The Real Estate Roundtable

April 25, 2022

VIA ELECTRONIC SUBMISSION

Ms. Vanessa A. Countryman
Secretary, U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 205499–1090

[Submitted via email to rule-comments@sec.gov]

Re: SEC Release No. IA-5955; Securities File No. S7-03-22 (February 9, 2022).
Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

Dear Ms. Countryman:

The Real Estate Roundtable[1] (Roundtable) is pleased to provide comments to the Securities and Exchange Commission (Commission) on the above-referenced proposal to impose new rules (Proposal) under the Investment Advisers Act of 1940 (the "Advisers Act" or the "Act").

The estimated total dollar value of U.S. commercial real estate was $20.7 trillion as of 2021:Q2.[2] Real estate private equity is a vital part of the U.S. commercial real estate market and the overall economy and offers numerous benefits to investors.

The Proposal would impose sweeping reforms of regulations over real estate private equity investment advisers and the private funds they advise. If adopted as proposed, the new rules could have a significant impact on real estate private fund disclosures, reporting, fees and expenses, and operations. In addition, the Proposal seeks open-ended and extensive information from

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[1] The Real Estate Roundtable and its members lead an industry that generates more than 20 percent of America's gross national product, employs more than 9 million people, and produces nearly two-thirds of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the U.S.'s leading income-producing real property owners, managers, and investors; the elected heads of America's leading real estate trade organizations; as well as the key executives of the major financial services companies involved in financing, securitizing, or investing in income-producing properties.

[2] According to a recent study by Nareit primarily using data from CoStar.

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stakeholders and the public (quantitative and qualitative) regarding all of the proposed rules, posing more than 800 individual questions as well as more than 60 specific questions regarding the cost-benefit analysis alone.

Real estate private equity delivers substantial benefits to the economy and investors that could be undermined by the Proposal.

Real estate private equity firms raise capital from outside investors – limited partners – and use this capital to acquire, develop, improve and operate real estate assets, generally for long-term holding periods. Those assets may ultimately be sold to realize a return on investment or redeveloped. The limited partners typically include sophisticated investors such as pension funds, endowments, insurance companies, family offices, funds of funds, and high-net-worth individuals. Real estate private equity investment firms generally focus their investment activity on "income-producing" or "commercial" real estate assets such as office, industrial, retail, multifamily, healthcare and specialized properties like hotels, data centers, cell towers and other complex mixed-use properties.

The real estate private equity and private credit industries play a positive role in communities across America. During the pandemic, real estate private equity and private credit investment have supported millions of jobs, developed and improved thousands of properties, and delivered the strongest returns for public pensions. This success and growth have in turn delivered billions of dollars in returns for investors and helped develop and improve countless U.S. commercial and multifamily real estate properties. More broadly, real estate private equity and private credit advisers continue to deliver superior returns to investors compared to other asset classes.[3]

The Proposal is unnecessary.

As discussed, the vast majority of investors in private funds are qualified purchasers. Qualified purchasers are large, sophisticated investors, which are presumed to be able to evaluate and appreciate the risks associated with their investments.[4] The Commission does not—and cannot—show that qualified purchasers are unable to protect their interests and make sound investment decisions. Private funds have been around for decades, and qualified purchasers continue to choose this form of investment, which has amassed a strong track record of delivering positive high returns. Indeed, the increased interest of large, sophisticated investors in real estate private equity is one of the most pronounced current investment trends.[5] All of this indicates that qualified purchasers are satisfied with the current business model of private funds.

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[3] For purposes of this letter, we generally refer to real estate private equity and private credit fund advisers as "real estate private equity advisers" and the funds such advisers manage as "real estate private equity funds." We note that the Proposed Amendments include private credit funds within the private equity funds classification for purposes of Form PF.

[4] *Prohibition of Fraud By Advisers of Certain Pooled Investment Vehicles*, 2006 WL 3814994, at *8 n.45.

[5] *See* Hugh MacArthur, et al., *The Private Equity Market in 2021: The Allure of Growth*, Bain & Co. (Mar. 7, 2022), https://www.bain.com/insights/private-equity-market-in-2021-global-private-equity-report-2022/.

The Commission also asserts that "even sophisticated" investors have had difficulty evaluating private funds,[6] but proffers only flimsy support for that proposition.[7] Seven years ago, a number of state treasurers and controllers wrote that the "cost structures of private equity are complicated."[8] The letter, however, acknowledges that private equity funds "generally disclose information on all types of fees," and confirms that when "comparing 10-year annualized returns, pension fund investments in private equity have outperformed other asset classes."[9]

The Proposal will create harmful, counterproductive consequences.

The extensive additional reporting requirements contemplated by the Commission will be enormously costly. The increased cost will decrease returns for all private fund investors and will drive from the market smaller fund sponsors—who lack the back-office infrastructure needed to efficiently comply with the proposed reporting requirements.

At the same time, the proposed prohibited-activities rules will create potentially counterproductive incentives for private fund advisers. Many investors rationally choose to limit the liability of private fund advisers so that advisers will be properly incentivized to take efficient risks, rather than passing up opportunities out of fear of potential litigation costs. By prohibiting investment advisers and investors from agreeing to limit an adviser's liability, the Commission will restrict investor choice and eliminate an incentive structure that many investors have found to work.

The proposed prohibited-activities rules would also force private fund advisers to "restructure their fee and expense model."[10] That restructuring would be very costly in and of itself, but would also raise costs in other ways. Because private fund advisers would not be able to pass through certain expenses as actually incurred, advisers would need to charge large, fixed management fees with sufficient cushion built in for any unexpected developments. Investors will therefore likely end up paying more across the board.

Just a few years ago, the Commission recognized that the "relationship between an investment adviser and its client has long been based on fiduciary principles not generally set forth."[11] Specifically, the Commission expressed the view that a "hedge clause in an agreement with an institutional client" was not per se incompatible with an adviser's fiduciary duty to its client.[12] The Proposal effectively

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[6] Proposing Release at 16,954; *see also id.* at 16,892 & n.24.

[7] *See* Proposing Release at 16,892 n.24.

[8] Letter from State Treasurers and Comptrollers (July 21, 2015), https://comptroller.nyc.gov/wp-content/uploads/documents/SEC_SignOnPDF.pdf.

[9] *Id.*

[10] Proposing Release at 16,922.

[11] Commission Interpretation Regarding Standard of Conduct for Investment Advisers, 84 Fed. Reg. 33,669, 33,670 (July 12, 2019).

[12] *Id.* at 33,672 n.31.

reverses both of those positions, abandoning a principles-based system and categorically banning hedge clauses, without an adequate explanation of its change in position.[13]

The Proposal also cannot be squared with the Commission's longstanding position that its mission is not to protect investors from themselves, but rather to promote informed decision making based on disclosures. As the Commission put it at the time of enactment of the 1940 acts, "If [a fund is] going to be a speculative investment trust, and they disclose that fact to their investors, and the investors want to invest in that type of investment company, who are we to say, 'No; you shall not invest in that type of company'?"[14] By prohibiting widely accepted contractual provisions freely adopted by counterparties negotiating at arm's-length, the Commission has discarded its role as "a disclosure-based agency," in favor of being a "merit regulator."[15]

The Commission has not given the public a meaningful ability to participate in this rulemaking.

The Administrative Procedure Act (APA) requires agencies to afford the public an opportunity to meaningfully comment on proposed rules. Yet here, the Commission has proposed a number of incredibly complex, massively consequential rules—all at the same time—and given the public abnormally short, **30-day** comment windows to participate in these interrelated rulemakings.[16] In these circumstances, it is not feasible for market participants and other members of the public to meaningfully participate in the Commission's pending rulemakings—as has been forcefully explained to the Commission by numerous commenters who are struggling to exercise their rights under the APA to participate in those consequential rulemakings, and to provide the information that the Commission itself has repeatedly said *it needs* in order to properly consider all important aspects of what it is proposing.[17]

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[13] *See Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2126 (2016) ("'[u]nexplained inconsistency' in agency policy is" a "reason for holding an interpretation to be an arbitrary and capricious change from agency practice"); *see also Goldstein v. SEC*, 451 F.3d 873, 883 (D.C. Cir. 2006) (vacating agency decision that "failed adequately to justify departing from its own prior interpretation").

[14] 1 *Hearing on S. 3580*, *supra* note __, at 233 (statement of David Schenker, Chief Counsel, SEC).

[15] Paul. S. Atkins, Comm'r, U.S. SEC, Recent Experience with Corporate Governance in the USA (June 26, 2003), *available at* 2003 WL 21515877, at *5 (the SEC "is a disclosure-based agency, not a merit regulator"); *see also, e.g.*, Securities Act Release No. 598, 1935 WL 28958, at *1 (Dec. 10, 1935) ("The Commission wishes to take this occasion to emphasize again that registration of a security does not imply quality of merit. The Commission is an office for the registry of information on securities. It does not pass on the merits of securities."); Harvey L. Pitt, Chairman, U.S. SEC, Testimony Concerning Financial Literacy (Feb. 5, 2002), *available at* 2002 WL 198062, at *2 ("Ours is a disclosure-based system. And it is our job to promote clear, accurate and timely disclosures—proactively."); Laura S. Unger, Comm'r, U.S. SEC, Securities Law and the Internet (July 28, 2000), *available at* 2000 WL 1161254, at *2 (the SEC is "a disclosure-based agency").

[16] The Commission cannot count the time *before* a proposal is published in the Federal Register. The Commission's attempt to do so is unprecedented and unlawful, particularly because Federal Register versions typically differ from the proposal initially released by the Commission.

[17] *See* Letter from Alternative Credit Council, et al. to The Honorable Gary Gensler, Chair, U.S. Sec. & Exch. Comm'n (Apr. 5, 2022).

The Commission cannot lawfully apply the Proposal to existing contracts.

Finally, if the Commission proceeds to a final rule despite all the concerns discussed above, that rule must not apply to existing provisions of negotiated contracts between investors and advisers. Even if such a rule "operat[ed] only from [its] passage," the rule would still fall within the ban on retroactive legislation because it would "affect vested rights and past transactions."[18] Because such "settled expectations should not be lightly disrupted," "the presumption against retroactive legislation is deeply rooted in [American] jurisprudence."[19] When it comes to agency rules, the presumption against retroactivity means that "a statutory grant of legislative rulemaking authority will not, as a general matter, be understood to encompass the power to promulgate retroactive rules unless that power is conveyed by Congress in express terms."[20]

Neither Section 211(h) nor 206(4) of the Advisers Act expressly gives the Commission the power to promulgate retroactive rules. Section 211(h) authorizes the Commission to "promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes," but says nothing about whether such rules can prohibit or restrict those practices retroactively.[21] Section 206(4) likewise is silent on whether the Commission's "reasonably designed [means] to prevent … acts, practices, and courses of business as **are** fraudulent, deceptive, or manipulative" can apply retroactively to existing contractual arrangements. The Proposal would therefore exceed the Commission's statutory authority to the extent its provisions are intended to have retroactive effect.

In addition, the Proposal would violate the Fifth Amendment's Due Process Clause if its provisions were applied retroactively. Retroactive laws violate due process unless "the retroactive application of the [law] is itself justified by a rational legislative purpose."[22] Applying these proposed rules to existing, negotiated contracts between highly sophisticated parties is irrational for the reasons explained elsewhere in this letter. In particular, mandatory renegotiations of investor agreements would be a very costly and disruptive undertaking without any countervailing benefits. Nor would the Proposal advance the Commission's own stated goals, as advisers and investors will ultimately achieve many of the same financial outcomes under less efficient structures. Finally, retroactive application of the Proposal would be arbitrary and capricious under the APA, since the retroactivity would unduly upset longstanding reliance interests and investment-backed expectations of highly sophisticated parties.

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[18] *Landgraf v. USI Film Prods.*, 511 U.S. 244, 269 & n.23 (1994); *see also id.* at 280 (law has "retroactive effect" if "it would impair rights a party possessed when he acted, increase a party's liability for past conduct, or impose new duties with respect to transactions already completed").

[19] *Id.* at 265; *see also Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988) ("Retroactivity is not favored in the law.").

[20] *Bowen*, 488 U.S. at 208.

[21] 15 U.S.C. § 80b-11(h)(2).

[22] *Pension Ben. Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 730 (1984).

Conclusion

As the real estate investment fund industry is required to bear more regulatory burdens and demands, the risk is that capital formation will be unduly hindered. We are therefore concerned that the Proposal, if finalized, could hinder real estate capital formation, the development and improvement of real properties, essential economic activity and jobs.

Moreover, we believe that this particular Proposal is unnecessary, and would curb the entrepreneurialism, flexibility, and investment returns that make real estate private equity an increasingly attractive option for the world's most sophisticated investors. We are also concerned that the Proposal vastly exceeds the Commission's statutory authority to regulate in this area.

We trust that the Commission will find our comments helpful. Should you have questions or require additional information, please contact Clifton E. Rodgers, Jr., by telephone at [redacted] or by email at [redacted].

Thank you for the opportunity to comment on this important issue.

Sincerely,

Jeffrey D. DeBoer
President and Chief Executive Officer