SUBMITTED ELECTRONICALLY

April 12, 2011

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Re: Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Release No. IA-3145, File No. S7-05-11

Dear Ms. Murphy:

We are submitting this letter in response to Release No. IA-3145 (the "Proposing Release"), in which the Securities and Exchange Commission (the "Commission") has requested comment on a proposed rule to require investment advisers registered under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), to file a new Form PF. Form PF is intended for use by the Financial Stability Oversight Council (the "FSOC") in monitoring risk to the U.S. financial system. Our comments focus specifically on the effect of the new Form PF filing requirements on private equity and growth capital funds ("private equity funds") and their affiliated private equity firms, which are sometimes also referred to as advisers, managers or sponsors (hereinafter, "private equity sponsors").

The Private Equity Growth Capital Council (the "PEGCC") is an advocacy, communications and research organization and resource center established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy. Established in 2007 and formerly known as the Private Equity Council, the PEGCC is based in Washington, D.C. The members of the PEGCC are 33 of the world's leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest.[1]

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1 The members of the PEGCC are: American Securities; Apax Partners; Apollo Global Management LLC; Avista Capital Partners; The Blackstone Group; Brockway Moran & Partners; The Carlyle Group; Crestview Partners; Francisco Partners; Genstar Capital; Global Environment Fund; GTCR; Hellman & Friedman LLC; The Jordan Company; Kelso & Company; Kohlberg Kravis Roberts & Co.; KPS Capital Partners; Levine Leichtman Capital Partners; Madison Dearborn Partners;

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As discussed in Section I below, the PEGCC respectfully requests that the Commission not require private equity sponsors to file Form PF. As discussed in our prior comment letters to the FSOC,[2] private equity funds and private equity sponsors do not present systemic risk concerns, because, among other things: (*i*) private equity funds and private equity sponsors are not meaningfully interconnected with other financial system participants, with very limited counterparty exposure; (*ii*) there is no meaningful financial interconnection between a private equity sponsor, the funds that it manages or the companies in which those funds invest ("portfolio companies"), and therefore the distress or failure of one portfolio company would not adversely impact the private equity fund, its sponsor, or any of its other portfolio companies;[3] (*iii*) private equity funds typically engage in little or no borrowing; (*iv*) private equity funds and private equity sponsors are too small in size to present systemic risk concerns; (*v*) private equity funds pursue long-term investing strategies focused on acquiring primarily illiquid securities; and (*vi*) investors in private equity funds typically are prohibited from redeeming their interests for the life of the fund, making a "run" on the fund impossible.[4]

The Proposing Release does not demonstrate that private equity sponsors or private equity funds are particularly interconnected with the financial system in ways that "make them too interconnected to fail."[5] Instead, the Proposing Release focuses on borrowing by portfolio companies. While the failure of a portfolio company would be extremely unfortunate for the company and its creditors and other stakeholders (including employees and shareholders), such a failure would not have any spillover effect on the private equity fund that had invested in the portfolio company, the sponsor of the private

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MidOcean Partners; New Mountain Capital; Permira; Providence Equity Partners; The Riverside Company; Silver Lake; Sterling Partners; Sun Capital Partners; TA Associates; Thoma Bravo; Thomas H. Lee Partners; TPG Capital (formerly Texas Pacific Group); Vector Capital; and Welsh, Carson, Anderson & Stowe.

2 Copies of the PEGCC's prior letters to the FSOC of November 5, 2010 and February 25, 2011 are attached.

3 Private equity funds and their sponsors do not guarantee or pledge assets to secure each others' obligations, nor is their debt (if any) cross-collateralized. The same is true between portfolio companies owned by a private equity fund.

4 Investors in private equity funds commit to invest in the fund for a period that could extend for ten years or more without any opportunity to redeem their interests. Therefore, unlike other types of financial firms, a private equity fund cannot be subject to a "run" by its investors seeking to redeem their interests that could have a cascading effect on the financial system (*e.g.*, by contributing to volatility in the securities markets that might result if a fund was required to dispose of its investment portfolio to meet redemption requests by its investors).

5 *See* Proposing Release, n. 54 (discussing issues related to Long-Term Capital Management, a hedge fund that was rescued through Federal Reserve intervention in 1998 because of concerns that it was "too-interconnected-to-fail.").

equity fund, other portfolio companies owned by the private equity fund or other funds managed by the sponsor. Thus, the expressed concerns in the Proposing Release fundamentally relate to the risks that a portfolio company may not repay a loan.

In the case of portfolio companies that are themselves financial institutions, the PEGCC believes that if the Commission or another regulator is concerned about borrowing by a financial institution, then the information concerning that company and its leverage should be obtained from the company or its regulator rather than from the company's shareholders (which in this case happen to include a private equity fund). There is nothing unique about private equity funds that would justify the imposition of a reporting requirement on them that is not applicable to other types of shareholders.

In the case of portfolio companies that are not financial institutions, the PEGCC believes, as an initial matter, that the risks posed by such companies do not fall within the jurisdiction of the FSOC. However, if the Commission is concerned (as the Proposing Release seems to suggest) that leveraged lending practices raise systemic risk concerns, the PEGCC respectfully requests that the Commission instead work with the FSOC and other regulators to collect information on these lending practices from the lending institutions (which do fall within the FSOC's jurisdiction). The PEGCC believes that lending institutions are the best source for this information because, among other reasons, (*i*) they will have information on the borrowing practices of all leveraged businesses, and not only the portfolio companies of private equity funds, and (*ii*) they will have information on all types of loans. As noted above, the PEGCC does not believe that a shareholder that happens to be a private equity fund should be treated differently than other shareholders. Furthermore, the PEGCC does not believe that there is any evidence to suggest that the financing arrangements entered into by portfolio companies of private equity funds are significantly different from the wide range of other types of financings entered into by other businesses, including loans to highly leveraged companies that are not owned by private equity funds.

More broadly, the PEGCC wishes to point out that the concepts of systemic risk and economic dislocation are distinctly different and should not be conflated. The former falls directly within the objectives of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The latter does not. Businesses across the United States are leveraged. Indeed, most businesses must depend on debt financing for capital because they cannot access equity markets. The intent of the Dodd-Frank Act is not to regulate how businesses use leverage in their capital structures but rather to regulate the extent to which an entity may, under certain adverse economic conditions, create cascading effects that imperil the financial markets or create risk to taxpayers. There is no justification for singling out private equity sponsors, alone among all shareholders of businesses in the United States, to be subject to a discriminatory and onerous reporting regime designed to monitor how their portfolio companies use leverage.

As discussed in Sections II, III and IV below, if—notwithstanding the lack of systemic risk, the lack of jurisdiction over portfolio companies that are not financial institutions and the limitations and inefficiencies of obtaining borrowing information from portfolio companies—the Commission concludes that private equity sponsors should be required to file Form PF, the PEGCC respectfully requests that private equity sponsors should not be required to file the Form more frequently than annually and that the Form should be substantially revised to take into account the structures, operations (*e.g.*, valuation procedures), and lower relative risks of private equity funds and private equity sponsors.

The PEGCC also respectfully requests that the Commission adopt the compliance date, amendment and certification changes outlined in Section V below.

I. Private Equity Funds and Their Sponsors Do Not Present Systemic Risk Concerns that Justify the Amount of Reporting Required by Proposed Form PF

As the Commission has noted, the PEGCC has previously addressed in great detail why private equity funds and their sponsors do not present systemic risk concerns.[6] While we do not repeat those arguments here, we do wish to respond to the reasons provided by the Commission in Section II.A.3 of the Proposing Release for its initial conclusion that the activities of private equity sponsors (or, more precisely, borrowing by portfolio companies) may be important to the assessment of systemic risk to the U.S. financial system. The Commission seems to put forward four overlapping concerns that lead it to its initial conclusion. We do not believe that any of these four concerns (discussed in paragraphs A, B, C, and D below) is valid or demonstrates that private equity sponsors (or private equity funds or their portfolio companies) pose any systemic risk concerns. Further, these concerns do not provide a basis for the onerous reporting regime that the proposed Form PF would impose on private equity sponsors.

A. *Bridge Financings Do Not Present Systemic Risks*

The first concern set forth in the Proposing Release is that the bridge loans that are employed in certain private equity acquisition transactions may raise systemic risk concerns. The Commission points out that leveraged private equity transactions often rely on banks to provide bridge financing until the permanent debt financing for the transaction is completed. The Commission goes on to state that "[w]hen market conditions suddenly turn, these institutions can be left holding this potentially risky

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[6] *See* Proposing Release, n. 77 (citing Comment Letter of the Private Equity Growth Capital Council (Nov. 5, 2010) responding to the Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, Financial Stability Oversight Council Release (Oct. 1, 2010), 75 FR 61653 (Oct. 6, 2010)). *See also* the PEGCC's letters, *supra* note 2.

bridge financing (or committed to provide the final bank financing, but no longer able to syndicate or securitize it and thus forced to hold it) at precisely the time when credit market conditions, and therefore the institutions' own general exposure to private equity transactions and other committed financings, have worsened."[7]

Bridge financing is but one of many techniques used by operating companies and management buy-out teams as well as private equity funds to finance an acquisition of a company. Bridge financings serve to make the sale process of a company more competitive. In a typical buyout transaction involving possible bridge financing, a private equity fund, on behalf of a portfolio company (or an acquisition vehicle), arranges a bridge commitment from one or more lenders to provide "back up" financing to the portfolio company (or the acquisition vehicle) that will be available if a public bond financing, or other form of more permanent financing, cannot be completed before an acquisition transaction closes. This back-up financing provides greater certainty that the underlying transaction will close, thereby benefiting the seller (*i.e.*, the company's owners, who may include public shareholders), particularly where the seller is in need of liquidity. Bridge loans, therefore, help support the financial stability and liquidity of the seller.

As a general matter, the PEGCC believes that focusing on bridge loans places a disproportionate emphasis on a small segment of leveraged buyout financings.[8] The PEGCC further believes that the terms of "bridge loans" have evolved dramatically over time (and continue to evolve) depending on various market forces. To the extent that the FSOC is concerned about lending practices relating to portfolio companies, the PEGCC believes that bridge loans should not be analyzed separately from other lending to portfolio companies (discussed below)—or to other leveraged businesses, for that matter. For example, the risks relating to the inability to syndicate bridge loans do not present fundamentally different issues than the inability to syndicate other types of debt incurred by any type of borrower as part of any type of financing.[9]

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7 Proposing Release, p. 24 – 25.

8 For the period from 1999 to 2010, bridge loans were generally less than 2% (and never exceeded 5%) of the total source of proceeds for leveraged buyouts. Standard & Poor's, LCD's Leveraged Buyout Review – 1Q11 (2011). The Commission only cited one article to support the importance of bridge loans to leveraged private equity transactions. *See* Proposing Release, n. 71 (citing Steven M. Davidoff, *The Failure of Private Equity*, 82 S. Cal. L. Rev. 481, 494 (2009)). The Davidoff article provides little data on the amount of bridge financing actually used by private equity funds.

9 We note that the reports referenced in n. 72 of the Proposing Release discuss the risks relating to undistributed bridge loans in the context of a wide variety of other types of loans, such as securitized loans and other debt instruments. *See* Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence, at 2 (Mar. 6, 2008) (not mentioning private equity, bridge loans or leveraged buyouts specifically but rather referencing the general issue of "leveraged loans to corporate borrowers"); Private Equity and Leveraged Finance Markets, Bank for International

Furthermore, the PEGCC believes that the Proposing Release mischaracterizes bridge loans as a risky form of financing. Bridge financing is relatively expensive compared to public bonds, so borrowers generally prefer not to draw on bridge commitments if a public bond offering can be completed on a timely basis. In addition, bridge loans may or may not be secured by the assets of the borrowing portfolio company. These factors, or the absence of a financing alternative at any point in time, also do not necessarily mean that the bridge financing, as such, is unduly risky relative to other forms of financing. The PEGCC also submits that, if this perception of risk is based on a view that bridge financing is short-term financing that must be refinanced within a short period of time or a default will result, that perception is incorrect. Any bridge financing which is not repaid or subsequently refinanced within a relatively short period of time is, by its terms, converted to long-term debt.

Finally, the PEGCC believes that any perceived systemic risk resulting from bridge financings is best dealt with by the prudential regulators of the lending institutions, either through reporting or regulation. There is no reason to impose reporting burdens on private equity sponsors. If in fact there is a problem with bridge commitments and loans (and the PEGCC is not aware of any history of serious problems with the repayment of bridge loans by portfolio companies), it exists primarily if lenders are not adequately capitalized, or if they otherwise fail to mitigate the risk (for example, by not syndicating their funding obligations before signing the commitment letter, or by not taking other risk mitigation steps such as reducing the number of the types of lending arrangements that they enter into).

These issues are presented in other lending contexts as well (including bridge loans where the underlying transaction does not involve any private equity fund).[10] To the extent a problem exists, it is with lending practices generally, not one created by one particular class of borrowers or a particular type of loan. This concern, if valid, is best addressed through prudential regulation of the lending institution—not by imposing reporting burdens on private equity funds and their sponsors and portfolio companies.[11] Reporting by lenders on their lending in a variety of contexts (including bridge loans)

Settlements Committee on the Global Financial System Working Paper No. 30 (Jul. 2008) at 1-2, available at http://www.bis.org/publ/cgfs30.pdf (discussing leveraged buyout activity in the context of the larger leveraged loan market); Bank of England, Financial Stability Report, at 19 (Oct. 2007), available at http://www.bankofengland.co.uk/publications/fsr/2007/fsrfull0710.pdf (discussing the issues of bridge loans along with asset-backed securities and commercial paper).

[10] *See* Michelle Sierra, AT&T $20b bridge loan draws pricing of 75bp, Reuters (Mar 29, 2011) (describing bridge loan in the proposed purchase of T-Mobile USA by AT&T). We note that according to this source, the largest two bridge loans in the U.S. have not involved private equity funds.

[11] The PEGCC also believes that the total outstanding amount of bridge financing at any time is relatively small and, therefore, highly unlikely to pose a risk to the financial system.

seems to us to be more likely to address the Commission's concerns and uncover potential systemic risks, as compared to requiring reporting only with respect to certain types of shareholders (*i.e.*, private equity funds) of certain borrowers (*i.e.*, portfolio companies).

B. *Portfolio Company Leverage Does Not Present Systemic Risk*

The second concern put forward in the Proposing Release is that "the leveraged buyout investment model of imposing significant amounts of leverage on [a private equity fund's] portfolio companies in an effort to meet investment return objectives subjects those portfolio companies to greater risk in the event of economic stress."[12] Although the Commission appears to be particularly concerned about the prospect of a private equity fund effecting a leveraged buyout of "an entity that could be systemically important"—a concern that we address in section I.D. below—the Proposing Release suggests that the Commission may be concerned about leverage of portfolio companies generally.

As the PEGCC has discussed at length in letters to the FSOC,[13] private equity sponsors and private equity funds generally are not leveraged, and, while some portfolio companies are leveraged, the amount of leverage is relatively modest.[14] Defaults related to the debt of private equity portfolio companies after the latest recession were below average.[15] In any event, the failure of a private equity portfolio company that is not itself

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[12] Proposing Release, p. 26.

[13] *See* the PEGCC's letters, *supra* note 2.

[14] The average gross leverage ratio of private equity deals is historically approximately 2.85:1, although some portfolio companies may be materially more or less leveraged. Standard & Poor's Q4 2010 Leveraged Buyout Review. By comparison, Lehman Brothers was leveraged at approximately 32:1 at the end of February 2008, a gross leverage ratio relatively common among large broker-dealers at that time. See Lehman Brothers Holdings Inc., Quarterly Report on Form 10-Q, for the quarterly period ended February 29, 2008, at pages 5-6 (available at http://www.sec.gov/Archives/edgar/data/806085/000110465908023292/a08-10156_110q.htm). See also Tobias Adrian and Hyun Song Shin, "Liquidity and Leverage, *Journal of Financial Intermediation* (2010), at page 433, Figure 16.

[15] The PEGCC is not aware of any evidence that private equity-owned businesses default on their debt obligations at a rate greater than other businesses. In fact, there is evidence that the default rate for private equity fund portfolio companies is lower than the average default rate for all U.S. corporate bond issuers. *See* Kaplan, Steven N. and Per Stromberg, "Leveraged Buyouts and Private Equity," *Journal of Economic Perspectives,* Volume 23, Number 1 (Winter 2009) (analyzing data on 17,171 worldwide private equity acquisitions announced between 1970 and 2002 and finding that the annualized default rate as of 2007 for private equity portfolio companies was 1.2%, compared to the average default rate of 1.6% reported by Moody's for all U.S. corporate bond issuers); Thomas, Jason, "The Credit Performance of Private Equity-Backed Companies in the 'Great Recession' of 2008–2009," *Entrepreneurship & Finance,* Vol. 5, No. 30 (April 12, 2010), supported by the PEGCC, available at SSR: http://ssrn.com/abstract=1582666 (analyzing private equity-backed companies

systemically significant does not present systemic risk concerns because of the way that private equity sponsors, funds and portfolio companies are structured (*e.g.*, no cross-collateralization, as discussed above).

Similar to the situation with respect to bridge loans, there is nothing unique about a lender's loans to private equity portfolio companies that would make them more risky than a wide range of other types of loans made by the lender to other companies owned by public shareholders, public companies or other institutional investors.

Therefore, the PEGCC submits that the most direct manner to obtain information concerning these types of systemic risks, if any, is to collect the information from the lenders who face such risks and not from the borrowers. The PEGCC believes that banks and other lending institutions are in the best position to collect and compare information across all types of borrowers (*e.g.*, a bank's exposure to all highly leveraged companies, whether the owner is a private equity fund or another type of owner), and to provide information that will allow regulators to assess the systemic risks (if any) that such lending practices present. Requiring private equity sponsors to provide reports on these loans would be duplicative of information provided by the lending institutions to their regulators. For these reasons, we do not believe that the reporting burden described in the Proposing Release should be placed on private equity sponsors or funds, when the necessary information is more readily available from banks and other lending institutions.[16]

C. *Favorable Financing Terms Do Not Create Systemic Risk*

In support of its conclusions regarding the risks relating to bridge loans, specifically, and portfolio company leverage, more generally, the Commission noted that "prior to the recent financial crisis, a trend in private equity transactions was for private equity sponsors to enter into buyout transactions with seller-favorable financing conditions and terms that placed much of the risk of market deterioration after the transaction agreement was signed on the financing institutions and the private equity adviser."[17]

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acquired in a buyout or similar transaction between 2000 and 2009 and held through 2008-2009 and finding that private equity-backed businesses defaulted at less than one-half of the rate of comparable companies during 2008-2009).

16 To the extent that a bank or other lending institution is not within the jurisdiction of the FSOC, we believe that the underlying loans are unlikely to present a systemic risk to the U.S. financial system. Under these circumstances, any increased risk exposure would be to institutions that are outside of the U.S. financial system. As discussed, the borrower (such as a private equity fund's portfolio company) does not itself present systemic risks to the U.S. financial system.

17 Proposing Release, p. 25.

Rather than creating systemic risks, the PEGCC believes that the "covenant-lite" and other favorable terms negotiated by some borrowers with some lenders are actually a source of stability to portfolio companies during periods of economic stress. These terms reduce the number of defaults by portfolio companies that would ordinarily be tripped by covenants and encourage negotiations between a lender and its borrower during times of stress (rather than incentivizing the lender to immediately exercise its default remedies).[18]

The PEGCC believes that it would be a serious mistake to conclude that the ability of private equity portfolio companies (and other borrowers) to obtain financing on favorable terms creates systemic risk.[19] It certainly should not provide a basis for imposing a burdensome reporting regime on private equity sponsors.

D. *Investments in Financial Companies by Private Equity Funds Do Not Provide a Basis for Discriminatory Treatment*

The Proposing Release states that if a private equity sponsor or fund "conducts a leveraged buyout of an entity that could be systemically important, information about that investment could be important in the FSOC monitoring and assessing financial risk."[20] It is not clear (and it is not discussed in the Proposing Release) what additional risks a private equity fund investment in a systemically important bank or nonbank financial institution places on the bank or nonbank financial institution, as compared to an investment by any other type of investor. Furthermore, it is not clear why a private equity fund should be required to provide the information of interest to the FSOC, and not the financial institution itself.

If the FSOC wishes to obtain information about the leverage levels of banks and nonbank financial institutions that could be systemically important, the PEGCC believes that it should obtain that information from those institutions, not from their securityholders. If the FSOC wishes to obtain information on equity holders of systemically important financial institutions, it is likely that banking regulators will receive from a systemically important lending financial institution more than sufficient

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18 *See* Michael N. Reczek, An Examination of the Value of Covenant Lite Debt to Issuing Companies (April 1, 2010), available at http://w4.stern.nyu.edu/glucksman/docs/Reczek2010.pdf (discussing "the ability to delay bankruptcy and the associated restructuring costs" among the values of covenant-lite debt).

19 Despite the talk about private equity borrowers, the Commission's discussion of "seller-favorable financing conditions and terms" seems to focus on the failure of lending institutions either to adequately understand or manage the increased risks relating to changes in the conditions and terms of loans. *See* Proposing Release, p. 25. We believe that this supports our conclusion that the best method to obtain information concerning the systemic risks relating to leveraged loans and bridge loans is from the lenders.

20 Proposing Release, p. 26.

information on any shareholder (including any private equity fund) that is a significant investor in that institution.

II. Recommended Modifications to the Obligation to File Form PF and Related Definitions

As noted above, the PEGCC does not believe that private equity funds present the types of systemic risk concerns that justify requiring private equity sponsors to report on Form PF, and that there are more efficient and effective ways to obtain information about leveraged lending practices and exposures (*i.e.*, by obtaining such information from lenders). As discussed below, the PEGCC believes that the Commission has the discretion not to require private equity sponsors to file Form PF. The PEGCC believes that the Commission should use its discretion accordingly to exclude private equity sponsors from the Form PF filing requirements or, at least, to tailor the reporting requirements to address those concerns that the Commission has identified.

A. *The Form PF Reporting Obligation Need Not Apply to All Registered Private Fund Advisers*

The Commission appears to interpret new Section 204(b)(5) of the Advisers Act to mean that it must require all registered investment advisers with private fund clients to file Form PF.[21] As the Commission has recognized, however, the literal language of the statute is not clear on whether the rulemaking and reporting is mandatory.[22] We believe that Congress provided the Commission with sufficient flexibility to decide which investment advisers should be required to provide reports about private funds as well as what information those investment advisers should be required to report. This Congressional intent is shown generally in the repeated use of the clause as "necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk by the Financial Stability Oversight Council" in various provisions of Section 204(b).[23] Specifically, Congress applied this standard to Section 204(b)(1)(A), which provides the Commission with the discretion to determine which advisers must file these reports. Section 204(b)(5) provides the Commission with the discretion to determine which information should be contained in the reports; there is no reason to believe, however, that this provision limits the discretion of the Commission to determine that certain classes of private fund advisers should not be required to file the reports. Therefore, we do not believe that it would be appropriate to read Section

21 *Se*e Proposing Release, n. 101.

22 *See* Proposing Release, n. 12 (stating that Section 204(b)(1) should not be read in isolation).

23 *See* Sections 204(b)(1)(A), 204(b)(3)(H), 204(b)(4) and 204(b)(5).

204(b)(5) in isolation as limiting the discretion of the Commission to impose reporting obligations on some classes of private fund advisers but not on others.

Furthermore, the Commission has broad discretion to impose different requirements on different classes of investment advisers. For example, Section 211(a) provides the Commission with the power to "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters." Congress affirmed this discretion with regard to private fund advisers in the new Section 203(n).[24] Section 203(n) specifically directs the Commission to "take into account the size, governance, and investment strategy" of the private funds advised by a newly registered investment adviser and to tailor the Advisers Act requirements to "reflect the level of systemic risk posed by such funds."

Thus, the Commission has the discretion <u>not</u> to impose the new reporting regime on private equity sponsors if the Commission concludes (as it can) that such a filing is not necessary and appropriate for the assessment of systemic risk.

B. *The Definitions of Various Types of Private Funds Are Fundamentally Flawed and Should Be Modified*

Proposed Form PF defines the term "private equity fund" by what it is not—that is, a private equity fund would be a "private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course." Because the proposed definition of "private equity fund" depends on the scope of the definition of "hedge fund" and because of the extensive reporting required by advisers to "hedge funds," it is critical that the Commission ensure that funds that are intended to be classified as "private equity funds" are not mistakenly classified as "hedge funds."[25]

As noted below in Section II.B.2, the PEGCC believes that, if the Commission concludes that private equity sponsors should file Form PF, the Commission should only require reporting with respect to those funds that present systemic risk concerns based on the nature of their portfolio companies. We believe that this may be done either by

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24 *See also* Proposing Release, n. 41.

25 While not without their issues, we do not comment in this letter on the definitions of liquidity fund, real estate fund, securitized asset fund or venture capital fund, since they do not appear to encompass funds that would ordinarily be considered private equity funds for these purposes. We note that many private equity funds share many of the characteristics of venture capital funds and, like venture capital funds, do not present systemic risks. Similarly, we note that many real estate funds may have characteristics similar to hedge funds (*e.g.*, making portfolio investments that incorporate a significant amount of leverage). The fact that Form PF does not impose onerous reporting burdens on sponsors of large real estate funds suggests that such burdens should not be imposed on private equity sponsors or their funds.

tailoring the definition of "private equity fund" or defining sub-categories of private equity funds.

If the Commission decides to include a definition of "private equity fund," the PEGCC believes that it would be more straightforward and more accurate to define a private equity fund affirmatively based on the structural characteristics of the typical private equity fund: (*i*) the fund does not provide investors with redemption rights in the ordinary course; (*ii*) the fund calculates incentive allocations (carried interest allocations) based *primarily* on gains realized from sales or other dispositions of portfolio companies, and not based *primarily* on unrealized appreciation in the fund's portfolio;[26] and (*iii*) the fund has not borrowed an amount in excess of one-half of its net asset value (including any committed capital) and does not have a gross notional exposure in excess of twice its net asset value (including any committed capital).[27] We believe that these elements capture the essence of the structure of a private equity fund and would not reflect the characteristics of the typical hedge fund.

1. Definition of "Hedge Fund"

If the Commission decides to maintain the definition of "private equity fund" currently in the Proposing Release, the PEGCC believes that the definition of "hedge fund" must be modified to ensure that it does not result in "private equity funds" being mistakenly classified as "hedge funds."

Form PF defines the term "hedge fund" as a private fund that: (*i*) has a performance fee or allocation calculated by taking into account unrealized gains; (*ii*) may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital); or (*iii*) may sell securities and other assets short.

We believe that the definition of "hedge fund" is overly broad and could catch many private equity funds that are not, and were not intended to be, included in the hedge fund reporting regime. The definition should be modified, as discussed below.

First, the use of the term "may" in reference to borrowing and short selling is problematic. Private equity fund documents are often worded to give the sponsor the

26 The use of the term "primarily" in this element of the definition is important. As discussed below, we believe that this element of the hedge fund definition may present technical issues for certain private equity funds.

27 Under this approach, the Commission should add an exclusion from the definition of "hedge fund" for any fund that is a private equity fund. We assume that the Commission would also maintain its existing exclusions from the definition of private equity fund for liquidity funds, real estate funds, securitized asset funds and venture capital funds.

ability to pursue the investment objectives of the fund, even if, as a practical matter, it is unlikely or there is no expectation that the sponsor would undertake a particular activity.[28] The fact that a fund has the authority to ("may") incur debt or sell short, even if does not actually do so, should not cause the fund to be characterized as a hedge fund. If these activities do present the types of risk that warrant the type of reporting that is appropriate for hedge fund sponsors, a private equity sponsor should not be required to comply with those requirements until a fund that it manages actually engages in such activities. The PEGCC urges the Commission to modify the definition of hedge fund to this effect.

Second, the absence of any materiality or other similar threshold concept with respect to short selling is problematic. We understand why the Commission would focus on short selling in an effort to describe the activities of a hedge fund. In doing so, however, the Commission should not create a definition so broad that it includes private equity funds. As a general rule, private equity funds do not sell securities short, but exceptions exist.[29] Even if a fund engages in short selling, the fund should not be considered a hedge fund if such activities are not a material part of its investment strategy and are not engaged in to any material extent or are not engaged in for speculative purposes. The PEGCC urges the Commission to modify the definition of hedge fund to this effect.

Third, the Commission's inclusion of a bright-line performance fee test as part of the definition of hedge fund could lead to unintended results. This test appears to be based on the fact that, in general, hedge funds calculate performance fees (often referred to as incentive allocations) based on unrealized gains and that private equity funds calculate performance fees or allocations (typically referred to as carried interest) based

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28 The PEGCC believes that using a potential standard ("may") as opposed to an active standard ("does") leads to more difficult interpretative questions and less clarity. We note that most private equity funds do not borrow or engage in short selling. Many private equity funds are prohibited by the terms of their governing documents from borrowing or engaging in short selling. Some private equity funds simply do not borrow or engage in short selling, but the fund documents are silent on the issue. Furthermore, some private equity fund documents give the fund broad latitude to pursue its investment objectives and do not expressly prohibit the fund from borrowing, so technically the fund "may" borrow—even if the fund is effectively restricted from borrowing (*i*) by statements made in the private placement memorandum prepared when interests in the fund are marketed to investors, or (*ii*) because the fund is required by its governing documents to use reasonable best efforts (or some variation thereof) to avoid the receipt of "unrelated business taxable income" (a type of income that can arise from the incurrence by a fund of acquisition indebtedness) in the hands of the fund's partners.

29 Some private equity funds may be permitted to sell short "but not for speculative purposes." Some private equity funds may engage in limited hedging activity to protect against currency fluctuations or, under certain circumstances, engage in limited short selling for specific risk management purposes.

on realized gains.[30] We note that hedge fund and private equity fund performance fee calculations can be distinguished in other respects: (*i*) private equity funds generally include general partner clawback clauses,[31] while hedge funds generally do not; (*ii*) private equity funds generally calculate and receive their performance fees at or after the time of an event, not periodically, whereas hedge funds generally calculate their performance fees on a periodic basis generally not exceeding one year; and (*iii*) the performance fees of private equity funds are only paid out of realized gains (even if the allocation of the gains may be in part based on unrealized gains and losses). The PEGCC urges the Commission to modify the performance fee element of the definition of hedge fund so that it reflects that hedge funds calculate performance fees based *primarily* on unrealized gain.

Finally, the PEGCC believes that the Commission should define a "hedge fund" to be any fund meeting three out of the following four characteristics: the three current factors discussed above (short selling, borrowing, and performance fee) and the presence of periodic redemption rights for investors, subject to limitations such as lock-up periods.[32] We believe that such an approach would encompass all of the hedge funds, while minimizing the unintended risk that a private equity fund would be improperly categorized as a "hedge fund."

2. The Definition of "Private Equity Fund" Should Be More Focused on Perceived Risks

Assuming that the Commission concludes that certain types of private equity funds may present systemic risks, the PEGCC believes that the definition of "private equity fund" is overbroad considering the limited systemic risks identified in the Proposing Release. The systemic risk discussion appears to focus only on two types of

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30 In certain circumstances the calculation of carried interest may take into account unrealized gains and losses—although, not in a manner that increases the carried interest amount, above the amount that would be distributed were unrealized gains and losses not taken into account. For example, in certain private equity funds, when a realization (*e.g.*, sale) of a portfolio investment occurs, the general partner is entitled to a percentage of the gains realized on the sale, reduced by any unreimbursed losses from previous realizations and, often, further reduced by unrealized losses in the portfolio—or reduced by unrealized losses net of unrealized gains in the portfolio.

31 A general partner clawback requires the return of a certain portion of any performance fee received by the general partner from a fund where the amount previously distributed to the general partner exceeds the amount it should have received based on the subsequent realization of the fund's investments.

32 As implicitly noted in the current definition of "private equity fund," another key factor that distinguishes private equity funds from hedge funds is that private equity funds typically do not offer their investors redemption rights in the ordinary course, whereas hedge funds typically do following an initial lock-up period and are subject to "gates" and other limitations.

private equity funds: (*i*) leveraged buyout funds and (*ii*) funds that invest in financial institutions. The term "private equity fund," however, is defined as a "catch all" bucket into which the Commission sweeps most private funds that are not hedge funds, liquidity funds, real estate funds, securitized asset funds or venture capital funds.[33] As noted above, the Commission's concerns about leveraged buyout funds seem unwarranted. If the Commission has concerns about private equity funds that invest primarily in financial institutions, and concludes that Form PF is the most efficient means to collect data about such risks (as noted above, we do not believe that it is), then the obligation to file Form PF should be modified (either by changing the definition of private equity fund, or modifying the rule elsewhere) so that it is limited to investment advisers that manage private equity funds that invest primarily in such financial institutions.

3. Definition of "Large Private Fund Adviser"; Annual Calculation

Form PF will impose particularly onerous reporting requirements on private equity sponsors that fall within the term "Large Private Fund Adviser" as defined in proposed Form PF. The Commission acknowledges that private equity funds "present less potential risk to U.S. financial stability" than hedge funds and liquidity funds,[34] yet the Commission uses the same threshold of $1 billion in assets under management for each type of private fund adviser. The PEGCC urges the Commission to eliminate the concept of Large Private Fund Adviser with respect to private equity sponsors in recognition of the very low systemic risk concerns that private equity sponsors and private equity funds present.

If the Commission is unwilling to take this approach, the PEGCC urges the Commission to increase significantly the threshold categorizing a private fund sponsor as a Large Private Fund Adviser in recognition of these lower risks. In addition, the Commission should base the reporting requirement on a metric other than assets under management. Specifically, the PEGCC recommends that the Commission measure a private equity sponsor's size based on the proprietary assets of the private equity sponsor, inclusive of the private equity sponsor's own investments in the funds (and portfolio companies) that the sponsor manages. The assets that the private equity sponsor manages for third-party investors (whether pursuant to separate managed account arrangements or through private equity funds managed by the sponsor) should not be counted.

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33 The definition also excludes private funds where the fund does not provide investors with redemption rights in the ordinary course.

34 Proposing Release, p. 19. For its part, as discussed above and in the letters referred to in footnote 2 above, the PEGCC believes that the size of a particular private equity sponsor or fund is not particularly relevant to a systemic risk analysis in the absence of cross-collateralization with another private equity fund or sponsor and in view of the limited interconnectedness with other financial system participants.

In addition, we believe that the calculation of whatever metric is used to determine if a private equity sponsor is a Large Private Fund Adviser should only be required to be made annually. Given that private equity funds typically make long-term investments in operating businesses, the value of their assets under management is less likely to fluctuate, or be relevant, in the short term. Also, given that their investments typically are illiquid, those assets are difficult to value. In view of these two facts, we do not see the utility to regulators (and we do see the burden on private equity sponsors) of requiring mid-year changes in Form PF reporting. The PEGCC therefore respectfully recommends that, to reduce the administrative burden on private equity sponsors and the Commission, the Large Private Fund Adviser determination (if any) be made only at the time of a private equity sponsors' annual filing.

4. Definition of "Fund of Funds"

The PEGCC believes that the definition of "fund of funds" is too narrow, in that it is limited to private funds that invest exclusively in other private funds. We believe that, at a minimum, a fund of funds should be permitted to invest in cash and other similar short-term investments pending long-term investment. Furthermore, we believe that a fund of funds should be allowed to engage in a *de minimis* amount of direct investing (for example, by permitting a fund of funds to invest up to 30% of its capital commitments in direct, non-fund investments).[35] The PEGCC urges the Commission to modify the definition in these respects.

5. Definition of "Controlled Portfolio Company"

A private equity sponsor would be required to provide more detailed information with respect to the portfolio companies that it "controls." However, the definition of "control" imported from Form ADV (where there is a presumption that a person has "control" of a company if it holds more than 25% of the company's voting securities) is too broad. First, private equity funds with minority stakes may not be in a position to cause the portfolio company to take on the leverage the Commission has identified as presenting systemic risks. Second, these funds may also not be in a position to cause the portfolio company to provide the necessary information for the required reporting. The PEGCC believes that, for purposes of Form PF, the definition of "control" should only cover situations where the private equity fund owns a majority of the portfolio company's voting securities.

[35] The threshold should be expressed as a percentage of total capital commitments rather than a percentage of invested assets to provide greater assurance that the timing of an investment or disposition does not impact the fund's categorization.

III. Recommended Modifications to the Information Required to Be Provided on Form PF

With regard to the information required on Form PF, the PEGCC believes that, as a general matter, the form should focus less on the reporting of specific detailed data. As the Commission has noted, where Form PF indicates that a specific fund presents a systemic risk, the Office of Financial Research may make more targeted requests for information.[36]

Furthermore, as noted above, we believe that (*i*) lenders, and not portfolio companies (borrowers) or their private equity fund owners (or the funds' sponsors), are the best source for information regarding lending (*e.g.*, bridge loans), and (*ii*) the definitions of hedge fund and private equity fund have not yet been tailored sufficiently to the point where the funds that will be required to provide this detailed information will be of the type the Commission has identified as presenting systemic risks.

We have identified several specific Form PF reporting requirements that should be modified or eliminated.

A. *Performance Reporting*

The Commission should not require quarterly or monthly performance calculations by private equity sponsors.[37] The PEGCC is not aware of any private equity funds that calculate their performance on a monthly basis. The Commission appeared to acknowledge this fact in connection with its comparison of certain types of private fund managers in discussing the reporting requirements imposed on Large Private Fund Advisers.[38] Nor is there any practical need for private equity sponsors to value their assets monthly. As discussed below, such a requirement, whether monthly or quarterly, would impose significant burdens on private equity sponsors. The value of such reports in assessing systemic risk is dubious.

B. *Creditor Identification*

The Commission should not require that every private fund (no matter its investment strategy or size) identify each creditor with respect to borrowings equal to at least 5% of the fund's net asset value.[39] It is unclear how this information will benefit

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[36] *See* Proposing Release, pp. 16, 18.

[37] Form PF, Section 1b, Item C, Number 14.

[38] *See* Proposing Release, p. 32.

[39] Form PF, Section 1b, Item B, Number 10.

financial service regulators and it is likely duplicative given that much of this information could be provided by the lending financial institutions. Furthermore, providing this information would be very burdensome on private equity sponsors.

In addition, if the Commission decides to require this information on Form PF, the PEGCC believes that the Commission should not require that the creditor be identified if a borrowing that exceeds the 5% limit has been securitized or syndicated. Under these circumstances, the portfolio company may not know who the "creditor" is and there may be no practical way to find out.

C. *Portfolio Company Information*

The PEGCC does not see any reason why Form PF should require a private fund sponsor to provide any portfolio company data with respect to a portfolio company that has issued public securities (debt or equity) and files reports with the Commission under the Securities Exchange Act of 1934. These portfolio companies already make extensive, publicly available filings that can be a source of data for the Commission and other regulators.

In addition, the Commission should not require reporting of information on the indebtedness of portfolio companies, either on an aggregate or individual basis.[40] As discussed above, there is no evidence that borrowing by portfolio companies raises systemic risk concerns, or that the borrowings by these companies are any different than any other company's indebtedness from a systemic risk perspective.

We also believe that obtaining, standardizing and reporting that information will be more burdensome than the Commission anticipates. For example, as discussed above, a private equity fund might be deemed to "control" a portfolio company for Form PF purposes, but not have sufficient influence to receive the detailed information necessary to break down the portfolio company's indebtedness by maturity. In addition, debt-to-equity ratios are highly dependent on the accounting methodologies of the underlying portfolio company, making, for example, a calculation of a weighted average unreliable. This unreliability may be increased in times of economic stress when accounting values differ most markedly from actual market value, meaning that these items would be least reliable when they are most necessary.

D. *PIK and Zero-Coupon Debt*

The Commission should not require information on pay-in-kind (PIK) or zero-coupon debt. The Commission has not identified any systemic risk associated with these financial instruments that would warrant such granular reporting.

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[40] Form PF, Section 4, Item B, Numbers 59 – 62.

E. *Breakdown of the Fund's Investments by Industry and Geography.*

Form PF would require private fund advisers to provide breakdowns of each reporting fund's investments by industry, plus a geographical breakdown of the reporting fund's investments by percentage of gross asset value.[41] Such granular reporting should not be required. The Proposing Release does not identify the purpose that disclosure of this data would serve. For example, does the fact that a private equity fund has invested a substantial amount of assets in Brazil have any bearing on systemic risk? If it does, the Proposing Release does not explain what that might be.

IV. Quarterly Filing Requirements Impose Disproportionate Burdens on Private Equity Sponsors that Are Large Private Fund Advisers

Large Private Fund Advisers would be required to file Form PF on a quarterly basis within 15 calendar days after the end of each calendar quarter. While we disagree that a private equity sponsor should be required to file quarterly reports on Form PF, a 15-day deadline would be utterly impractical, given the level of detail and specificity that would be required. The Commission dramatically underestimates the amount of time that would be required to collect and generate the required information, as well as the amount of time and costs that would be required to develop the systems required to support these reports. The PEGCC believes that many of its members do not have portfolio accounting and risk systems presently designed to produce the information the proposed Form PF would require, particularly on a quarterly basis.

For example, a private equity sponsor would be required to determine its regulatory assets under management as well as performance-related information (which we discuss below). While we believe that this might be a challenge even for a fund that invests primarily in publicly-traded securities, it would be a totally inadequate period of time for a sponsor that manages a portfolio of illiquid assets. The valuation process of most private equity funds involves a detailed review of the financial and business affairs of each portfolio company (based on a number of assumptions and estimates) and multiple layers of review and approval including, generally, the sponsor's audit committee and, in certain circumstances, the fund's investor advisory committee. In addition, this process generally cannot begin until each portfolio company provides the necessary financial statements, which may not be for 60 days after the end of the quarter. Furthermore, the PEGCC believes that additional legal review would be required with respect to any filing with the Commission.[42]

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[41] Form PF, Section 4, Item B, Numbers 67 and 68.

[42] We also question the requirement that the annual Form PF be filed on or before the date on which the private fund sponsor's annual Form ADV update is due. The firm's compliance, financial, legal and administrative personnel would be focused on preparing two extremely important, fact intensive and

Requiring private fund sponsors to file quarterly reports suggests that the Commission believes that the portfolios of private equity funds can fluctuate dramatically in the short term. As a general matter, they do not. A private fund generally has an "investment period" of approximately 5 to 6 years to invest commitments. Depending on the transaction environment, these investments and realizations of investment may be made more or less rapidly. However, unlike many types of funds (including mutual funds), private equity fund portfolios are not subject to rapid turnover, and it is difficult to see the value to regulators focusing on systemic stress or risk the benefits that would be gained from such frequent reporting.

Finally, it is unlikely that quarterly filings will reveal trends that would provide meaningful information that could be used to identify systemic risk. Since all of the returns to investors are derived from realized gains, the interim performance data is essentially economically immaterial.

Taken together, the PEGCC believes that (*i*) the increased burden of requiring quarterly reporting of performance-related information outweighs any marginal benefit to the Commission or the FSOC; and (*ii*) to the extent that any quarterly reporting is required, the Commission must provide a time period of at least 90 days for a private equity sponsor to execute its rigorous valuation process.

V. Procedural Issues

A. *Recommended Modifications to the Form PF Compliance Date*

If it does not exempt private equity sponsors from the obligation to report on From PF, the Commission should, at a minimum, delay the effective date of the reporting requirements for a year. Form PF requests quite complex information and prospective filers should have an opportunity to develop the reporting systems necessary to produce accurate and timely information. This is particularly important given the potential liability for reporting inaccurate information or not updating the form on a timely basis.

B. *Amendment to the Filing*

The PEGCC believes that, given the hasty filing schedule, investment advisers should be given flexibility to amend their filings to correct inaccuracies promptly upon discovery. For example, if a private equity sponsor who is a Large Private Fund Adviser receives new data regarding a portfolio company after the 15-day quarterly filing window, the sponsor should be allowed to amend its Form PF to provide the updated information without the risk of adverse consequences. For purposes of clarity, any such

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sensitive filings that would be due at the same time. We suggest that the annual filing date for Form PF be at least 60 days after the deadline for Form ADV annual filings.

amendment should not be viewed as violating the certification of Form PF (discussed below).

C. *Certification Requirement*

The PEGCC does not believe that the certification requirement of Form PF is appropriate in view of the nature of the information to be reported (*e.g.*, valuation of illiquid assets) and the filing schedule proposed by the Commission. As we have noted, the filing schedule envisioned by the Commission will necessarily curtail the ordinary valuation processes of private equity sponsors and, therefore, will make certification more difficult. At a minimum, the PEGCC believes that the Commission should allow an adviser to base the certification on knowledge and materiality qualifiers and should only require the certification at most annually.

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The PEGCC appreciates the opportunity to comment on the proposed rule and would be pleased to answer any questions you might have regarding our comments, or regarding the private equity and growth capital industry more generally.

Respectfully submitted,

Douglas Lowenstein
President
Private Equity Growth Capital Council

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Kathleen L. Casey, Commissioner
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner

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