Private Equity Fund Bargaining:
What We Know (and Don't Know)

Research Handbook on the Structure of Private Equity and Venture Capital
(Broughman & de Fontenay eds., forthcoming Elgar Publishing 2024)

William W. Clayton*

Draft: December 18, 2023

1. INTRODUCTION

It is difficult to overstate the importance of private equity in the modern global economy. Private equity sponsors control an impressive share of the world's commercial activity,[1] and private equity funds have long occupied a prominent place in the investment portfolios of pension plans, sovereign wealth funds, university endowments, and foundations across the world. The global economy has been going private for many years, with global private market AUM growing by fourteen times since 2000 (compared to four-fold growth in public AUM over the same period), and the dramatic rise of private equity has played a central role in that shift.[2]

Given the massive amount of capital flowing into private equity, research on the formation and governance of these funds—including the rights and obligations of limited partners and general partners and how those terms are bargained—is remarkably nascent. The academic literature offers far more insight, by comparison, into the management relationship between private equity funds and the portfolio companies that they own. And while there is a substantial body of research in the finance literature focused on the performance of private equity funds, considerably less is understood about the relationship between general partners and limited partners and how the contours of that relationship are negotiated.

There is a straightforward explanation for why this knowledge is so limited: Publicly available data about private equity fund terms and bargaining processes is exceedingly rare, making it difficult to document even basic facts about how various aspects of the industry work. In addition, investors in private equity funds are typically loath to share private equity fund contracts with researchers due to non-disclosure constraints, and they generally demand anonymity before providing even qualitative accounts of how they go about negotiating private equity fund contracts. This has made the shadowy world of private equity funds challenging for

* Associate Professor, BYU Law School.

[1] In the United States, for example, there are over 8,000 private equity-backed firms, nearly double the total number of publicly traded firms, and private equity M&A activity accounts for approximately 30% of all global M&A activity. (McGrath & Nerkar 2023).

[2] As one example of the industry's prominence, over the past five years investors poured $6.4 trillion of new capital commitments into private equity funds. *See* Bain & Co., *Private Equity Outlook in 2023*, https://www.bain.com/insights/private-equity-outlook-global-private-equity-report-2023/. Global IPO markets, by contrast, raised only $1.5 trillion over the same period. *See* https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/global-ipo-activity-cut-nearly-in-half-in-2022-just-20-launched-in-us-during-q4-73793488.

Electronic copy available at: https://ssrn.com/abstract=4598908

outsiders—and even the market participants themselves[3]—to navigate. Yet, recognizing the critical role of private equity in the global marketplace, some scholars have pressed forward, dealing with these obstacles by relying largely on anonymous interviews and surveys, common wisdom about industry practices, and public comments issued by regulators, among other things.

Against this backdrop, recent regulatory developments in the United States have forced a reckoning with the following two questions: How much do we really know about the general partner-limited partner relationship in private equity funds, and how much does that knowledge tell us about how that relationship should (and should not) be regulated? Starting in early 2022, the top U.S. securities regulator (the "SEC") commenced a rule-making process that proposed to overhaul and dramatically expand the agency's traditional oversight of the private funds industry. This initiative put unprecedented pressure on both sides—those in support of increased regulation and those against it—to marshal their best arguments and best evidence in favor of their preferred outcomes, with paradigm-shifting consequences at stake. Ultimately, after a contentious and drawn-out public comment period, the SEC finalized a disclosure-based rule in 2023 that, while substantially less aggressive than the initial proposal, will nevertheless dramatically affect how the industry works.[4]

Much can be learned from examining the evidence that was produced by policymakers, market participants, and scholars during this rule-making process, but perhaps just as important, much can also be learned from the evidence that was *not* produced. The SEC's initiative thus provides important insight into the limits of our knowledge of private equity funds and where more research and data would help to enhance the policy dialogue.

2. THE BASICS: PRIVATE EQUITY FUND BARGAINING

Private equity sponsors raise money from investors and use that capital to buy controlling stakes in businesses and other assets. In return for their services, they receive management fees and a share of the profits earned on those investments (called "carried interest"). The capital commitments made by a fund's many investors are typically "pooled" together into a single fund formed as a limited partnership. The fund's investors are limited partners of the fund, and the fund sponsor acts as the general partner.

The rights and obligations of the fund sponsor and the fund's investors, respectively, are set out in an extensive document called a limited partnership agreement (or "LPA"). Before investors enter a fund, they are given an opportunity to review the fund's LPA and, if desired, seek to negotiate its terms. Investors also typically receive a document called a private placement memorandum (or "PPM") which sets out an extensive set of disclosures about the risks and conflicts that accompany an investment in the fund (Schell et al. 2023).

---

[3] "For private equity funds, empirical information about the 'market' is . . . significantly limited. . . . [E]ven the most active [market] participant is unlikely to acquire in-depth familiarity with more than a fraction (almost certainly a small fraction) of the private equity funds which accept and deploy capital in any given year." (Schell et al. 2023).

[4] Securities & Exchange Commission Final Rule, Private Fund Advisers; Documentation of Registered Investment Adviser Compliance (Rel. No. IA-6383; File No. S7-03-22) (Aug. 23, 2023), https://www.federalregister.gov/documents/2023/09/14/2023-18660/private-fund-advisers-documentation-of-registered-investment-adviser-compliance-reviews.

Electronic copy available at: https://ssrn.com/abstract=4598908

After fundraising is complete, a sponsor has a set period (often between three to five years) to use the fund's capital to make investments in target companies or other assets (often called "portfolio companies" or "portfolio assets"). Sponsors seek to buy undervalued assets, make improvements to them, and, eventually, sell them for a profit. When the sponsor finds investment opportunities during the fund's investment period, it will issue a "capital call" to the fund's investors, obligating them to contribute capital to the fund. Funds typically have a finite life (typically between 10-15 years, with the potential for limited extensions), and sponsors typically must sell the fund's remaining assets and distribute proceeds to investors before the fund's termination (Breslow & Schwartz 2023).

The interests of fund managers and investors are aligned by certain incentives. Because most funds have a limited life, the sponsor is said to have strong reputational incentives because it knows that it will need to go raise additional funds in the future if it wants to continue making profits. At another level, a major component of a fund sponsor's compensation typically consists of incentive compensation in the form of a percent of the fund's profits (called "carried interest"), and sponsors are typically required to invest a percentage of their own capital in the funds that they manage. Where these incentives are not sufficient, private equity sponsors and investors are thought to account for conflicts of interest and other concerns in the fund's governing documents, including through disclosures and procedures set forth in the fund's LPA and PPM.

Because investor capital is typically locked up for many years in a private equity fund, it is perhaps unsurprising that LPAs and PPMs are lengthy and complex and attempt to deal with a host of contingencies that cannot be solved through the mechanisms described above. But a closer look at private equity bargaining shows that the complexity—and the potential for conflicts of interest—goes much further. For example, in addition to negotiating the terms of the fund's LPA, many investors separately negotiate their own "side letter" with respect to the funds that they invest in (Clayton 2020a, Tucker & Jeffers 2022, de Fontenay & Nili 2023). Unlike the terms of the LPA, which apply to all investors in the fund, side letter terms apply only to the investor that is the recipient of the side letter, and they can modify the terms of the LPA as they apply to that investor. Historically, investors have reported that they are commonly prevented from seeing the side letters granted to many of the other investors in the same fund.

In a similar vein, it is also common for sponsors to invite a subset of their largest investors to "co-invest" alongside the fund in a target company. This means that an investor will have exposure to the portfolio company not just by virtue of its investment in the fund, but it will also simultaneously take a direct stake in the portfolio company. Often, sponsors offer co-investments to these investors on a heavily discounted or no-fee basis (Braun et al. 2020; Fang et al. 2015). Other investors establish their own "separately managed accounts" and "funds of one" that participate in a mix of the investment opportunities identified by the sponsor, often alongside certain of the sponsor's pooled funds.

Another commonly cited source of complexity is the fact that sponsors, through their affiliates, have a long history of providing various forms of paid services to the portfolio companies owned by the funds they manage (Phalippou et al. 2018). While there can plausibly be efficiency benefits when a sponsor's affiliate provides these kinds of services instead of a third party, it also clearly opens the door to complexities and conflicts of interest when the sponsor is effectively acting on both sides of these transactions. Figuring out how to categorize

Electronic copy available at: https://ssrn.com/abstract=4598908

and account for these kinds of fees in the sponsor's overall fee stream has historically been a challenge in the industry.

Looking more broadly, it is also quite common for private equity sponsors to owe overlapping duties to different funds and accounts simultaneously. Moreover, sponsors have even branched out and formed subsidiaries that engage in activities that have historically been left to other types of financial institutions, such as advising on mergers and acquisitions and underwriting securities issues, creating another set of conflicts for investors to take into consideration (Tuch 2017; de Fontenay 2019).

Finally, one particularly controversial recent development has been the practice of "continuation funds" (Kastiel & Nili 2023 comment letter). Traditionally, sponsors had little choice but to liquidate their portfolio companies and distribute the proceeds to investors at the end of the life of a fund. But in recent years it has become common practice near the end of a fund's life for the fund's sponsor to establish a new vehicle that acquires certain of the portfolio companies held by the prior fund, giving existing investors the option of "rolling over" into the new vehicle or accepting the offered consideration. Again, while this type of transaction could plausibly be in the best interests of the fund and its investors under the right circumstances, it is also easy to imagine highly problematic conflicts of interest between the investors and the sponsor overwhelming the benefits.

These are just a few examples, but they illustrate a basic reality about private equity fund bargaining: private equity is a complex world where the market participants must account for and protect against an extremely complicated set of conflicts and contingencies that cannot be dealt with through conventional reputational and incentive alignment alone.

3. THEORIES OF BARGAINING INEFFICIENCY IN PRIVATE EQUITY FUNDS

Given the substantial net worth requirements to invest in private equity funds,[5] a reasonable starting position might be to assume that private equity fund investors and sponsors will navigate the complexities and conflicts described above effectively on their own. Yet, starting around 2010, various industry observers raised concerns about whether private ordering was working very well in private equity funds. Perhaps most prominent, Congress granted the SEC dramatically increased authority in 2010 to examine private equity fund managers. After performing a multi-year "examination sweep" of the industry, the SEC announced in 2014 that hidden fees and expenses were a rampant problem in the industry, and they indicated that private equity fund contracts suffered from a host of deficiencies that enabled this kind of misconduct by fund sponsors.[6] In the years since, the SEC has maintained a specially focused private funds examination unit and has periodically repeated similar critiques regarding what they perceive to

[5] Under rules passed pursuant to the Securities Act of 1933, anyone that wants to invest in a privately held company must be an "accredited investor" meeting certain net worth thresholds (generally $1 million for individuals and $5 million for institutions). Additional standards apply to investors in private investment funds under the Investment Advisers Act of 1940 (investors generally must satisfy the "qualified client" standard) and the Investment Company Act of 1940 (under one commonly used exemption, individuals must have $5 million in assets and institutions must have $25 million in assets).

[6] Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Spreading Sunshine in Private Equity (May 6, 2014), https://www.sec.gov/news/speech/2014--spch05062014ab.html.

Electronic copy available at: https://ssrn.com/abstract=4598908

be problematic bargaining outcomes in private equity funds. Several media commentators and scholars also voiced concerns about various practices in private equity funds, questioning whether private bargaining has really led to optimal outcomes (Harris 2011; Spindler 2009; Morris & Phalippou 2012; Magnuson 2018; Clayton 2022b).

This controversial history has prompted some scholars to search for possible explanations. What could possibly be preventing the well-resourced industry participants in private equity funds from structuring their affairs effectively? What, in other words, could be the *causes* of these alleged inefficiencies?

This question has important implications for at least two reasons. First, while it is easy to see why some of the controversial practices noted above have caused alarm over the years, it is nevertheless quite difficult to prove objectively that the substance of any negotiated contracting outcome is or is not suboptimal. For example, some market observers have criticized private equity fund agreements for severely diluting the fiduciary duties owed by sponsors to their investors,[7] but a common alternative viewpoint argues that modifying a sponsor's fiduciary duties actually enables it to produce higher returns for investors (Ribstein 2009). Testing which viewpoint is "correct" is a difficult thing to do, particularly in this private setting where information is so limited. However, if one can demonstrate that there are problems in the *process* by which the relevant terms have been bargained, it would certainly help reinforce the idea that there could be significant deviations from optimality. On the other hand, if no such process-related flaws can be shown, it would dramatically undermine such claims.

Second, if we accept that there are, in fact, deviations from optimality, understanding the flaws in the bargaining process that led to those deviations provides regulators with a much stronger basis for identifying the most effective, targeted interventions. To use a medical analogy, it is very difficult to apply an optimal treatment if all you understand are a patient's symptoms, but when you have a diagnosis of the underlying disease, you are much better positioned to prescribe an effective, targeted response. I have argued in recent work that in the private funds context, it is particularly important for regulators to be thoughtful and targeted if they are going to intervene due to the relative sophistication of the parties (Clayton 2022 comment letter). In this context, it makes sense that interventions should seek to address any underlying causes of bargaining inefficiency narrowly while otherwise preserving the parties' freedom to contract as much as possible.

Below, I have summarized various theories that scholars have proposed over the years to explain possible causes of bargaining inefficiency in private equity funds. Importantly, because of the dearth of data in this area, these theories generally reflect scholars' best efforts to explore important policy questions raised in this space in spite of the limited available information. Acknowledging the limits of their knowledge, scholars' policy proposals in this space have generally been quite modest and limited in scope.[8]

[7] *See, e.g.*, Institutional Limited Partners Association, Letter to Subcommittee on Investor Protection, Entrepreneurship and Capital Markets (Mar. 14, 2019) ("Strong fiduciary duties are the foundation of the relationship between LPs and the PE advisers they invest with."), https://ilpa.org/wp-content/uploads/2019/03/2019.3.14-ILPA-Letter-to-Subcommittee-on-Investor-Protection-Re-Best-Interest-Hearing.pdf.

[8] "[I]t cannot simply be assumed that every intervention will be beneficial. As the SEC enters this uncharted territory, its regulatory activity should be calibrated to respond to the impediments to effective bargaining in private equity. Doing this requires a robust theory for what those impediments are and how they impair bargaining outcomes in private equity funds, and academic analysis of such issues has historically been quite limited." (Clayton

Electronic copy available at: https://ssrn.com/abstract=4598908

Most of these theories have fallen into one of two categories: theories that blame the internal workings of institutional investors, on one hand, and theories that blame the structure of private equity bargaining, on the other. I also consider a few additional explanations below.

Theories That Criticize Institutional Investors

Do institutional investors suffer from agency problems?

In an early study of the venture capital industry, Gompers and Lerner (1996) showed that when demand for private equity investments increased, private equity fund managers did not charge correspondingly higher fees. Instead of negotiating for higher fee rates, Gompers and Lerner found, managers and investors instead negotiated for more flexible covenants in private equity LPAs that enabled them to enrich themselves through more indirect channels. Gompers and Lerner posited that one explanation for this outcome could be that the investment officers working at institutional investors prefer to dilute restrictive covenants than pay higher prices because those kinds of changes will be buried deep within the fund's LPA and, as a result, are less likely to be noticed by the investment officer's superiors. Diluting restrictive covenants could thus be viewed as an indirect—and inefficient—way to make price adjustments that is less likely to attract the scrutiny of an internal staff member's superiors and thereby raise fewer concerns about censure and career risk.

In other words, it could be that some of the controversial outcomes in private equity fund contracts are caused by conflicts of interest between the staff members making decisions on behalf of institutional investors and the underlying beneficiaries of those institutions. Various other studies have claimed to find evidence of internal agency problems leading to suboptimal behavior by the institutions that invest in private equity funds (see, for example, Hochberg & Rauh 2013; Bernstein et al. 2013; Andonov et al. 2018; Jackson working paper).

Do regulated investors engage in suboptimal bargaining?

Scholars have also observed that many investors in private equity are regulated institutions that must comply with their own regulations and requirements (Clayton 2020b). These investor-level regulations can be expected to have two effects. First, when investors are legally obligated to obtain certain contractual terms from managers pursuant to rules that apply only to them, those terms are not the product of free market bargaining between sophisticated parties. Instead, they are created by legislatures and regulatory institutions. Second, investor-level regulation can also be expected to add to negotiating costs, as it necessitates more bilateral bargaining between investors (who must obtain terms that other investors are not required to get) and managers.

Does two-staged bargaining strip institutional investors of bargaining power?

2022b). Magnuson (2018) described the policy suggestions set forth in his article as "merely a starting point of a longer conversation"; Morris & Phalippou (2012) indicated that their intention was "not for anyone, least of all regulators, to dictate specific terms and rules"; and Appelbaum & Batt (2021) noted that "[f]urther investigation . . . is needed to determine what effects [potential interventions] may have on PE fund performance and whether they introduce other potential conflicts."

Electronic copy available at: https://ssrn.com/abstract=4598908

Another theory of bargaining inefficiency in private equity funds blames the widespread practice of two-staged bargaining by institutional investors (Choi & Triantis 2012). It is very common for institutional investors to have separate investment departments and legal departments, and investment teams will often make decisions about whether to invest in a fund before the legal department has even seen the fund's governing documents. At that point, it is very difficult (if not impossible, practically speaking) for the legal team to cause the institution to pull out of the fund, which presumably limits their bargaining power.

Theories That Criticize the Structure of Private Equity Bargaining

Another type of theory blames the bargaining environment for problems in private equity funds. According to these theories, even if all the investors in the market are sophisticated and informed, there are nevertheless coordination problems and other related to the structure of the bargaining process that can lead to problematic outcomes.

Does side contracting create problematic bargaining incentives?

Even though private equity funds generally pool the capital of their investors together into a single fund, there are a few ways in which investors' interests can become fragmented. For example, as noted above, it is common for investors to sign "side letter" agreements with sponsors in addition to the LPA that applies to all of the investors in the fund. Larger investors can also be given opportunities to co-invest alongside a fund—sometimes at significantly reduced fee rates (or for no fees at all). In addition, large investors can avoid investing in funds altogether by setting up their own separately managed accounts ("SMAs") with a sponsor, sometimes (again) with lower fee rates than the fees paid by investors in ordinary funds. While a separately managed account is a distinct vehicle from a sponsor's funds, it typically will invest in a percentage of many of the same deals that the sponsor's funds are investing in.

In an early paper examining this fragmentation dynamic, I focused primarily on the question whether we should be concerned that sponsors will allocate their best deals to co-investment vehicles and SMAs and away from the pooled funds where their other investors are invested (Clayton 2017).[9] I concluded that sponsors likely have powerful reputational incentives *not* to do this because their reputations are primarily tied to the performance of their pooled funds. This conclusion is consistent with studies in the finance literature finding that co-investments generally achieve performance that is either worse (Fang et al. 2015) or no different (Braun et al. 2020) than pooled fund performance.

But deal allocation is not the only way in which fragmentation can plausibly harm investors in private equity funds. For example, if large investors can bargain for terms that benefit only themselves (such as fee discounts or no-fee co-investment opportunities), we might be concerned that they will over-invest in bargaining for those things and under-invest in bargaining for LPA terms that generate positive externalities for the other investors in a fund. In a 2020 paper, I argued that this is likely to be a valid concern if we assume that individualized

[9] While this 2017 paper can be read as having a broader focus than this question alone, a close read shows that this was the most important question motivating the article and its conclusions.

Electronic copy available at: https://ssrn.com/abstract=4598908

benefits are commonly granted to investors through side letters and other avenues (Clayton 2020a). Of course, whether this is a realistic assumption is an empirical question—and there was little available data to measure it at the time. Other scholars have come to similar conclusions about the potential for harms from fragmentation (Morris & Phalippou 2012; Magnuson 2018). Later studies have suggested that this kind of unequal treatment may be relatively uncommon in side letters (de Fontenay and Nili 2022) and more common in co-investments and other "alternative vehicles" (Lerner et al. 2022).

Do large investors have inefficient incentives to leverage their resource advantages?

Scholars have also argued that large investors have an incentive to negotiate for unnecessarily complicated contracts due to their resource advantages over small investors—another form of a coordination problem. (Morris & Phalippou 2012) Doing this could plausibly be in an institutional investor's best interest when they care primarily about how their portfolio performs on a relative basis compared to the rest of the market. For larger institutional investors with more resources, their competitive advantage should increase as contracts become more complex. Compared to smaller investors, large institutions might be able to generate superior information about the true cost of contracts and use that information to outperform other institutional investors and industry benchmarks.

Do professional advisors have incentives to seek suboptimal terms?

Some scholars have argued that as the industry has become increasingly institutionalized, more and more industry participants have developed a vested interest in maintaining the status quo, even if it is suboptimal. The law firms representing both managers and investors, for example, are incentivized to avoid standardization, and scholars have also theorized that the external law firms representing private equity fund managers have self-serving incentives to reject investor-friendly terms even in cases where accepting those terms might be acceptable to the manager (de Fontenay & Nili 2023). One can imagine similar incentives on the part of financial analysts, investment consultants, and investment banks to avoid efficiency-enhancing improvements in the bargaining model (Batt & Appelbaum 2021).

Are suboptimal terms sticky after they are adopted?

It has been argued that some of the basic ground rules for private equity bargaining (which have been in existence for decades) have created an inherently unlevel playing field and put investors at an informational disadvantage. These include (i) confidentiality restrictions that prevent investors from communicating with other investors in the same fund or sharing fund documents and (ii) the custom that fund investors pay all of the legal expenses incurred by the fund manager during the negotiation process (up to a certain limit). If these terms are so problematic, can their persistence be explained?

Path dependence is one possible theory. According to this view, contract terms that are no longer optimal might persist due to factors including network benefits from standardization, anchoring effects, and herd behavior, among others (Magnuson 2018). Another theory might be that these terms are inherently sticky because they make it harder for investors to bargain.

Electronic copy available at: https://ssrn.com/abstract=4598908

According to this logic, one could argue that once terms like this become the norm, it immediately puts investors in a weaker negotiating position, which makes it harder for them to push back against *those very same terms* in the future.

Other Academic Theories of Bargaining Inefficiency

Does private equity fund bargaining suffer from multiple agency problems?

Scholars have also applied multiple agency theory to private equity funds (Batt & Appelbaum 2021; Magnuson 2018). A multiple agency view of private equity argues that conflicts of interest are so complex and thoroughly embedded in the private equity ecosystem that they are extremely difficult to untangle. Scholars have argued that the various roles played by fund managers, and the web of relationships that sponsors maintain with various counterparties (including banks and creditors), generates complex conflicts of interest that grow increasingly intractable as the institutional players continue to grow larger and larger in size (Tuch 2017; de Fontenay 2019).

Are terms in private equity shaped (indirectly) by the federal securities laws?

Scholars have also argued that the private equity model is, at its core, not the product of rational bargaining between private parties, but instead merely reflects what the parties have to do to avoid the reach of the federal securities laws (Spindler 2009). This approach suggests that the parties would actually prefer to give investors greater voice and transparency (among other things) than they typically receive in private equity funds, but that they would prefer to tolerate those problems than incur the costs of falling under the public securities regime. This theory is essentially a criticism of public company securities regulation, rejecting the idea that the private equity fund model is a more enlightened form of governance borne of sophisticated private bargaining.

Counterarguments to Claims of Bargaining Inefficiency

Just as it has been difficult to prove or quantify the theories of bargaining inefficiency described above in this data lite environment, it has also been difficult to disprove them for the same reasons. One common counterargument cites the industry's extraordinary growth over the years. If the terms in private equity funds are so bad, so the argument goes, why would sophisticated investors voluntarily choose to keep allocating more and more capital to the industry? Defenders of private equity will also argue that strong investment returns are ultimately the only metric that really matters, and they cite to academic studies finding that the private equity industry has a track record of outperformance over on a net-of-fee basis (see, for example, Kaplan & Sensoy 2015; Kaplan & Stromberg 2009; Metrick & Yasuda 2011; Harris et al. 2014).[10]

[10] Importantly, there is disagreement and nuance on the question of private equity outperformance. For example, Phalippou (2014) finds that even though the average private equity fund outperforms the S&P 500, it underperforms a leveraged small-value index, which is arguably a more relevant comparison. Ang et al (2018) found no evidence of outperformance when benchmarking against a passive, low-cost mutual fund invested in value stocks. Driessen et al.

Electronic copy available at: https://ssrn.com/abstract=4598908

Some finance studies have also looked more directly at specific aspects of private equity fund bargaining, with mixed results. For example, Robinson and Sensoy examined the relationship between fees and performance in private equity funds in 2013, concluding that the data shows evidence of efficient bargaining of fee terms between investors and fund managers. Specifically, Robinson and Sensoy found that higher-fee funds do not underperform on a net basis, suggesting that investors and managers are appropriately accounting for a manager's skill level when negotiating fee rates. But this conclusion is mixed, as the authors also caution that there is evidence to show that sponsors sometimes take advantage of information asymmetries to game the contractual provisions in these agreements.

Another study draws mixed conclusions with respect to the portfolio company fees charged by private equity sponsors (Phalippou 2018). On one hand, Phalippou's study showed that an enormous magnitude of fees (equal to 6% of all equity invested in the sample) were paid through opaque portfolio company fee channels during a 20-year sample period, with little evidence to support any kind of efficient or value-generating explanation for the non-transparent payments—a discouraging outcome suggesting a likelihood of suboptimal bargaining. At the same time, however, the author also found evidence that the market eventually responded appropriately (after multiple decades) to this practice, as the high fee charging managers were eventually punished and struggled to raise capital from investors in future funds.

Finally, there are also mixed outcomes in studies asking whether sponsors inflate their reported returns when they raise new funds or otherwise time their fundraising to coincide with peak performance. Interestingly, various studies conclude that managers do, in fact, appear to engage in this kind of strategic activity (see, for example, Jenkinson 2013; Barber & Yasuda 2017; Brown et al. 2019). But Brown et al. (2019) also found that the practical effect of this manipulation is likely muted because investors will see through the manipulation eventually and refuse to invest in the future funds of misreporting sponsors.

These studies further underscore the murky state of the literature on bargaining between private equity fund managers and investors.

4. RAISING THE STAKES: THE SEC'S PROPOSED RULE ON PRIVATE FUNDS

The need for answers to the questions discussed above took on a much greater sense of urgency and consequence starting in early 2022, when the SEC released a proposed rule that would have imposed unprecedented regulatory interventions on the U.S. private fund industry. Citing the dramatic growth and influence of the private fund industry and the massive investment exposure of public pension plans and university endowments, the SEC proposed imposing an extensive set of standardized disclosure obligations, prohibitions, and mandatory rules. Echoing many of the same concerns that the agency had expressed in the mid-2010s, the SEC argued that these sweeping interventions would help to protect investors and promote efficiency in private funds. Traditionally, the SEC had always taken a relatively hands-off approach to private funds and left investors—who must satisfy minimum net worth requirements—to protect their own interests.

(2012) do not find evidence of outperformance after decomposing returns into systematic risk exposure and abnormal performance.

Electronic copy available at: https://ssrn.com/abstract=4598908

One of the core critiques of the SEC's proposal was that it did not provide a very robust accounting of what was *causing* the bargaining inefficiencies that it was seeking to fix (see, for example, Grundfest 2022 comment letter; Clayton 2022 comment letter; Flannery 2022 report). The SEC's proposed rule described some of the theories set forth in the academic studies discussed above in support of the proposed changes, but it did not provide any independent data to confirm the validity of those theories. Instead, the proposal was largely anecdotal in nature and based on a limited set of enforcement actions against private equity sponsors, and the SEC acknowledged that it lacked data to forecast many of the market-wide economic effects of the proposed intervention. While many of the proposed changes were supported by investors, the proposal was highly controversial and was met with stiff pushback by many other industry participants and commentators.

The controversy evoked by these proposed interventions illustrates a basic challenge that makes private fund regulatory policy particularly difficult. On one hand, as discussed throughout this chapter, market-wide data on bargaining practices and contract terms in private funds is extremely sparse. But at the same time, the need for information to inform policymaking in a sophisticated space like this is unusually strong, for two reasons. First, because private market investors must satisfy minimum asset requirements, there is naturally a greater need to verify the existence of contracting inefficiencies to legitimize intervening generally. Second, as noted above, investor sophistication also creates greater pressure to apply any interventions narrowly and calibrate them thoughtfully so they address the underlying problems that are causing the inefficiencies without impinging more than is necessary on freedom of contract (Clayton 2022 comment letter). This combination creates a challenging tension.

In the United States, rules created by federal agencies like the SEC are subject to judicial review, with courts reviewing them to determine whether the need for intervention has been sufficiently demonstrated and if the agency has sufficiently considered the expected costs and benefits. The SEC proposal thus created a high stakes moment for industry participants and industry commentators. For those that supported increased regulation, this was the prime moment to marshal their best arguments in favor of the need for intervention and to provide any available data in support (filling the data void left by the SEC's proposal). For those that were opposed to increased regulation, on the other hand, this was the moment to make their best arguments against intervention and to provide data to support those arguments. Likewise, for scholars with data or other information that could assist in the policy dialogue, this comment period was the ideal time to share any such contributions for maximal influence.

Interestingly, perhaps the biggest takeaway of the comment period is that no trove of data emerged to provide a substantially clearer window into the world of private equity fund bargaining. Moreover, even though over 370 comment letters were filed between February 2022 and July 2023, most market commenters provided only limited input on *why* interventions are needed in the industry, possibly because the SEC's request for comments did not include a request for comments on the factors that cause bargaining to go awry in private funds. Instead, investors were asked to focus more on specific details of implementation than the conceptual question of what causes bargaining to break down and whether the proposed interventions were addressing the right problems in the first place.

That said, certain valuable contributions did materialize during the comment period that helped to shed new light on some specific questions relating to private equity fund bargaining. For example, during the comment period, two papers (de Fontenay & Nili 2023; Jeffers &

Electronic copy available at: https://ssrn.com/abstract=4598908

Tucker 2022) were released with data sets that provided new insights into the nature of fragmentation through private equity side letters. In both papers, the authors assembled a set of side letters collected from institutional investors and described their contents. These papers were the first of their kind, shining a descriptive light for the first time on the terms found in investor side letters, with important implications for how we understand the nature of fragmentation in the private equity universe.

Similarly, in another study filed as a comment letter with the SEC, scholars provided new interview data on continuation funds, a controversial practice that previously had received little scholarly coverage (Kastiel & Nili 2023 comment letter). As noted above, continuation funds are a fast-growing practice in the industry where instead of liquidating all of a fund's holdings at the end of its life, sponsors establish a new vehicle and offer existing fund investors an opportunity to buy in to the new fund. This paper provided new details based on interviews about how continuation funds work, the potential benefits they can provide, and the conflicts of interest that they implicate.

I also submitted a paper as a comment letter that showed polling results on the following question: what do institutional investors perceive to be the causes of bargaining inefficiency in private equity funds? When asked to identify the top explanations for why investors accept problematic terms in LPAs, the most common response from institutional investors was that they fear they will lose allocation to managers' funds—which is another way of saying that they will get cut out of a manager's current or future funds if they bargain too hard. Other top responses similarly pointed to a lack of bargaining power on the part of investors (Clayton 2022 comment letter). That paper characterized the polling results not as a source of definitive answers (given the limitations of the study), but as something to help focus the policy dialogue on the right questions.

Finally, near the end of the comment period, a debate emerged that zeroed in on this issue of bargaining power. On one hand, the trade association for institutional investors in private equity funds (the Institutional Limited Partners Association, or "ILPA") released additional investor survey data that further emphasized the claim that a bargaining power imbalance between investors and managers is a primary culprit for bad contracting outcomes. But not long after the ILPA survey report was made public, the Committee on Capital Markets Regulation (the "CCMR") released a report saying just the opposite. Relying on information from a commercial data provider and industry statistics collected by the SEC, the CCMR concluded that the level of concentration in private equity is actually quite low compared to the market for publicly traded firms and the market for mutual funds.

ILPA responded to the CCMR report by arguing that even if the report is correct, the on-the-ground reality is that there are various bargaining practices that nevertheless generate problematic outcomes—and interestingly, many of the bargaining practices identified by ILPA were variations on the different academic theories summarized in "Theories of Bargaining Inefficiency in Private Equity Funds" above. Unfortunately, however, ILPA did not provide any new data to quantify these issues beyond the investor survey responses noted above. Accordingly, this last exchange effectively brought the debate back full circle to the original question considered above: how exactly should policymakers respond to these kinds of theories in the absence of market-wide, unbiased data?

Electronic copy available at: https://ssrn.com/abstract=4598908

5. DATA CHALLENGES REMAIN: THE SEC'S FINAL RULE ON PRIVATE FUNDS

More than 18 months after its initial rule proposal, the SEC enacted a final rule in August 2023. Interestingly, the SEC appeared to heed much of the criticism of its original proposal and backed down from the most aggressive aspects of the proposal. The final rule was largely reduced to establishing standardized financial reporting requirements that sponsors must provide investors and enhanced disclosure obligations for certain kinds of conflicted transactions. The SEC's willingness to listen to criticism and the staff's efforts to ground its analysis more deliberately in the causes of bargaining inefficiency were laudable developments.

Yet the final rule did little to introduce new sources of data or other information that substantially sharpened our understanding of the causes of bargaining inefficiency in private equity funds. Most of the data that the SEC pointed to was anecdotal, was derived from investor self-reporting in the form of comment letters and surveys, or was based on a limited set of SEC enforcement actions. Such sources are subject to significant limitations (including, for example, the possibility of respondent bias and other forms of bias), even if they may be the best sources of information currently available to the public[11] on many of these issues (see Clayton 2022 comment letter).

Interestingly, as part of the final rule's economic analysis, the SEC identified what it viewed as the six most important sources of market failure justifying intervention (these included, for example, a sponsor's ability to obtain asymmetric information, difficulties that investors have coordinating their efforts, and purported conflicts between large and small investors, among others). In many of these cases, the SEC used indefinite language indicating that the source of market failure "may" exist, underscoring the fact that many important open questions still remain.

Of course, in light of the scaled back version of the rule, the SEC's failure to generate very much additional publicly available data to support these sources of market failure is less concerning than it would have been if the SEC had attempted to pass the more aggressive interventions that it had originally proposed. Compared to some of the proposed changes, mandatory standardized disclosure to investors is a lighter-touch intervention, and one could certainly make the case that it would ameliorate many of the possible theories of bargaining inefficiency described above.

The final rule has been formally challenged by various private equity trade groups, so it will be up to the courts to determine if the proffered justifications for the regulatory interventions pass muster as a matter of administrative law and securities law. That analysis is beyond the scope of this chapter.

Regardless of the ultimate legal outcome, the final rule serves as a striking demonstration of the nascent state of our collective understanding of bargaining in private equity funds, particularly in light of the 18-month policymaking process that preceded it. Of course, this does not mean that the bargaining inefficiencies described by the SEC and the theories summarized above should be presumed to be invalid or that the SEC was necessarily wrong to proceed with intervening in the face of this uncertainty.[12] The only thing we can really conclude with

[11] Neither the proposal nor the final rule makes clear how much data the SEC has access to (or what form that data takes) that the agency is restricted from sharing with the public.

[12] The agency's willingness to scale back the final rule to focus primarily on disclosure should certainly be viewed as a helpful factor in this regard.

Electronic copy available at: https://ssrn.com/abstract=4598908

confidence is that unbiased, market-wide data is extremely hard to come by in this space. Yet the industry's size and influence will likely only continue to grow in coming years, putting increasing pressure on all these issues.

6. WHERE SHOULD RESEARCH ON PRIVATE EQUITY FUND BARGAINING GO FROM HERE?

This chapter has focused on the United States as the most active locus of private equity policy activity in recent years. Time will tell what lessons other countries draw from the SEC's experience and the extent to which others follow suit. Each country will need to decide where their regulatory regime will fall on the spectrum between a truly private, hands-off approach to private equity and an approach more traditionally associated with publicly held mutual funds.

In the United States, uncertainty about the future of private funds policy looms large. As noted above, a lawsuit has been filed to challenge the SEC's final rule, so it is possible that a portion or all of the SEC's rule will ultimately be struck down. Even if the rule stands, there will be uncertainty regarding the ultimate net effect of the rule—taking into account both the possible benefits and the costs of the intervention. Furthermore, it is impossible to predict what actions the SEC might take under a different administration, or what Congress might ultimately choose to do.

In the meantime, the need for more high-quality research on private equity fund contracting and the GP-LP relationship keeps growing as the private equity industry continues its stunning growth trajectory. The better our understanding of potential bargaining inefficiencies and their causes, the better-equipped policymakers will be to craft policy—and make updates to past decisions if needed—in a targeted and effective manner. Scholarship seeking to empirically test the various theories described above and the claims made by the SEC in the final rule would be valuable. In addition, if the SEC's final rule is not overturned, finding ways to measure the effects of the rule and compare how bargaining worked before and after the intervention would help bring greater clarity and accountability to the policy dialogue. Research on the promise and pitfalls associated with using regulatory experimentation in the private funds context would also be quite helpful, in light of the substantial unknowns (see Lee 2013).

In the American context, I have encouraged the SEC to work on building the foundation for a more robust policy dialogue in the longer term. This includes doing more to gather objective information about bargaining across the industry to inform its policymaking activities (and sharing them with the public when possible in aggregated and anonymized form) and taking a more deliberate approach to studying what might be causing private ordering to fall short in the market. When gathering information about private fund bargaining, the more sizable and unbiased the data sources are, the more useful they will be. The final private funds rule appeared to be largely focused on immediate policy implementation and not on paving the way for the long-term policy dialogue, and it is yet to be seen whether more will be done to address the latter.

Industry participants can also help to support more effective policy efforts, including by providing scholars with access to more objective data on industry contracting and making themselves available for interviews and surveys. Moreover, in contrast with the policy and academic settings described above (where market-wide data on private equity fund bargaining

Electronic copy available at: https://ssrn.com/abstract=4598908

has proven to be extremely hard to generate), the commercial tools available to industry participants who want to understand and benchmark their private fund terms has been improving dramatically in recent years. These advances bode well for fruitful future collaboration between industry and academics.

The future of private funds policy may be uncertain, but what is clear is that this is an exciting and consequential period for scholarship on private equity fund bargaining. Studying this space has always required scholars to work creatively and overcome a distinctive set of challenges, but the potential for high-quality scholarship to contribute to policy improvements in this important space is enormous. The SEC's rule-making process has shined a light on a need for more work on private equity fund bargaining in the United States and abroad, and scholars can play a useful role in supporting the policy dialogue going forward.

7. BIBLIOGRAPHY

Andonov et al. (2018). Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds, *Journal of Finance*, 73:2041.

Barber, Brad M. and Ayako Yasuda (2017). Interim Fund Performance and Fundraising in Private Equity, *Journal of Financial Economics*, 124:172.

Batt, Rosemary & Eileen Appelbaum (2021). The Agency Costs of Private Equity: Why Do Limited Partners Still Invest?, *Acad. Mgmt. Perspectives*, 35:45.

Bernstein et al. (2013). The Investment Strategies of Sovereign Wealth Funds. *Journal of Economic Perspectives*, 27:219.

Braun, R. et al. (2018). Adverse Selection and the Performance of Private Equity Co-Investments, *Journal of Financial Economics*, 136:44.

Breslow, Stephanie & Phyllis Schwartz (2015). Private Equity Funds: Formation and Operation (Benedicto ed.).

Brown, Gregory W. et al. (2019). Interim Fund Performance and Fundraising in Private Equity, *Journal of Financial Economics*, 132:267.

Choi, Albert & George Triantis (2012). The Effect of Bargaining Power on Contract Design, *Virginia Law Review*, 98:1665.

Clayton, William W. (2020a). The Private Equity Negotiation Myth, *Yale Journal on Regulation*, 37:67.

Clayton, William W. (2020b). Public Investors, Private Funds, State Law, *Baylor Law Review*, 72:294.

Clayton, William W. (2022a). How Public Pension Plans Have Shaped Private Equity, *Maryland Law Review*, 81:840.

Clayton, William W. (2022b). High-End Bargaining Problems, *Vanderbilt Law Review*, 75:703.

Clayton, William W. (2022 comment letter). High-End Securities Regulation, *Harvard Business Law Review* (forthcoming), posted as a comment letter on Dec. 22, 2022 at https://www.sec.gov/comments/s7-03-22/s70322-20153418-320839.pdf.

Peter Easton et al. (2023). *Monitoring in Private Equity*, The Palgrave Encyclopedia of Private Equity (2023).

Fang, Lily & Victoria Ivashina (2015). The Disintermediation of Financial Markets: Direct Investing in Private Equity,

Electronic copy available at: https://ssrn.com/abstract=4598908

Flannery, Mark J. (2022 report). Report, Appendix 2 to American Investment Council Comment Letter to SEC Release No. IA-5955, https://www.sec.gov/comments/s7-03-22/s70322-20126669-287340.pdf.

de Fontenay, Elisabeth (2019). Private Equity's Governance Advantage: A Requiem, *Boston University Law Review*, 99:1095.

de Fontenay, Elisabeth & Yaron Nili (2023). Side Letter Governance, *Washington University Law Review*, 100:907.

Gompers, Paul and Josh Lerner (1996). The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements, *Journal of Law & Economics*, 39:463.

Gompers, Paul and Josh Lerner (1999). The Venture Capital Cycle.

Grundfest, Joseph A. (2022). SEC Comment Letter posted at https://www.sec.gov/comments/s7-03-22/s70322-20126231-286797.pdf.

Harris, Lee (2010). A Critical Theory of Private Equity, *Delaware Journal of Corporate Law*, 35:259.

Harris, Robert et al. (2014). Private Equity Performance: What Do We Know?, *Journal of Finance*, 69:1851.

Hochberg, Yael V. & Joshua D. Rauh (2013). Local Overweighting and Underperformance: Evidence from Limited Partner Private Equity Investments, *Review of Financial Studies*, 26:403.

Jeffers, Jessica S. & Anne M. Tucker (2022). Shadow Contracts, *University of Chicago Business Law Review*, 1:259.

Jackson et al. (working paper). Catering and Return Manipulation in Private Equity, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4244467.

Jenkinson, Tim et al. (2013). How Fair are the Valuations of Private Equity Funds?", https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2229547.

Kaplan, S.N. and Berk Sensoy (2015). Private Equity Performance: A Survey, *Annual Review of Financial Economics*, 7:597.

Kaplan, S.N. and Per Stromberg (2009). Leveraged Buyouts and Private Equity, *Journal of Economic Perspectives*, 23:121.

Kastiel, Kobi & Yaron Nili (2023 comment letter). High-Class Conflicts, https://www.sec.gov/comments/s7-03-22/s70322-20160265-328503.pdf.

Lee, Yoon-Ho Alex (2013). An Options Approach to Agency Rulemaking, *Administrative Law Review*, 65: 881.

Lerner, Josh et al. (2022). Investing Outside the Box: Evidence from Alternative Vehicles in Private Equity, *Journal of Financial Economics*, 143:359.

Magnuson, William (2018). The Public Cost of Private Equity, *Minnesota Law Review*, 102:1847.

McGrath, Patia J. & Atul Nerkar (2022). Private Equity: Antecedents, Outcomes, Mediators, and Moderators, *Journal of Management*, 49:158.

Metrick, Andrew & Ayako Yasuda (2011). Venture Capital and Other Private Equity: A Survey, *European Financial Management*, 17:619.

Morris, Peter & Ludovic Phalippou (2012). A New Approach to Regulating Private Equity, *Journal of Corporate Legal Studies*, 12:59.

Phalippou, Ludovic et al. (2018). Private equity portfolio company fees, *Journal of Financial Economics*, 129:559.

Electronic copy available at: https://ssrn.com/abstract=4598908

Ribstein, Larry (2009). Partnership Governance of Large Firms, *University of Chicago Law Review*, 76:289.
Robinson, David T. & Berk Sensoy (2013). Do Private Equity Fund Managers Earn Their Fees?, *The Review of Financial Studies*, 26:2760.
Robinson, David T. & Young Jun Song (2023). Fees in Private Equity, The Palgrave Encyclopedia of Private Equity.
Schell, James M. et al. (2023). Private Equity Funds: Business Structure and Operations.
Spindler, James C. (2009). How Private is Private Equity, and at What Cost?, *University of Chicago Law Review*, 76:309.
Tuch, Andrew (2017). The Remaking of Wall Street, *Harvard Business Law Review*, 7:315.

Electronic copy available at: https://ssrn.com/abstract=4598908