saw a lot of secondaries come to the market. … Some of the smartest investors in the world got caught in a liquidity trap, and they had to sell some of their private capital investments. … And that's just a good time to buy things at a discount."

- **Retail access to private markets.** The push to expand retail access to private markets is taking place just as the industry confronts new macroeconomic challenges. Even in the best of circumstances, retail investors would inevitably face risks of asymmetric information and adverse selection. In nearly all cases, retail investors simply do not have the resources and professional know-how of the pension funds, endowments, and insurance companies that invest in private markets. And as we have seen, a plurality of survey respondents believe that even these large and sophisticated institutional LPs are at a negotiating disadvantage with GPs.

  Risks of adverse selection would compound the challenges. Private equity funds exhibit particularly wide dispersion of performance.[102] To be successful, private market investors must have an ability to pick top-tier funds—and then have access to invest in them. Yet retail investors would be competing for access with institutional investors with millions if not billions to invest, and top-tier funds are often oversubscribed. It is unclear whether the top funds would welcome or avoid investments from defined contribution plans.[103]

  Illiquidity would constitute another major challenge, requiring both a multi-year investment horizon and cash management in the period between the investment commitment and the fund's drawdown of investor cash. Perhaps mechanisms could be found to offer some liquidity for retail investors who wish or need to withdraw their investments before the fund closes.[104] Even so, however, the J-curve nature of private market performance, with positive returns coming only later in the investment horizon, could harm retail investors who withdraw money prematurely.

[102]According to McKinsey, an 18 percentage point gap separates top and bottom-quartile PE funds with vintages of 2009–2019 (Averstad et al. 2023, p. 12).

[103]"The leftovers that will be trickled down to Main Street will be the dredges of the industry," argues Bloomberg opinion columnist Barry Ritholtz in Kaissar and Ritholtz (2020). Brown et al. (2022, pp. 11 and 13), however, say that the argument could cut either way. On the one hand, "DC plan providers may get beneficial access or allocations to top-performing general partners (GPs) who want to avoid liquidity shocks as they craft strategies for how to deploy capital." On the other hand, they continue, "better performing GPs are often oversubscribed, and thus, this perception [of liquidity demands] could result in better GPs not wanting commitments from DC plans."

[104]Moreover, retail investors would have to manage their cash in the period between their investment commitment and the fund's capital call. But cash-like returns prior to the drawdown would dilute the private market returns, as Brown et al. (2022, p. 13) point out.

APPENDIX A. CLIMATE-RELATED DISCLOSURES

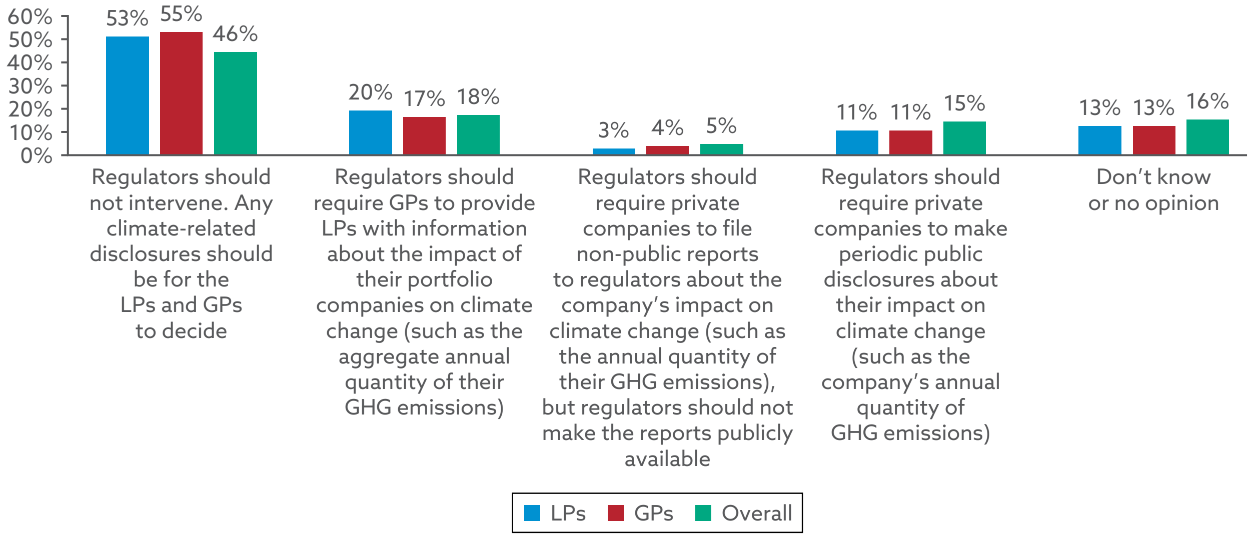
Policy choices involving climate disclosures and other climate-related regulations of public companies have played a central role in policy debates on the national and international stages in recent years. If such regulations are limited solely to public markets, they will fail to capture significant segments of the economy that are private. Moreover, some fear that climate change regulation of public companies could push some of them into private hands or carve out polluting business units and turn them private. Therefore, some see the need for a holistic regulatory approach that encompasses both public and private companies. Applying sustainability regulation to private markets, however, would run counter to the traditional light-touch regulation of the industry.

Survey respondents expressed a clear preference for private ordering (Panel A of **Exhibit A.1**). A plurality (though not a majority) opposed regulatory intervention, saying instead that LPs and GPs should be allowed to determine the question for themselves. The remaining responses were split among other policy options. GPs and LPs gave similar responses, with majorities of both groups opposing regulatory intervention.

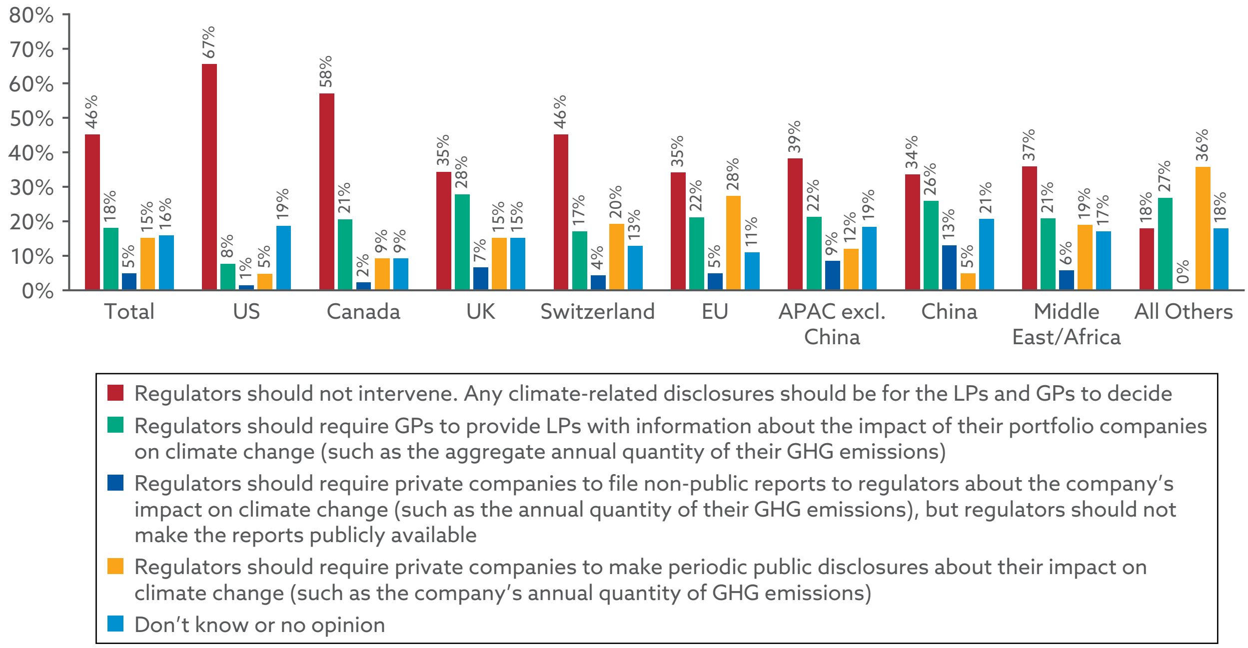
Regulatory requirements for climate-related disclosures also proved unpopular across individual markets (Panel B of Exhibit A.1), with pluralities agreeing that regulators should leave the decisions to LPs and GPs. Opposition to climate-related measures was greatest in the United States (67%) and Canada (58%).

Exhibit A.1. Climate Change Disclosures (*n* = 749)

A. Which of the following statements do you most agree with about private company climate change disclosures?



B. Country and regional breakdown



APPENDIX B. SPECIAL REDEMPTION PRIVILEGES

The survey asked about special redemption privileges, which may be found in hedge funds but generally not in illiquid private funds, such as private equity and private credit funds. A plurality of LPs, GPs, and respondents overall agreed that such privileges should be allowed—but only if the private fund adviser discloses the practice in writing to prospective and current investors and gets their consent (Panel A of **Exhibit B.1**). This was the top choice in every region/market without exception (Panel B of Exhibit B.1).

The SEC's new rules, in contrast, went beyond disclosure and consent. The rules prohibit preferential redemptions where they may have a material, negative effect on other investors, subject to limited exceptions. This policy option polled a distant second in our survey. In the United States, just 24% favored this option, while 44% favored a policy of disclosure and consent.

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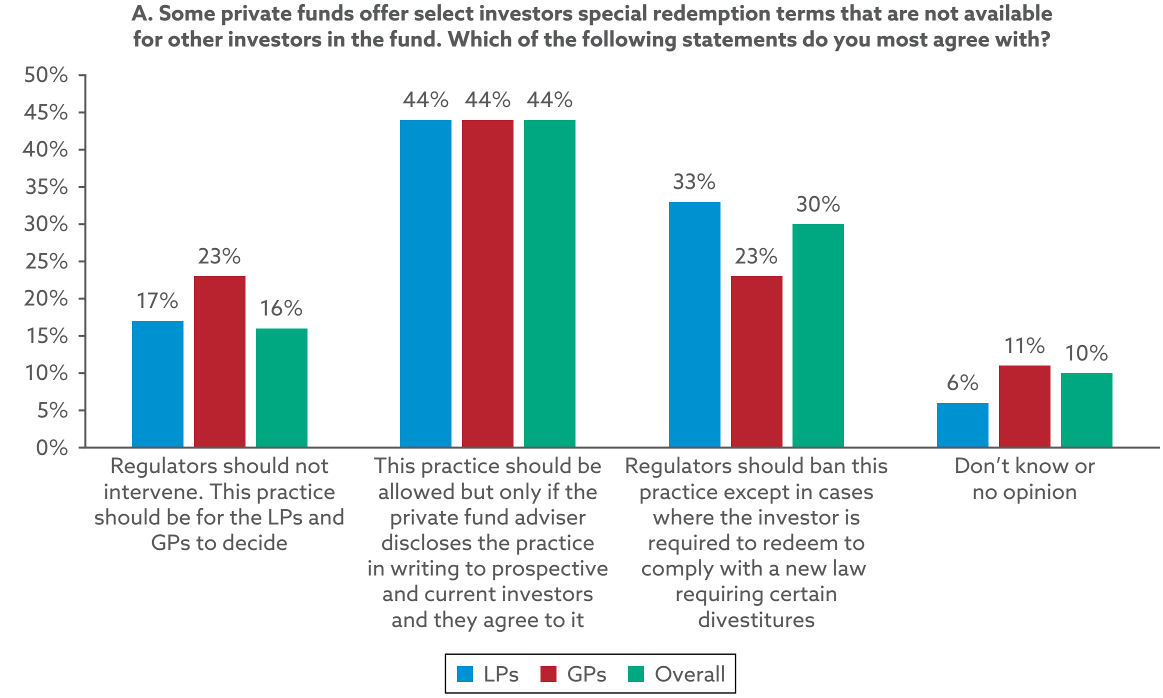
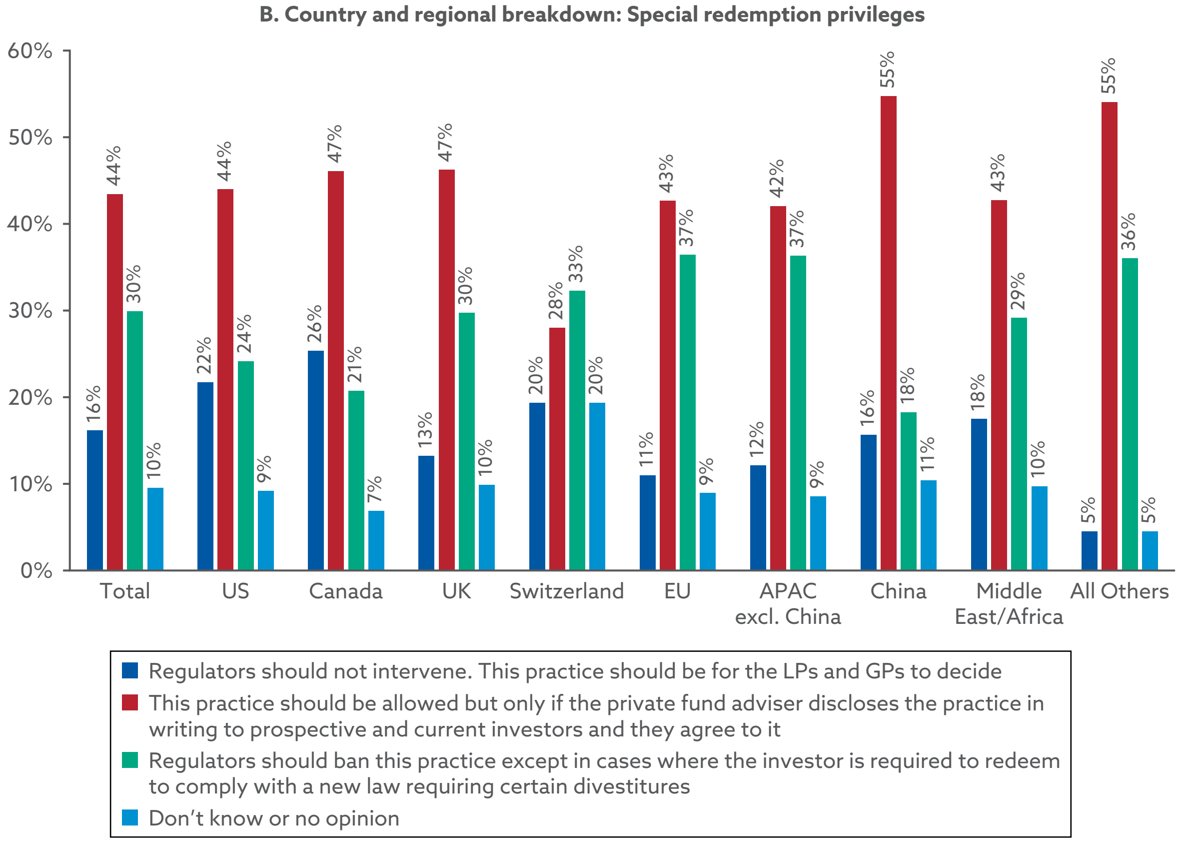
Exhibit B.1 Privileged Redemption Terms (*n* = 748)





APPENDIX C. DUELING COURT BRIEFS: THE SEC'S PRIVATE FUND ADVISER RULES

The lawsuit to strike down the SEC's new Private Fund Adviser Rules portrays them as an unnecessary and dangerous intrusion into private markets that have flourished under private ordering and a hands-off regulatory approach. The following are excerpts from the petitioners' lawsuit:

> This market-oriented, contract-based approach has worked remarkably well. … Reflecting private funds' long track record of success, investors have steadily *increased* their investments in private funds. … [italics in original]
>
> Private funds draw these investments by generating strong returns through tailored commercial arrangements that are only possible due to the existing market-based regulatory framework. …
>
> In short, Congress's decision to shield private funds from the comprehensive regulatory structure applicable to investment companies has worked as planned. In a highly competitive marketplace, the world's sharpest investors have voted with their feet by increasing their investments in private funds.[105]

The investors' amicus brief,[106] in contrast, argues that the new rules are needed to protect investors from structural flaws in private markets. The title of one section of the brief states the argument succinctly: "The Private Fund Adviser Rules Seek to Mitigate Against Adviser Conflicts Of Interests Borne Of The Structural Inequalities In The Adviser-Institutional Investor Relationship."

The amicus brief portrays a flawed negotiating process shrouded in secrecy:

> The historical success that adviser counsel [i.e., lawyers representing private fund managers] have had in moving fund terms in favor of advisers is the result of market concentration, informational asymmetries, and misaligned incentives, not market forces. … Institutional investors … are bound by clauses to not publicly disclose LPAs and to not share with other investors in a fund—other than certain investors with most favored nation clauses—their side letters with the adviser.

In addition, the amicus brief speaks of "misaligned incentives [that] are particularly troublesome in private fund investments because the usual mechanisms of resolving them—transparency and fiduciary duties—do not function consistently across private funds."

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[105]Opening Brief for Petitioners (p. 1).

[106]ILPA et al., Amicus Brief.

Yet, for all their differences, both sides appeal to the larger interests of society and everyday people. The plaintiff's brief states, "Private funds are a competitive, thriving sector of our economy. They invest in thousands of companies, with millions of employees, and have returned, over the years, tremendous gains to investors—generally exceeding the returns available from other investment options."[107]

The amicus brief, meanwhile, invokes the interests of what it calls "everyday people" and "real people":

> Many LPs are institutions, including some of the largest pension plans in the United States, with a mandate to serve real people who rely on the returns generated through private fund investments. Indeed, these returns can make the difference between institutions meeting—or not meeting—their financial obligations to their beneficiaries. The Private Fund Adviser Rules seek to address the systemic imbalance between advisers and investors, allowing institutions to better carry out their missions and ultimately benefit their members—teachers, police officers, fire fighters, students, judges, and others.[108]

[107]Opening Brief for Petitioners.

[108]ILPA et al., Amicus Brief.

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